Low Hanging Life Insurers

By Stan Luxenberg *Mon, Feb 20, 2012*

Patient investors in search of stock-market bargains might consider the shares of U.S. life insurance companies.

The prices of all types of financial stocks sank in 2011, but the share values of life insurers suffered ear-popping losses in altitude.

Shares of MetLife (NYSE: MET) fell to $29 in December from around $46 in January. Hartford Financial (NYSE: HIG) dropped to $15 from $26. In recent weeks, life insurance company stocks have rebounded, but analysts say that the shares are bargains at their current levels.

“The stocks are trading for much less than their book values, and the shares are significantly undervalued,” says Gavin Magor, senior financial analyst for Weiss Research.

The stocks are depressed largely because of fears that low interest rates are hurting profits. When rates decline, bonds produce lower long-term returns. Life insurers hold 76% of their assets in bonds, according to Moody’s. With interest rates on 10-year Treasuries having dipped below 2%, some insurers have already reported minor damage to profits. The problem becomes acute when bonds mature and companies must reinvest the principal at lower rates.

Along with low rates, stock market volatility also punished insurers last year. Volatility drives up the cost of hedging variable annuity income guarantees. Sales of variable annuities suffer when the equity mutual funds appear unattractive. As a double-whammy, asset-based fee revenue also falls when assets under management decline in value. That makes it hard for variable annuity issuers to recover the commissions—deferred acquisition costs, or DAC—that they paid intermediaries.

Despite these 80-knot headwinds, analysts say that the companies (MetLife is 144 years old, Prudential 137) can survive the current period of low rates—even if the Federal Reserve keeps its promise to hold rates near zero until 2014.

Weiss Research points out that balance sheets have been improving since the financial crisis. For the industry, surplus capital—the assets in excess of liabilities—increased from $266 billion in 2007 to $313 billion in the third quarter of last year, according to Weiss. “The insurers are in pretty good shape overall,” said Magor.

In a recent report, A.M. Best agreed that the industry has gotten financially stronger. At the end of 2010, the credit rater gave stable ratings to three-fourths of the life/health companies that it covers. By the end of 2011, the proportion had increased to more than 90%.

But a long yield-drought could hurt the industry, Moody’s cautions. If returns on 10-year Treasuries stay at 2% for a decade, the rating agency estimates, investment spreads would compress and accounting rules would require companies to increase reserves. In that event, most companies would be downgraded. Such conditions have prevailed in Japan.

Still, the U.S. is not likely to trod Japan's flat path, Moody's said. A sluggish recovery is more likely. It should gradually nudge interest rates higher, boosting the profits of life insurers in the process. A spike in prevailing interest rates, on the other hand, would hurt the prices of bonds that insurers have in inventory and create paper losses—at least temporarily. But analysts expect any rate spikes to be short-lived.

While acknowledging all the difficulties that plague life insurers, analysts seem to agree that markets have oversold them. "The stock market is not valuing earnings as much as it has in the past," says Steven Schwartz, a Raymond James analyst in Chicago.

The price-earnings ratio of insurers has typically ranged from 60% to 80% of the figure for the S&P 500, he told RIJ. In 2008, the insurance multiple climbed as high as 140%. Then as markets collapsed, insurance stocks cratered, and the ratio dipped below 30% in the first quarter of 2009. In the rally of recent weeks, the multiple has reached 63%. Schwartz expects more upward progress. "As the economy improves, earnings will increase," he said.

Yields on BBB-rated corporate bonds stabilized in the fourth quarter and began rising a bit in recent weeks, Schwartz noted. The climbing rates have already helped boost insurance company share prices, he says. More rises are likely. "As the economy picks up, corporate yields could move higher," he says.

Among life insurance stocks, Schwartz recommends Lincoln National (NYSE: LNC). He figures that the shares could rise to $31 from the current $23 over the coming year. At $31, the stock would still trade at a multiple of just 8.3 times 2012 estimated earnings. The S&P 500 currently trades at 12.6 times estimated earnings. He had been recommending MetLife, but he recently lowered his rating to "market performer" because the stock had appreciated.

Principal Financial (NYSE: PFG) is also on Schwartz' buy list. The Des Moines-based company's strong sales force and brand equity should enable it to benefit from an improving economy, he said. Principal is expanding into emerging markets, where demand for financial products is brewing.

Insurance stocks have been unduly punished compared with financial stocks overall, argues Eric Berg, an insurance analyst for RBC Capital Markets. As markets grew harsher in the past decade, returns on equity for financials declined to a feeble 7.8%, a 58% drop. It wasn't quite as bad for insurers, whose RoE dropped to 10.9%, a decline of 28%. Yet, despite the relative resilience of insurers, their price-book ratios fell 61%, about the same as the decline for financials.

Insurers' price-book ratios indicate just how cheap the sector has become, some analysts say. MetLife shares now sell for 64% of book value, while Hartford' shares trade for only 37% of book. "All the traditional life insurers are trading below book value," said Drew Woodbury, an insurance analyst for Morningstar. "According to our estimates, the fair values for the stocks are right around the book values."

Corporate management teams evidently agree that their stocks are cheap; they have been buying back shares. And those repurchases help boost share prices. "Instead of sitting around with cash—which earns nothing—the smart thing to do is to deploy the capital by raising dividends or buying back shares," said Berg.

Prudential Financial (NYSE: PRU) and Principal Financial are Berg's picks. Principal has already announced that it will buy back $100 million worth of shares, and Prudential intends to buy back a hefty $1.5 billion by this June.

Overall, macro trends should be friendly to the insurance industry. Many companies are expanding globally again, demand for life insurance remains steady if not spectacular at home, and aging Boomers are excellent candidates for annuities, which only life insurers can issue. As Morningstar's Drew Woodbury put it, "Now that a lot of people have seen their 401(k) balances bounce up and down, they are looking for guaranteed income."