INVESTMENTS FOR CASUALTY COMPANIES

BY

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1. UNDERWRITING PROFITS

Underwriting profits are so meagre that the return from the investment of the reserves becomes a question of vital importance. During the past few years it would appear from the published accounts of casualty companies that they have been relying on their investment earnings almost entirely for furnishing stockholders dividends. The news value of this statement is not very great as a similar condition exists in the fire business today. The effect of this condition of affairs on the future policy of insurance companies, however, will probably be far reaching. The progress of those companies who extract an extra 1% on their invested assets will be relatively very much more rapid than that of their competitors. As the business is running today an increase of 1% on invested assets is equivalent to an increase of over 20% dividends.

2. THE FUNDAMENTALS OF A GOOD INVESTMENT

The fundamentals of a good investment are commonly assumed to be (a) safety of principal through the lifetime of the security, and (b) regularity of interest income. For the most part casualty company investments are in high grade bonds and in the circumstances it may be apropos to review the elements which enter into the makeup of each type of security.

U. S. Government Bonds: These securities naturally head the list, ranking as the premier security of the world today. As to their eligibility for casualty insurance company investments, there can be no question. Approximately 33⅓% of casualty companies' earning funds are invested in United States government securities. The only debatable point is the amount or relative proportion of assets which should be so invested. They are, of course, readily convertible to cash, are ready collateral

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for borrowing, the paper or loans secured against them being eligible for re-discount at the Federal Reserve Bank. Their defect—if one may apply such a term to an obligation of the United States—lies in their freedom from taxation. In the hands of an individual they are free from normal income tax. In the treasury of a corporation and of an insurance company the income derived therefrom is exempt from corporate taxation imposed by the federal government.

The history of casualty business in the last few years has been one of little profit. In these circumstances it would appear that some monetary gain is made by a company transacting a rapidly expanding new business in keeping down its holding of Liberty Bonds to reasonable proportion owing to the fact that the underwriting loss which is caused by the financial strain of setting up reserves may be off-set for taxation purposes against the interest income and it is not until the interest income exceeds the underwriting loss that any benefit is derived from holding tax free securities.

However, the State Departments quite properly insist in deposits being put up in the form of Liberty Loan bonds or other securities of a like grade and this, added to the quick marketability feature, leads one to think that the reasonable sized holding of United States government bonds is a desirable thing.

State and Municipal Bonds: State and municipal bonds at the present time loom pretty large in the balance sheets of casualty companies, amounting to 19% of the total invested assets. There are circumstances where, for taxation reasons, a large holding of such bonds is desirable but it would seem that on general grounds it is undesirable for corporations, whether they be insurance companies or not, to hold bonds which carry special features by way of exemption from taxation which apply to individuals as distinct from corporate holders. The point will readily be appreciated if the gross yield of a state or municipal bond in the hands of a very wealthy individual is considered. To a man whose income is in the top bracket of the Federal Income Tax Schedule, a high grade state bond, which nominally yields 4%, in effect gives the same net income as a fully taxable bond yielding over 5%.

I, therefore, would incline to the view that the present holdings

of state and municipal bonds of casualty companies have been and still are on the heavy side and that group of securities will tend to dwindle in importance as years go by.

From the records of the companies with which I am associated it is quite clear that from the standpoint of interest, income, and capital appreciation this class of bond has made a relatively unfavorable showing.

An additional disadvantage is the relatively poor market which this type of security enjoys.

Railroad Bonds: From the approximate figures I have compiled it would seem that about 26% of the total investments of casualty companies are invested in railroad bonds. This outlet for insurance companies funds is satisfactory in every way.

The bonds are fully taxable so that the complication of freedom from taxation does not arise. For the most part they are very well secured, being the obligations of the constituent parts of the greatest industry in the world. The underlying bonds are so well protected on most of the prominent systems of the country that it is almost unthinkable that any default can ever take place. This type of security is readily saleable and provided that reasonable care is exercised in their selection I can see no reason why they should not continue to show satisfactory results.

This is a short summary of their merits. As to the disadvantages, I think there is only one. They are a favorite medium of investment for the mammoth life insurance companies in the United States. As you doubtless know, the life insurance companies are more closely restricted as to the character of their investments than is the case with casualty or fire insurance companies. For example:

In many states life insurance companies are precluded from buying preferred or common stocks. In some states they are precluded from buying bonds which are not specifically secured on property. In other words, general obligations and unsecured charges like debentures are not admissible. This legislation, coupled with the phenomenal rise during the past few years in new life insurance business transacted, has resulted in an unprecedented demand for high grade railroad bonds and obligations of like security. So great has been this demand that in

many issues there is evidence of scarcity value, if one may use the term, arising, and consequently, owing to this concentrated buying the market has been marked up when contrasted with industrial bonds of like character. I have been so impressed during the past few years with the persistent accumulation of securities of this type that I took the pains to investigate the position of one or two of the prominent issues. I think it can be safely said that at least one-third of the outstanding amounts are already in the treasuries of insurance companies, savings banks and similar institutions. Furthermore, it would seem that there is very little likelihood of any considerable amount of bonds so held coming into the market. In these circumstances, provided that money remains reasonably easy and that no disturbing factor of major importance arises, such as a world war, there would seem to be an improving market ahead for this type of bond. The importance of the life insurance companies in the investment market today cannot be too strongly stressed.

Public Utility Bonds: At the present time about 7% of the invested assets of the companies are in this type of security. Speaking generally, they yield a little more than railroad bonds of the same class, due to the fact that the current supply happens to be larger. This condition, however, is probably a temporary one which will disappear in the course of the next few years, as life insurance companies are being forced to buy them in increasing quantities.

As to their fundamental security—they have not the background of proved earning power that the underlying railroad bonds have. On the other hand, the corporations whose obligations they are, are so inextricably intertwined with the economic life of the United States that it is improbable there will be any question of default on senior issues.

The public utility bond of today is a more modern financing instrument than the old type of railroad bond. Latitude has been allowed for future corporate needs by leaving many of the mortgages open in the sense that further issues of bonds can be made, a limit being generally imposed such as that the additional issue is not to exceed 75% of the cost of any improvements made.

It would seem that the electric light, power, telephone, and similar industries are not quite on such a fundamentally stable

basis as is the railroad industry. The future would seem to hold more possibility for change but in spite of that I would rate highly the obligations of the leading public utility companies in this country today and would predict a rosy future for them.

Real Estate: I suppose I must subscribe to the orthodox view that real estate should only be owned by casualty companies in so far as the need of the business demands. There would seem to be no objection to companies owning their own offices and also sub-letting sufficient space in the building which houses their offices to allow for reasonable expansion. Beyond this I would not be prepared to go. Casualty companies appear to hold a relatively insignificant amount of real estate.

Mortgages: There is no reason why a moderate amount of these investments should not be held. Properly selected they yield a steady income and suffer no depreciation. On the other hand all possibility of profit is eliminated as generally the obligations run for relatively short periods. The placing of money on mortgage, however, is a highly technical business and calls for considerable judgment and knowledge of values. In the case of a life insurance company with several hundreds of millions of dollars assets, it is not uncommon to see a highly skilled mortgage department functioning with profit to the company; the overhead of the department being negligible when distributed over the relatively large amounts advanced. The casualty companies, however, have not the gigantic assets of the life insurance companies today and, consequently, I would be disposed to counsel concentration on localities where values are well known than the diffusion of efforts over a larger territory with consequent lack of specialized information.

Stocks: The subject of stocks logically divides itself into three headings—guaranteed stocks, preferred stocks, and common stocks. A moderate amount of the first two is not uncommon but personally I think there is little in their favor. Their position in the financial structure of a company is between the upper and the nether millstones. If things go well they get their regular dividend, if things go badly they are unsecured and not infrequently fare no better than common stocks.

Common stocks, themselves, on the other hand, are, I think, entitled to serious consideration. This statement probably

invites severe criticism. My opinion, however, is the deliberate outcome of five years of study of conditions in the security market and I am satisfied that with proper management very advantageous showing can be made by investments in sound common stocks. Selection of the proper channels calls for qualities that differ perhaps from those which are needed in analysing Bonds and fixed interest bearing obligations.

Here it is necessary rather to observe the future trend of an industry rather than to examine its history. Above all, however, the risks attendant upon such investments must not be overlooked. They are the last line in the capital structure and in bad times are apt to suffer severely. I sometimes feel that there is something illogical in casualty companies assuming the large contingent risks they do in their bonding business and at the same time pursuing an ultra-conservative course in their investment operations. I am satisfied that given sound management and, of course, that is a condition precedent to the success of any business, a greater measure of profit can be obtained for stockholders by buying into sound properties than by guaranteeing the performance of certain obligations, which is frequently done in the course of their daily business. On the other hand, the steady and persistent accumulation of the bonds of the life insurance companies will, I am sure, force the fire and casualty companies to seek an outlet for their funds in channels not open to their life insurance company competitors in the security market. Today the casualty companies have about 10% of their assets invested in common stocks.

3. Differences Between the Requirements of Life, Fire, and Casualty Companies in the Matter of Investments

A few words on the fundamental differences in the needs of the various insurance companies may not be out of place.

Life companies are primarily concerned with unquestioned security and yield. For the most part their bonds are held to maturity. I suppose there is an attempt made to make the average unexpired term of their bonds coincide with the average duration of the life insurance contracts on their books. There is no such need in the fire and casualty business.

In the case of fire companies the question of liquidity of their assets should always be borne in mind. They should be so

equipped in the financial sense that some sudden conflagration will not catch them flat footed. I suppose 50% of the assets of the first line fire insurance companies are readily saleable.

Casualty companies are not hampered, it seems, in any way. They should seek the high investment list always maintaining an eye on increasing their yield.

4. Distribution by Maturity

It is generally considered prudent to arrange for maturities to conform to some reasonable scheme. I suppose the average company will find the unexpired term on its bonds to run in the neighborhood of 20 to 25 years, depending largely upon the amount of government issues held. It would be generally considered good practice always to have 15% of the invested assets falling due within the next 5 years. This factor, however, can be unduly stressed in the case of casualty companies and I would feel perfectly safe in urging a company to extend its average maturity when the bond market looked good. Conversely, I think profit, or rather saving in depreciation, would result if the mean maturity were shortened when it appeared that a decline in fixed yielding securities was imminent. Of course, here again the requirements of life and fire companies differ among themselves and again differ from those of casualty companies.

5. Fundamental Investment Policy

Most casualty companies in the United States appear to have followed a reasonably conservative investment policy seeking the highest grade of securities inclining rather to be ultra-conservative, I would say. They have avoided more speculative bonds with their inducement of a higher interest yield. In spite of that fact, however, they have all enjoyed great benefit from the upswing in the bond market which has occurred since the year 1920. To achieve anything like the same results during the next 5 years is probably going to be much more difficult and if underwriting profit remains meagre and money remains easy I would not be surprised to see the more conservative companies investing increasing amounts in securities which might be expected to show capital appreciation due to increased earning power of the properties.

As the magnitude of the invested funds grows I think you will find that an increasing amount of specialized attention will be devoted to the investment end of the business. Companies will become large enough to justify the constant attention of one man to this end of their corporate operations. If this diagnosis of the trend is correct we might reasonably expect to see the companies loom largely in the day to day trade in investment securities in Wall Street.

New York City banks add considerably to the profits they derive from loaning money for commercial needs by buying and selling investment securities. There is no reason why insurance companies should not follow that lead. If a bank with its deposit liability is justified in trading in securities then surely a casualty insurance company is, as there is no possibility of an immediate call for funds.

In Conclusion

6. Present Outlook in Security Market

I suppose this rough statement would not be complete without some reference to the present outlook in the security markets today, with special reference to investment of casualty companies' funds. The outstanding financial operation in the next two years will unquestionably be the refunding of the 3rd Liberty Loan. Mr. Mellon on a rising market has handled the operation to date in a masterful manner. On three occasions he has succeeded in advancing the maturity date so far ahead that for all practical purposes the operations have postponed any further worry indefinitely. There still remains, however, over two billion dollars of 3rd Liberty Loans to be dealt with and it would seem that there is a likelihood of the next refunding operation being done on a 3¾% basis.

The operation of the United States Treasury Sinking Fund has been so extensive that we shall soon be contemplating serious reductions in outstanding amounts of Liberty Loan issues. This, again, is an additional feature tending to force insurance companies into wider fields for their investments. The outlook for money seems to indicate a plentiful supply. All these factors augur higher bond prices. The only force which can militate

against that trend, it seems, is that which would be set into motion in the event of the United States extending the resources of her money market and investment market on a very much more extensive scale to foreign nations. What the future holds during the next five years in this regard is very largely a matter of conjecture.

Today the ability of the United States to produce wealth both from the farm and the factory is unprecedented and there are very good reasons why the industrial plant particularly should be run as near to capacity as possible. This indicates a distinct probability of fixed capital piling up in increasing quantities in the near future. So far as the outlets for this capital are concerned it seems that the geographic position of this country, its political and economic history, do not augur an easy transition to a position where the United States becomes a great lender nation as Great Britain became in the latter half of the 19th century.

The average American investor does not take kindly to foreign securities. Contrast that position with the condition we find in the investment market in London. There is the same background of individuals buying high grade investment issues such as the War Loans in London and the Liberty Loans in the United States. There is, however, one great difference. Life insurance is a much more potent factor in the economic life of the United States than is the case in Great Britain. The average Britisher invests his savings himself; the average American has a considerable portion of his savings invested for him by the large life insurance companies. This condition, I have little doubt, leads to a strong disinclination on the part of the average American investor to embark on the uncharted sea of foreign investment.

Viewing the sum total of these factors I incline to the view that high grade security prices will move to higher levels. They in turn will induce preferred stocks to follow them and finally the common stocks of corporations of proved earning power and established position will be affected by the overflow of investment funds. This, it seems to me, is the trend of the tide. The situation may change, however, and change with the rapidity of a kaleidoscope. Only constant vigilance will enable one to discern when the turn arrives.