The Investment Policy of Canadian Life Insurance Companies

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INVESTMENT PRINCIPLES APPLIED TO LIFE INSURANCE COMPANIES

Investment has been defined as the productive employment of capital, the term productive referring to the interest return rather than to the use to which the money is put. The prime consideration of the investor, however, is the safety of his capital. This is particularly true of life insurance companies, for the funds which they invest are trust funds, morally if not legally. It is obvious from the very nature of investments that absolute safety of principle is impossible. It is secured rather by "a system of classification and diversification based on the law of averages and producing an expected minimum loss".[1] This policy of diversification is reflected in the investments of every insurance company, and indeed in the investments of every organization and individual with sufficient capital available to take advantage of it. The folly of "putting all your eggs in one basket" has been demonstrated too often in the past to be ignored. Hence the funds of life insurance companies are distributed throughout the various fields of investment suitable to them; mortgages, bonds, stocks, etc. Diversification is also practiced within these various fields. For instance, in their portfolios of bonds one finds government, municipal, public utility and industrial bonds. In any of these more particular fields one will find that the bonds are

1 Gill, E.C., "Investments of Canadian Life Insurance Companies" Proceedings of the Insurance Institute of Toronto (1932-33)

varied geographically, so that local conditions do not materially affect the portfolio as a whole. Continuing further we see, in the case of public utility and especially in the case of industrial bonds, that the investments have been varied as to industry as well. Diversification, however, does not ensure safety of capital unless careful consideration is given to each single investment before it is made. In later chapters we shall study the main facts to be considered before investing in the different fields. In the past investors have gone on the assumption that the rate of interest offered is roughly proportional to the risk entailed in that investment. The validity of this postulate would seem somewhat doubtful, however, when the history of the past twenty years is considered. During the two depressions in that period many securities, which, by this rule, should have been relatively safe, proved worthless, whereas others of a more speculative nature proved to be good investments.

In the interests of the stock-holders and the policy holders it is the duty of the life insurance company to obtain the highest yield possible from the funds at its disposal, consistent with the safety of the capital. In this connection the expense of looking after the investments is of great importance. A bond requires a minimum of handling. A mortgage, on the other hand, requires considerable initial expense, constant attention for the collection of interest and the care of the property, and frequent reinvestment. Also, in the case of a bond, the expense and responsibility of a foreclosure is

shared with other bond-holders. The mortgage holder has to bear this expense alone. The difference in the expense of handling has been estimated at between 1% and three quarters of 1%. Considering the general level of interest rates in these two fields, then, there is very little difference in the net return from these types of investments, although possibly the return from mortgages is a little greater.

A third characteristic that most investors deem advisable is marketability. Fire and casualty companies must meet short-term obligations, rarely exceeding three years in time. The liabilities of life insurance companies, on the other hand, are essentially long-term obligations, running as long as fifty years or more. Thus the necessity of ready convertibility is to a great extent eliminated for life insurance companies. If investments have been so diversified that they mature at regular intervals, current income from these maturing investments and from premium payments will be sufficient to take care of current expenditures in normal times. It is necessary, then, that only a relatively small proportion of the investments of a life insurance company be kept in a liquid form. The development and increase in popularity in late years of cash surrender and policy loan clauses in insurance contracts has to some extent increased the need for liquidity of funds. Any further developments along that line will have to be considered with the greatest care, and may lead eventually to a complete change in investment policy. The ability to disregard marketability has proved of great value to life

insurance companies. Because of a lack of convertibility, mortgages have a rather narrow market and hence usually provide a slightly higher yield than other types of investments. Thus, in the investment portfolio of any life insurance company, we find a large percentage of mortgages. In the case of securities too, many issues will be found which, because of the vagaries of public interest, have very little marketability but which are sound investments. Such securities often produce a better than average return.

We have seen the three main principles of investment modified to make them applicable to life insurance companies; the security of the principal, adequacy of yield and marketability. These three are by far the most important principles to be considered, but they are not the only ones. The duration of the investment is often of great interest. In a period of unusually depressed interest rates short-term rather than long-term securities should be bought. When they mature, the money may be reinvested in long-term securities at a higher rate, thus keeping the yield as high as possible over a period of time.

The legality of the issue must also be determined. The Canadian and British Insurance Companies Act lists the securities in which life ihsurance companies may invest. Prior to the passing of this act most companies kept well within the limits as shown in the act for their own protection. One noteworthy exception was the policy of one very large Canadian life insurance company which invested very heavily in common stocks and sustained great losses in the crash of 1929. In the

following chapter we shall discuss in detail the provisions of this act.

Of lesser importance, but of great interest, is the question of foreign investments. In general such investments usually prove inferior to what might be called "home" investments. No life insurance company should have a greater amount invested in the currency of any country, with the possible exception of the United States, than their liabilities on life insurance contracts in that country.

Constant supervising and reviewing of the investment portfolio is necessary to maintain the safety of the capital. Some investments naturally require less attention than others but, for the moment disregarding individual investments, the policy as a whole must be checked constantly to ensure that the greatest possible return consistent with safety is being obtained.

LEGAL RESTRICTIONS ON INVESTMENT

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The Canadian and British Insurance Companies Act passed by the Dominion Parliament in 1932, together with later amendments restrict the investments of insurance companies within quite narrow limits. For purposes of simplification we shall consider the restrictions in the various fields of bonds and debentures, stocks, mortgages, real estate, policy loans and other loans separately.

Life insurance companies may invest in the securities of, or those guaranteed by, any federal or state government, or securities of, or those guaranteed by, any municipal government in Canada or any country in which the company does business. They may also invest in the bonds of any corporation secured by a mortgage on real estate, plant or equipment, or by securities owned by that corporation which are legal investments under this act for life insurance companies. The debentures of any corporation which has paid regular dividends on its preferred or common stock for a period of five years before the investment is made are also legal investments. In later years amendments to the act gave life insurance companies the right to invest in bonds or debentures secured by an assignment to a Canadian trust company, by the Dominion or any provincial government, of an annual payment large enough to meet the interest and principal when due; the debentures of any corporation secured by a statutory charge upon real estate,

plant or equipment, provided the interest in full has been paid regularly on other securities of the corporation of the same class for the ten years preceding the investment; equipment trust bonds or certificates of any railroad company incorporated by the Dominion or any province, or owned or controlled by any such company; and the bonds and debentures issued by any public utility company responsible to the government of the United Kingdom of Great Britain and Northern Ireland or of any British dominion, or any minister of such government, or to a body so responsible. Life insurance companies may not invest in any bonds or debentures if the payment of interest or principal on those securities is in default. No loan may be made to any corporation if more than one half of the capital stock of that corporation is owned by any director or officer of the insurance company, his wife or child, or any combination of these.

Because of the security, or rather the lack of security, offered, investments in preferred and common stock are most carefully restricted. Any corporation must have paid regular dividends on its preferred stock for a period of five years before that preferred stock becomes a legal investment for a life insurance company. Investments may be made in common stock guaranteed by any corporation, if that corporation has paid regular dividends on its own preferred or common stock for a period of five years, and if the guaranteed stock is not more than 50% of the preferred or common stock of the guaranteei

corporation. The common stock of any corporation is a legal investment only if regular dividends of at least 4%, or of $4. per share if the stock has no par value, have been paid for seven years before the investment is made. Not more than 30% of the total stock issue of any corporation may be bought. Life insurance companies may not invest in their own shares or the shares of any other life insurance company. The Treasury Board may authorize securities not included here if they are received in payment or part payment for securities sold by the company, or obtained in the reorganization or amalgamation of any corporation whose securities the company holds. These securities, however, must be sold within five years unless it can be proved that they are not inferior to the securities for which they were substituted. When this act was brought up in the House of Commons one of the most discussed portions was sub-section 6 of section 63 which stated that the total book value of the investments in common stock must not exceed 15% of the total ledger assets. Common stock received as a bonus or dividend is not to be included in this section. Much against the wishes of many members of the House any company which held more than 15% of its assets in common stock at the time the bill was passed was not to be included in this restriction until the amount it held fell to 15%. In the meantime, it could make no new investment in common stock.

The act also allows a life insurance company to invest

in mortgages on real estate in Canada or elsewhere where the company is operating. The amount loaned must not exceed 60% of the valuation of the real estate covered by the mortgage, except when the mortgage is taken as part payment for real estate sold by the company. Closely allied to the question of mortgages is the question of real estate. A life insurance company may hold such real estate as is necessary for the prosecution or expansion of its business, or such as is bona fide mortgaged or hypothecated to it as security for a debt. Real estate obtained through foreclosure processes must be sold within twelve years of that foreclosure, unless the Treasury Board grants an extension to this time limit. Regardless of anything said in this act, life insurance companies must obey all provincial mortmain laws.

Although this act applied to all insurance companies certain portions of it apply only to particular types of such companies. The most striking illustration of this is the authorization of loans by life insurance companies on the security of policies issued by any company registered in Canada. These loans are authorized for life insurance companies alone and are not legal for other forms of insurance companies. They may also lend money on the security of any stocks in which the company can legally invest, provided that the aggregate of the amount loaned and the amount invested in such securities may not exceed the amount which may be invested therein under restrictions elsewhere in the act. No part of the act prevents a life insurance company from accepting any

additional securities, which are not legal investments for them, as greater security for a loan.

Thus having protected life insurance companies, to some extent, from poor investment of their funds, the act goes on to protect them from their own officers. It states that all investments must be made in the name of the company. No director or officer, his wife or child, may have any pecuniary interest as borrower, principal, co-principal, agent or beneficiary except that they are entitled to the full rights of any life insurance policies they may have in the reception of policy loans.

Despite what may seem to be rather severe limitations, the investment policies of life insurance companies have been built up more from past experience and observation than from legislation. "They have set up their own principles of operation and standards of acceptability .... and have gained the reputation of being perhaps the most intelligent buyers in the investment market."[1] .

[1] Jordan, D. F., Jordan on Investments, New York, 1942.

- III -

BONDS AND DEBENTURES

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The great importance of bonds and debentures in the investment policy of life insurance companies is shown by the fact that the percentage of the total assets of Canadian life insurance companies invested in these securities has increased from 38.89% in 1926 to 59.74% in 1941. In general these securities form what is probably the best investment for life insurance companies. Considering bonds and debentures from the viewpoint of the investment principles described in Chapter I, we find that, relative to other types of investments, they possess good security of capital, good marketability, and a rather low interest rate. Counteracting this latter characteristic to some extent is the smaller expense of handling.

To the casual observer in the past, and even to many so-called "experts", it seemed that safety was an inherent quality of bonds because of the allocation of specific property as security for the debt. The experience of the last decade, however, has proved the fallacy of this. Some writers to a large extent ignore the security offered for the protection of the bondholder, placing the emphasis rather on the strength and soundness of the contracting enterprise. Their argument is based on -

"1. The shrinkage of property values when the business fails.

2. The difficulty of asserting the bondholders' supposed

legal rights.

3. The delays and other disadvantages incident to a receivership."[1]

Obviously there is truth in this argument, but one must be careful not to carry its practical application too far. The proponents of any new theory generally have a tendency to make extreme claims for it. It must be admitted that the person who, as a result of defalcation and receivership, receives 40¢ on the $1. for his bonds is in a more favourable position than the person who receives nothing for his debentures and stocks. It is a question, then, not of disregard of specific security, but rather of an increased interest in the present financial position and the future possibilities of the individual enterprise and the industry as a whole. Granting that a mortgage does not ensure complete protection, we must seek definite standards upon which to base our judgments of bonds and also of debentures.

First must be considered the general nature and location of the business or government issuing the securities. Bonds and debentures are usually classified as government and government guaranteed, municipal, public utility, railroad, and industrial issues. Each of these separate classes has its own characteristics. Government and government guaranteed bonds are considered the safest, because presumably the taxing powers of any government could use up the earnings of all

[1] Graham and Dodd, Security Analysis, New York, 1940.

private corporations in the country before the security of its own issues would be threatened. A government in financial difficulties, however, may not exercise its taxing powers to the limit, It may repudiate the debt. In such an eventuality cannot recover their losses through legal action. The safest investment for a Canadian company would be Dominion of Canada bonds. But what about foreign government bonds? Some are undoubtedly on a par with, or even superior to, Canadian government bonds, but many are worthless. Similarly in the other classes will be found good and bad investments. Hence, although some classes may seem inherently more speculative than others, they should not be discarded "in toto". The issues in the more speculative classes should, on the other hand, be subjected to more severe tests.

The safety of an issue depends to a large extent on the size of the issuing body. The smaller the body the more vulnerable it is to unexpected happenings. At the same time, the smaller it is the harder job it has in borrowing new funds to tide it over periods of financial embarrassment. The trouble comes in deciding the minimum size of the issuing authority of any class of securities. The limit may be set at a figure which excludes several first-class bonds; but it is safer to risk excluding some good bonds than to take a chance on including many poor ones. We must keep in mind, however, the fact that this restriction does not exclude all poor issues, for the biggest company or municipality may be

in such a financial state that its securities are highly speculative. Other restrictions must be added to weed out such issues.

The past record of all issuing bodies should be carefully studied before its securities are bought. It must have been functioning long enough that a true picture of its financial stability may be obtained, and obviously if it has recently defaulted payments of interest or principal on any of its bond issues, all of its issues must be considered as speculative and so not suitable for investment. A study of the dividend record of companies whose bonds are under consideration is often of great value too. Although the size of the dividends paid does not always indicate the company's ability to pay regular interest charges, the trend in the size of the dividends over a period of years will often warn an investor in advance of approaching financial difficulties and so enable him to invest or reinvest his funds in safer enterprises.

Possibly the most important specific test of safety is the ratio of earnings to interest charges. This ratio may be computed in several ways. A method in wide use prior to the last decade allowed the deduction of the interest charges on the senior issues before the calculation of the ratio for any junior issue. When the underlying issue is relatively small this method is effective; but in general it tends to give the appearance of better protection than is actually present. This difficulty may be overcome somewhat

by basing the calculations on the sum of the interest charges both on the issue under consideration and also those on issues having prior and equivalent claims on earnings. For instance, suppose a company had an underlying issue of $2 millions worth of 3% bonds and a junior issue of $1 million worth of 4% bonds with an income of $120,000. The coverage on the underlying issue would be two times. With the first system the coverage on the junior issue would be one and one half times. By the second method, however, the coverage on the junior issue becomes one and one fifth times. The most conservative and hence, for our purposes, the best method would be the consideration of the relationship of the earnings to the total interest charges. In our illustration then, both issues would be considered covered one and one-fifth times. Obviously in a time of prosperity or in a time of depression the use of the previous year's earnings in these computations will not give an accurate picture of a company's stability. Rather the average results over a period of time should be considered. The length of this period of time should be so taken that it does not give undue stress either to depressions or periods of prosperity. At present possibly a seven-year average would be the best for it would give weight to the "repression" of 1938-39 and also to the last few years which have brought prosperity to most firms.

Also of great importance in the case of public utility,

railroad, and general industrial issues is the relation between the value of the property and the bonded debt. It will easily be seen that this relationship is roughly equivalent to the relationship between the stock capitalization and the bonded debt, except when the company concerned has a large debenture debt. In this case the term debenture refers to obligations of the issuing company secured by the general assets and integrity of the issuer, whereas bonds are secured by a direct charge upon a specific asset. Although restrictions based on the relationship between the stock capitalization and the bonded debt may exclude some well secured bonds they will provide added protection in general. To escape from the admitted unreliability of balance sheets it is better to consider the market value of the stocks concerned. Although the market value, in many cases, seems to bear no relation to the real value of the stock, it is generally agreed that it is the best indication of the true value and especially in times of depression the safest value to take.

The minimum figures selected must be left to the judgment of the company concerned. It is of interest, however, to note the minimum requirements suggested by Graham and Dodd in their book Security Analysis.[1]

"Size of borrower:

Municipalities: population 10,000

Public utilities: gross revenues 2,000,000

[1] Page 156.

Railroads: gross revenues	3,000,000.
Industrials: gross revenues	5,000,000.

"Interest coverage: (7-year average)

Public utility bonds	$1\frac{3}{4}$ times
Railroad bonds	2 times
Industrial bonds	3 times

"Market value of the stock issues:

Public utilities	50%	of the bonded debt
Railroads	66 2/3%	of the bonded debt
Industrials	100%	of the bonded debt"

As mentioned before losses sustained on government bonds cannot be recovered through legal action. It would seem, then, that willingness to pay is the prime consideration when investigating such securities. Willingness to pay on the part of the government, however, depends on convenience, which in turn depends on ability to pay. Then the record of past payment and the present financial position must be considered. The best measure of the latter is the debt per capita or the net debt as a percentage of the assessed value of the taxable real estate in the territory involved. The basis of assessment must be known to make any accurate use of the latter measure. Much the same comments may be made about municipal obligations. Municipalities, however, may be sued and so willingness to pay is not of such prime importance. In the case of municipalities where bonds are often issued to cover the expense of constructing or improving public works, willingness to pay is correlated with the enjoyments of the

benefits to be derived from the works. Thus the issue should be checked to ensure that its duration does not exceed that of the works for which it is paying. As an extreme case, the town of West Farms, now part of New York City, issued street improvement bonds in 1873 to mature 274 years later, in 2147!

Private issues show many differences from public issues. All industries show a definite pattern of economic growth, from experimentation through development to saturation and sometimes eventual decline. This is most strikingly illustrated in the public utility field. Electric light and power companies are now in the period of development and so are the most attractive companies in the field for investment. The extensive use of electricity for lighting, heating and power has cut down the uses of gas to heating and cooking. Despite this gas companies, too, are in the development stage, although much nearer the saturation point. The telephone industry is also approaching the saturation point, whereas telegraph companies have been faced with declining revenues. Water companies are mostly owned by the municipalities which they serve. The few private companies, however, although they have definitely reached the saturation point, form good investments because of the remarkable stability of income which they enjoy. Street railways, although enjoying momentary prosperity through wartime restrictions, are slowly losing out to the strong competition supplied by motor cars and buses. For its issues to be in a good investment position a public

utility should be a regulated monopoly of a necessity.

At one time railroad bonds were considered the best private bonds available. Now, through the increased financial difficulties of even the largest companies and the rapidly increasing importance of public utilities, the latter companies surpass the former in the opinion of most present day investors. In Canada we are not troubled to such an extent by railroad issues, for of the two railroad systems here one has an excellent record, whereas the bonds of the other are government guaranteed.

In the field of general industrial bonds the problems are much more complex. We find wide variation in sales and profits in good and poor years varying with the elasticity of demand for the product or service offered. In many lines, too, are encountered problems of overproduction arising from excess capacity and free competition. Thus to provide a good investment field an industry should be supplying a necessity. A degree of monopoly often aids the securities of an enterprise but must not be overvalued. Control of sources may be counteracted by new discoveries: patent protection expires; even a monopoly based on efficient production may be threatened by resourceful competitors. Companies which control the product from raw material to the finished article are more stable than those which contribute only one stage in the manufacturing process. Again companies which must carry large inventories, especially if those inventories are perishable,

are subject to more violent fluctuations in profits. The restrictions of tariffs must also be considered if the company concerned depends on foreign trade for a large portion of its business. After considering all these details and applying the restrictions based on the balance sheet as suggested before it is well to apply the rule - "If in doubt about an investment, don't make it."

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REAL ESTATE MORTGAGES

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It has been estimated that about 55% of the wealth of the nation is represented by land. It is only natural, then, that loans secured by mortgages on real property, that is land and buildings, form the largest and most important field for investment. Because of a lack of marketability, mortgages do not form a proper investment for such institutions as banks, where liquidity of funds is of prime importance. Life insurance companies, on the other hand, find mortgages not only suitable but profitable investments, and have had no little part in the development of the technique of mortgage investment.

Mortgages fall naturally into two groups - urban and farm. Before investing in urban mortgages it is customary to make a general survey of the territory concerned. The population growth and trend, the variety and prosperity of local industries, and past and present construction activity give some indication of the progressiveness of the community. Of utmost importance, too, is the adequacy of public services and transportation facilities. As a check on this survey the financial standing of the municipality should be considered, its debt structure and record of payment, and its tax levy and collection record.

In appraising the value of individual buildings there

are several methods used, of which we shall mention only the three most important. The reproduction cost of a property is the cubical content of the building multiplied by the cost per cubic food of a building of the same type and construction, less depreciation, and plus the value of the lot. The latter figure is determined by multiplying the width of the lot by a fair price per foot frontage based on similar lots in the near vicinity. The comparative value method of appraisal makes use of recorded sale prices and asking prices of similar buildings. It must be remembered, however, that price is affected not only by market conditions and conditions of supply and demand, but also by the relative bargaining ability of those concerned and the motive of sale or purchase. The applicability of this method depends on the freeness of the sale of the buildings considered. A third method, that of income capitalization, is used primarily for income producing buildings. Rent income is estimated from the knowledge of similar units. From this is deducted taxes, insurance, repairs, management and other maintenance costs, and an allowance for vacancy and depreciation to give an estimate of net income. This amount should equal all mortgage requirements plus some cash income for the owner.

In addition to the general considerations of the territory involved, the present character and the probable trend of the immediate location should be considered. The extent to which the district is built up and the percentage of owner

occupancy is important if the district is residential. Transportation and shopping facilities, local improvements, and protection from adverse influences, restrictions, etc., all increase the value of a property. As for the property itself, the age, structural soundness, architectural attractiveness and resistance to the elements of the building, and the topography, size and shape of the lot are important factors in considering the saleability of the property. Before granting the loan the mortgagee should be carefully investigated. Of importance is his economic and social background, his occupation and permanency of employment, his income, his obligations and the record of his payment of past obligations, his age, and the purpose of the loan.

Of all urban properties single family residences, and in particular those inhabited by the owner, are the best security for mortgages. Larger homes are less saleable and low priced houses are usually of cheaper construction and deteriorate more rapidly. Thus the moderate priced homes form the best investment. The market for two and four family residences and apartment houses is smaller than for single family residences. There is a greater spread between maximum and minimum rent and depreciation is always greater. In the case of retail stores the location is most important - the proximity of transportation facilities, the density of traffic, parking facilities and the size of the area served. The presence of apartments above the store increases the possible

revenue. In considering a mortgage on such property as this it must be remembered that the safety of the loan to a large extent depends upon the prosperity of the enterprise housed in the property. Office buildings, to represent a good investment, must be exceedingly well situated and fully modern, and should as well be relatively free from the danger of strong competition. Specialized properties such as garages, warehouses, factories, theatres and hotels are not readily convertible to other purposes and so are more seriously affected by changing conditions than other properties and often provide poor investments. Mortgages on churches and educational institutions are generally satisfactory when accompanied by personal bonds to cover any deficit left in case the members of the group split up.

For farm mortgages many of the same considerations hold. In studying the location of the farm attention must be given to the climate for crop growth, the extent of the development of the district, the type of farming done, roads and transportation facilities, and the adequacy of civic, social and marketing centres. Consideration must be given the farm itself, the soil types on it, its size, its arable acreage and state of cultivation, the adequacy of water supply and drainage, its topography, the suitability of improvements (buildings, fencing, etc.), and crop yields. The borrower must be investigated as to his social and economic background, his experience and farming ability, his record with regard to past

debts, his age, and his nationality.

The appraisal of farm lands is much more difficult than that of urban properties. It must be assumed that the income, in produce or rent, from an individual farm will be equal to that of similar farms in the locality. Assuming also that the average prices and yields locally over a period of years will be approximately the same in the future, future income on the farm can be estimated. The deduction of taxes, insurance premiums, maintenance, fertilization, depreciation, etc. then gives the expected net return. The value of the farm based on productivity will be given by these earnings capitalized at a proper rate. The capitalization rate will be influenced by the money market, the risk involved, and the marketability of the farm. The basic valuation of the farm is then arrived at by adjusting the capitalized value for the factors of location. It is of prime importance that in every urban and farm mortgage the mortgagor shall carry fire insurance on all buildings involved. A constant check must be maintained to ensure that this insurance is now allowed to lapse.

In 1935 the Dominion Housing Act was passed to encourage building. This was replaced in 1938 by the National Housing Act. Under this act the Dominion government and various types of lending institutions cooperated to provide funds for the erection of new buildings. The government provided 25% and the lending institution 75% of the total loan. The loan was to be not less than 70% and not more than 80% of the lending value (the lesser of the estimated cost of production and

the appraised value) of the building for buildings valued at more than $2,500. For houses under $2,500. the range of the loan was to be between 50 and 90%. Repayment was to be made in equal monthly instalments on a 10, 15, or 20-year amortization plan with interest at 5%. The mortgagor had the privilege of full repayment after three years on the payment of three months interest as a bonus. If the building were built for sale, 25% of the loan was to be withheld until it were sold, the sale being subject to the approval of the lending institution. For multiple family dwellings the limits on the loans were 80% for those less than $2,400. per family unit and 90% for those less than $2,700. per family unit. These loans were to be amortized in half yearly payments for 35 years, and bore interest at 2%. For multiple family dwellings, too, 25% of the loan was to be withheld until 90% of the apartments were satisfactorily leased. All buildings constructe under this plan had to conform to certain minimum standards of construction. To make this plan more attractive to the lending institutions, among whom life insurance companies were prominent, the government entered into contracts with each institution guaranteeing up to 25% of the total amount loaned by the institution. Although the National Housing Act is still in force, the acute lumber shortage has greatly restricted its use.

In the late 1930's there was a marked trend toward the practice of amortization in equal monthly instalments. This

was a direct product of the depression and the need for closer supervision. This method, however, has proved to be very expensive, and it is probable that investors will revert to quarterly or half-yearly payments. A mass of debt legislation affording relief to debtors regardless of the rights of creditors has caused the curtailment of activities in some sections of the country particularly in the field of farm mortgages. Until the outbreak of war, low prices for farm commodities and prolonged droughts also caused the curtailment of farm mortgages. The National Housing Act has strengthened the field slightly but even with this life insurance companies have been decreasing their mortgage portfolios every year. Despite a great reduction mortgages still have a very important place in the investment policy of every life insurance company.

STOCKS

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One may well ask what stocks have to do with investment. Recalling thd debacle of 1929 it would appear that stocks are inherently speculative and entirely out of place in a discussion of investment. But is that conclusion true? A survey of stock and bond prices in the past twenty years will show many stocks with better records than some first class bonds. This is partially the result of the policy of some companies of retiring their bonded debt, thus leaving their common and preferred stocks in the advantageous position of having first claim on all earnings. Many companies, such as International Harvester, Eastman Kodak, and General Motors, have no bonds outstanding. In such a situation undoubtedly their preferred stocks are the senior issue of the company. They should, then, be worthy of purchase as investments rather than on a speculative basis. At this point, however, the argument begins. Some people claim that, despite the many speculative features of stocks, an analytical technique may be applied to their selection which merits the use of the term investment. On the other hand, others claim that any such attempt merely throws a rosy glow over a problem impossible of solution.

During the years before the last Great War the technique of investing in stocks was very similar to the technique of

investing in bonds. It was based on: (1) a suitable and established dividend return, (2) a stable and adequate earnings record and (3) a satisfactory backing of tangible assets.[1] The emphasis was placed on past record with a lesser interest in future possibilities which indicated, at that time, speculation. The analyst, then, first checked the balance sheet and supplementary reports to ensure that there was no weakness in the organization. After eliminating the poorer issues those remaining which seemed to have the best future prospects were purchased as investments.

In the post-war period investors began to realize that past records were highly undependable standards upon which to base investments. At the same time the possibility of future profits seemed so great that a complete reversal of attitude took place. Investors began to place the emphasis on future earnings. In many cases of receivership had proved to be of little value. Thus, with no apparent connection between assets and earnings, the investors turned to the past trend of earnings to give some indication of what might be expected in the future. As long as this trend was upward it could be expected that, for a time at least, future earnings would be greater and so the stocks of that company would make a good investment. In following this theory, investors ignored entirely the market price of the stock in determining its desirability as an investment. While the trend of earnings

[1] Graham and Dodd, Security Analysis, New York, 1940, p.351

of any company was upwards its stocks were in great demand. As a natural result of this its market value increased, decreasing the interest return on the principal invested and thus defeating the original purpose of investment in stocks. Because of the greater instability of business, average earnings had ceased to be a dependable estimate of future earnings, but that alone did not make the trend of earnings a more dependable estimate. On the other hand, the law of diminishing returns, increasing competition and the variations of the business cycle made it quite undependable. Actually this theory of "investment" was merely a highly coloured attempt to justify speculation.

Having seen the breakdown of two former systems, the basic question remains. Can the purchase of stocks be regarded as investment, or must it remain purely speculation? For the individual stock it must be speculation. But investment may be conceived as a group operation where rigid standards of acceptance and wide diversification will produce a favourable average result. Obviously a stock which appears to have a bright future will rarely be offered on the market at a low price judged on the basis of earnings, dividends and assets. The most appropriate field for stock investment, then, would include those securities which are cheap according to these quantitative tests and which appear to have average future prospects. Becuase of the preoccupation of the stock market with stocks which appear to have exceptional prospects for the

future, the shares of many well financed companies which, although not spectacular in any way, show every indication of continuing to make their present rate of profit, may be bought at a much lower price than would be paid for a corresponding interest in a private business.

There are three elements which should enter into the valuation of a share - the dividend rate and record, income account factors, and balance sheet factors. Investment is closely linked with dependable income. Therefore a stock should have a well established dividend and the price paid for it should vary as the amount of the dividend. In recent years a policy of withholding a part of the earnings to better the financial standing of the company has grown up. Of two companies in the same general position and the same earning power the one offering the higher dividends will sell at the higher price on the open market. This is true because, in general, investors would rather have the benefits of the profits when they are earned than the promise of their return at some date in the future with interest. The stockholders are quite justified in this stand, for experience has shown that when profits are withheld for the sake of stabilizing dividends, even though a large reserve is built up, the procedure is often of no avail during a depression. Many companies during a depression in the past have failed to declare dividends when their balance sheet has shown a reserve for dividends many times in excess of the average dividend payment. Likewise the

ploughing back of profits into the business benefits the business at the expense of the shareholder; for seldom does a company expand at the same rate as would the dividends with interest compounded. In a rapidly expanding company it may be necessary to plough back a large part of earnings. In such a case the reasons for the policy should be fully and satisfactorily explained, and the amount should be offset by a stock dividend to be retired when the additional capital is no longer required in the business. The dividend record should show that roughly at least 70% of earnings have been distributed before the investor buys a stock.

From profit and loss statements we can get some indication of earning power. As noted before the investor must be careful not to give too much stress to this factor of earning power for several reasons. A twofold test of earnings and assets is more reliable than a single test of earnings. At the same time earnings fluctuate more widely than the balance sheet, and hence indicate an exaggerated instability into the enterpris Profit and loss statements, too, can be far more misleading than balance sheets. It is common practice to have the income statements audited by independant public accountants along with the balance sheet; but even then both the statements and the auditors' report need interpreting. Accounting practice varies so widely from firm to firm that the investor must be certain that he understands exactly how the statement has been set up. He must watch particularly nonrecurrent profits and

losses, reports of subsidiary companies, and deductions for reserves.

Many types of nonrecurrent profits or losses can be put either in current income or expenses or in a surplus account. In computing the profits or losses for any one year, these items should be segregated from the ordinary operating results of the year to give a more faithful picture of the earning power. Likewise they should be included in any computation of average earnings over a period of time. A consolidated income account is necessary to give a true picture of the year's operations, when a company has a significant interest in one or more subsidiaries. Some companies make it a practice to include in their income statements all companies 50% of whose stock they own. Other companies use the figure 75%. No limit for this can be set, however, for the number of shares outstanding and the size of the dividend determine the importance of the profits from such investments, as well as the percentage of the stock owned. For instance the interest of Du Pont in General Motors, which represents about 23% of the stock outstanding, is certainly significant. If the subsidiary's profit or loss is significant, and, by all indications, would seem to be of short duration, the amount may be treated as a nonrecurrent item. Possibly the easiest way of manipulating income accounts is through depreciation and amortization charges. These charges should be based on regular accounting rules applied to fair valuations of the

fixed assets, and the net plant account, i.e. the present value of the plant plus all depreciation charges, should not be allowed to decrease over a period of years. These charges may be reduced in the investor's calculations if they regularly exceed the cash expenditures on the property. But, on the other hand, they must be increased in his calculations if they are both less than the average cash expenditures, and also less than the reserve required by ordinary accounting practice.

The income tax paid by the corporation will give a rough check on the income statement as a whole. If it is found that any questionable accounting practices are employed, the investor should shun all the securities of that corporation however good they may appear on the surface. The earnings record is useful in indicating what may be expected in the future; but it must be remembered that the validity of earning power, as measured by average earnings, depends upon the degree to which annual results approximate the average. That is, the trend of earnings must be considered too in conjunc tion with the average earnings. To be eligible for investment, the market price of a stock should not be more than twenty times the average earnings. For a stock with average prospects for the future this figure should probably be around 12 or 12½ times average earnings. If these figures are exceeded, the market price is too high and investment becomes speculation. The value of a common stock subject to dilution by conversion

privileges must not be set at a figure higher than would be justified if these privileges were exercised in full. It must be remembered that quantitative data are useful only to the extent that they are supported by a qualitative survey of the enterprise. The permanence of the business as a whole, the position of the individual company in the field, the quality of managership and other factors must be considered to complete the picture.

To complete the quantitative tests the balance sheet must be studied with extreme care. As was pointed out before, the value of a company's assets as shown in the balance sheet often has little connection with the value derived from these assets if the company goes into liquidation. Book value shows the investor what tangible assets he is buying. This is of interest, but not of prime importance, in security analysis. Of more practical use if "current asset value". This consists of current assets alone, less all liabilities and claims ahead of the issue and divided by the number of shares outstanding. This is generally roughly equal to liquidating value. It is a matter of record that, in the past ten years, some stocks have sold at prices consistently lower than their liquidating value. In such a case, either the price is too low, or the company should be wound up. On the whole, this class is undervalued and hence provides a wide field for investment. Issues which are losing their current assets at a rapid rate must be avoided; but those showing prospects of

favourable future development, or having had a large earning power in the past, often prove to be fine investments.

On the other hand, the balance sheet is usually studied to show up any possible financial weaknesses. Long experience has dictated that the ratio of current assets to current liabilities should be 2:1. At the same time current assets, less inventories, should at least equal current liabilities. If neither of these tests is met, the company is undoubtedly in a very weak financial position. When the balance sheet shows a large bank debt, or an early maturing funded debt, the company should be checked much more thoroughly; for insolvency usually comes when a large debt falls due. If the company is in a sound financial position, it will have little trouble in refunding the debt. But if it is not sound, the difficulties may be great enough to ruin it. The comparison of balance sheets over a period of time is extremely useful as a check on reported earnings per share, to determine the effect of profits or losses on the financial position of the company, and to trace the relationship between the company's resources and its earning power over a long period.

With such an analysis as is sketched here the intelligent selection of stock for investment is possible. The great danger lies in disregarding certain tests when the stock appears to have exceptional opportunities and thus passing from the field of investment to the field of speculation. With one notable exception, Canadian life insurance companies have

pursued a conservative policy with regard to investments in stocks. The one exception was the Sun Life Assurance Company. In 1930 its books showed that 55.89% of its total assets were invested in stocks. At the same time similar investment of all other Canadian companies was only 3.34% of total assets. This astonishing policy nearly ruined the Sun Life during the stock market crash of 1929-30. Only the action of the Superintendent of Insurance and some private financial aid saved it from complete collapse. The Canadian and British Insurance Companies Act passed in 1932 provided that all statements shall show investments valued at current market price. When these market values are unduly depressed, however, the Superintendent may set a higher valuation on the security, provided that valuation does not exceed the one used in the next preceding statement, or, in the case of securities purchased since the last statement was issued, not greater than the book value of the security at the time of the statement. Ever since the act has been in force, and for some years before, the Superintendent of Insurance has set an arbitrary valuation on all stocks for purposes of the annual statements. Thus, by showing a much larger investment portfolio than was justified on the basis of the market price, the Sun Life managed to avert serious difficulties. Nevertheless it sustained a loss during that period from which it only slowly recovered. It was largely on account of this loss that restrictions were placed on stock investment in the Insurance Act of 1932, whose provisions we

have already noted in a previous chapter.

The experience of the Sun Life can best be illustrated by the accompanying table. The figures used in compiling the table are those which were authorized by the Superintendent of Insurance, not the market price.

The Percentage of the Total Assets of
Canadian Life Insurance Companies
Invested in Stocks

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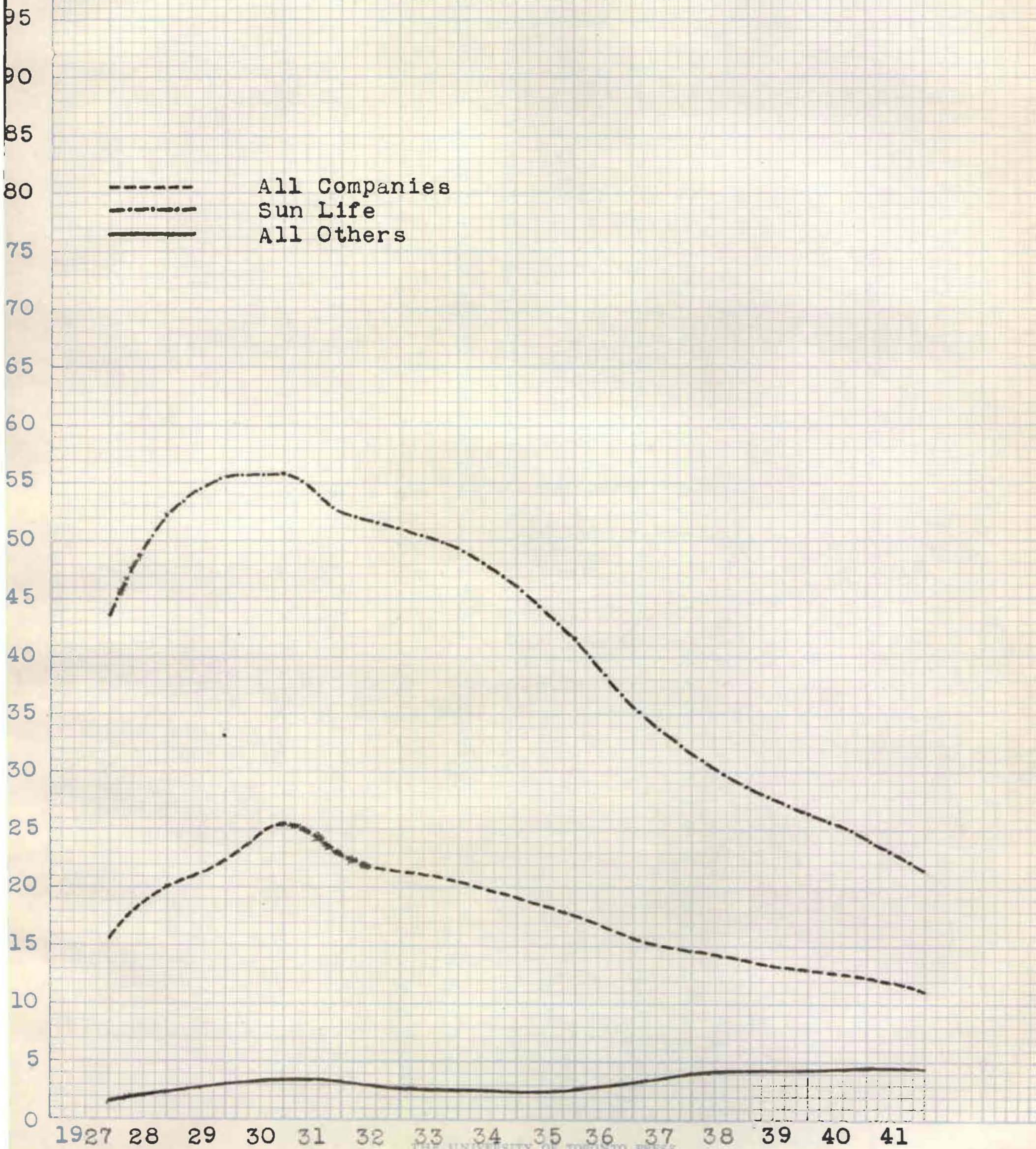
Year	Sun Life	All Others	All Companies
1927	43.67	1.64	15.68
1928	52.24	2.43	20.05
1929	55.51	3.07	22.21
1930	55.89	3.34	25.61
1931	52.39	3.22	22.97
1932	51.05	2.72	21.45
1933	49.37	2.61	20.49
1934	46.05	2.49	19.08
1935	41.84	2.77	17.77
1936	35.69	3.27	15.79
1937	31.59	4.02	14.74
1938	28.81	4.24	13.80
1939	26.50	4.38	12.99
1940	24.30	4.45	12.14
1941	21.61	4.42	11.05



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- VI -

OTHER INVESTMENTS

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Policy loans, real estate and collateral loans, as well as mortgages, bonds and stocks, will be found among the assets of Canadian life insurance companies. Of these three, policy loans are by far the most important. For some years up to 1928 the ratio of loans to reserves varied within quite narrow limits around 15% for all companies in Canada. After 1928 the volume of loans increased until the ratio reached a maximum of 20.9% in 1932. The ratio then gradually decreased until 1938 when it was 15.8%. Policy loans were inaugurated as a selling point for life insurance. Since the company was merely lending the policy holder money which he had already paid in in premiums on his policy, the security of such loans was the best possible. Despite this, life insurance companies have never encouraged policy loans. Apart from the purely ethical argument that the protection of the borrower is lessened, it has been found that often, when the borrower finds it difficult to repay the loan, he allows his policy to lapse. In this way the company loses much business. Since individual loans are, of necessity, small, there is a heavy expense involved in handling policy loans. Because the interest rates on such loans quoted in policy contracts must of necessity be applicable for a long and indeterminate period, and because of the fear of a possible rush for loans if the rate were low which might jeopardise the company's financial position, it

became customary to charge a very high interest rate. This rate was often as high as 10%, and, even after making allowance for the expenses of handling, these loans averaged about 6% before 1936. In 1935 an amendment to the Canadian and British Insurance Companies Act came before the House of Commons which included a provision that the interest rate on policy loans be restricted to 5%. It was argued that the security behind these loans was better than that behind government bonds and hence the interest rate on them should be restricted. This was actually a part of a general scheme to lower interest rates, purporting to bring them in line with other prices and reduce the national debt burden. In answer to the argument that there would be a rush for loans, proponents of the amendment stated that there would not likely be a great increase and, even if there were, it was up to the insurance company to control the rush. Life insurance officials said that a lowering of the interest rate on policy loans would encourage borrowing for speculative purposes, and could only be injurious both to the policy holder and the company. Finally the amendment was dropped on the promise of the Canadian Life Insurance Officers Association that after Jan. 1, 1936 the rate would be no higher than 6%. Despite the many fears of the insurance companies, policy loans have proved profitable and the amount of business lost through lapsing contracts has not been great. There use has made it necessary to keep a larger percentage of funds in a liquid state. The

careful diversification of investments to provide a constant stream of maturing obligations, however, has provided this liquidity with very little change in general investment policy.

Neither of the other two types of investment mentioned at the beginning of this chapter are of great importance to life insurance companies. Real estate obtained through foreclosure of mortgages may be held only for a limited period of twelve years. Other than property so held, insurance companies are restricted to that amount of real estate which is necessary for the prosecution or expansion of their business. This prevents the buying of real estate purely for investment purposes. Some companies, however, have spent huge sums on the erection of magnificent head offices and branch offices. Since these buildings are larger than present business requires, office space in them is rented to other firms. Nevertheless this source of income is negligible compared with the total income.

Collateral loans, i.e. loans secured by collateral security, are even less important in the investment portfolios of life insurance companies. In 1940, out of 28 companies only five had collateral loans outstanding, and those loans totalled only $125,253., whereas the total assets of all companies was nearly $2,500,000,000. When they are used at all, collateral loans are used sparingly on the best of security to preserve the liquidity of the portfolio.

- VII -

THE INTEREST RATE

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Previously we defined investment as the productive employment of capital. It is natural, then, that all investors should be vitally interested in the interest rate. In the past the trend of long term interest rates has been "between an extreme range of from 2 to 8% and a more normal range of from 3 to 6%."[1] During the past ten years, however, the rate has remained consistently low, even in the face of the considerable increase in business activity in 1936-37. This would seem to indicate a certain permanency in this low interest rate. While this may be so to some extent to the large amount of capital available for investment, yet it is undoubtedly due largely to governmental policy. In 1932 the Imperial Conference adopted a resolution which included the following statement - "In the monetary sphere the primary line of action towards a rise in prices should be the creation and maintenance, within the limits of sound finance, of such conditions as will assist in the revival of enterprise and trade. Among these conditions are low rates of interest ...." Accordingly the government of the Dominion of Canada set about reducing the interest rate. This was effected by legislative action, and in many cases by the mere threat of such action. Formerly the interest rates on mortgages were sometimes as high

[1] Jordan, D. F., Jordan on Investments, New York, 1942.

as 9%. Under the National Housing Act money could be borrowed for building purposes at the rate of 5%. Threatened with legislative action, the Canadian Life Insurance companies were forced to reduce the interest charged on policy loans.

In conjunction with this policy of reducing the interest rate, new government bonds offered to the public bore a much lower rate of interest than those being retired. In 1930 the average coupon interest rate on Dominion and Provincial direct bonded debt was 4.98%. When business revived in 1936, however, the financial advisors of the government ignored the original purpose of lowering the interest rate and, seeing that this policy had led to a greatly reduced fixed debt burden, they decided to continue the policy. In 1938 the average interest rate on direct governmental obligations was 3.86%. In early 1943 three Victory Loans were listed in the bond market, on which the interest rate was 3%. All three of these were selling above their maturity value, bringing the effective rate of interest below 3%. At the same time the coupon rate of interest on the majority of the outstanding Treasury Bonds of the United States was between 2 and 3%. In 1940 the effective rate of return obtainable from the purchase of United States Treasury Bonds of the longest maturity outstanding was 2.25%. From the viewpoint of the investor this is the most important rate in the money market, for it is the common denominator of all investment values. It provides a constant standard by which to judge the rental value of money.

As this policy continues and refunding operations replace maturing obligations with new bond issues at lower interest rates, the profitable employment of capital is becoming more and more difficult. Referring to the policy of depressing interest rates, the Honourable E. N. Rhodes, Minister of Finance, in his annual financial statement to the House of Commons of the Dominion of Canada in 1934, stated that "this (policy) would involve, what is too frequently overlooked, a reduction in payments to be made by, as well as to, Canadian creditor institutions such as insurance companies, mortgage companies, trust companies and banks." There is undoubtedly some truth in this statement. Canadian life insurance companies, however, are operated for the benefit of the policy holder, as well as the stock holder. Although the reduction in the national debt burden may produce a reduction in taxation, it is unlikely that such a redution would be proportional. Except in a period of low prices, then, either the policyholder, the stock holder, or both, must suffer. So far the government has shown no indication of varying its policy whether prices are high or low.

On the other hand, a rise in the interest rate might be fully as dangerous as, or even more dangerous than, a continuance of the present low rate of interest. Although the present level seems to be well established there is no assurance that future governmental action or, possibly, some unforeseen financial situation developing from the present

world conflict, will not raise the interest rate. It is only natural that, of two bonds having the same security, the one offering the greater rate of interest will be the one in greater demand on the open market. Corresponding to the difference in the rate of interest, then, there will be a difference in the market price. If the present low rates were to return to their previous levels, long-term bonds would lose about 25% of their market value. Such a price decline would be equivalent to the loss of approximately ten years' interest - a considerable sum for a large investor like an insurance company. Formerly it was the custom in a period of low interest rates to invest only in short-term obligations. In this way the investor was able to buy long-term obligations when the interest rates recovered from their unnatural depression, and so take full advantage of the money market. At any given time, the interest on short-term obligations is always less than that on the longer-term issues. If the present low interest rates are permanent, then, a continued policy of buying only short-term bonds would lose a great deal of money for the investor. If they are liable to change in the near future, however, it would be folly to buy long-term bonds. Thus, not being able to predict the future with any accuracy, the investor finds himself caught between two fires.

More and more investors have been turning to stocks as a solution to this problem. This is a logical procedure, because the rate of return on stocks is not fixed, but rather

fluctuates with the varying conditions of business in general. Thus, if the interest rate on bonds remains at its present low level, the investor will get the higher rate offered on stocks provided that the demand for stocks does not raise their price in the market and so lower the effective rate of return. On the other hand, should the bond interest rate rise, the dividend rate on stocks will rise proportionately and this increased yield will offset to a large extent the loss in market values of the low interest bearing bonds already in the possession of the investor. But what would happen if a severe depression depressed the dividend rate below the interest rate? Does the possibility of a higher return compensate for the greater risk involved? It is fairly well agreed among investors that larger investments in stocks are advisable if not necessary. The problem is - how far can an investor safely go in buying stocks? This question of safety is of utmost importance to life insurance companies, for the funds at their disposal for investment, coming chiefly from premium payments on policies, are of the nature of trust funds. New York State, recognizing this fact, does not allow life insurance companies registered in that state to invest in stocks. In Canada, before 1932, life insurance companies could buy unlimited quantities of stocks. After the unfortunate experience of the Sun Life Assurance Company, however, it was decided that some restriction was necessary. After much consultation, Dominion and Provincial insurance authorities

and representatives from the Canadian life insurance companies decided that an insurance company could not safely invest more than 15% of its total assets in stocks. When the Act of 1932 was read in the House of Commons there was much opposition to this provision, many members claiming that, if life insurance companies were to be allowed to invest in stocks at all, the amount of their investments should not be allowed to exceed 1%. It is highly doubtful, then, that our legislature would amend the Act even if the insurance companies thought it advisable. Recalling again the experience of the Sun Life and remembering that life insurance funds are of the nature of trust funds, it would seem that 15% is a fair figure beyond which it is unsafe to go.

Despite greatly increased business activity, taxes on corporations have so cut into income that dividends have had to be reduced. At the same time, however, increased personal income taxes and the issuance of several government bonds has so reduced purchasing power that the market prices of stocks have been reduced even more than the dividend rate. The present, then, is an excellent time to increase stock holdings. Some may condemn this point of view as unpatriotic. But with low market prices the only reasons for selling stocks are to pay taxes or to invest in Victory Bonds. In either case your money is going to the government as surely as if you, personally were buying a bond. Stocks thus bought will provide a higher yield than the bond, and will also prove to be a kind of safety

valve during post-war readjustments. The wise investor, then, should now be increasing his stock holdings.

GENERAL POLICY

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In a world of constantly shifting values the investment policy of Canadian life insurance companies has been kept as flexible as possible. In 1935, the general manager of the Northern Life Insurance Company of Canada suggested the following investment plan[1] -

First Mortgages		40.0%
Fixed Interest Bearing Securities		
Dominion Bonds	5.0%	
Provincial Bonds	7.5%	
Municipal Bonds	15.0%	
Public Utility and General Industrials	10.0%	
Industrial Bonds and Preferred Stocks	2.5%	40.0%
Common Stock		2.5%
Policy Loans and Real Estate		17.5%
		100.0%

At that time this division of investments was fairly close to that followed by the majority of companies. In the following years, however, heavy droughts and debt adjustment acts made necessary a sharp reduction in farm mortgages. Later the National Housing Act strengthened the mortgage field, slowing down but being unable to arrest the annual decrease in

[1] Geddes, G. W., "An Investment Plan for Life Insurance Companies The Proceedings of the Insurance Institute of Toronto, 1934-35.

mortgages held by insurance companies.

The coming of World War II greatly unsettled all investment policies. With the attendant prosperity the payment of mortgage interest and principal has been unusually rapid. Municipal governments have reduced their bonded debt by one-sixth. The Provinces are either reducing their debts or at least not increasing them to any extent. Along with these reductions have come several new Dominion issues, floated to aid in the prosecution of the war. With Dominion issues greatly increased and other fields greatly decreased, insurance companie had to turn to Dominion bonds for investment. For example, the Confederation Life Association, in 1942, made a net investment in the war bonds of Canada, Great Britain, and the United States of $12 millions, although its total assets only increased by $7.8 millions in the same period. This was made possible by reductions of $500,000. in Provincial bonds, $1,300,000. in municipal bonds, $900,000. in other bonds, $500,000. in policy loans, $250,000. in mortgages, and $200,000. in real estate. All Canadian life insurance companies have made similar changes in their investment portfolios. In all they have purchased in excess of $380 millions worth of Canadian Victory Bonds up to the beginning of 1943. This astronomical figure is the equivalent of around $113. for every insured person in Canada. This does not mean to imply that the change has been made purely from economic motives. All insurance companies have cooperated in every possible way with the

government in the war effort. One of their greatest contributi
has been in providing experienced salesmen to help in the Victo
Loan drives.

Along with this patriotic endeavour, however, it is only good business to look ahead and plan for the future. Financial developments in the post-war period remain a matter for conjecture. It is certain that there will be a great business expansion. The change from war production to a peace time economy, the reopening of some businesses temporarily closed down, and the development of new businesses springing from war time inventions and improvements will require huge sums of capital. Canadians will demand many products which they have been unable to procure during the war. Foreign trade will reach unprecedented heights. There has been so much destructior in war torn Europe that it will take some time before life will return to normal and industries are rebuilt. In the meantime, America will have to supply the commodities to satisfy the demands of the Europeans. To finance this expansion of business there will be large industrial bond issues offered on the market at attractive rates. At the same time Provincial and municipal governments will be floating new issues to finance the backlog of public works, the need for which has grown with every year. The Dominion government will also be demanding huge sums from investors in order to finance refunding operatior expand social legislation, and many post-war rehabilitation schemes. In the face of all this activity, will the government

be able to maintain the low interest rate, as it has so effectively for the past ten years? The demand for capital will be so great that it is highly probable that the government will be forced to offer higher interest rates to be able to compete in the open market with industrial concerns. An appeal to patriotism in a time of war always brings an immediate response. However, when the war is over, investors who have paid high taxes during war time are going to maximize their earnings regardless of any appeals. Then, although the government may be able to slow down to some extent any increase in the interest rate, it would appear that that rate will go up naturally through the interaction of supply and demand. Many people are expecting a great influx of British capital into Canada on the cessation of hostilities. The effect of this possible influx will depend on its size and hence is impossible to gauge at the present moment.

With these considerations, therefore, it would seem advisable for life insurance companies to increase their holdings of stocks to between 10 and 15% as protection against a possible, if not probable, rise in the interest rate. At the same time only bonds of relatively near maturities should be purchased. Then if the interest rate returns to its former level, these short-term bonds can be replaced at maturity by longer term bonds at the higher rate. Whether the interest rate increases or not, selected stocks can be purchased now at bargain prices which will undoubtedly appreciate in market value

during the post war period. If the interest rate remains constant, these stocks will provide an additional income which will counteract the loss in interest due to the holding of short-term bonds. If, as appears likely, the rate increases, this additional income will counteract the loss on any long-term bonds which the company may be holding.

In the past life insurance companies have gained the reputation of being the most astute investors in the securities market. Now is the time for them to prove their astuteness. The experience of the Sun Life does not encourage the buying of stocks. But, with market conditions as they are today and the present statutory limitations, life insurance companies can greatly increase their revenue by increasing their holdings in common stocks.

APPENDIX I

The Investments of Canadian Life Insurance Companies, 1927-40

(Percentages of Total Assets)

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Year	Government Bonds	Municipal Bonds	Other Bonds	Mortgages	Preferred Stocks	Common Stocks	Policy Loans	Real Estate	Collateral Loans
1927	12.81	12.22	12.63	24.42	3.20	10.25	13.63	2.65	.03
1928	10.57	10.00	11.79	23.58	2.63	17.41	12.90	2.38	.03
1929	8.89	8.66	12.08	23.12	2.33	19.88	13.81	2.47	.04
1930	8.05	7.99	12.28	22.40	3.18	20.59	15.18	4.07	.05
1931	9.76	7.74	12.52	21.17	3.07	19.51	16.25	4.01	.02
1932	10.76	8.49	11.21	20.26	2.09	19.05	17.82	4.31	.01
1933	13.51	8.13	10.46	19.10	1.83	18.44	17.39	4.55	.01
1934	17.23	8.36	11.19	17.44	1.56	17.43	15.96	4.71	.01
1935	20.76	8.52	11.56	15.98	1.74	15.93	14.46	4.82	.04
1936	23.19	8.95	14.23	14.79	1.74	14.05	12.96	4.88	.01
1937	25.45	8.74	15.03	13.95	1.74	13.00	12.14	4.45	.04
1938	26.29	9.57	15.97	13.36	1.59	12.21	11.35	4.43	.01
1939	26.37	10.00	17.13	12.97	1.54	11.45	10.50	4.28	.01
1940	28.65	9.69	17.60	12.47	1.56	10.58	9.97	4.08	.00

APPENDIX II

The Canadian and British Insurance Companies Act

Section 63

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Save as hereinafter provided, any company registered under this Act may invest its funds, or any portion thereof, in the purchase of

(a) the debentures, bonds, stocks or other securities of or guaranteed by the Government of the Dominion of Canada or of or guaranteed by the Government of any province of Canada; or of or guaranteed by the Government of the United Kingdom of Great Britain and Northern Ireland, or of any Dominion, colony or dependency thereof; or of or guaranteed by the Government of any foreign country, or state forming a portion of such country; or of any municipal or school corporation in Canada, or elsewhere where the company is carrying on business; or guaranteed by any municipal corporation in Canada; or secured by rates or taxes, levied under the authority of any province of Canada on property situate in such province and collectible by the municipality in which such property is situate; or

(b) (1) the bonds of any corporation which bonds are fully secured by a mortgage or hypothec to a trustee upon real estate or upon the plant and equipment of such corporation used in the transaction of its business; or upon bonds, debentures or other evidences of indebtedness of stocks owned by such corporation of a class or classes authorized by this section

as investments of any company, and the inclusion as additional security in such mortgage or hypothec of any other assets not of a class authorized by this Act as investments of any company shall not be deemed to render ineligible such bonds as investment, or

(1-a) the bonds or debentures of any corporation which are secured by the assignment to a trust corporation in Canada of an annual payment which the Government of Canada has agreed to make, when such annual payment is in amounts sufficient to meet the interest falling due on the bonds or debentures outstanding and the principal amount of the said bonds or debentures maturing for payment in the year in which the annual payment is being made: or

(1-b) the bonds or debentures issued by any incorporated charitable, educational or philanthropic institution in respect of which bonds or debentures annual subsidies equal to the interest and sinking fund accruing on such bonds and debentures are, by virtue of any general or private Act of any province of Canada heretofore passed, payable by or under the authority of such province to a trust company as trustee for the holders of such bonds or debentures: or

(1-c) the debentures, debenture stock or other evidences of indebtedness of any corporation which are fully secured by statutory charge upon real estate or upon plant and equipment of such corporation used in the transaction of its business, provided interest in full shall have been paid regularly for a

period of at least ten years immediately preceding the date of investment in such debentures, debenture stock or other evidences of indebtedness upon the securities of that class of the corporation then outstanding; or the bonds or other evidences of indebtedness of such corporation which are fully secured by mortgage or hypothec to a trustee of securities of the class hereinbefore in this sub-paragraph first mentioned; or

(1-d) equipment trust obligations or certificates issued to finance the purchase of transportation equipment for a railway company incorporated by or under the authority of an Act of the Parliament of Canada or of the Legislature of any province, or for a railway company owned or controlled by a railway company so incorporated which obligations or certificates are fully secured by an assignment of the transportation equipment to, or by the ownership thereof by, a trustee, and by a lease, or conditional sale, thereof to the railway company so incorporated; or

(1-e) bonds, debentures or other evidences of indebtedness issued by an authority constituted by Act of the Parliament of the United Kingdom of Great Britain and Northern Ireland or of any British Dominion and responsible to such Government of such Kingdom or Dominion or to any Minister of such Government, or to a body so responsible, with power to administer or regulate the administration of any port or harbour or system of transport or to distribute or regulate the distribution of electricity, water or gas, and to levy, impose or make taxes,

rates, fees or other charges fixed or authorized by the said Parliament or subject to the approval of the said Government or Minister or of a body responsible to said Government or Minister; or

(11) the debentures or other evidences of indebtedness of any corporation which has paid regular dividends on its preferred or on its common stocks for a term of at least five years immediately preceding the date of investment in such debentures or evidences of indebtedness, or

(111) the preferred stock of any corporation which has paid regular dividends upon such stocks, or upon its other preferred stocks ranking equally therewith or upon its common stocks, for not less than five years preceding the purchase of such preferred stocks, or

(1V) the stocks of any corporation which are guaranteed by a corporation which has paid regular dividends upon its preferred or common stocks for not less than five years precedin the purchase of such guaranteed stocks; provided that the amount of stocks so guaranteed is not in excess of fifty per cent of the amount of the preferred or common stocks, as the case may be, of the guaranteeing corporation, or

(V) the common stocks of any corporation upon which regular dividends of at least four per cent per annum or, in the case of stocks with no par value, of at least four dollars per share per annum have been paid for the seven years next preceding the purchase of such stocks; Provided that not more than thirty

per cent of the total issue of the stocks of any corporation shall be purchased by any company, and that no company shall be permitted to invest in its own shares nor shall any company registered to transact the business of life insurance be permitted to invest its life insurance funds in the shares of any company which transacts the business of life insurance; Provided further that if any such corporation has, pursuant to a voluntary reorganization of its capital account and without affecting the status or diminishing the value of its outstanding securities including the capital stock, substituted common shares of no par value for shares of par value, then dividends declared on the said no par value stock shall be deemed to be dividends of at least four dollars per share per annum if the sum thereof is equivalent to at least four per cent of the said common stock of par value and the proceeds of any additional issue of common stock made at the time of, or subsequent to, the aforesaid substitution of shares; and in such circumstances dividends of at least four per cent per annum on the common stock of par value immediately preceding the substitution shall be regarded as dividends on the no par value stock; or

(c) ground rents, mortgages or hypothecs on real estate in Canada, or elsewhere where the company is carrying on its business, provided that the amount paid for any such mortgage or hypothec shall in no case exceed sixty per cent of the value

of the real estate covered thereby; or

(d) life insurance policies issued by the company or by any other company registered to transact the business of life insurance in Canada subject to the provisions of subsection nine of this section.

2. Any such company may lend its funds or any portion thereof on the security of

(a)any of the bonds, debentures, stocks or other securities in which any company may invest its funds under the provisions of the next preceding subsection; Provided, however, that the amount loaned on the security thereof together with the amount invested therein shall not exceed in the aggregate the amount which might be invested therein under the provisions of this section; or

(b)real estate or lease holds for a term or terms of years or other estate or interest therein in Canada or elsewhere where the company is carrying on business; Provided, however, that no such loan shall exceed sixty per cent of the value of real estate or interest therein which forms the security for such loan, but this proviso shall not be deemed to prohibit a company from accepting as part payment for real estate sold by it, a mortgage or hypothec thereon for more than sixty per cent of the sale price of such real estate.

3. The Treasury Board may authorize the acceptance by any company of bonds, stocks or debentures, not fulfilling the foregoing requirements of this section

(a) in payment or part payment for securities sold by the company; or

(b) obtained under a bona fide arrangement for the reorganization of a corporation whose securities were previously owned by the company, or for the amalgamation with another corporation of the corporation whose securities were so owned;

but the bonds, stocks or debentures whose acceptance is so authorized shall be absolutely sold and disposed of within five years after the acquisition thereof, or within such further time as the Governor in Council shall on the report of the Minister fix and determine, unless it can be shown to the satisfaction of the Minister that the bonds, stocks or debentures whose acceptance is so authorized are not inferior in status or value to the securities for which they have been substituted.

4. For the purpose of determining the eligibility as investment under this section of the preferred or common stocks of any corporation, the capital account of which has been voluntarily reorganized without impairment of the status or value of its outstanding securities, including the capital stock, dividends paid on the preferred and common stocks of the corparation before such reorganization may be counted as dividends paid on such stocks respectively of the corporation.

5. No such company shall lend any of its funds to any director or officer thereof or to the wife or any child of such director or officer except on the security of the company's own policies; nor shall any such company lend any of its funds to any corporati

if more than one half of the shares of the capital stock of the said corporation are owned by any director or officer of the wife or any child of any director or officer of such company, or by any combination of such persons;

(5a) No such company shall invest any of its funds in bonds, debentures or other evidences of indebtedness on which payment of principal or interest is in default.

6. Except as hereinafter provided, the total book value of the investments of any such company in common stock shall not exceed fifteen per centum of the book value of the total ledger assets of the company.

7. If any such company has on hand, at the date of coming into force of this subsection, investments in common stock of a total book value in excess of fifteen per centum of the book value of the total ledger assets of such company at the said date, the provisions of the last preceding subsection shall not apply to such company until the first day of January following the year in which the amount of the said investments is first reduced to fifteen per centum or less of the total ledger assets of such company, and on and after the said date the said provisions shall apply, but until the said date no investment in common stocks shall be made by such Company.

8. The amount or value of shares of common stock acquired after the coming into force of this and the two next preceding subsections of this section by any such company as bonuses or dividends on preferred or common stocks shall not be deemed

to be an investment in common stocks for the purposes of the two next preceding subsections.

9. Notwithstanding the foregoing provisions of this section, no company other than a company registered to transact the business of life insurance, may invest or lend its funds or any portion thereof in the purchase of, or on the security of policies of life insurance.

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