# Brompton Insights

## Canadian Lifecos – Well-Positioned for Higher Rates

**April 19, 2023**

**Fund in focus:** [Brompton Lifeco Split Corp. (LCS, LCS.PR.A)], [Life & Banc Split Corp. (LBS, LBS.PR.A)], [Brompton North American Financials Dividend ETF (BFIN)]

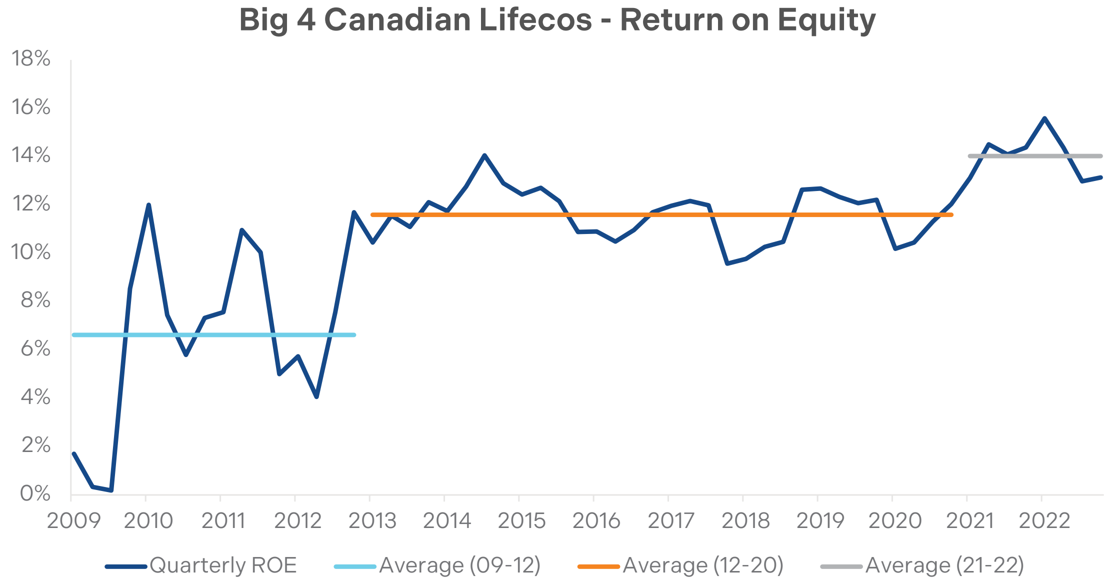
Canadian life insurance companies ("lifecos") have significant exposure to various macroeconomic factors including interest rates, equity markets and corporate credit. Interest rates typically have the biggest impact on the sector as lifeco reserves and earnings have historically had a high degree of economic sensitivity to changes in interest rates. This is the result of a duration mismatch between a lifeco's insurance liabilities and its invested assets. Most life insurance products result in a long duration liability for the insurer that writes the policy. This occurs since buyers of life insurance policies are often in their early 40s and are therefore expected to live for several decades. A lifeco's invested assets, on the other hand, typically have a shorter duration profile. This mismatch means that lifecos are generally helped by rising interest rates and hurt by declining interest rates.

Over the past decade, however, Canadian lifecos have taken significant steps to reduce the earnings drag caused by low interest rates, while still maintaining some upside exposure to higher rates. The biggest factors contributing to this are:

- a shift in business mix to focus on products with less interest rate sensitivity;
- re-pricing insurance products to account for low interest rates when determining customer premiums;
- better management of the asset and liability mismatch through the investment portfolio and hedging activities; and
- a focus on cost cutting and operating efficiency.

As a result of these measures, the Canadian life insurance sector has been able to generate higher and more consistent returns over the past several years. Exhibit 1 shows the quarterly return on equity (ROE) for the Canadian lifecos from 2009 to present. For the period from 2009 to 2012 the average ROE was 6.6%, while this improved to 11.6% for the period from 2013 to 2020 and to 14.0% over the past two years.

**Exhibit 1 – Better earnings quality through consistently higher ROEs**




*Source: Bloomberg as of April 14, 2023*

Additionally, while some of these factors such as a shift in business mix and better balance sheet management also reduce the benefits of higher interest rates, other factors such as product re-pricing and operating efficiency mean that the Canadian lifecos stand to benefit significantly from the rise in rates we have seen over the past year.

As a result, there is potentially more improvement to come if rates stay higher for longer. In our view, higher and more stable returns demonstrate that Canadian lifecos have been producing better quality earnings over the past several years then they did a decade ago. We believe this should have translated into an improvement in valuations. However, Exhibit 2 shows that Canadian lifecos currently trade at only 8.4x forward price-to-earnings, which is only slightly above the ~8x multiple they troughed at in 2011, at the peak of fears around low interest rates and poor returns. As such, we believe that the lifecos present an excellent buying opportunity at this time.

**Exhibit 2 – Valuation Multiples Look Attractive**

**Candian Lifecos - Forward P/E**


*Source: Bloomberg as of April 14, 2023. Canadian Lifecos are represented by the S&P/TSX Composite Life & Health Insurance Index.*

## Brompton's Approach

At Brompton, we have experience investing in Financials and have several products that investors can use to get exposure to the Canadian lifecos, including in our split share funds and ETFs. The following Brompton funds all trade on the TSX and focus specifically on Financials including an allocation to lifecos:

| Fund Name | Preferred Share Ticker | Class A Ticker | ETF Ticker |
|---|---|---|---|
| Brompton Lifeco Split Corp. | LCS.PR.A | LCS | |
| Life & Banc Split Corp. | LBS.PR.A | LBS | |
| Brompton North American Financials Dividend ETF | | | BFIN |

BROMPTON FUNDS

VALUE

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