Brompton Insights

Canadian Lifecos – Well-Positioned for Higher Rates

January 18, 2024

Funds 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)

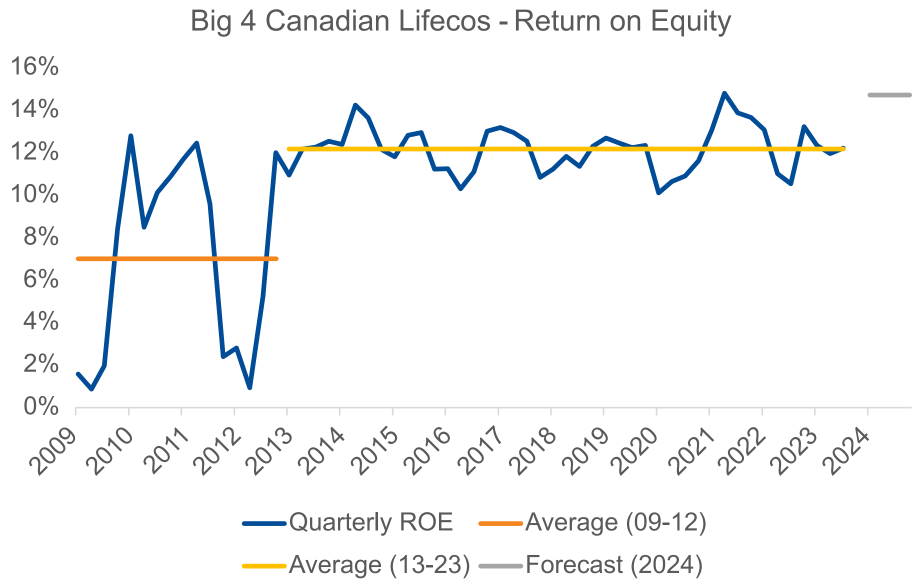
Canadian life insurance companies ("lifecos") have significant exposure to various macroeconomic factors including interest rates, equity markets, and corporate credit. Interest rates typically have the biggest impact on the sector as lifeco reserves and earnings have historically had a high degree of 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 company that writes the policy. This occurs since buyers of life insurance policies are often in their early 40s and 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, the Canadian lifecos have taken significant steps to reduce the impact caused by low interest rates, while still maintaining some upside exposure to higher rates. The biggest factors contributing to this are as follows:

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

As a result of these measures, the life insurance sector has been able to generate higher and more consistent returns over the past several years. Exhibit 1 shows the median quarterly return on equity (ROE) for the Canadian lifecos from 2009 to present. For the period from 2009 to 2012 the median ROE averaged 7.0%, while this improved to 12.2% for the period from 2013 to 2023 and is expected to rise to 14.7% in 2024 according to Bloomberg consensus forecasts.

Exhibit 1 – Better Earnings Quality Through Consistently Higher ROEs

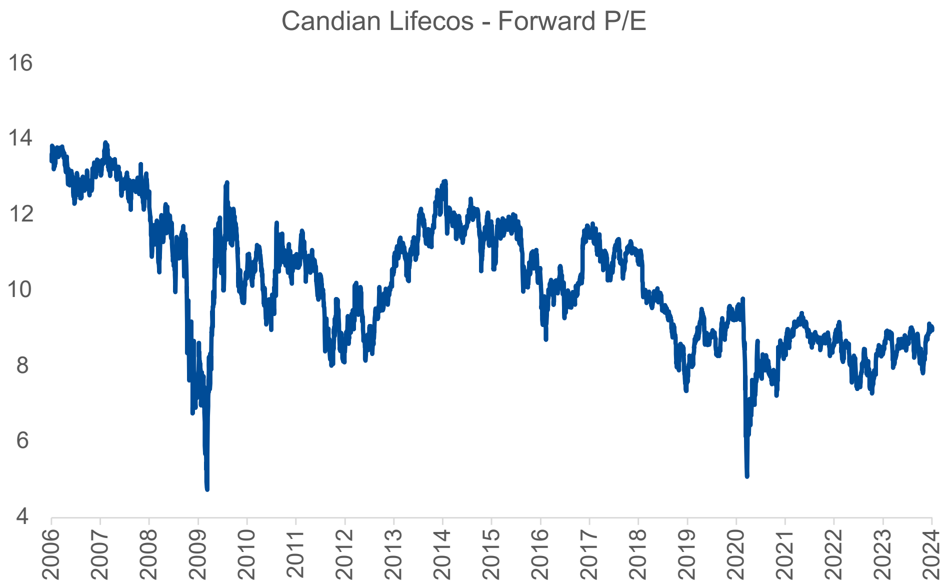


Source: Bloomberg, as of January 4, 2024.

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 lifecos stand to benefit significantly from the rise in rates we have seen over the past two years as new premiums are invested into higher yielding assets. While there may be some movement lower in interest rates over the coming quarters as inflation continues to subside, we believe that we are in a "higher for longer" interest rate environment and that we are unlikely to see rates move back towards zero like we did in the decade after the global financial crisis. As such, we believe that returns for the lifecos in the coming years are likely to remain elevated relative to the experience of the 2010s.

In our view, higher and more stable returns demonstrate that Canadian lifecos have been producing better quality earnings over the past several years than they did a decade ago. We believe that this should have translated into an improvement in valuations. However, Exhibit 2 shows that the Canadian lifecos currently trade at only 9.0x forward P/E, which is well below the long-term average of 10.2x.

Exhibit 2 – Valuation Multiples Look Attractive



Source: Bloomberg, as of January 4, 2024.

Given the improvement in earnings quality and the expectation for higher ROEs in 2024, we believe that there is upside potential in valuations and that the lifecos present an excellent buying opportunity at this time.

Brompton's Approach

At Brompton, we have decades of 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: Brompton Lifeco Split Corp. (LCS), Life & Banc Split Corp. (LBS), and Brompton North American Financials Dividend ETF (BFIN; BFIN.U).

Brompton Lifeco Split Corp. (LCS) provides leveraged exposure to Canada's four largest lifecos and high monthly distributions:

				Annual Compound Returns[1]			
Fund Name	**Ticker**	**Distribution Rate[2]**	**Portfolio**	**1-Yr**	**3-Yr**	**5-Yr**	**10-Yr**
Brompton Lifeco Split Corp.	LCS	14.1%	Canada's largest lifecos	65.2%	32.3%	31.0%	10.2%

(1) Returns are for the period ended December 31, 2023 and are unaudited. The table shows the compound return on the Fund's Class A share for each period indicated. Past performance does not necessarily indicate how the Fund will perform in the future. The information shown is based on Net Asset Value per Class A share and assumes that distributions made by the Fund on the Class A shares in the periods shown were reinvested at Net Asset Value per Class A share in additional Class A shares of the Fund. (2) No distributions will be paid on the Class A shares if (i) the distributions payable on the Preferred Shares are in arrears, or (ii) in respect of a cash distribution, after the payment of a cash distribution by the Fund the NAV per Unit would be less than $15.00.

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There are ongoing fees and expenses with owning shares of an investment fund. An investment fund must prepare disclosure documents that contain key information about the fund. You can find more detailed information about the fund in the public filings available at www.sedarplus.ca. The indicated rates of return are the historical annual compounded toral returns including changes in share value and reinvestment of all distributions and do not take into account certain fees such as redemption costs or income taxes payable by any securityholder that would have reduced returns. Investment funds are not guaranteed, their values change frequently and past performance may not be repeated.

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