Life Assurance Funds, Investment Procedures

By
J. T. CORBETT,
F.I.A., A.S.A.
Actuary, Australasian Capital Assurances Ltd.

Fixed interest securities in the form of company investments such as debentures and notes have proved to be relatively satisfactory investments for Life Offices but there is continual worry about the risks involved in this class of investment and the need to improve the provisions of the Trust Deed and nature of limitations on borrowing. Companies wishing to raise moneys by debentures and notes need to face up to the disadvantages of such borrowing and not merely reap the benefits.

Companies, generally speaking, borrow in the form of a debenture or note issue as an alternative to raising capital in the form of ordinary shares or preference shares primarily because of the taxation advantage to the company and also sometimes because such borrowings enable the control of the company to remain with the existing shareholders, who are sometimes overseas companies.

The Life Offices' Association for Australasia in 1966 drew up certain guide-lines in respect of Trust Deeds for debenture and note issues and this is a very encouraging forward step and will, I believe, lead to improvement in the nature of debenture and note issues available to the public and to Life Offices, that is, provided Life Offices discourage investment of their funds in those issues which do not fully measure up to the standards set down in the Life Offices' Association recommendations.

In this same field, there is a need to look again at the role of the Trustee Company and to examine the nature of the Trustee Company and its powers under a Trust Deed. Some Trustee Companies have indeed performed very well and been most conscious of their onerous duties but others, unfortunately, would appear to have embarked on a policy of accepting Trustee fees without paying proper regard to their long-term duties as a Trustee for a debenture or note issue.

Mortgages:
In the mortgage field the Life Offices are still prominent in supplying finance to commercial undertakings in the form of mortgage on factory and office premises and also in the form of housing loans to individual persons, usually existing policyholders. In this regard it is interesting to note that at current rates for house mortgage lending, and bearing in mind the appreciable office costs of supervising such an investment and its relative short-term nature, these investments compare unfavourably with a commercial mortgage which can be made at higher interest rates for larger amounts and with less office expenses per dollar loaned.

It can reasonably be stated that in order to achieve a comparable net return after all outgoings, the Life Office probably needs to obtain an endowment assurance or whole life policy with a sum assured equal to four times the amount of the house loan and that this life business needs to be entirely free of commission to any agent, in order to make the housing mortgage investment attractive.

The continuing activity of Life Offices in the housing mortgage field over very many years clearly demonstrates their willingness to act in the national interest. In view of this, one wonders why the Commonwealth Government felt it necessary to impose the 30/20 legislation restrictions on Life Office investments. If Life Offices held no investments in housing mortgages but replaced these with commercial mortgages or debenture investments at current rates, there would be an overall increase in the earnings of Life Offices of approximately $7m. per year.

Since the Government has virtually compelled Life Offices to hold more public securities than they would otherwise be likely to hold, Life Offices might reasonably reduce their investment in house mortgages which, as I have said, had largely been made with a view to acting in the national interest.

Property
Freehold property has become an increasingly important item in Life Office investment and in 1965 it was the largest single type of new investment measured in terms of increase in assets. In recent years there has been increasing investment in purchase lease transactions. In 1966, Mr. Louis Ginsburg, speaking at an Institute of Actuaries Investment Seminar in London, said, "So far as the purchaser was concerned, the lease-back was a trouble-free investment. The vendor-tenant was responsible for repairs, insurance and maintenance, as well as services and there was only one rent to collect. On the other hand, because of the magnitude of the transaction and the possible nature of the property involved, the financial standing of the tenant was crucial. For obvious reasons, his covenant must be impeccable." After making further brief comments, Mr. Ginsburg concluded "that was all that was involved in lease-backs;
there was nothing terrifying about them."

The popularity of purchase lease in Australia has been, I think, rather surprising, and whilst in general it seems a most attractive investment I believe there are dangers that the documentation used at the present time is inadequate. Normally a lease might be granted for a 40-year period and there is no provision for cancellation of the lease. It does seem to me that frequently the properties subject to purchase lease are properties which the Life Office would not normally purchase as an investment but is attracted because of the nature of the investment and the standing of the tenant. However, if the venture proves to be unsuccessful from the tenant's point of view, say a retail store opened in a new area, then there does seem to be a danger that the tenant would vacate the premises and the Life Office would need to take frequent Court action to obtain judgment for the rent owing to the time of each Court action.

I think the documentation could be improved if it were provided that if any payment were in arrear for more than one month, then, say, 5 years' payments fell due immediately. In such a case if there were need to take Court action then a judgment could be obtained for 5 years' rent and not merely one or two months' rent. Similarly, if the tenant gets into financial difficulties and a Receiver or Liquidator is appointed, then there would appear to be dangers of non-payment of rent and also doubts about where the rent owing ranked compared with the other liabilities of a company. Here again, I feel there are arguments in favour of documentation which provided that upon appointment of a Receiver or Liquidator to the tenant company 5 years' rent would fall due, that this would rank as an Unsecured Creditor of the company but that the owner should also be free to relet the property to another tenant and to cancel the lease.

**The Life Office Role:**

One broader aspect of Life Office investment is whether or not the Life Offices are, because of the nature of some of their investments, in effect entering into other types of business than their prime business of life assurance. In this connection we might compare Life Offices as an Investment Institution with the Banks as Investment Institutions. Perhaps Life Offices should be asking themselves what precisely is their role in the investment field. I don't wish to imply that even if they are entering into other types of businesses that this is wrong; provided the investment is always aimed at producing the maximum possible return in the form of interest or capital appreciation, then this surely is what they must aim for; but perhaps it should be remembered that they are Life underwriters and that they are only investors because Life underwriting results in the accumulation of funds which must be invested.

**Preference Shares:**

Preference shares are perhaps unique in the investment field in that virtually only Life Offices have any interest in preference shares as an investment at their current yields. This is very largely brought about by the long-term nature of preference share investment and by the taxation legislation which, in effect, means that preference dividends are more than tax-free in the hands of a Life Office provided the 30/20 requirements are observed. There are, however, some dangers in investment in preference shares and, in my opinion, the normal documentation for a redeemable preference share issue leaves much to be desired.

It seems to me that if the redemption terms of a preference share issue are not met or if dividends are not paid on preference or redeemable preference shares, the preference shareholders should be able to take control of the company in much the same way as a breach of a Trust Deed for a debenture issue effectively enables the debenture holders to take control of the company. At the very least, in such circumstances, the preference shareholders should automatically have some representation on the Board of Directors and not merely the right to vote, since, in the majority of cases, the right of preference shareholders to vote will not enable them to elect a representative on the Board.

As Life Offices are virtually the only class of investor interested in preference shares at the present time, they surely have the power and the duty to take such steps as are necessary to ensure that effective remedies are available to the preference shareholder when things are not going right.

**Balance Sheet Value and Market Value:**

Now for a few comments on one aspect of investment in ordinary shares. Much has been written recently about the failure of Life Offices to state in their Balance Sheets the market value of their holdings of ordinary shares, and it was pleasing to note that one Life Office, whilst rejecting the proposition of revealing market values of their investments, did disclose the extent of their largest investments in ordinary shares.

There does seem to me to be an anomaly in the fact that Life Offices as investors in the shares of companies welcomed the changes in company legislation which now requires companies to disclose the market value of any shares held in other companies and yet Life Offices themselves are not prepared to disclose this information. As the Balance Sheet for each Life Office has to be accompanied by a certificate stating whether the assets are in the aggregate fully of the value stated therein, this seems to imply that the Offices must in fact value their assets regularly—even though this may be on an approximate basis in respect of certain assets.
Also, in reviewing the portfolio performance for a Life Office's investment in ordinary shares, undoubtedly the Investment Manager has the portfolio of ordinary shares valued at regular intervals, and this in fact can be done through the services of a Stockbroker free of charge.

Perhaps the time has come when Life Offices should recognise that their reports are basically reports to their own policyholders on the investment of the moneys owned by the policyholders and that, therefore, it is desirable that Life Offices give more information to their own policyholders and to the public at large regarding their investments. In addition, it is perhaps worth pointing out that, in theory at least, the actual holdings of a Life Office in ordinary and preference shares can be determined by an outsider by searching the Registers of all Companies. A valuation could then be made and compared with the book value stated in the Life Office Balance Sheet. It would be most unfortunate if, because they failed to disclose this information, Life Offices encouraged some enterprising person to do just this. Life Offices could then be faced with the publication of this information in a manner perhaps unfavourable to them.

**Superannuation Business:**

The most notable of recent developments in Life Office activities is undoubtedly the development in Superannuation business. Deposit administration and managed fund types of Superannuation Schemes are essentially investment services coupled with certain clerical and secretarial activities.

One of the dangers in a private pension scheme is in the investment of some of the pension fund assets in the shares of the company itself—and, unfortunately, we have many examples of this in Australia. The Institute of Directors, London, in their 1965 reprint of "Standard Boardroom Practice" commented on Superannuation Schemes as follows:

"The attraction of a good pension scheme for employees is too well known to need re-statement here. What perhaps is not so widely recognised is the danger of a Board seeking to meet its pension obligations out of its general assets which could vanish in a liquidation. If the Directors invest a pension fund in their own business they are taking on extra responsibilities for the company's success. Should the company fail, they will be left with a strong moral responsibility and will have defeated the object of the scheme. Pension funds should be kept quite separate from other investments, and the trustee should, as a general rule, be barred from either investing the funds in the company or making them available to the company by way of a loan."

**Capital Appreciation:**

The distribution to policyholders of capital appreciation on Life Office investments is a problem. It can hardly be claimed that this problem has been solved and yet some efforts have been made to do so. Life Offices must constantly ask themselves to what extent this capital appreciation is occurring and to what extent they are entitled to or should feel obligated to distribute the appreciation. Certainly, one factor which must be borne in mind in any distribution is the necessity to provide for taxation on appreciation when this becomes a reality rather than a mere book profit.

**Ordinary Share Dividend Yields and Earnings Yields:**

Another item of importance is the extent to which Life Offices have been successful investors in ordinary shares and how their own performance measures up with share price indices and dividend indices. In this regard the present share price indices leave some room for improvement and dividend indices in their present form are of very little use.

Until recently I thought it impractical to calculate a realistic dividend yield in respect of all listed Ordinary Shares, as this would have involved calculating the total dividends paid by approximately 900 companies (including those not currently paying dividends) and then dividing this by the total market value of the shares in those 900 companies. However, the Annual Report of the Sydney Stock Exchange Limited for year ended 30th June, 1966, shows figures of listed company profits and dividends and these, together with information supplied to me by Mr. Denis Patterson, of the Research and Statistical Bureau of the Stock Exchange, enabled me to calculate some fairly reliable figures—I think I am correct in saying that no such figures have previously been calculated or published.

Firstly, let us look at what is published. The Sydney Stock Exchange produces a monthly figure for Ordinary Share yields and as at 30th September this was 6.55% based on 591 companies and at 30th June, 1966, it was 6.38% based on 578 companies. Now this yield figure is a most unreliable guide to true dividend yield because it is unweighted by size of company. It is compiled by adding up the actual dividend yield for each company whose shares were actually traded during the month and dividing the result by the number of companies. Not only does it fail to take into account the size of the company, but it also ignores all companies which are not paying a dividend! As I have said, it is of little use, yet it received substantial publicity and is commonly graphed with Commonwealth Bond yields. Even the Stock Exchange Report says it has "relative crudity".

Now the Sydney Stock Exchange Annual Report shows that for Sydney-listed companies the profits and dividends for year ended 31st De-
December, 1965, were $520m. of profits and $315m. of dividends. These, however, include most Preference dividends and exclude mining (other than non-ferrous) companies and some large overseas-based companies such as P. & O., National Dairies and Placer as well as S.E.A.Q. variable interest stock. The market value of all Sydney-listed ordinary shares at 30th June, 1966, was $9,925m. but if we exclude mining (other than non-ferrous) and the overseas-based companies, the market value was $7,428m. We also need to exclude Preference dividends from the dividend figure and as there were $137m. face value of Preference Shares listed at 30th June, 1966, I have assumed that dividends in respect of these would be approximately $7m., leaving dividends for year ended 31st December, 1965, of $308m. Total dividends have been increasing at a rate of about 9% p.a., so that as at 30th June, 1966, the dividend figure might be taken as $320m. in respect of about 850 Ordinary Shares with a market value of $7,428m. Therefore, the true dividend yield for Ordinary Shares at 30th June, 1966, would seem to be 4.3%—not 6.4% as shown by the Sydney yield figure.

One further figure which can also be calculated is the earnings yield by making use of the profit figure given for companies in the Stock Exchange Report. True earnings yield at 30th June, 1966 (after correctly treating losses as negative profits) would seem to be 7.2%. It is hoped that current work being done by Actuaries will eventually lead to completely reliable and consistent price indices and dividend yields being available. The Sydney Stock Exchange is interested in seeing this happen.

Dealing with a Broker:

Some Life Offices complain that Stockbrokers are often difficult to deal with and that the broker is reluctant to change his systems, which often means Stock Exchange systems, to fit in with the Life Office standards. For example, settlements for purchases of shares. Many offices insist upon settlement only upon production of scrip or a marked transfer and then further insist on lodgement of this scrip themselves—incidentally, a procedure which would appear to be contrary to the proposed new share transfer system.

The argument put forward is that there is a risk of loss in paying for the shares and then letting the broker attend to the lodgement of scrip with the company—some offices then say one must do this because you can’t be sure that you can trust the broker. Yet those same offices are prepared to lodge a cheque and application form for new issues of shares or debentures with the broker for transmission to the company. In this case if a broker wished to defraud a client there is more opportunity for him to do so than is the case where he has been paid for shares and handed back the signed marked transfer. In fact, you have to trust your broker and if you don’t trust him perhaps you should not deal with him in any transaction whatsoever.

Practical Aspects:

Whether the office be large or small, practical Life Office investment involves budgeting, decision-making, buying and selling of investments, research into particular investments, switching of securities, dealing with bonus and cash issues and the protection of the investment. There is a wide difference between the extent to which a small office can expend money on these matters when compared with a large office, and as a result there are many differences between the Investment Department in a large office and in a small office, even though they may be investing in a similar number of companies and a similar number of issues, but with a large difference in the average amount invested in each issue.

Investment policy and decisions surely should be based on logical reasoning and not influenced by bookkeeping methods and yet, in practice, sometimes bookkeeping considerations determine the investment decisions. I do not think this is very prevalent in Life Offices, but it does still persist in some, and certainly does in some small funds, such as private Superannuation Schemes.

For example, if a fixed interest security purchased at a premium shows a higher yield to maturity than another purchased at a discount then surely the former security is the one to buy—but in some cases the office may have a bookkeeping method which means that a security purchased at a premium will be written down to par immediately (and not amortised over the term to maturity) and if this is done a book loss shows up immediately and may influence the office to avoid purchase at a premium even though it is the better purchase in the circumstances. Similarly, if logically a switch from a low coupon short-term Commonwealth Government security into a high coupon long-term one is thought to be desirable but the low coupon stock will involve sale at a book loss, then the decision to make the switch should not be influenced by the bookkeeping procedures.

Protection of the Investment:

The protection of the investment is an interesting subject and we need to consider whether the Life Office should set itself aside or whether it should be active as a shareholder, attending meetings and voting on questions, as well as gathering together other shareholders to obtain support when it seems desirable to oppose the existing Board. This becomes of even greater importance when one considers the very large investments in particular companies that are held by Life Offices, where it becomes difficult to sell the holding when the fortunes of the company appear to be
declining, perhaps due to inefficient management.

There have been some examples in the United Kingdom (and also to a lesser extent in Australia) of a Life Office taking an active role as a shareholder but it does seem to me that the assumption of partnership of a company by the purchase of ordinary shares, whether it be by an individual buying a few hundred shares or a Life Office buying several hundred thousand shares, does mean that the Life Office must face up to the responsibility that rests on all shareholders to participate in the company activities and to be probing in their questions of management performance. Such activity must surely, in the long run, result in more efficient companies and better returns on our own investments in those companies.

If a Life Office holding a mortgage over a property did not interfere and be very active in pursuing its investment when things went wrong, then there would be very substantial losses on occasions through mortgage investment. These losses, in fact, in mortgage investments are very minimal because of the close watch which is kept and the willingness of Life Offices to protect their investment. What a contrast exists in this respect between investment in mortgage and investment in ordinary and preference shares.

Life Offices, in common with other investors, are conscious of the need for companies to disclose more information about their activities in order to have better facts upon which to base investment decisions. Particularly necessary in company reports is the disclosure of sales figures by product and the disclosure of assets and profits for the principal sections of a company's activities.

Another item is the method of election of Board of Directors and here, it seems to me, a much improved system would be to have the entire Board stand for re-election each year and voting to be by proportionate or cumulative method with each share having equal voting rights. Such a system would ensure that, for example, in case of a Board of 10, a body of shareholders holding 10% of the capital could always have one representative elected to the Board—at the present time they would not be able to do this and, in fact, could hold 49% of the capital without being able to be sure of electing a single representative to the Board.

Life Offices are often said to be unwilling to sell the shares they hold in companies whose future is doubtful. Whilst it is true that often a Life Office can only decide on sale of a stock when it is too late and the market price has already fallen appreciably, it is nevertheless desirable that a more active investment policy be adopted with a view to selling when a stock is performing poorly or when the price appears to be unrealistically high.

Put simply, perhaps one should always sell a stock if one is not prepared to purchase it at the current price. Deciding to sell a stock which appears to be overpriced is a difficult decision to make and, of course, profit on realisation will be taxable but one certainly can't go broke making profits—Rockefeller said he made his money by always selling too soon.

Let me return again to points made with regard to the importance of investment to a Life Office. I have endeavoured to demonstrate that a relatively small increase in interest earnings is of more importance financially to a Life Office and its policyholders than a substantial reduction in expenses. Great efforts are made and should continue to be made to keep expenses firmly under control and reduce them to the lowest level possible, but one must ask whether sufficient efforts are being made in the investment field to increase the return. As I have mentioned earlier it seems possible that before long the increase in interest earnings since 1953 will have been such as to achieve the same benefit as an elimination of all expenses.

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Inquiries—Mr. G. Seck, City Mutual Life Assurance Society Ltd., Sydney.