Canada’s Life Co’s are the Best Way to Play Rising Rates

Description

Bond yields have been stirring of late as the yield on the 10-year U.S. Treasury has lifted from 1.70% at the end of April to its current mark in the 2.20% range.

There is a collection of stocks on the Canadian market that is poised to do very well should this move continue. And, even if rates don’t move higher today or tomorrow, over the medium- to long-term there is really only one direction that they can go.

The Canadian life co’s, which include the likes of **Manulife** (TSX:MFC), **Sunlife** (TSX:SLF) and **Great-West Life** (TSX:GWO), and even Great-West’s parents, **Power Corp.** (TSX:POW) and **Power Financial** (TSX:PWF), stand to benefit from this inevitable rise. Here’s why…..

Profits up, book value up, stock price up

The reason is two-pronged. Life insurance companies are huge owners of fixed income securities, which they use to match their long-life liability profiles. Their profitability has been hindered in recent years as bonds that had been yielding, say, 5% matured and the proceeds had to be re-invested into bonds that yielded, say, 3%. Should rates rise, the proceeds from these 3% bonds will be reinvested at a more attractive rate as they mature. This is good for interest income and good for the bottom line.

The other prong is more complicated.

For accounting purposes, life co’s must calculate the present value of their long-life liabilities on a quarterly basis to carry them on their balance sheet. To calculate this present value, a discount rate that is tied to current bond yields is utilized. When bond yields are low, the discount rate is low, and therefore the denominator in the present value calculation is low. This causes liabilities to be high, and impacts the equity value of these companies (Assets – Liabilities = Equity). As bond yields rise, liabilities will shrink and book value (shareholder’s equity) will benefit.

The Foolish Bottom Line

Combine the increased profits associated with rising yields and a shrinking liability profile, along with all the other good things that these companies have going for them (ageing demographic, int'l expansion) and you've got yourself a nice little recipe for a solid long-term return. Plus, all 3 pay a nice dividend to boot!

The Canadian life co's are 3 of this country's finest businesses. The Motley Fool's Special Free Report "**3 U.S. Companies That Every Canadian Should Own**" profiles 3 of the best that our neighbour to the south has to offer. To download this report at no charge, simply **click here**.

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Fool contributor Iain Butler owns shares of Sunlife Financial. The Motley Fool has no position in any stocks mentioned at this time

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:GWO (Great-West Lifeco Inc.)
2. TSX:MFC (Manulife Financial Corporation)
3. TSX:POW (Power Corporation of Canada)
4. TSX:SLF (Sun Life Financial Inc.)

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