Why Sun Life Financial Inc. Is the Safest Play on Canadian Insurance

Description

For Canadians seeking an alternative to the big banks within the financial sector, Canada's insurers are always a wise choice. Although the economic picture for insurers isn't ideal now, there are numerous long-term macro trends that are incredibly favorable.

With baby boomers aging, there are poised to be huge increases in demand for retirement products, as well as health benefits. The recent downloading of responsibility for retirement and benefits from governments and employers to employees will only further accelerate this demand.

However, with the Bank of Canada recently reducing the overnight interest rate to a meager 0.75%, and memories still fresh of Canadian insurance stocks plummeting during the recession due to excessive exposure to equity markets, investors may be wondering how to best capture the potential growth for this sector, while minimizing their risk.

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Fortunately, not all insurers have equal risk profiles, and for investors seeking to minimize risk while maximizing returns, **Sun Life Financial Inc.** (TSX:SLF)(NYSE:SLF) is a much safer bet then its largest competitor, **Manulife Financial Corp.** (TSX:MFC)(NYSE:MFC).

Sun Life has less interest rate sensitivity

For better or for worse, insurance companies have revenues that are highly sensitive to interest rates. Insurance companies make money largely through two separate streams — underwriting and investment income.

Underwriting refers to the traditional business of charging premiums, and then paying out expenses to policyholders. However, since there is often a lag time between when premiums are received and expenses are paid out, insurers invest the premium income in bond and equity markets, earning a return.

These returns enhance insurer earnings, and allow them to decrease the prices of policies. When interest rates are weak, however, insurers not only suffer from weaker earnings due to less investment income, but also may need to raise prices on policies to ensure liabilities are properly funded. This can in turn restrict sales.

Fortunately, insurance companies can reduce exposure to interest rates by making sure they match the duration of their assets with the long-term nature of their liabilities, as well as through hedging strategies. Sun Life has excelled at this in relation to Manulife.

In Q3 2014, Sun Life estimates that a 100 basis point decrease would result in a $300 million reduction in net income (58% of net income), compared to $700 million (63% of net income) for Manulife. The same decrease would also only reduce Sun Life's MCCSR by 6%, while reducing Manulife's by 16%

Sun Life has lower equity price sensitivity

Sun Life also has a much lower sensitivity to equity price fluctuations than Manulife, and this is due to the fact that Sun Life has a much smaller annuity and segregated funds business. Annuities are retirement products that are relatively high risk for insurers, since they receive a premium today, and then guarantee minimum payments often for several decades. These payments are guaranteed regardless of what happens to interest rates and equity prices.

Insurers make money on these products through the spread between the rate of return guaranteed to policyholders, and the rate of return earned by the insurance company in the underlying fund. When equity markets fall, not only do insurers earn a smaller spread, but they are also still on the hook for the money guaranteed to policy holders. Insurers need to use their capital and reserves to absorb this risk, and as a result the annuity and segregated fund business is not only risky, but capital intensive.

Sun Life made a huge move to reduce exposure to these sorts of products, by recently selling its U.S. annuity unit for $1.35 billion. Of the insurers earnings, 40% were derived from products tied to volatile capital markets before the sale, and the company now has most of its revenue generated by much safer fee-based wealth management businesses, and underwriting.

The result? A 10% equity market decline would reduce net income by only $50 million for Sun Life, compared to a huge $480 million for Manulife.

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1. Bank Stocks
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3. Investing

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1. NYSE:MFC (Manulife Financial Corporation)
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3. TSX:SLF (Sun Life Financial Inc.)

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