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Views On Major Multinationals

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Summary: This session presents analysts' views on major insurance multinationals. Participants gain insight into the way investment analysts look at large companies in determining their buy/sell recommendations.

MR. HUBERT B. MUELLER: The title of this session is "Views on Major Multinationals." In a nutshell, this session is intended to present analysts' views on how they look at major insurance companies worldwide. What we're hoping you will get out of this is a better understanding of the way analysts look at large insurance companies in determining buy and sell recommendations and in determining their ratings.

My name is Hubert Mueller. I am a principal in the Hartford office of Tillinghast. Our distinguished panel of financial analysts includes Rob Procter from Morgan Stanley, Julie Burke from Fitch and Tom MacKinnon from Scotia Capital.

Rob Procter is managing director and head of insurance research for Morgan Stanley in London. He heads the team responsible for identifying and researching investment opportunities among European and global insurance stocks for Morgan

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Stanley's institutional and retail clients. Prior to joining Morgan Stanley in 1997, Rob worked as an insurance analyst for four years with Robert Flames Securities and with Lehman Brothers. He's also an actuary. He became a Fellow of the Institute of Actuaries in the U.K. in 1992, while working with Bacon and Woodrow Actuarial Consultants. He then worked at Scottish Equitable as a pensions business actuary. In 2000 he was ranked second in the Institutional Investor Survey for coverage of the Pan European insurance sector. In the most recent global survey, he's actually *Institutional Investor's* top-ranked global insurance analyst.

MR. ROB PROCTER: I'm going to talk a little bit about how we see the shape of the global insurance industry and what we think the challenges are that face the key global players. Then I'll finish up with what we think might be the appropriate strategies looking forward to overcome some of these challenges.

The first point is that it always strikes me that the life insurance industry is far more local in nature than either non-life or reinsurance. We still find, particularly in Europe, and Europe is my area of specialty, that products, distribution mechanisms and tax regimes differ markedly in different markets. The extent to which companies have really garnered international synergies or cross-border synergies to date, I think, is really very, very limited. At the same time, the opportunity in the life insurance sector, and for this purpose we talk generically about life savings, pensions, etc., appears to be huge. In Europe, we talk about the need to save as never having been greater. The stepping back from providing pensions to the populations by governments and corporations is occurring. And in some markets, indeed, we see new tax breaks emerging, essentially, from the state to really try and encourage individuals to save more for their retirements. So, on the one hand, there appears to be quite a positive investment case here. There's a good top-line growth story for the life insurance industry, which I think is pretty much a global phenomenon.

On the other hand, the paradox from an investor's standpoint is, at the same time, that life insurance faces a number of challenges like never before. We would argue that the providers—that is, the life manufacturers, have less control or declining control of distribution. We've tended to regard the distribution as a key element in the value chain because, put simply, distributors are close. They have the proximity to the customer. Naturally, we see growing competition from banks and asset management-type firms. One of the solutions that some life companies have chosen to pursue is to seek mergers with banks. That is a strategy that I think is still hotly debated in terms of whether it makes sense, and I'll come back to that later on in the presentation.

I think there's a general feeling that the products the life industry offers, certainly in some markets, are perceived to have provided poor value for customers, which subjected customers to high costs and penalties in the contracts they've taken out. We've had in the U.K. market, for example, the pensions mis-selling scandal, which really negatively impacted the sentiment toward the sector. We have accounting changes that are coming in Europe. And then I think, lastly, the contrast I would draw between the European insurance industry and the U.S. insurance industry, in particular, is that Europeans have tended to be far more equities invested. And, of course, that has been a problem in the last two or three years with the declining value of equity markets. Suddenly, we've seen a situation where the insurance industry in Europe has really gone from being materially overcapitalized to the detriment of shareholder returns as recently as two or three years ago to today. I would argue that today we are in a situation of undercapitalization.

Thinking about a few of these issues in a little bit more depth, there is a quote taken from one of the major newspapers in the U.K. that argues that customers have been given a poor deal. They've suffered high charges. They've suffered penalties on contracts, which were not been explained properly by the adviser or the distributor that has sold them the life insurance contract. Clearly, there's a poor customer image of the life insurance industry, and there's a need to change, which I have to say the regulator in the U.K. market is addressing with vigor at the moment. But I think some of the issues he's trying to address, naturally, will become relevant in other European markets in due course.

Looking at capital, as I've said, we've argued that there's been a dramatic reduction in the level of capital of the European insurance industry in the past two or three years. What we're trying to look at for each company is what is a reasonable measure of excess capital. And to construct this measure we've looked at embedded value. I'll talk a little bit more about embedded value in a moment as being available capital, and, on the other hand, required capital being broadly 1.5 times statutory minimum requirements. That's statutory European minimum requirements, which broadly would be consistent with, say, an AA rating.

The message should be clear that there's a real bifurcation taking place in the sector between some companies, which appear to have still relatively adequate amounts of capital, on one hand and, on the other, some that appear to be particularly short of capital. I think that's a real issue as some of the other changes that I've mentioned, particularly accounting changes, become relevant, and I'll talk a little bit about that in a moment.

In fact, if we think about what is happening in the accounting world in Europe, we see a move toward international accounting standards by 2005. All listed European insurers will be required to report using international accounting standards. While we do not yet know what will fully be prescribed by this standard, the direction it appears to be going in is the so-called "fair-value approach." As an equity analyst, I think it's very difficult to say that that really means right now in terms of reserving, but a preliminary comment I would make is that some of the guarantees that European insurers, particularly continental European insurers, have provided their policyholders with over the years will likely have to be stochastically modeled, which will involve a cost for an additional reserve to be set up on the balance sheet in a way that point estimates or embedded value don't currently allow for. In short, this will mean that liabilities and assets will go up. Capital, therefore, will go down. But then not only will you have the equity effect placing downward pressures on shareholders funds, but you have this effect from the accounting change that is coming also creating pressure for the life industry.

Having said all of that, when we look at the valuation and we look at price to embedded value in Europe as being a key measure of assessing how cheap or expensive an insurance stock is, I would argue that the sectors actually held up relatively well or very well, in fact, given these concerns. We currently find European insurance universe trading at something like 1.5 times embedded value. When we look back at the range of embedded value, the price to embedded value over the past four years, we see, roughly speaking, a range between 1.2 and two times, so it's somewhere in the middle. But, arguably, the game has changed, and these new pressures that are coming to bear on insurance companies, perhaps, are not properly reflected in stock prices today. Indeed, we take quite a cautious view on life insurers in Europe right now, particularly in the U.K. and in the U.S.

Another difference between the U.S. and the European insurance industries, particularly to address the title of this session, is when we look at the multinationals that I follow in Europe; we find that they're really engaged in a number of different activities. We really have a different landscape in European insurance to U.S. insurance, where companies on the whole tend to be involved either in life insurance or property and casualty (P&C). Most companies in Europe tend to have both activities. It makes the investment or getting to the bottom of the investment case for an individual company more difficult. It makes finding pure plays on the reinsurance, or the non-life, theme, or the life theme, for that matter, quite difficult. In fact, you see for the top 10 or so companies by market capitalization in Europe, they all to a large extent are involved a variety of different activities, Swiss Re excepted, perhaps.

How does the industry go from here? I think that scale is a given, that companies must focus on growing their scale and lowering their unit costs. I think there is a need like never before to reduce internal costs in insurance businesses. I think mergers and acquisitions (M&A) activity may be a way forward, but I think what I would describe more as a restructuring focus, where insurance companies think about which business they're really in. What is their real core competency? Are they a manufacturer? Are they a distributor? Which markets do they have strong positions in? Which do they not have strong positions in? It's these sorts of considerations, I think, that will be dominant in terms of driving M&A looking forward.

I think the reality today is that very few companies focus on their customers—really think about what their customers want—and think about providing an excellent quality of service to customers. All the life companies talk about it; few, I think, are very good at it. And I'll show you in a moment that we think there's actually a direct correlation between the quality of customer service and, ultimately, the profitability of the business, which is important. And I think maybe looking for new great opportunities in emerging markets, for example, also, can be a way forward.

We conducted a survey recently among all the European and U.S. insurance companies in which we follow just to try and gauge how managements are thinking. Do they actually want to acquire or are they interested in M&A activity? We found that 62 percent, in fact, have a moderate or a high appetite for acquisitions or to engage in M&A activity. That's lower than last year. We conducted the same survey last year and I think the result was more like 75 percent. But, nonetheless, the appetite is still there.

As I said earlier, could bancassurance be the way forward? I think investor opinion and management opinion is extremely divided on this issue. As far as I can see, there is very little reason for a bank to contemplate buying an insurance business. On the other hand, for insurance manufacturing businesses that are, perhaps, trying to move into distribution, it may make sense for them to consider buying a bank in some situations. The obvious one in Europe that springs to mind from last year is in Germany where Allianz bought Dresdner Bank. In looking at the performance of the stock price since that deal was announced, you could be forgiven for thinking it's a complete disaster. But I think there is some merit to that transaction. I think, ultimately, that if the strategy here of providing a better quality of service to customers via multiple distribution channels can work, then maybe there is some value creation there. But, of course, at the same time from the insurance company's perspective, if you engage in that kind of transaction you are naturally exposing your shareholders to other types of risks, notably credit and investment banking risk, which obviously they didn't have before as holders of a pure insurance stock.

As I said, some evidence has passed that bancassurance is working. Fortis, for those of you who don't know, is a company that is based in the Benelux region. It's quite a large company. It's, I think, the 15^{th} largest financial institution in Europe on market capitalization, with something like $35 billion. It's really been one of the companies that has focused its strategy on bancassurance, on selling a wide range of financial products—insurance products, mutual funds, banks savings products—through multiple distribution channels, such as its bank outlets, brokers and agents.

What we find is that in the bank channel, in particular, where there's obvious ownership of that channel, when we look at the profitability of new life business sold through channel—and by new profitability we're looking at the embedded value measure—we find that the new business margin, as we define it, actually appears highest for that channel. So, perhaps, some evidence is there that this strategy does work.

As I said, customer service is an area in which few companies really focus today. I think at the end of the day this is still a very product-dominated or a product-focused business. I think there are some companies, but unhappily few, that have really turned that idea on its head and said, let's look at the whole business from the customer viewpoint and how can we provide a better service to the customer. Indeed, why should we provide a better service to the customer?

Financially you can show that there is logic in doing this. Chart 1 shows a correlation between the product density—the number of products you're selling to a customer—and the new business margin. Clearly, for those that have managed to increase their product density to above, let's say, the traditional 1.5 products for an insurance enterprise to, let' s say, three, four or five products to the customer by selling a range of different types of financial service products, we've seen a clear uplift in terms of new business margins. So, yes, there's a financial uplift here. This is an area more companies should be thinking about, and we expect to see it.

Finally, I want to mention some growth opportunities. We see an increasing interest from all insurance businesses to focus on the emerging markets. There are huge opportunities afforded by the Asian markets and some new markets really just beginning, such as in China, which has great potential for the longer term.

In terms of how we look at these opportunities or how we value these opportunities today, one example that I would cite would be Prudential U.K. It only ventured into the Asian markets less than 10 years ago and is now doing like something like 50 percent of its total premiums and more than 50 percent of its total new business profits from that part of the world. In terms of the way that analysts look at this business, using the conventional thinking that we should value a life company at embedded value, plus some multiple of new business profits that reflects the underlying growth or the expected growth in the future of that business, we actually value Prudential's Asian operation. It's something over four times embedded value compared to about 1.5 times for the European insurance sector as a whole. I suspect that if we were to look at a similar kind of valuation methodology for AIG's business, for example, we would be using similar metrics. And it does have an impact on valuation.

My final point is on the U.K. life insurance stocks and it's the idea that you can show high or new business profits as a percentage of your embedded value, as Prudential does. Prudential does it largely because of its exposure to those Asian markets, then the market is prepared to afford you a higher price to embedded value, overall, for the stock.

MR. MUELLER: Julie Burke is a managing director in Fitch's North American Insurance Rating Group. Fitch is an international rating agency formed from a merger of Duff and Phelps and Fitch in June of 2000. Julie manages the insurance analytical staff in the Chicago office and is a member of the Insurance Ratings Committee there. She also has responsibility for coverage of life, health, annuity and property and casualty insurers. Before joining Fitch, she was a senior vice president and head of insurance analysis and research at ECR, which she joined in

1991 as an assistant vice president. Before joining ECR, she was with Duff and Phelps as well with the American National Bank and Trust Company of Chicago.

MS. JULIE A. BURKE: After hearing my co-panelists' biographies I've come to the realization that I'm probably the only non-actuary in the room. I want to provide some overview of how we're currently viewing the U.S. life insurance industry. The second thing I want to talk about is the idea that a company can't be a true multinational company unless it's participating in this market. And, finally, I've been assigned three companies to talk about, and I will do that at the end of the presentation.

We assigned a negative outlook on the life industry back in August 1998. What that really means is that downgrades are expected to outnumber upgrades. That outlook is still in place today. The key drivers back in '98 were intense competitive pressures from both inside and outside the industry; the shift to lower margin products, like variable annuities, mutual funds, and asset management; increased earnings volatility, somewhat coming from these newer products; and declining sustainable earnings and capital growth. In the mid- to late-'90s, a lot of the capital growth that companies were experiencing was really being driven from investment results. In the last couple of years, that's turned around a bit. The final driver was increased customer expectations. I think all of us are always looking now for 24/7 service, and I think the U.S. life insurance industry has never been particularly strong on the technology side. Those drivers, as we see it, are still in place today.

Downgrades continue to outnumber upgrades. What we see is that most of the downgrades tend to be driven by operating performance, whereas upgrades tend to be more driven by transactions, such as when a stronger company buys a weaker company and the weaker company gets upgraded to something near or, perhaps, at the purchasing company's rating.

Forgetting about the doom and gloom, we should also point out that this industry remains very, very strong. Our average insurer financial strength rating in this market is somewhere between AA and AA minus, which is much higher than other financial services providers, like banks, mutual funds, asset managers, finance companies, and so on.

I want to talk a little bit about some of the things we're looking at as we're doing our 2002 company reviews. The first comment is on corporate activity. We do expect M&A activity to pick up somewhat. We had a very slow 2001. I guess the only real major transaction was AIG's purchase of American General. We do expect over the long-term that there will be continued consolidation down to a fewer number of players. We believe that the financial services modernization impact will continue to remain somewhat moderate. We haven't really seen a major kind of convergence-type transaction. We had the Citigroup thing prior to the legislation being put in place.

Demutualized companies need to gain traction or else. What we mean is that most of these companies had a five-year protection period. As time goes on and they move closer to the end of that protection period, these companies really need to get their earnings up to public company-type levels in order to stay independent.

The small and middle mutual companies have a challenge. What we're referring to is that we've questioned the long-term viability of some of those small to mid-sized mutual companies. The typical profile there is that they've got very strong relative capital, but not a lot of momentum on the sales and on the growth side. We're always asking ourselves what's going to be the trigger for some of these companies to get together, and we just haven't seen it happen yet.

Another thing to watch in 2002 is the post-Enron environment. Even though Enron wasn't a life insurance company, I think it sent shock waves through all the capital markets and all the companies. Some of the things we're seeing are improved disclosure and transparency. We saw that in the 10K's that were released in March. Companies are providing more detail and analyst supplements. Also, we're noting a more challenging audit environment and regulatory scrutiny. This probably isn't a big surprise. A lot of the auditors look at what happened to their compatriot, Arthur Andersen, and say that could have been us, so I think the auditors are getting a lot tougher.

We're hearing on the regulatory side that it's just very difficult to get anything approved by the SEC. A lot of these capital market offerings are being delayed and delayed because the SEC is really making sure that every t is crossed and every i is dotted.

We are seeing, we think, better governance. Boards of directors are certainly more engaged in the business. Enron for them was a wake-up call in terms of what their responsibilities are. There is more risk management within companies. Companies are taking a second look at their internal control systems. They're looking at things like enterprise risk management and value-at-risk and those sorts of things. I think what we'll see going forward, and I think we've already seen it in our own rating business, is that entities like the SEC, auditors, regulators, rating agencies and stock analysts are probably going to be a little more conservative and not be so willing to give management the benefit of the doubt.

The third thing to watch in 2002 is tough credit markets. Last year was the worst credit market we've had since 1990. There was a 13 percent high-yield default rate. In a downward migration within portfolios, even within the investment grade portion, there was a big migration from the single-A category to the BBB category. We do expect elevated losses through the first half of 2002, and certainly we are seeing it. Fitch expects that to tail off somewhat in the second half, but the full-year default projection is 6 percent. So it's still a tough credit market ahead relative to what we had seen several years ago.

Spread compression is a big concern of ours and another thing to watch in 2002, particularly for fixed annuities writers and UL writers. We had 11 Fed rate cuts last year. Interest rates are at a 40-year low. Companies with their spreads start bumping up into the minimum crediting rate guarantees. The big question we have is, will companies stretch for rates, whether that be duration or credit quality? If the past is any history, the answer to that is probably yes, so that's something we're obviously keeping a close eye on.

Another thing to watch in 2002 are variable products, which are kind of interesting. When they really became popular in the early and mid-'90s, the thought was these are risk-free businesses. Our view has always been that these products have more risk than certainty something like risk-based capital (RBC) would charge for it. It's not your traditional insurance risk, where it's underwriting and investment risk, but more I would say earnings volatility risk. We certainly saw that last year with lower-fee income from lower assets under management, increased reserving for minimum death benefit guarantees and income guarantees. And we also saw it with acceleration of deferred acquisition cost (DAC) write-offs. So we believe that there are risks in these products. They also, have thin margins relative to more traditional products and tend to be in more competitive environments. But the flip side is that variable products are here to stay. There's no doubt that the consumers like them. They like having some control over their retirement future, but we do expect the demand for these products to ebb and flow with the performance of the equity markets.

Further offloading of mortality risk is something else we'll watch in 2002. Currently, more than two-thirds of mortality risk written by direct writers is being reinsured. That's being driven primarily by this reinsurance arbitrage, the pricing difference between what direct writers are charging and what the reinsurers are charging. What this does for the direct writers is that it releases some capital that they can invest other places.

A couple of the interesting developments we've seen is on the securitization side and two kind of major transactions, Prudential and then Money Group, which I would say is more of a quasi-securitization, where they're issuing debt that is supported by cash flows coming off the closed block. That's a new thing, and we would expect other recently demutualized companies to probably look at that as well. What this does in their mind is it monetizes the closed block, and they can use those proceeds to do acquisitions and build up that ROE that I talked about earlier.

Another thing to watch is that we're certainly seeing a tougher financing and liquidity environment. Capital market access is more difficult, particularly for lower-rated credits. It's a difficult time to be short-term where you have refinancing risk because the capital markets are somewhat bumpy. Also, the banks are just much tougher in terms of what they're willing to lend and the terms they're willing to lend at.

A big concern we have are these triggers, oftentimes rating triggers that are sometimes within debt contracts and sometimes within insurance contracts. That's one of the things that really hurt Enron and led to their ultimate demise. So those are issues we're focusing a lot on.

The last thing I wanted to say on this topic is about further industry bifurcation. There are haves and have-nots in the U.S. market. We see the haves as companies that have scale, financial flexibility, access to capital and diversification. The have-nots are those companies that don't have those things. There is also the runoff of the traditional business. Our view is that the stable, predictable business is somewhat being replaced by business that's of a lesser quality, at least from a credit perspective in terms of predictability, stability and earnings.

As for investment in infrastructure, we think scale is really important. Technology is not cheap, and so those companies that are the haves will have the resources to build that infrastructure. Leverage continues to increase, and this is primarily financial leverage being driven by the demutualized companies, many of which had no debt leverage before, but are now building up their debt to public company-type debt levels.

In light of all the things we've talked about, is it still possible to have AAA life insurance companies? We certainly have a number of those. Our view is that, yes, it is possible for companies to have AAA profiles, but we think that it will become less frequent as time goes by because of all these issues that we've talked about.

I noticed in reading *U.S.A. Today* that there are only eight companies left in America that have AAA senior debt ratings, and AIG is one of them. I want to talk a little bit about their profile from a multinational perspective, some of the management fundamentals and what we see as rating drivers for this company.

AIG is a true multinational. They're in 130 countries, and they're pretty evenly split, with their insurance earnings about 50/50 between U.S. and foreign. It's also a true multi-line, although American General kind of pushes it more toward the life side. They're now about two-thirds life and one-third P&C in terms of insurance earnings. Their growth strategy, historically, has been built from the bottom up. They did that even in the U.S. in their domestic life business, their personal lines, P&C to a great degree, and also in a lot of their foreign operations. They had a little change in strategy, I think, in recent years with two major acquisitions, Sun America and American General. The company has a very strong brand internationally, probably stronger than it is here in the U.S. And they've been a real beneficiary of the flight to quality when there's trouble in the markets.

In terms of management fundamentals, this is a pretty unique company. They have a matrix management structure, whereby their business unit managers report up through their geographic head as well as the product head. I think that's pretty unusual, at least in insurance organizations. They have, obviously, the legendary

CEO. The thing we always hear from AIG people is that the best and worst thing about Greenberg is he probably knows more about your business than the person who's running the business knows about it. They have significant internal controls, and this from a credit perspective is one of their key strengths. They have a holding company infrastructure that looks at things like market risk, credit risk, reserving and actuarial issues that do not flow at all through the business unit. It's strictly at the holding company, so there's not really an opportunity for conflicts of interest with the business units. As a result, I think they have a lot of checks and balances and they very rarely are surprised by events. They've also had a long-term perspective.

As you probably know, their origins are in China. When communism came in there, they got wiped out, but they reentered or restarted talks with China back in the 1970s. It took several decades, but now that's bearing fruit for them. They also have a real performance culture. In other words, you either perform or you're gone. So it's a very intense organization.

Some of the rating drivers for this company are that they have real extraordinary operating results and a strong competitive position in most of their operations and diversification. They're not particularly capital rich. A lot of companies that have very high ratings get there by holding excess capital. This is not a company that does it, so they earn their ratings on operating performance. The key rating challenge for us, and I assume the other agencies, is the concept of how far you can stretch the AAA. They bought and they've entered a lot of businesses that are not AAA businesses and, also, businesses that have a lot more leverage than their traditional business does. So that's a challenge for rating agencies as far as stretching that AAA.

The second company to talk about is ING. ING is a company we rated AA+. They're in 65 countries. About half of their earnings, though, are from the Netherlands, their home country. They have a strong domestic and European franchise. They're about two-thirds in insurance in terms of their earning profile and one-third in banks. Europe dominates this company. Seventy-three percent of earnings are from Europe and 16 percent in the Americas, even though they've made significant acquisitions here. In the U.S. they've probably been among the most active and aggressive acquirers in recent years. It's a little bit different than earlier acquisition strategies, where I think they've tended to go in in a small way with a small position in a company, build confidence in it, and then, ultimately, own 100 percent. They also in the developing countries have more of a green field growth strategy, where they're building from the ground up, which has been successful. So they're doing green field, they're doing strategic alliances, and they're doing acquisitions. One of their key challenges is, I think, branding. They currently have 70 brands, which they're trying to bring down to one brand. I'm sure everyone's seen the television commercials that they've put out recently, so that's obviously a multi-year, multimillion-dollar-type endeavor.

In terms of management fundamentals, they have a unique governance structure. They have a supervisory board, which includes no one from the company. Then they have an executive board, which strictly consists of executives within the company. And then they have executive committees for each of their core regions—Europe, Americas, and Asia-Pacific. They're progressing to more of a centralized management style.

They have had some integration challenges here in the U.S. They took two big integration bites with Aetna and ReliaStar back-to-back. ReliaStar had a very negative surprise with the 9/11 tragedies: 525 million Euros of gross losses, although they had cat cover to absorb a lot of that. But, as a result, the company is exiting that business. They also have a renewed or new emphasis on synergy and expense cuts, because I think you could argue that they've been pretty slow in integrating the companies that they've bought.

In terms of rating drivers, this was a company we did have at AAA at one time and, as I said with AIG, this was a situation where they did have excess capital, which got them to the AAA level. With the two big U.S. acquisitions, they've spent their excess capital, so we adjusted the rating one notch. One of the things they've done is they've significantly increased performance targets, and I think this is to address some of the stock analysts' concerns about earnings. So there's been a lot going on with that company, and we're just going to watch and see how things progress.

The final company I have to talk about is Skandia Group. On our initial submission to the SOA, our rating was AA minus, and we lowered this rating, I think, the first week of May. But this is a company that has had a significant transformation of their business over the last 10 years. They've reinvented themselves. They exited P&C and reinsurance, what they would call risk businesses, and more recently exited asset management. They've moved to a single product focus—unit linked, or what we would call variable annuities. They're in 25 countries, but really only three companies really drive their business, the ones in the U.S., the U.K. and Sweden. They don't do acquisitions. They felt that they have a unique culture that can get diluted by acquiring someone else's culture. But they did have a bit of a change in orientation because they did make an acquisition in the U.K. very recently, a company called Bank Hall, which provides services to interfinancial associations. Their strategy is really an intermediary focus, where they serve as the go-between between fund managers and the ultimate distributors of the product, so they can argue that they don't compete with their customers.

In terms of management infrastructure, they have a model and an infrastructure that's maintained in Stockholm and then exported to each new country that they operate in. This corporate group serves as a resource for all the various units around the world, so the R&D is really done there and then exported. They do move people quite frequently between the operating units and the parent company, particularly when they're growing into a new region, again, to get that culture embedded in the new organization.

In terms of rating drivers, they've been a very innovative marketer. They were very early on with the multimanager projects and, first, with the bonus products. I would say they're a high beta company in that they're going to do well when markets are good and not so well when markets aren't doing so well. One of the challenges we had as a rating agency is, does geographic diversification mitigate a single product focus? The conclusion we've come to is, well, not really, because we are seeing growing correlation between capital markets as the world gets smaller and smaller. I will say, however, that they' have a lot more variability in their U.S. business than they have in either the U.K. or Sweden.

The other thing I'd say about them is that they're in these, as some people would say, non-risk businesses. As I said earlier, we think they are a little bit risky, but how much capital does a company hold for it? So that's a constant challenge in looking at this company.

MR. MUELLER: Our next speaker will be Tom McKinnon of Scotia Capital in Toronto. Tom is the top-ranked insurance analyst in Canada, according to a recent survey, and he has been covering the insurance industry there since its demutualization beginnings in 1998. Tom is also an actuary, and he joined Scotia Capital in mid-1998 from a role with Tillinghast in New York, so I do know Tom from before his time there, when he was a consultant in our New York office, specializing in the insurance sector and working on projects for about six years involving life insurance, product development, capital management, demutualizations and mergers and acquisitions. And prior to that, he also spent six years as an actuary with Canada Life.

MR. THOMAS G. MACKINNON: After about 12 years working as an actuary in life insurance, and six years at Canada Life, and then six years at Tillinghast in New York, I had decided in 1998 to move to back to Canada to cover the newly emerging Canadian insurance sector as all the companies were demutualizing. I thought it was an opportunity that I couldn't watch from the sidelines. It's been really exciting and challenging, and a lot of fun, but there are some noticeable differences I could share with you just from working as an actuary with a life insurance company or an actuary with an actuarial consultancy versus working as an equity analyst.

When you work as an actuary at a life insurance company, there's always a tremendous amount of detail that needs to be considered in developing a product, pricing a block of business or developing an appraisal value. They can take months to process the data and come up with a final answer, be it premiums for a thousand or the final appraisal value. Your constituents are always actuaries as well, and, as we know, when you're presenting detailed results to actuaries or you've processed a lot of data, the actuary's nature is then to challenge you as to whether, in fact, you processed the data correctly. Did you come up with the answer accurately? That's just generally their nature.

When you work as an equity analyst, obviously the details are important. But the amount of time you have to process the information isn't three weeks or three months; it's usually about three hours at the most. And, most importantly, you have to come up with a message.

What does that mean? We all know insurance companies are complicated financial institutions with a lot of moving parts. My job is to summarize the issues, be it the quarterly results, an acquisition, raising capital, or whatever, and present my view in less than one minute to institutional investors. That's the challenge and that's the exciting part of the job.

I'm going to present issues regarding the Canadian multinational life insurers. I'm going to start with a snapshot just generally of the Canadian life insurance companies and some issues they face. Then I'm going to look at internationalization and consolidation, looking at Canadian life companies, how they've expanded, and what are some of the recent transactions. I don't think we've really discussed much here in terms of current valuation measures, both for the sector in general, and for individual companies. And I'll finish off with a brief discussion on embedded values, since nearly all of the Canadian life companies, in addition to GAAP reporting, have now adopted embedded value reporting.

There are six stock Canadian life insurance companies. We have to cover the P&C companies as well, so that gives another two, maybe three, so we've got about eight or nine companies to cover there. The largest would be Manulife and Sun Life. Just to put it in perspective, their market caps are both $14 billion each. That's 30 percent higher than John Hancock's market cap or 70 percent higher than Lincoln's market cap, so these are not small and insignificant companies. And Sun Life's assets under management are about $260 billion, I guess, third behind Prudential and MetLife. So the total market cap of the Canadian life insurance stock companies is about a half of that in the Standard and Poor's (S&P) Life and Health Index. But to put that whole thing in perspective, the S&P 500 Life Health Index is less than 1 percent of the whole S&P 500. So among North American life companies, Manulife and Sun Life are about number four and five in market cap behind MetLife, which is about $22 billion, Prudential is at about $20 billion, and AFLAC is at $16 billion. The majority of the earnings of the Canadian life insurance companies comes from outside of Canada, so they are truly international life companies.

Just to touch quickly on the Canadian market, it's like the U.S. market. It's relatively mature. But unlike the U.S. market, it's much more saturated. For example, a top player in Canada in a certain segment might have about 15 percent market share, but a top player in the U.S. segment would probably have no more than 5 percent market share. So we've got six or seven players here with over 70 percent of the market share. In top-line growth, in terms of new sales or total premiums and deposits—really more on the insurance side—it's always been around 5-6 percent. We got a bit of a jump in 2001with universal life (UL), on variable-based UL products, but that was more of a one-off than we had seen last year. Just like in the U.S., new sales have come back down to lower single digits.

As a consequence of the market really being small, Canadians are generally overinsured in a limited number of tax vehicles. There's a limited amount you could put away in terms of tax-deferred vehicles in Canada. In the U.S., the variable annuity has unlimited amounts that you can put into it. There are limits on that in Canada, so, consequently, the Canadians have looked to expand internationally, and any global players in the Canadian market that don't have scale have exited the marketplace.

To underscore the internationalization of the Canadian life companies, the companies with the largest cap, Manulife and Sun Life, have the smallest percentage of their earnings from Canada. These companies have all been international for decades—for almost a century. Manulife has been in the U.S. and in Hong Kong each for over 100 years, so they're really developed international expertise. This isn't something they just recently decided to embark on. This is very important if you want to develop, especially in Asia where you need to develop distribution, which takes time.

Manulife is in the top 15 in the variable annuity market in the United States and in the top six in UL. In terms of the small- to mid-sized 401(k) market, they did have the largest number of sales in 2000 and 2001. They're number two in all of Asia-Pacific behind AIG. And they were the second life insurer ever to get a license in China, and they are the number one life retrocessionaire in North America as well. Sun Life is in the top 10 in both individual and fixed annuities in the United States and is in the top 10 in terms of mutual fund assets under management through its mutual fund subsidiary, Massachusetts Financial Services. So the scale that these companies have outside of Canada is not insignificant. I think the benefits of the internationalization here are primarily in the diversification of the earnings base and that provides stability and earnings growth going forward, which investors want.

Here are some recent examples of international expansion. In the fall of 2001, Sun Life purchased Keyport and the Independent Financial Marketing Group from Liberty. This moved them into the top 10 in both individual fixed and variable annuities in the U.S. And they've expanded in Sun Life and just recently got a license in China as well. Great West has beefed up its managed care operations in the U.S. by acquiring General American and All America's health care operations. Manulife purchased in the beginning of 2001 the defunct Japanese insurer, Daihyaku. And Sun Life continues to expand through its mutual fund's subsidiary, MFS, into Japan and Europe.

We have a laundry list of companies that have left Canada for the reasons I mentioned: saturated marketplace, competitive, no scale, go deploy your capital elsewhere. I could probably draw up one similar to the U.K. I have four that I just thought of during the presentation. Lincoln exiting U.K. MetLife pulling out of the

U.K. Sun Life pulling out, and Manulife. So I suspect we could start drawing a list of companies that may have started to pull out of this in the U.K., probably for some similar reasons. U.K. companies that have left Canada include Royal & Sun Alliance, Commercial Union and Prudential. European companies that have left Canada include AXA, ING, Zurich, and U.S. companies that have left Canada include MetLife, New York Life, Prudential, Aetna and American General. The only ones really still hanging around in Canada outside of the Canadian domestic ones are Hancock, through a subsidiary, Maritime Life, and AIG.

I wanted to mention a couple of merger and acquisition (M&A) transactions that they had there. Two were distressed companies, Crown Life and North American Life. The other two went for pretty good multiples, 2.3 times book. And it's not surprising that both Clarica and London Life had large career sales forces. So anybody with large career sales force companies is going to pay up for them. I think that, clearly, has become an asset. What we've noted too is that just in terms of net sales, if you've got a career sales force in these volatile equity markets, you've done a better job than all the other companies in terms of retaining clients. There are lots of blocks of business transactions here as well. We could probably have a long list of companies in the U.S. with similar things, but shedding off noncore businesses has been the recurring theme. If we look at Manulife, they got out of the U.K. in March of '95 and then got out of disability insurance. They're getting out of U.S. group insurance. In fact, the CEO has tombstones in his office of businesses he's divested because they never hit the internal company hurdle. But it's true that he did take a company that had 7 percent ROE in '94 and has brought it up to 16 percent ROE in 2002.

The Sun is another example. They kept pulling out of the trust business and getting rid of a casualty company in the U.S. They got rid of another trust company in the U.S., so they've been shedding off non-core businesses. I'm seeing transactions between banks and insurance companies as well. Banks were doing some more of this group pension administration and asset management business and selling that stuff off to the insurers because that was deemed to be non-core for the banks as well.

Clearly, internationalization is evident in every market. U.S. domestic stock insurers make up 21 percent of the market of U.S. individual insurance sales in 2000. Prudential is public now, so they're not in that mutual insurer category, but I think that brings the U.S. domestic stock life insurance companies up to maybe about 25 percent. International stock insurers make up 29 percent. We sort of threw AIG into the international stock life company. It's really more of a life company than a multiline and is more international than anything, so we put it in there. It's also not covered by any domestic U.S. stock insurance analysts or life companies. It's covered by more of the multi-line analysts as well. So we can see that there's a growing percentage for international stock life companies within the U.S. individual insurance marketplace. They're not insignificant.

We see the same with variable annuity sales as per Bard's. The international characters here, again, make up 36 percent of sales for 2000. U.S. financial service conglomerates are growing as well, with 10 percent market share. If we did this presentation another five or six years from now, I would expect that percentage to be considerably higher. The U.S. market is in no way dominated by U.S. domestic stock insurers. It's truly dominated by multinationals and the like.

I want to switch gears a bit and talk about valuation measures. One measure investors want to see is: how does the sector look? Before they start looking at companies, they want to see if the sector looks generally expensive or cheap. For this we look at P/E multiples, given the fact that life insurance companies have traditionally been lumped in with the interest-sensitives. They're in an interest-sensitive bucket, although I would argue that their earnings aren't necessarily interest-sensitive. They're still put in this interest-sensitive bucket along with other financials.

Obviously, if you have a P/E ratio of 13 times your forward earnings, it would look a lot more attractive in a 5 percent interest rate environment than it would in a 10 percent interest rate environment, given the interest-sensitivity bucket they've been lumped into. That's why we look at the P/E relative to the bond yield or, in this case, we've just taken the inverse of the P/E relative to the bond yield. Also, some investors like to compare. If they like financial services, they want to see if I would pick banks or life insurers at this point in time. So we'll look at that as well.

Obviously, within the sector, the P/E is important and the P/E relative to the growth is important. So, obviously, a 10 times company growing their earnings at five percent is not as attractive as a 10 times company growing their earnings at 15 percent. I also look at the price to book versus ROE. That produces an interesting and strong correlation. And then, finally, I'll touch on embedded value, since in addition to GAAP reporting, the Canadian life insurance companies have adopted embedded value reporting.

In determining the attractiveness of the sector, we look at the forward 12-month earnings yield to the 10-year U.S. Treasury yield (Chart 2). Effectively, we're looking at the relative spread of a life insurance stock versus a 10-year bond. The higher the spread, the more attractive the sector is. This is sort of like looking at stocks driving in the rear view mirror, but we said that any time that it got above one standard deviation above the mean, we'd go in and buy life insurance companies and sell the S&P 500. And then when it dropped down to one standard deviation below, do the opposite. We found out that, by and large, you would have outperformed the S&P 500 all the way through that timeframe by just playing that game. This is how this sector's P/E looks relative to the bond yield.

Based on that, we're neutral on the sector because the result comes in at or near the mean right now, which effectively tells us that we're neither over- nor underweight on the sector. And then given the fact that our economists are telling us that the U.S. 10-year Treasury bonds would be more than likely going up than down over the next 12 months, that would suggest that the sector is probably fairly valued and there's no real deep value in it.

If we look at the 12-month P/Es relative to banks, some people want to know if they should take life insurance companies over banks right now (Chart 3). What's the tradeoff? Life insurance companies have traditionally traded above the money center banks, which included J.P. Morgan Chase, Bank of America, and Citigroup. It dipped out in the end because the S&P ended up changing the bank index, and we lumped in more of the service banks, like Wells Fargo and the Bank of New York, that were trading at fairly high multiples, so it threw the argument out of whack. But if you make a comparison against money centers, despite the lower ROEs, generally, they did trade at a premium in terms of P/E, and that was largely due to the fact that they had more stability in their earnings.

Clearly, in Chart 4, the defensiveness as a sector shines here. Investors will pay a premium for something like this. They don't need to be woken up at night with real volatile earnings, earnings warnings and all that stuff. Give me something that's going to give me consistent earnings growth year in and year out. Hank Greenberg has one message for AIG: just grow your earnings at 15 percent. That's it. No other thing. And that's where they would trade. That's why the stock has consistently traded above its earnings growth rate. We found the same thing with the Canadian life insurance companies as well. More stability in their earnings versus the banks' commanded a premium.

Chart 5 is an interesting chart. You may have seen this kind of graph put together where you put price to book value on the Y-axis and the ROE on the X-axis and plot them. I'm using a logarithmic curve here. We found a very good fit. Effectively, it means that investors will pay more for a company with a higher ROE. It uses capital more effectively, so they'll pay a higher price to book multiple for it.

Now, we're all actuaries or are somewhat mathematically based, so we can break down Chart 6. On the Y-axis, it's price to book. On the X-axis, ROE is earnings over the book. Take the book value column in each of the X- and Y-axes, and this breaks down to price on the Y and earnings on the X. We can get the same correlation just charting that. So it really just comes back to say the P/E, in my opinion, is driving the stock price and driving the sector.

I'm going to finish up with a brief discussion on embedded value. I had issues with some of the current valuation measures and pushed for embedded value disclosure, in part, just because of my background. Just to focus on the earnings, the companies kept on telling us, "Everything we write is going to hit 15 percent of hurdle. That's the way you price everything." Well, how do we ever know that? We're never going to know that. Prove it to me. I think we can get that through at least the value of new business disclosure. Inconsistencies in DAC, amortization and its inconsistencies, and any other actuarial manipulation in the earnings didn't help in terms of comparability from earnings from one period to the next, nor comparability among companies. Finally, in terms of an acquisition, you really didn't have any idea of the company just because of that big multiple. Was it really adding value as a result of the acquisition? What was the price paid? If it was paid over the embedded value, what is the premium paid equal to the cost savings you expected to get?

I wanted to know these kinds of things, so I thought embedded value might help us. The Canadian Institute of Actuaries put an education note out in 2000 that described an embedded value reporting process. By end of 2000—in fact, in the first six months of 2001, the companies were producing year-end 2000 embedded value results. It's still in the early days, but I view this as just another tool in the toolbox of metrics to value a life insurer. The more you get in there, the more you don't have to rely on one versus the other. When you get a mix of valuation metrics, you can get a better picture of what really underscores the company.

As I said, we're just starting to get 2001 results, so it's interesting to see the movement from one year to the next. I think it's still in the early days, though, but to some extent, we've seen a higher price to embedded value multiple support a stock that would, traditionally, have a higher P/E multiple.

Around Christmas, Sun Life had said, "We're going to take over Clarica, and here's the price we're going to pay for it." It translated into a P/E multiple 14.4 times. It was not much above the group, and people said, "It's not enough. Someone else is going to come in. It's not a big enough premium." But I argued all along that this is a big premium because if you look at it on the price of embedded value, it's 15 percent premium to the group. This is a significant premium, and I don't think anybody else is going to step in. The thing closed yesterday and nobody else, of course, had stepped in, so that worked. The embedded value metric was the driver in terms of whether this was a fair price to pay for Clarica's business.

Let's look at a small cap company, Industrial Alliance. Traditionally, smaller cap insurers traded at discount, just for liquidity concerns. This one traded at a premium, 14.3, back in April, versus 14.1 for the group. People said that it didn't have a small-cap discount. And I said that if you look at the price on embedded value, it does. It's certainly trading at a much more attractive basis on an embedded value. Although it's the early days, I think it's worked its way, to some extent, into some of the valuation metrics of the Canadian life companies.

MR. JOHN TAYLOR: Across the board, it seems like two things are happening in our industry. One, we're moving out of life insurance into strictly investment operations to a great degree. Doesn't that change our structure from counter-cyclical to cyclical in the future? Also, with four different ways of measuring our results that seem to be on the horizon, does this, in effect, reduce the desirability of our companies to the investment bankers of the world?

MS. BURKE: Yes, I would agree that there is a shift away from what we think of as the traditional life insurance business into more broad financial services. That's part of the reason for the negative outlook on the industry and for the migration of ratings downward over the last 10 years or so. Our view is that we can't fault companies for doing it, because that's where the demand for products is. Life insurance, in and of itself, is a shrinking piece of the pie, so companies have to go where the market is. But from a credit perspective, those businesses are more cyclical, are more volatile and are less predictable than the traditional business. So we would certainly agree with your observations.

MR. PROCTER: I'll make some comments on the second question. It was a quite interesting one. From my perspective, the European insurance industry is fascinating in terms of valuation because every company reports earnings in a different way, which has never made life easy for analysts, investment bankers and companies assessing opportunities to buy other companies. That's really why the embedded value approach came about in Europe and perhaps ahead of North America, although we see it in Canada now. The interesting development in Europe is that the debate is moving on and analysts are actually questioning, and I've been questioning the embedded value approach itself. There are very different attitudes to this methodology in Europe versus the U.S., in particular. I've heard investors describe it as gain on the sale accounting because you basically recognize right up front the net present value of what you expect to realize in terms of cash flows. And those cash flows, themselves, may or may not materialize, depending on whether equity market returns are eight percent, bond yields are whatever and expenses are whatever. So I think there are question marks, even here. And I would also say that there is some criticism of the embedded value methodology, but it's not a real number. It's an accounting, and not a cash earnings measure, particularly for companies that are trying to manage capital in a scarcer capital environment. We see that particularly in Europe because of the degree of equity investment. It's perhaps not a great measure of those companies.

I hope that gives you some flavor of how we're thinking, but my view is as an analyst. You probably see far more detail as Tom alluded to because we have a very short space of time to go through numbers compared to the actuarial industry. But show me a perfect measure for valuing insurance companies. I share Tom's view that the more metrics we have, the better triangulation we have on value.

MR. MUELLER: Maybe just before Tom responds, also, if I could throw in a question. What does it take for embedded values to become more accepted in the U.S.?

MR. MACKINNON: Well, the first thing you said was about how the industry operates. Are we becoming more like phone companies? It's more cyclical. Even if an investor wants to buy a phone company, he could pay like 20 times earnings for T. Rowe Price. If you want to share in terms of an uptick in equity markets and take a company that's going to get a good portion of the uptick, and then if the things didn't look as good, it's not going to fall down as hard. You still get the play through an insurance company. If you pick up an insurance company at two-thirds of the multiple of a fund company, you'll get a sizable amount of the uptick, and you won't get crushed on the down spin. So I think in that regard, it's still a better play.

Then there is the subject of the four ways of producing results. I've always found it puzzling that retail stores would trade at higher multiples than insurance companies. I think it's because they can see the product. It's tangible, and they understand the rule that if you sell more shoes, you make more money. That's easy for them to figure out, so they put a big multiple on it. But they can't figure it out with insurance companies. And then they come out with even more confusing statements. From an analyst's perspective, we like to see a lot of disclosure, but I think from an investor's perspective, they don't like to see a lot of different numbers. They want to see one number, say, $0.48, and then they'll decide if it's good or bad. They don't like hearing, "Okay, it's $0.48, but if you back up this stuff, it's $0.54, and if you move this thing, it's $0.42. That becomes more of a confusing story. In the end, it provides our job with a better analysis, but it's still the nature of the business that because there are so many other intangibles on the balance sheet, these things are going to be difficult to value. But I applaud more disclosure rather than less.

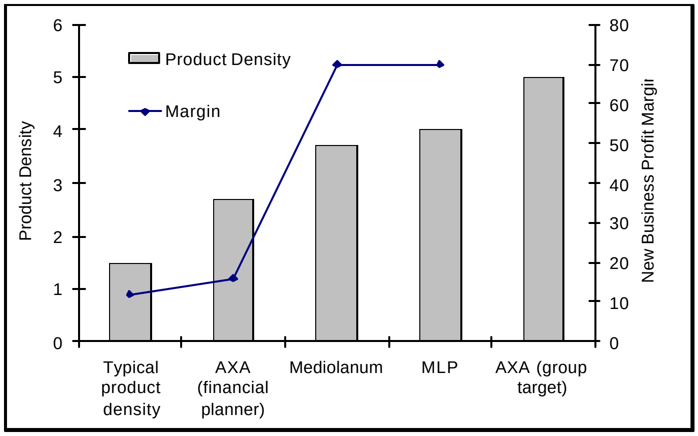
MR. CRAIG PICHETTE: In the last six months, we've seen two large European multinational insurers name Americans into CEO positions at Aegon and Zurich, which is historically an anomaly. Is there a message there about European management or American management?

MR. PROCTER: No. I know Aegon very well, and Aegon's unique because almost 70 percent of its earnings come from the U.S. life market and the U.S. life business. That's where all the acquisitions have been largely in the past 10 years that have created that profile today. It's just simply strange to find this company, frankly, domiciled in the Netherlands today. Aegon is a company that has a very tight executive board structure. They have had great consistency of the management team over time. And I think Shepard was the obvious guy to take over that mantle after a time. Zurich's a case I'm less familiar with, and it is a very different kind of an investment story, one that has struggled for various reasons. I think there, too, it was just the right person and the right place at the right time.

But I think to answer the question, specifically, is there a broader picture here? Yes. Any large European insurance company that has aspirations to being a global player must have a U.S. business. And the very largest companies recognize it. Management teams are becoming increasingly international, and there's absolutely no reason why an American CEO shouldn't be appointed to any of these companies.

Chart 1

A Clear Link Between Product Density and New Business Profitability....



Source: Fortis

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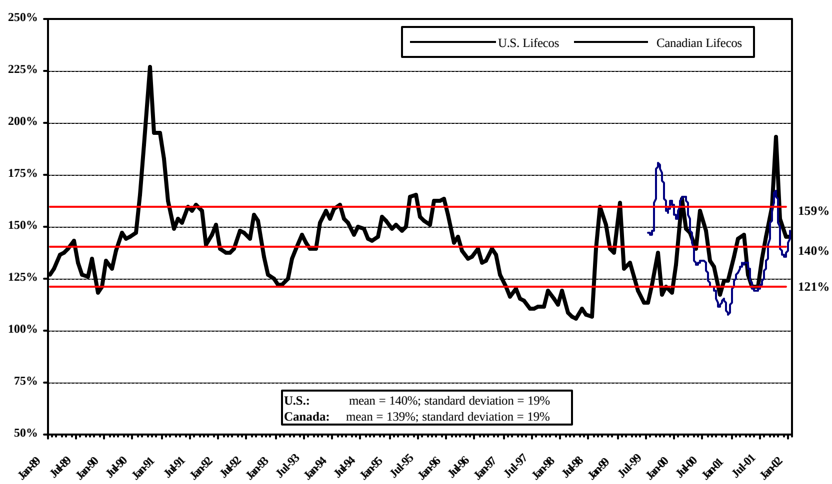
Chart 2

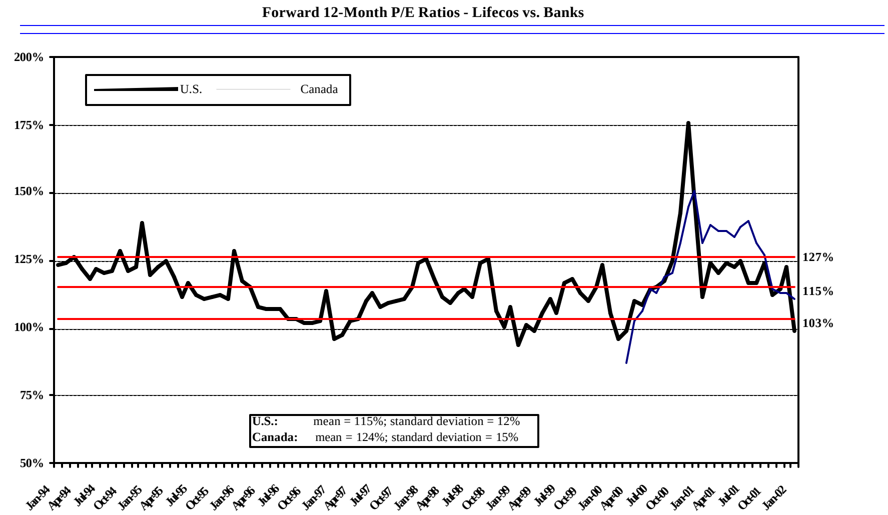
Forward 12-Month Earnings Yield to 10-Year U.S. Treasury Yield



Sources: Bloomberg, I/B/E/S, Reuters, Scotia Capital estimates

51

Chart 3



Sources: Bloomberg, I/B/E/S, Reuters, Scotia Capital estimates

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Chart 4

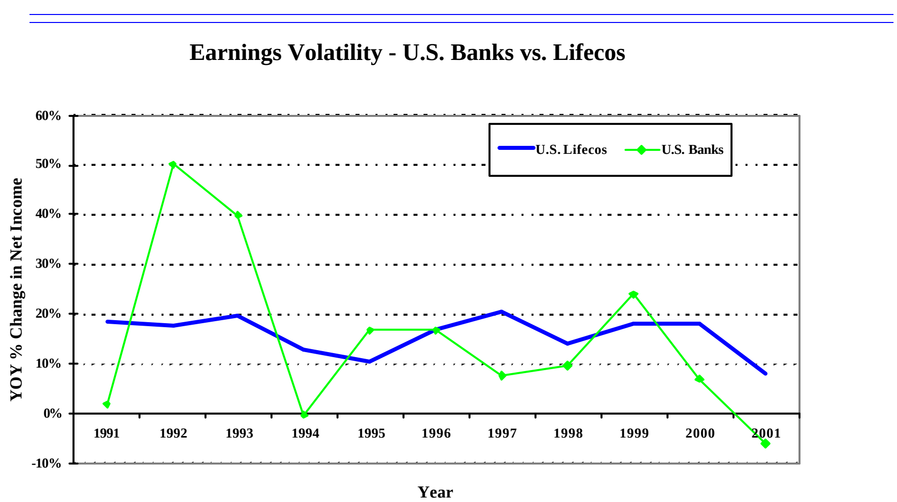

Chart 5

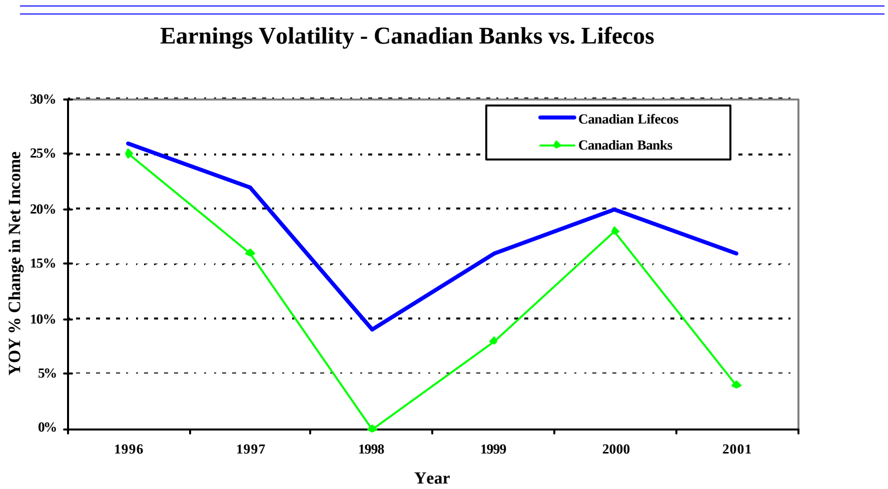

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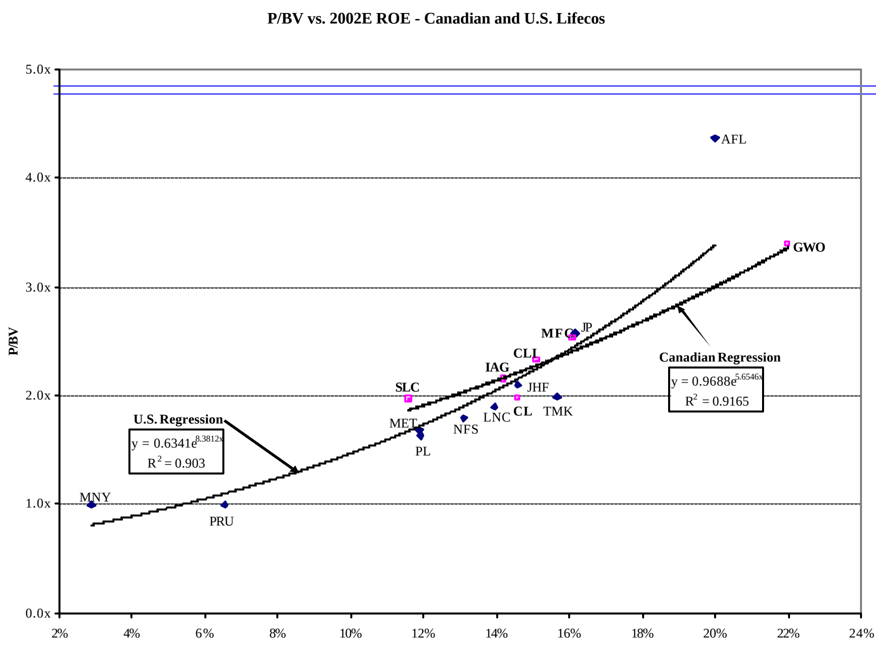
Chart 6



As at April 5, 2002 close.

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