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Rooting rates higher

John Hele, chief financial officer of MetLife (MET on the New York Stock Exchange), was thrilled to be asked an unfamiliar question at the Deutsche Bank Global Financial Services Investor Conference in New York on June 5. What would a 4% yield on 10-year Treasurys mean for the nation's largest life insurance company, a member of the audience wanted to know? Higher interest rates would be bullish, Hele replied—in particular, slowly rising interest rates would be bullish.

Now under way is a double speculation. If rates are really pointed higher (our first speculation), what would be the effect on the earning power of such interest-income-starved financial institutions as Charles Schwab Corp., MetLife and Lincoln National Corp. (our second)? We respond as Hele did. A nonexplosive rise in yields would smile on each company as well as on many others that have suffered in the post-ZIRP yield famine. Underscore, please, "nonexplosive." And do not forget the all-important qualifier, "All other things being equal" (English, as you know, for *ceteris paribus*).

With Schwab (SCHW on the Big Board), the arithmetic is easy enough. Step 1: Make an assumption. Say that rates rise by 100 basis points across the length of the yield curve. Schwab would capture about 60% of the resulting bounty, i.e., the company's interest-bearing assets would reprice that much more quickly than its interest-bearing liabilities. "As the '04-'06 rate hike illustrated," Bernstein Research explains, "this is possible because Schwab funds its balance sheet with a large and fairly consistent amount of idle client cash that is awaiting investment and is therefore largely interest-rate inelastic."

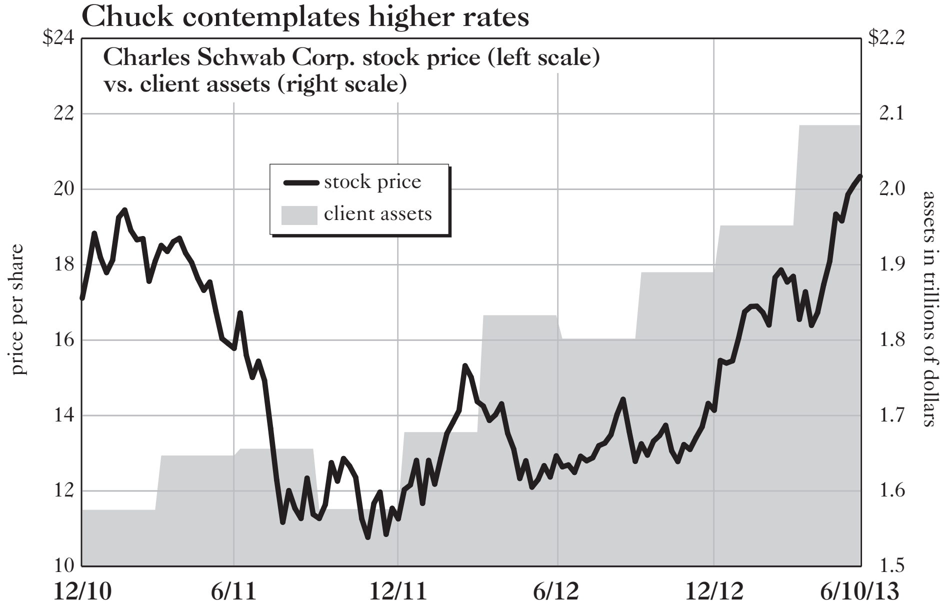
Step 2: Multiply that 60 basis points of net interest margin by Schwab's average interest-earning assets balance, which, in the first quarter, totaled $126 billion. Result: $756 million. This gives you Schwab's annual incremental net interest revenue, with which not much incremental direct expense is associated.

Step 3: Adjust for the money-market mutual fund fees that Schwab no longer earns but, come the restoration of actual interest rates, would earn again. In the first quarter, the sum the company didn't charge its money-fund customers was $155 million. Book those fees over four quarters, and the difference would come to roughly $600 million (also with very little corresponding incremental expense).

Step 4: Compute the potential earnings gain. Adding $756 million and $600 million gives you $1.36 billion. Multiply by Schwab's 38% tax rate and divide by 1.28 billion shares. Result: up to $0.66 a share in incremental earnings, depending on how much incremental investment in marketing and other client-related activities management chose to do. Schwab could garner most of that benefit within a couple of quarters following the rate increase.

Glancing at the track of the Schwab share price—up 50% in six months—you begin to suspect that Mr. Market has been working up the same figures. Maybe the old gentleman is discounting a return to the $2 per-share earning power of the long-ago year of 2007

Chuck contemplates higher rates



source: The Bloomberg, company reports

(compared to 69 cents a share in 2012).

"It's not so farfetched," colleague David Peligal observes, "given that, as of March 31, total client assets stood at $2.08 trillion, up from $1.57 trillion at the close of 2010 (in which year the company earned all of 38 cents a share). But it's not so clear that money-market interest rates are going up any time soon. Maybe the yield curve will continue to steepen, with note and bond yields rising while the funds rate remains stuck at zero. In such a setting, the seeker of an investment keyed to rising interest rates might look to MetLife instead."

Like Schwab and many another financial institution, MetLife has been rooting for a normalized yield curve. The ZIRP-y structure of rates in place punishes it and other life companies on both sides of the balance sheet. Low rates mean that assets yield less and liabilities cost more. Rising rates deliver a double measure of relief.

Take the example of a 3% fixed-rate annuity. Six or eight months ago, around the time this publication produced a bullish analysis of MetLife ("Ben Bernanke kicks Snoopy," Oct. 19), a life company would have had to go slumming in the junk-bond market to find an asset yielding the requisite 4.5% to make the arithmetic work. Today, the stretch is not so awkward: Ba1/BBB-minus-rated Alcoa Inc. has a 5.72% note, due in 2019, that yields 4.6%.

The example comes courtesy of Lisa Stange, chief investment officer of EMC Insurance Cos., who kindly provides an insider's view of the interest-rate sensitivity of the typical life insurer. "The impact of an interest-rate increase is, first of all, a statutory accounting benefit," she tells Peligal. "Insurers hold reserves based on actuarial assumptions for interest rates and required shocks to those interest rates. With rates this low, companies are holding large amounts of reserves because the formula for actuarial cash-flow testing says they must. . . . If interest rates rise, companies like MetLife will be able to release reserves related to actuarial cash-flow testing. Their balance sheet will show fewer liabilities, more assets and the stock price should move accordingly.

"If you're perfectly hedged," Stange continues, "it should have no economic impact on an insurer's existing book of business, because your asset and liability values move the same. But we're never perfectly hedged. The duration on the liabilities is just less predictable than that on the asset side, which is an investment that will move with interest rates. On the liability side, you may be hedging a variable annuity or a fixed annuity or a life insurance policy, and you're not exactly sure what is going to happen when rates rise. If it's a situation where people think it's because the economy is getting better, and they have a positive outlook for stocks, then you might get people staying in their stock variable annuity. Or you might get people jumping to a variable annuity that has more of a fixed portfolio behind it because rates are now higher. A variable annuity is basically just a group of stock and bond funds that a person can allocate between, and which also has some bells and whistles like guaranteed death benefit or minimum return. Now that's all on the variable annuity side. On a fixed-rate annuity, when rates rise people cash in their fixed-rate annuity. They get out of there, because at this point, they can do better reinvesting the money in a new fixed-income investment. So if there is not a big surrender charge, they leave.

"The assets backing that fixed-rate annuity," Stange winds up—"it depends how old they are. If these liabilities were put on many years ago, and they had minimum-rate guarantees, those assets might have already matured. The insurer might be sitting on something that is cash-like backing those liabilities. If rates go up, as an insurer you're happy. You're happy to pay out the annuitant and get the liabilities off the books. Remember, most of these fixed-rate annuities are quite underwater in that it will take a substantial rate increase to make a new liability more attractive than an existing liability. If you're an annuitant and you're in a fixed liability, and you're getting a minimum guarantee of 3%, it's going to take a little while before a new annuity will pay you 3%. So it won't just be a 50 basis-point increase in rates. It will take more than that."

Ultra-low rates weigh on an insurance company's share price in not so obvious ways. Running your eye down the asset side of MetLife's balance sheet, you see an item called "Deferred policy acquisition cost and value of business acquired"—or, to its friends, just DAC. No small thing is DAC, measuring $24.65 billion, or $22.33 per MetLife share. For further context, book value per share at the end of the first quarter (excluding unrealized gains or losses in the investment portfolio) came to $47.37 per share.

DAC is the capitalized cost of securing new business. It encompasses direct, incremental costs like commissions and underwriting and sales expenses. Deferred, the costs are designated an asset, and the asset is amortized over the life of the company's insurance contracts. The value of DAC depends on the profitability of the contracts, i.e., on "the value of the business acquired." Of course, interest rates figure significantly in any reckoning of that value.

"DAC was put on the balance sheet under assumption of higher interest rates when they wrote the policies many years ago," Steve Virgili, portfolio manager of New Vernon Investment Management, tells Peligal. "But persistently low rates will cause them to have to write down those assets at some point because the profitability of those policies will be lower with lower interest rates."

Fears of interest rate-related write-downs have weighed on Met's share price for a while. Thus, in the third quarter, the company recorded a $1.6 billion after-tax goodwill impairment to reflect the weight of current market and economic conditions on the estimated fair value of the American retail annuity business. It nicked almost 3% of book value. The customary year-end DAC review yielded another write-down, this one in the after-tax sum of $752 million. A reprieve from crisis-era rates would reduce, if not eliminate, apprehension about such future write-downs and contribute to the bullish petitioners' case for a higher share-price multiple.

Of course, more than interest rates bear on the MetLife stock price. Rates were still at rock bottom on April 23 when management disclosed a 49% boost in the quarterly dividend, to $0.275 per share from $0.185 per share. Regulation is in the mix of share-price causation as well. Were the company to be designated a "systematically important financial institution" (it would rather be called almost any other name), Steven Kandarian, chairman and CEO, warned shareholders at the May 21 investor day, Met's less heavily regulated competitors would gain, from the MetLife vantage point, a potentially costly advantage in the American retail business segment.

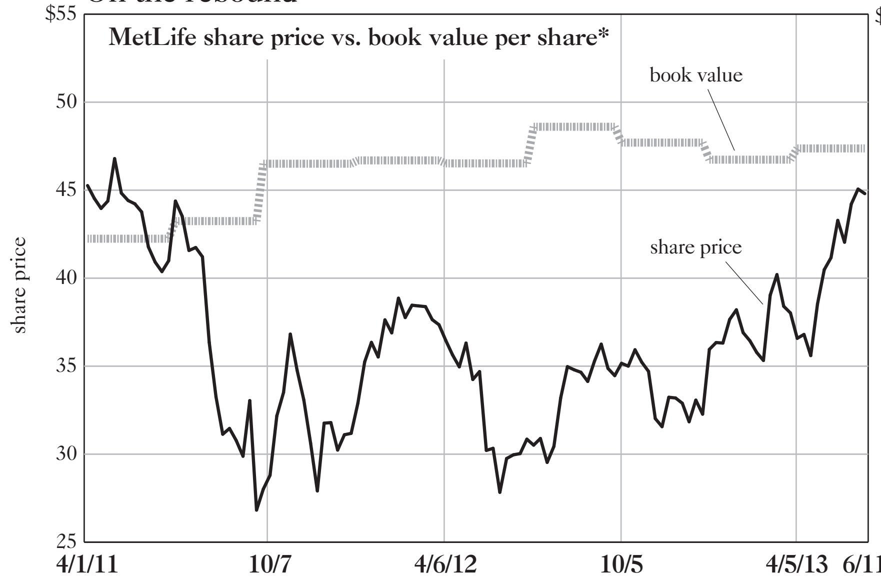
But interest rates are the share-price variable that is currently in motion. It would be useful to know which level of interest rates the market is currently using to value the share price. As Mr. Market is mum, we have been cogitating and investigating. For what it is worth, we surmise that MET today embodies the expectation of a 2.5%, 10-year Treasury yield. If we are right about that, a 3% 10-year note would be very good news to the MetLife constituency. A 4% 10-year note would be better news.

Certainly, a 10-year yield in excess of 3% would lighten management's burden of hitting the high end of its 12% to 14% return-on-equity target. Burdened by ground-hugging interest rates, the company produced a 7.4% ROE in the first quarter, well below the target but more or less in the middle of post-crisis full-year ROEs, e.g., 9.3% in 2008, minus 7.3% in 2009, 7% in 2010, 13.2% in 2011 and 2.4% in 2012. An upward push in yields might also be the occasion of an upgrade in MET's valuation profile. At the time of our bullish October analysis, the shares traded at six times trailing net income and 73% of book value (excluding unrealized investment gains and losses). We are prepared to entertain the hope that a valuation meaningfully in excess of book value is not beyond the realm of imagining (your editor, an owner of the shares, is pulling for it).

As slowly rising rates would be bullish, explosively rising rates would be—at best—problematic. MET has been borne along by the equity flood tide, and it would likely suffer in an equity ebb tide. An interest rate shock would surely not be constructive for earnings multiples. "If rates spike," Virgili says, not just to 4% but to 7% or so, "annuitants will likely cash in their policies to reinvest at higher rates and returns, which would force life companies to raise cash by selling bonds at precisely the wrong time. That said, I think rates would have to spike in a material and sustainable way for this adverse scenario to play out. So it's not a high-probability scenario, but definitely a non-zero scenario to be aware of for life insurance companies."

Do you wonder about mark-to-market losses on MET's legacy bond portfolio? Two points are germane. No. 1, only realized gains or losses are run through the income statement. Bonds that remain in the portfolio are marked at book value. Their carrying value does not change with market values or interest rates, though book value is adjusted if the prices at which the bonds were acquired were at a premium to, or a discount from, par. (Premiums are amortized, discounts accreted over the life of the bond.) No. 2, we should not forget the fundamental concept of interest on interest. Embedded in the concept of "yield to maturity" is the assumption that reinvestment rates will be identical to the coupon rate. If, however, to quote the bible on these matters, Leibowitz's and Homer's "Inside the Yield Book," "if future rates are higher than the purchase yield, then the realized compound yield will be more than the purchase yield." By no means would a bond bear market be bad news for every interest-rate-sensitive financial institution.

On the rebound



*excluding unrealized gains or losses in investment portfolio
source: The Bloomberg, company reports

At the MetLife investor day, CFO Hele was asked about the interest-rate hedges that management so forehandedly purchased almost a decade ago. And what, if anything, was the front office doing to protect the company against the unwanted consequences of rising rates?

"Well, it's something we discuss monthly, weekly with our investment team," Hele replied. "We have locked in—we have sold some of those derivatives or locked in some of its gains, so we won't participate on that piece—if it goes lower, but we have locked in the gains so we don't lose on the upside if rates come back up again." Most of the old rate hedges are rolling off this year, according to Nina Gupta, insurance analyst at Portales Partners, so they wouldn't detract much from the blessings of the correct—i.e., measured and nonviolent—kind of bond bear market.

On the evidence of its prescience both in interest rates and commercial real estate (you'll recall that Snoopy was the timely seller of Stuyvesant Town and Peter Cooper Village, immense Manhattan apartment tracts, before the 2007-09 bear market arrived), MetLife wins the nod for biggest and best life company under the American sun. But its very size and success has attracted the prying eyes of the federal too-big-to-fail police. Is there a smaller, less conspicuous life company that, like the Met, is also positioned to gain from rising interest rates?

Philadelphia-based Lincoln National (LNC on the New York Stock Exchange) is one such candidate. "Like MetLife," Peligal relates, "Lincoln did not go unprotected into what might prove to be the final phases of the great bond bull market. A couple of years ago, management bought $1.3 billion worth of hedges, so-called Treasury locks, of which about $300 million have matured with significant value. The $1 billion or so that are still outstanding are expected to deliver 6 1/2% to 7% rates of return for the company's guaranteed universal life business, guaranteeing about 75% of the cash flows required to service the relevant liabilities. Well done, management."

Lincoln, with its $9.5 billion equity market cap, will probably not be designated a "systemically important financial institution," or SIFI. Spared hot federal breathing down its neck, Lincoln's management has been able to deploy capital in ways that behemoth MetLife has not, notably by repurchasing stock.

"At the Lincoln investor day last week," Peligal writes, "LNC management reiterated prior guidance of deploying $400 million through capital management in 2013. They also disclosed that $150 million of share repurchases were completed in the second quarter, bringing the year-to-date total to $250 million. As a Keefe, Bruyette & Woods note from June 6 remarked: 'The second quarter total so far was above our prior estimate of $100 million, and in our view creates a reasonable likelihood that the company will exceed that $400 million guidance, even if they slow down the pace in the second half, similar to last year.'

"Along with higher interest rates," Peligal winds up, "this capital allocation policy seems to be helping Lincoln's stock. The LNC share price has moved to a little over $35 from $25, or about 41%, since our October analysis of MetLife. Over the same span, the MET share price has moved to just under $45 from $35, or roughly by 28%. Book value per share for Lincoln, excluding gains and losses in the investment portfolio, totaled $42 as of March 31, 2013, up from $36.76 on March 31, 2012. Thus, LNC is currently trading at 84.2% of book value per share (ex-portfolio gains and losses). MetLife, as noted, has a current book value per share of $47.37, up from $46.52 on March 31, 2012. Thus, MET is currently trading at 93.9% of book value per share. Perhaps this discrepancy is warranted given MET's 15%-plus return on *tangible* equity compared to 13.5% for LNC. Then again, LNC has greater sensitivity to rising interest rates than MET does, as measured by interest income as a percentage of total revenue: 40% for LNC, 30% for MET."

Altogether, we judge that while MetLife may be the more substantial, even the better business, Lincoln may prove the more rewarding stock. In this era of Dodd-Frank, size matters.

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