Is Manulife Financial Corp. Still a Risky Investment?

Description

Manulife Financial Corp. (TSX:MFC)(NYSE:MFC) has a reputation as a stable, blue-chip Canadian financial corporation, but as shareholders during the recession of 2008 know, this can be dangerous assumption.

Due to Manulife's excessive exposure to equity markets through its large segregated funds business, Manulife realized a $3.7 billion charge on net income due to equity market losses, resulting in a net income of $517 million, down from $4.3 million in 2007. Shares declined 65% alongside earnings, and Manulife was required to obtain a $3 billion bank loan to shore up its reserves and maintain capital requirements.

Although Manulife has made huge improvements with regards to risk management, the company still has a fairly large exposure to equity markets. Is it still a risky play?

Why Manulife was at risk

Manulife's risk can be traced back to its very large variable annuity business. Variable annuities are often described as "mutual funds with an insurance wrapper," and this is due to the fact that these products allow policy holders to benefit from the upside of an equity investment, while retaining certain guarantees.

For example, a policyholder may contribute premiums to a variable annuity 10 years, and after the period is up, they receive a guaranteed minimum income for life based on the highest value of the account during the 10-year accumulation period.

The insurance company is required to pay out these guarantees, regardless of the underlying value of the fund which the premiums were invested in. These funds are also invested in fixed-income instruments, exposing them to interest rate risk, and as a result, when equity markets and interest rates drop (as they did in 2008), the value of Manulife's guarantees exceed its account values.

In 2008 Manulife's total funds for variable annuities were $76 billion, which was $26 billion less than the guarantees it had made, and this difference is attributed to falling equity markets and falling interest rates (which increased the value of Manulife’s liabilities relative to its assets).

Although these products were hugely profitable for Manulife leading up to the 2008 crash, the long-term guaranteed nature of these products, and the fact that Manulife had largely opted not to hedge its risk, made the company highly exposed to an equity market decline.

Manulife has reduced its risk

Fortunately, Manulife has made several moves to reduce its overall exposure to interest rates and equity markets. In 2009 the company began a hedging program, which offsets losses from downward movements in equity markets, and Manulife currently hedges all new variable annuity policies and is progressing towards a goal of ensuring two thirds of its variable annuity business is hedged.

These hedges are costly and reduce upside, meaning that Manulife will not benefit as much from rising equity markets or interest rates. This is a worthwhile trade-off for investors, since it prevents them from the type of catastrophic losses observed in 2008.

In addition, Manulife is also working to match the duration of its assets with its liabilities, which reduces the impact of low interest rates. Insurers’ liabilities are often long-term in nature, and when assets like bonds do not match the duration of the liabilities, it is possible that short-term bonds can mature, and the insurance company may need to purchase new bonds at a lower interest rate.

As a result of these activities, Manulife has reduced its interest rate and equity market risk. In 2014 a 10% decline in equity markets reduced Manulife’s earnings by $480 million, or about 13% of net income, compared with a $1.3 billion reduction in net income in 2011, which represented over 100% of net income.

Manulife has made significant progress in reducing its risk, and although it is still one of the riskier insurance plays in Canada, its strong growth profile makes it a worthwhile buy.

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