TRENDS IN THE INVESTMENT OF THE FUNDS OF
AUSTRALIAN LIFE ASSURANCE COMPANIES
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1. Trends in Life Assurance

Life Assurance is one of the most important organised channels for personal savings in Australia to-day, though the accumulated savings are not as high as those currently reposing in Australian Savings Banks.

The ratio of Life Office assets in Australia to total savings bank deposits is somewhere between 75% and 80% - currently it is 78.6% as Life Office assets at 30.6.1972 were $6,556 million compared with savings bank deposits of $8,339 million at that date. The inflow of premiums into Life Offices shows a steady and persistent upward trend whereas the net movements in savings bank deposits show considerable fluctuations from year to year. The explanation, of course, lies in the contractual nature of the premium payments. Thus, even in the depression of the thirties there continued to be a strong positive inflow of premiums though the rate at which new assurances were effected was temporarily checked.

Another important channel of contractual savings are retirement benefit funds which are either underwritten by Life Offices, or privately administered in separate trusteeed funds. The funds from schemes underwritten by Life Offices are normally included in total Life Office assets. Retirement benefit business has been an extremely important factor in the growth of life assurance business in Australia over the last decade.

2. The Nature of Life Assurance

During the early years of life assurance, policy premiums were calculated on an annual cost basis. Each year an increasing premium was required in accordance with the advancing age of the insured, and the corresponding increase in the mortality risk. Experience proved that this one-year term assurance, renewable each year, often caused difficulty in the middle and later years of the insured's life, when the financial burden became intolerably heavy or his health deteriorated and made him uninsurable. The defects of annual cost individual assurance were corrected with the introduction of constant or level annual premiums. Under this system the insured enters into a long-term contract to pay an equal premium in every year his policy is in force. The premium is made up of three components -

(1) the cost of pure assurance (protection against mortality risks), plus

(2) a charge to cover the company's selling and operating expenses, minus

(3) an assumed rate of return on the investment of excess premiums during the early years of the policy.
3. Reasons Why Assurance Investments are Made

The special feature which distinguishes life assurance from other classes of insurance is that, in life assurance, funds must be accumulated to meet claims which will, in due course, be certain to arise under the contract. However, the time at which the claim will occur is uncertain - it may be very remote (as long, possibly, as one hundred years) and it may be accelerated or postponed by events occurring after the contract is made, which cannot properly be foreseen or the effect of which cannot be estimated in advance (for example, war, epidemics, advances in medical science).

The life assurance "fund" is not a reserve in the sense normally understood in the commercial world. It comes naturally into existence in consequence of the manner in which the constant or level premium is calculated whereby the annual premium payment is more than sufficient to cover the cost of the risk in the early years of the policy's currency, and less than will be necessary later as the death risk increases with the age of the insured. The excess of premium income over outgo in the early years requires to be accumulated in a "fund" for the purpose of financing the expected and inevitable deficiency of premium income in later years. Consequently, the successful investment of the accumulated funds to earn at least the rate of interest assumed in the premium calculations is essential (other things being equal) in ensuring that the Life Office is able to fulfil its long-term contracts as they fall due.

4. Theoretical and Historical Background to Life Assurance Investment

Generations of actuarial students are familiar with A.H. Bailey's "Principles on which the Funds of Life Assurance Societies should be Invested." These principles or canons were enunciated before the Institute of Actuaries in England in 1862 and they have been accorded continuing general assent.

In translating his principles into practice, Bailey recommended bonds, mortgages (which he considered ideal), loans on reversionary interests and bank deposits as suitable investments. On the other hand, he considered Government securities (which consisted almost entirely of undated consols at that time) to be thoroughly unsuitable because of their "inconvenient fluctuations" in market value. Ordinary shares, of course, were "too speculative."

Even as late as 1933, Bailey's principles were described as "being as applicable to our business to-day as they were in Bailey's time." In those days there were few advocates of ordinary share investments for Life Offices although in March, 1928, H.E. Raynes made a case for the inclusion of ordinary shares in Life Office investment policies in a paper entitled, "Place of Ordinary Shares and Stocks in the Investment of Life Assurance Funds." This paper was published that year in the Journal of the Institute of Actuaries, Vol. LIX. There were few converts to this opinion - one notable exception being the late Lord Keynes who was amongst the first to give ordinary
shares a prominent place in Life Office investment. In an address in 1928 to the United Kingdom Life Office of which he was Chairman, Lord Keynes advocated prudent investment in shares which he considered were underpriced in relation to bonds.

Since then the trend to acceptance of ordinary shares has accelerated.

5. Early Developments in Australia

More than two-thirds of the amount of life assurance business in Australia has for many years been transacted by five Australian Mutual Offices which were established between the years 1849 and 1878. It is natural therefore that the investment policy and practice of these offices should have had a profound influence on the Australian Life Assurance Industry. The constitutions of these offices were based upon those of British Mutual Societies existing at that time. The voting members, who were participating policyholders (owners of policies subject to increase by bonus additions), agreed to Articles of Association or Bye-Laws which set out, among other things, the powers given to the Board of Directors, for the investment of policyholders' funds.

For a considerable period, i.e. until about 1940, the investment powers granted to these Australian Life Offices by their Articles of Association were most restricted. For instance, in most cases, they did not allow any investment in the ordinary or preference shares of companies. Real estate was also forbidden, except for buildings of which a part or the whole was used by the Office as its own business premises. Even the debentures of companies were usually not permitted as investments of these Life Offices.

Operating under powers of this restrictive nature, the Australian Life Offices invested their funds mainly in the securities of Governments and Local Government bodies, loans on policies, and loans on mortgage. The amount and percentage distribution of their assets, up to the year 1940, are shown in the following table which gives an indication of the trend in the distribution of investments:

Table I - Australian Life Assurance Assets - 1880 - 1940

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Assets $A million</th>
<th>Government &amp; Local Government Securities</th>
<th>Loans on Policies</th>
<th>Loans on Mortgage</th>
<th>Real Property</th>
<th>Other Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>1880*</td>
<td>10.2</td>
<td>18.9</td>
<td>10.2</td>
<td>51.0</td>
<td>3.3</td>
<td>16.6</td>
</tr>
<tr>
<td>1890*</td>
<td>35.2</td>
<td>7.9</td>
<td>16.3</td>
<td>55.9</td>
<td>10.5</td>
<td>9.4</td>
</tr>
<tr>
<td>1900*</td>
<td>62.6</td>
<td>15.9</td>
<td>18.2</td>
<td>46.9</td>
<td>7.6</td>
<td>11.4</td>
</tr>
<tr>
<td>1910</td>
<td>74.0</td>
<td>29.4</td>
<td>14.3</td>
<td>40.0</td>
<td>7.4</td>
<td>8.9</td>
</tr>
<tr>
<td>1920</td>
<td>143.6</td>
<td>57.6</td>
<td>9.5</td>
<td>22.3</td>
<td>4.3</td>
<td>6.3</td>
</tr>
<tr>
<td>1930</td>
<td>288.0</td>
<td>50.6</td>
<td>11.7</td>
<td>26.3</td>
<td>4.0</td>
<td>7.4</td>
</tr>
<tr>
<td>1940</td>
<td>486.4</td>
<td>50.9</td>
<td>9.2</td>
<td>26.5</td>
<td>5.2</td>
<td>8.2</td>
</tr>
</tbody>
</table>

* Figures for Australian Assets are not readily available for 1900 or earlier. For the years 1880, 1890 and 1900 the figures are world-wide assets of Life Companies whose head offices were in Australia.
This pattern of investment seems quite appropriate for the earlier part of this period, say, up to the year 1910. Australia was just emerging from a colonial status - the six States having been federated as the Commonwealth of Australia in 1901. Manufacturing industries had not yet developed to any great extent and a large proportion of the commercial, financial and banking activity was still controlled by English companies. Local enterprises were mainly concerned with primary production, e.g. mining and timber, agriculture and the rearing of sheep and cattle. Even if the Life Offices had had power to invest, say, in shares of companies, there would have been relatively few sound opportunities for them to do so. In addition, interest rates obtainable on loans on mortgage appeared high relative to those simultaneously obtainable in Great Britain. They were thus considered satisfactory, and there was little pressure to move into "riskier" investment fields to gain a higher return.

6. The Influence of the Depression

The world-wide economic depression of 1930-1933 had a profound effect in Australia. The country's finances then depended principally upon its income from the export of primary produce such as wool, meat, and wheat etc. The prices for these exports fell so drastically that some corrective action had to be taken. Besides a 25% currency devaluation, the measures finally decided upon included a moratorium on the repayment of debts in Australia, and a 22½% reduction in the interest rates payable on most existing "fixed interest" securities. The reduction applied to Government and Local Government loans, and to policy loans and mortgage loans in which the Life Offices had mainly invested. The interest rates for new loans of these types also settled at much lower levels than previously.

These circumstances set up a new train of thought among Australian Life Office investment managers. The depression had shown that in a crisis, fixed-interest investments could lose much of their reputed advantages of security of capital and income. Attention was drawn to the fact that British Life Offices, even Mutual Societies, now had virtually no restrictions placed by their constitutions upon their powers of investment, and that many of them had in fact invested a proportion of their funds in equity-type assets. Furthermore, investigations published by H.E. Raynes in 1928 had shown that the ordinary shares of well established British companies had given results superior to those of the debentures of the same companies over long periods of time.

Allied to these thoughts was the realisation that with the increasing industrialisation of the Australian economy, there was a greater scope for investment in the shares of sound companies. The outcome of all these considerations was that in 1941 and the next few years, the Australian Life Offices obtained alterations to their Articles of Association which removed virtually all the restrictions previously placed on their powers of investment. However, it was not until well after the end of World War II in 1945 that any steps were taken by the Offices to exercise their enlarged powers.
7. Trends Since the Second World War

In Australia (and also in the United Kingdom and the United States), the Life Offices emerged from the war with their investment portfolios containing a disproportionately large representation of Government securities.

During the period from 1950 to 1960, the Australian population and economic activity increased at a high rate, with more and more emphasis on secondary industry and with substantial demands for mortgage finance for housing and business. In 1955, over 80% of assets were invested in gilt-edged Government and Local Government securities, loans on mortgages and loans on policies, clearly indicating support for Bailey's first principle of investment which emphasised that the first consideration should invariably be the security of capital.

Ordinary shares comprised 2.6% of the portfolio of Australian Life Offices in 1956 which was the same percentage as in 1952. However, between 1956 and 1964 the proportional significance of ordinary shares advanced to 10.2% of assets which compared with the United Kingdom situation that year of over 20%.

Australia shared in the world-wide experience of currency inflation, which has led to a widely-held view that in the long run such inflation is inevitable in a modern society. The view that equity-type investments, such as ordinary shares and real estate, would offer at least a partial "hedge" against currency inflation also gained strong support. In these circumstances, combining availability and lack of any statutory or other prohibition, the proportion of Life Office assets invested in equity-type investments rose significantly, as shown in the following table:-

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Assets $a</th>
<th>Government Policies %</th>
<th>Loans on Pref &amp; Ord. %</th>
<th>Other Assets %</th>
</tr>
</thead>
<tbody>
<tr>
<td>1940</td>
<td>486</td>
<td>50.9</td>
<td>26.5</td>
<td>5.2</td>
</tr>
<tr>
<td>1947</td>
<td>714</td>
<td>71.7</td>
<td>14.4</td>
<td>5.2</td>
</tr>
<tr>
<td>1950</td>
<td>892</td>
<td>61.3</td>
<td>21.3</td>
<td>7.7</td>
</tr>
<tr>
<td>1955</td>
<td>1,351</td>
<td>47.5</td>
<td>34.8</td>
<td>7.8</td>
</tr>
<tr>
<td>1960</td>
<td>2,135</td>
<td>33.4</td>
<td>42.6</td>
<td>14.2</td>
</tr>
<tr>
<td>1965</td>
<td>3,557</td>
<td>31.2</td>
<td>37.4</td>
<td>21.8</td>
</tr>
</tbody>
</table>

This changed pattern of Life Office investment, whereby substantial sums were applied to the purchase of shares and real estate, and also increased amounts in loans on mortgage and debentures of companies, naturally reduced the proportion of their funds which were invested in Government and Local Government loans. This trend gave rise to concern among members of the Government mainly on the practical grounds that the Government had grown to rely on substantial support from the Life Offices for its loan-raising programme. The argument
was also raised that, since the Government encouraged life assurance by allowing the premiums paid by policyholders to be deducted from their incomes before charging income tax, so also the Life Offices should be required to invest a proportion of their funds in Government securities.

In 1960, the Government announced its intention to pass legislation which would require a minimum proportion of the funds of each Life Office, and also of each Superannuation and Provident fund, to be invested in Government loans. However, it was later found that the Commonwealth did not have the constitutional powers necessary to enforce such a requirement on Superannuation and Provident funds. For this reason, and also because of the many public protests against the proposed use of compulsion in a field which affected the personal savings of the Community, the legislation finally passed in 1961 was of quite a different nature. This legislation, by amendment to the Income Tax Act, introduced the 30/20 ratio which ensures, through taxation penalties and valuable concessions, that Life Offices invest 30% of their funds in public securities (i.e. Government and semi-Government securities) including not less than 20% of their funds in Commonwealth Government Inscribed Stock. Thus, the outcome of this 1961 Income Tax legislation has been to make it virtually compulsory for all Life Offices to maintain at least 30% of their Australian assets in public securities.

8. Tax Situation

A Life Office, in its non-superannuation statutory fund, obtains a tax rebate on dividend income but is taxed on its capital gains irrespective of the "intention" at the time of purchase. Capital losses (if any) may be offset against capital profits in the same taxation year. This situation may be contrasted with that of the individual investor who is taxed on cash dividends and may or may not be taxed on capital gains depending on whether he is a trader in a particular stock.

A Life Office with a separate statutory superannuation fund is not taxable on cash dividends or on capital gains on investments in the fund, provided it complies with the 30/20 legislation. In fact, all income in a fund of this kind (including that from fixed interest securities) is not taxable. Consequently, trading in this Fund is frequent.

9. The Present Position

Australian Life Offices are continuing to build up the equity element in their investment portfolios. At the end of June, 1972, Life Office holdings of ordinary shares amounted, on book values, to $986 million or 15% of total assets. Property assets with a book value of $1,044 million represented 15.9%, making the total equity element 30.9% of total assets. This percentage is lower than the comparable figure for United Kingdom Life Offices where ordinary shares accounted for 27.5% and real property for 13.4% with the total equity element being just over 40% of total assets.
In the United States of America, where legislation varies between different States and imposes a number of restrictions, the investment pattern of Life Offices is such that around 7% is invested in ordinary shares and 3.2% in real property, making a total equity element of just over 10% of total assets.

Aggregate net investment in ordinary shares by Australian Life offices during 1971 was $104 million or about one-eighth the volume of acquisitions in Britain. However, this comparison has to be related not only to the smaller size of aggregate assurance funds in Australia, but also to the immensely bigger capital market available in Britain which gives all but the very largest Life Offices a great deal of manoeuvrability.

Loans on mortgage have always had a prominent part to play in the portfolios of Life Offices. In earlier times, before the growth of public debt and the coming to maturity of the stock exchanges, mortgage investments dominated the portfolios. However, there is a continuing decrease in the relative importance of mortgage loans (mortgages on commercial and industrial premises, housing loans and loans on rural properties) in favour of property and ordinary shares. Although the percentage has shown a decreasing trend, the amount, in absolute terms, has increased. For example, the percentage of funds invested in housing loans decreased from 15.1% in 1960 to 8% in 1970 whilst it increased by 48.9% in absolute terms, from $293.2 million in 1960 to $436.8 million in 1970.

A comparatively recent development which also is influencing the equity investment activity of Life Offices in Australia is the introduction by some Offices of investment-linked superannuation business whereby the superannuation plan Trustees specify, (apart from the 30% held in Public Securities), the proportion of the funds of their respective plan which is to be invested in fixed interest securities, ordinary shares and property investments. Provided the superannuation fund complies with the 30/20 requirements, active trading operations can be established as all income and capital gains on investments in the fund are not taxable. The performances of Life Offices in this superannuation field can be compared directly with each other and with Merchant Bankers and others managing superannuation funds in Australia.

10. The Future

Equity Investments

The very significant increase in ordinary share investments during the last fifteen years (from a proportional percentage of total assets of 2.6% in 1956 to 14.8% in 1971) is clear evidence of a more liberal interpretation of the concept of what is regarded as too risky an investment. Property assets increased during this period of fifteen years from 4.1% to 14.6% of total assets and it is reasonable to expect that equity investments will gradually expand to a percentage figure of about 35% of total assets.

Life Offices will have an increasing part to play, as one of the most important organised channels for personal savings in Australia, in maintaining a significant Australian ownership of
our secondary industries and natural resources as Australia develops its future role as a supplier to the World of secondary and raw materials.

**Fixed Interest Lending**

The decline in the relative importance of mortgage loans amongst Life Office investments will continue as a result of the continuing expansion of the percentage of total assets in the equity sector.

Life Offices, because of their national and public character, are subject to appeals for finance to promote developments of social benefit to the community even where the investment yields do not compare favourably with general market levels.

Since Life Office funds are drawn from all sectors of the community, and from all areas, there are pressures for investment coming from many and varied directions which tend to promote a spread of investments for public relations reasons, quite apart from the basic investment principle of spreading the risk factor.

The concept of making investments that will be a means of attracting new life business or at least consolidating existing business was one of A.H. Bailey's investment principles formulated in 1862.

Fixed interest lending (corporate, housing and rural loans) will remain the second largest grouping on the basis that Life Office investments can be divided into three parts comprising:

1. Equity investments
2. Fixed interest lending
3. Public sector obligations

**Public Sector Obligations**

It is reasonable to expect that the 30/20 ratio will remain unchanged. Consequently, public securities will continue to represent about 32% of Life Office assets. The two percent margin above 30% will be a safeguard against unintentional breach of the rule and will provide some liquidity should a need arise to take prompt advantage of a particularly attractive investment.

11. **Conclusion**

The changing patterns of investment have not involved any lowering of investment standards. They have been adopted because the new investments, after careful considerations, were considered to be suitable in fulfilling the basic Life Office objectives.

The level of the savings of the community channelled through the voluntary personal savings institutions, such as Life Offices, should increase with the advance in the living standards in Australia. This, in turn, will enable a greater spread of the long term capital available for public, business and private borrowers alike.