



Why Manulife Financial Corp. Is the Best Way to Profit From Rising Rates

Description

With the Canadian overnight interest rates having held steady at 1% since 2010, and the 10-year Government of Canada bond yield hovering at 2.28%, there has been increasing questions as to how long these historically low interest rates can last.

Interest rates cannot stay low forever, and it seems inevitable that they will eventually rise. The inflation rate and economic growth are key factors that determine interest rates, and with Canada's core inflation rate surging to 2.1% from 1.7% in July, a significant increase above economists' estimates of 1.8%, there is a possibility that the Bank of Canada may shorten its estimates as to when interest rates will rise.

The question for investors is how best to play this coming rise in rates. Financials and life insurers typically benefit most from interest rate increases. Within the life insurance sector, **Manulife Financial Corp.** ([TSX: MFC](#))([NYSE: MFC](#)) is poised to benefit most relative to its competitors. Here's why.

Insurance companies profit when rates rise

Life insurance companies are typically strong beneficiaries of rising rates. This is due to the fact that insurers make money in two ways. The first is underwriting income, whereby the insurer collects premiums and then pays out claims and expenses. When the premiums exceed the claims and expenses, the insurer profits.

The second way insurers make money is on investment income. Since claims are not all paid at once, insurers invest the money until it is needed. The returns on these investments are then used to offset the costs of claims, and to earn a profit.

Insurance profits are directly connected to investment returns, and on years with high investment returns, insurers have simply had to charge enough premiums to pay for claims and expenses, with profits being earned entirely from investment returns.

In Canada, an average of three quarters of insurers' investments are being held in government bonds, and therefore low interest rates mean low profits, since insurers are generating much lower returns

from investments.

Manulife is set to outperform its peers when rates rise

Why is Manulife better poised to benefit from these increases than, say, **Sun Life Financial Inc.** ([TSX: SLF](#))([NYSE: SLF](#))? It is due to Manulife's interest rate sensitivity; a result of its product mix.

In one study by Cannacord Genuity, Manulife was compared to Sun Life on how they react to interest rate increases, and the study found that a 100 basis point increase in the U.S 10-year treasury bond would result in four times more upside for Manulife's stock price versus Sun Life's stock price, with 50% upside for Manulife versus 13% for Sun Life.

This same study noted that Manulife and Sun Life have the same downside risk to a 50 basis point decline in bond yields. This implies that Manulife's interest rate sensitivity has a far better risk/reward ratio than Sun Life's and is therefore a better play on inevitable rises.

In Manulife's recent Q2 2014 report, it stated that this 100 basis point increase in rates would translate into a roughly \$100 million addition to annual net income.

An additional study by Desjardins Securities examining the correlation between bond yields and stock prices and comparing Manulife, Sun Life, and **Great-West Lifeco Inc.** ([TSX: GWO](#)) found similar results. It stated that every 10 basis point movement in bond yield would result in a corresponding 3.9% move for Manulife, 2.8% for Sun Life, and 1.5 for Great West, which shows clearly that Manulife offers better opportunity for returns in a rising rate environment.

Investors should consider Manulife not only as a play on higher interest rates due to its greater sensitivity, but also because it is a quality company. With a P/E ratio lower than its competitors', strong free cash flow, excellent capitalization, and a recent dividend hike of 19% in Q2, Manulife is well positioned for success.

CATEGORY

1. Investing

TICKERS GLOBAL

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

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