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Life Insurance – Where have the premiums gone?

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Concerns regarding the financial sector remain elevated. Market activity in 2009 has thus far been a nauseating experience, with the S&P declining 24% and the S&P/TSX down 15.5% on a year-to-date basis. The financial sector has been one of the weaker areas as there continues to be unease over capital sufficiency and sustainability of dividends, as well as concerns over earnings visibility given the combination of volatile markets and rising loan losses. Continuing its weak performance from last year, the S&P 500 Financial Index is has fallen 51.6% so far in 2009, while the Canadian sector is down 46.6% over the same period.

Hard to find refuge in this environment. Historically the insurance subsector has been a fairly sound safe haven during periods of economic turmoil. As previously published by Scotia Capital's Insurance Analyst Tom MacKinnon, "Over the last two recessions (2001, mid-1990 to early 1991), the lifecos and the P&C insurers outperformed the S&P500 by, on average, 6% and 13%, respectively...the lifecos and the P&C insurers significantly outpaced the S&P500 in terms of EPS growth, by, on average, 26% and 16%, respectively. The lifecos in particular have seen little slip in EPS growth in recessions." This economic downturn however, has demonstrated that no sector is immune to this severe case of deleveraging and resulting market collapse. The insurance sector has suffered just as much as any other industry from both an earnings and share price perspective; the S&P/TSX Insurance Index has fallen 43% year-to-date, while its peers south of the border are off 65.7% (based on the Dow Jones US Life Insurance Index).

The risk-reward proposition of life insurance stocks looks appealing. With dividend and earnings yields of life insurance companies well above the average seen over the last several years, one can argue that valuation and rational thinking has taken a back seat during recent trading activity. In our opinion, the lifeco stocks are reaching attractive levels that have already priced in a significant amount of risks associated with earnings and dividends. Although plenty of risks remain in the macro environment with the continued fallout of financials, uncertainty over automakers, and deteriorating corporate earnings, we believe these stocks represent excellent long-term investment opportunities. As Bear Stearns and Lehman Brothers have clearly demonstrated, anything can happen in the market place and these investments are not without risk; however, we would be comfortable gradually accumulating shares at current levels.

The topical issues weighing on the sector. We highlight some of the main concerns regarding these stocks and provide some opinions and/or facts that specifically address the issues.

1. Concerns of capital sufficiency remain a primary focus given exposure to equity markets.

- Canadian lifecos have progressively strengthened their capital positions over the past year. Current "Minimum Continuing Capital and Surplus Requirements" (MCCSR) ratios are well above historical trends and managements' preferred operating range (approximately 175%-200%). The performance of equity markets thus far in 2009 will likely have a negative impact on earnings (and thereby MCCSR ratio) this quarter but nonetheless, the degree of exposure appears manageable. The table below highlights the sensitivity of each company's MCCSR ratio to a 10% decline in equity markets. All else equal, it would take another material correction in the stock market for the Canadian lifecos to be forced to raise capital to shore up the MCCSR ratio.

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	Current MCCSR ratio	Sensitivity of 10% decline in equity markets (percentage points)
Sun Life (SLF)	232%	-3 to -5
Manulife (MFC)	233%	-20
Great-West Lifeco (GWO)	236%	-5
Industrial-Alliance (IAG)	200%	-14

Source: Company reports; Scotia Capital

2. Lifecos have become similar to a call option on the equity markets.

- With products such as variable annuities and segregated funds, Canadian lifecos' earnings have become much more susceptible to swings in equity markets. While these products generally represent longer-term liabilities that are due in 20-30 years time, the companies are required to take non-cash charges on their income statement in the interim to reflect changes in this liability. It is worth noting that there is no actual cash outlay related to these charges and when equity markets rebound, non-cash gains should be recorded on their income statement.
- Accordingly, the earnings power of life insurance companies are correlated with the performance of the stock market. Manulife's earnings are most levered to the performance of equities. On the other hand, Great-West Lifeco is the least sensitive to swings in the market, thereby making it the most defensive of the group. Given that the markets have already declined materially over the past year, and although we continue to wait for signs of a bottom, it can be argued that rewards are starting to outweigh risks in equity markets. Even if the market stabilized at current levels, the earnings visibility of the lifecos would drastically improve as these charges would no longer be a factor.

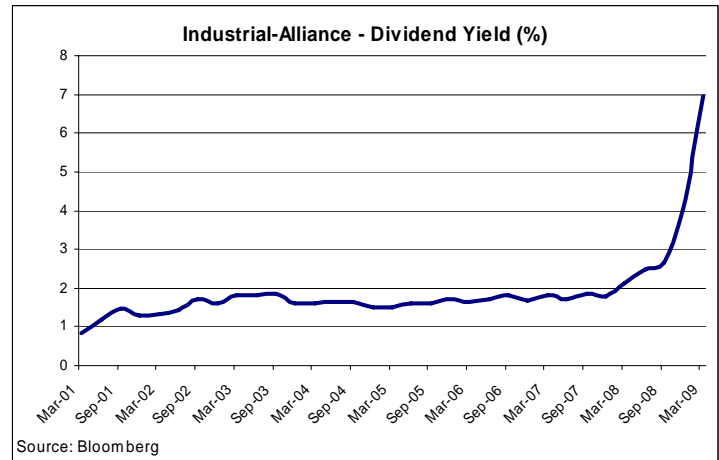
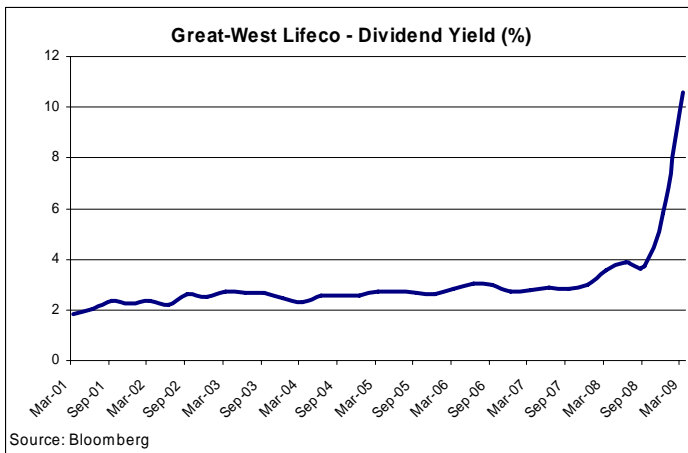
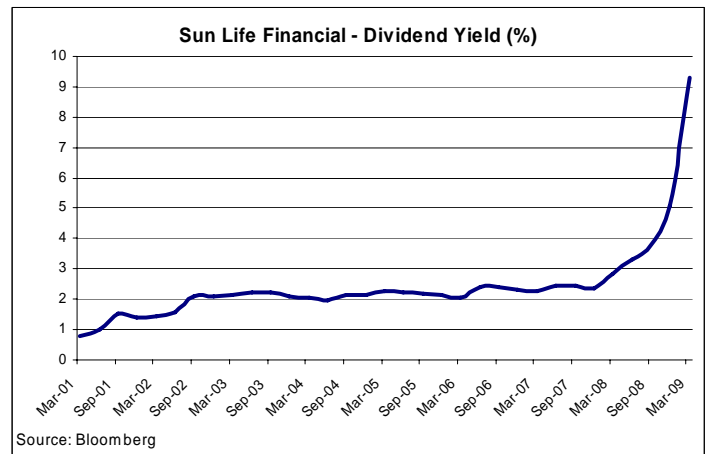
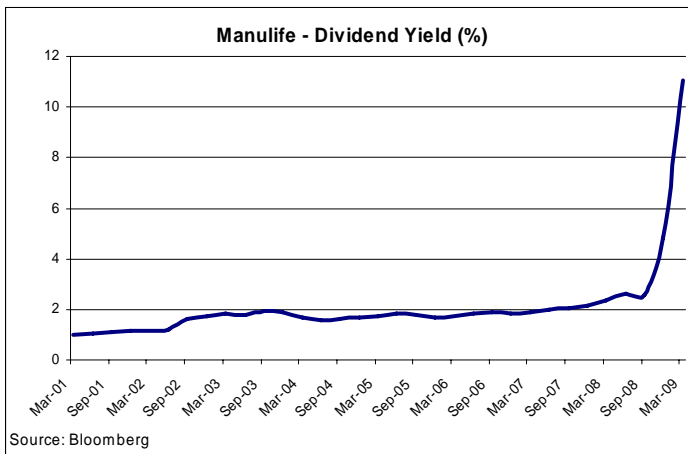
	Earnings sensitivity of 10% decline in equity markets
Sun Life (SLF)	(\$0.49) to (\$0.62)
Manulife (MFC)	(\$0.99)
Great-West Lifeco (GWO)	(\$0.18)
Industrial-Alliance (IAG)	(\$0.21)

Source: Company reports; Scotia Capital

3. Major lifecos in the U.S. have cut dividends and there are concerns Canadian counterparts could follow suit.

- Given the recent share price declines of the major Canadian life insurance companies, the market appears to be progressively pricing in the possibility of dividend cuts. Dividend yields of each major lifeco have reached all time highs and appear to be pricing in the possibility of even a 50% cut in the annual payout. While it is debatable the severity of the cut required, if any at all, we will leave that point for management and their respective boards to decide. The simple point is that the shares have arguably priced in some form of dividend cut.
- Also related to the concerns over dividend cuts, it is worth noting that such news has generally been well-received by the market recently. We would attribute this to a) alleviated concerns and more clarity on dividend policy, and b) preservation of cash helps to improve the company's balance sheet and provides companies with more breathing room in case of a prolonged economic downturn. Although we are not predicting this outcome, since the market has likely priced in some degree of dividend cuts at the Canadian lifecos, a reduction in the amount paid out to shareholders may not necessarily be received negatively.

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4. Potential acquisitions present a risk of dilution and added exposure to risky assets.

- A number of Canadian life insurance companies have been identified as potential bidders for various insurance assets rumoured to be up-for-sale. Manulife has been named as a potential buyer of various AIG assets in Asia while Sun Life is said to be reviewing assets of the struggling U.S.-based Hartford Financial. For the most part, a number of these possible acquisition opportunities represent sizeable distressed businesses. Accordingly, investors are concerned over possible equity issuances required to help fund a large acquisition (resulting in dilution and potentially over extending the balance sheet) as well as inherent risks that could come with distressed assets. While we concur that these are credible risks associated with any transaction, we highlight that management's experience and proven track record provides comfort in their ability to source attractive deals on reasonable terms. In fact, this could potentially prove to be a great opportunity for the Canadian lifecos to capitalize on an environment marked by motivated sellers of distressed businesses.

Summary

The share prices of Canadian life insurance companies have faced somewhat of a perfect storm in the face of negative sector sentiment, declining equity markets, and unease over sustainability of dividends. We are of the view that a significant portion of these risks are now reflected in current share prices. The stocks now offer a compelling risk-reward scenario and in our opinion, present good long term investment opportunities. For those seeking a high beta play to the market, we would select Manulife and for those with a more defensive/cautious view, we would recommend buying Great-West Lifeco.

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The stock is expected to outperform the average total return of the analyst's coverage universe by sector over the next 12 months.

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High

High financial and/or operational risk, low predictability of financial results, high stock volatility.

Caution Warranted

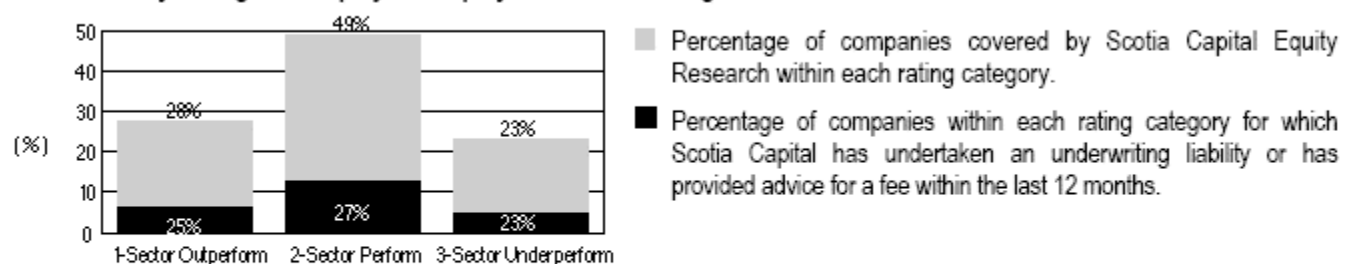
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