# GRANT'S

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## Ben Bernanke kicks Snoopy

Risk is one thing, uncertainty another, as the economist Frank Knight famously observed. Mortality is a risk. That's because actuaries can measure it. Interest rates, however, present uncertainty. That's because economists can only guess about them—where they're going, that is. Who knows what the Federal Reserve is up to, or, for that matter, whether that fabled institution is really pulling the strings as we suppose?

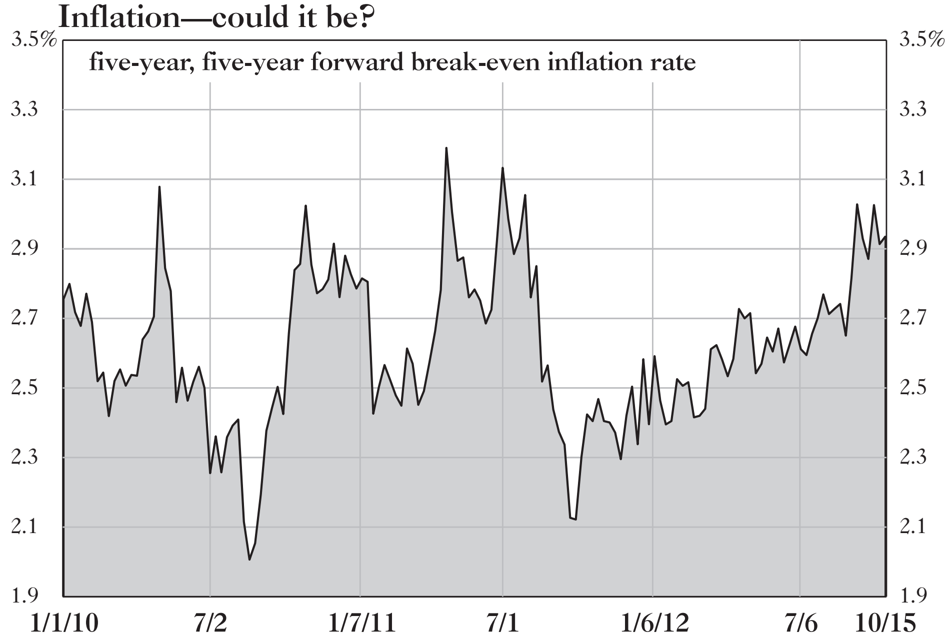
Interest rates, insurance stocks and politics are the subjects on the agenda. Let us say—just to speculate—that Mitt Romney takes the prize. He places a call to Ben Bernanke to invite the former professor of economics to consider an early return to the Ivy League. Or, let us say—again, just to brainstorm—that inflation makes an unscripted return in the second term of Barack Obama. In any case, a new, tauter monetary policy suddenly looms. Yields rally and stock prices sink, but not the prices of insurance stocks. They push higher on the prospect of an end to the great yield famine. Skipping down to the bottom line, *Grant's* is bullish on MetLife (MET on the New York Stock Exchange), a superlative franchise with an ordinary valuation.

You don't just drop in on the land of life insurance without a guidebook and a dictionary. The natives speak a language all their own, and they tell you only so much about what they do and why they do it. What the visitor can know is that interest rates are the crux of the valuation matter. Rising rates, providing the rise was measured and not shattering, would be bullish for the long-depressed life insurance earnings. Falling or stagnant rates would continue to be very bearish indeed.

Actuaries have been calculating the risk of mortality for the better part of 200 years. They have learned to draw a pretty fair bead on how long you, gentle reader, may expect to live. Economists have been dealing with the uncertainty of interest rates for just as long. Sad to relate, they are no better at forecasting rates than they were when they started. And now there's another source of uncertainty, to wit, the mysteries surrounding the possible consequences of the Fed's radical policies—"learning by doing," as the chairman forthrightly described his monetary M.O. at Jackson Hole, Wyo., on the last day of August.

Crack open Homer's and Sylla's "History of Interest Rates" and observe the generation-length ups and downs of bond yields. They fell, persistently if irregularly, between 1861 and 1899, a 38-year bond bull market. They rose from 1900 to 1920, fell from 1920 til 1946, rose from 1946 til 1981 and fell from 1981 to this very day. Unless, of course, they have resumed an uptrend without anyone having the courtesy to announce that fact. The cycles seem to have a motive power of their own. William Jennings Bryan's wild-haired inflationary talk couldn't stop the bond bull market of the 1890s. Nor did reflationary New Deal policies reverse the bond bull market of the 1930s. And neither, at first, did the bitter, Paul Volcker-administered anti-inflationary medicine of 1979-81 succeed

**Inflation—could it be?**



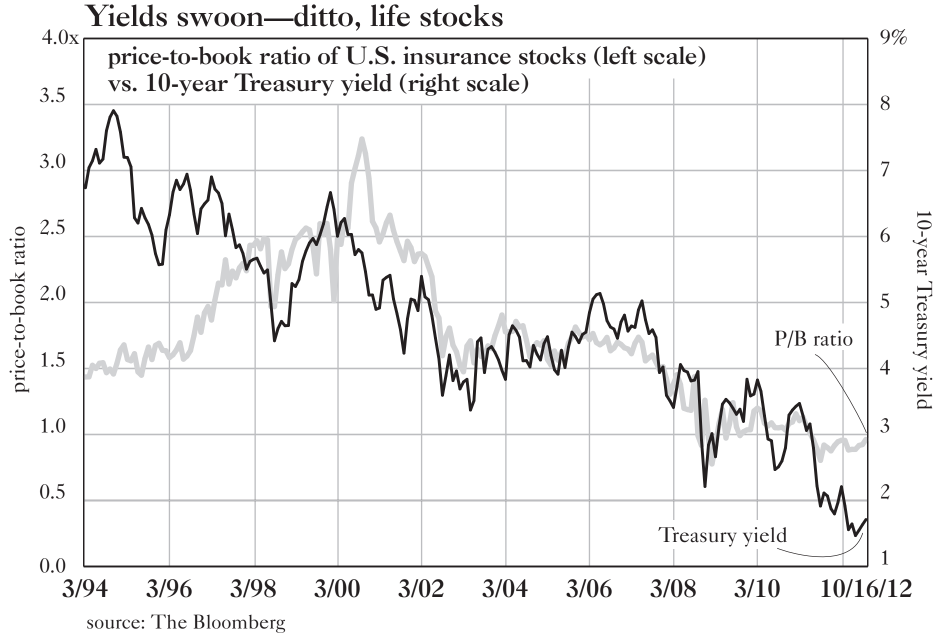

source: The Bloomberg

in stopping the final, violent phase of the post-1946 bond bear market. And, for that matter, neither have ZIRP, QE and Twist so far turned back the post-1981 bond bull market.

A truism—though not always an obvious one—is that these cycles do eventually turn. An article in the June 1 edition of this publication ("Nobody knows anything") described the unanimity of opinion on interest rates at the 1899 lows, when James W. Alexander, the president of the Equitable Life Assurance Society, invited Wall Street to venture a forecast. When Alexander asked the gurus of the McKinley era for their best guess, bonds had been in a 38-year bull market. Our own, post-1981 updraft in bond prices just turned 31.

Of course, managers of life-insurance general accounts don't need to be reminded how steep is the plunge in interest rates. They are well aware of the cost that the collapse has exacted. In 2007, let us say, management asked the investment officers if 3% was not a viable yield to offer on a long-term annuity. How could it not have been? Actually, it wasn't. Nowadays, companies are having to resort to speculative-grade debt to fund five-year annuities promising just 2.5%. At that—witness Dish DBS Corp. 4 5/8s of 2017, rated Ba2/BB-minus, quoted at 3.85%—a 2.5% promise seems almost rash.

"I'm guessing that many companies are losing money on their existing book," Lisa Stange, chief investment officer of EMC Insurance Cos., tells colleague David Peligal. "And the reason is because we all price in a certain amount for overhead, for our expected credit losses, for our marketing expenses, and for everything that it takes to run the company. We expect most people to take their money at the end of five years and reinvest it. But some of it will be sticky, and since they get a guaranteed minimum rate, even though it's a low rate typically, there will be some hangers-on. So maybe, we say, we need a six-year investment. At that point, when we sell the annuity, we go out and buy a six-year bond at some spread that's over what we would credit this annuitant. Now, unfortunately, if they hang on forever, because their guaranteed minimum when we did these annuities some time ago was 3% (because no one ever thought rates could go below 3% on a corporate bond), then all of a sudden our corporate bond matures in six years but the annuity hangs on. So now we have cash. And we still have the liability hanging out there that needs to be paid 3%. And they can hang on to that forever."




With interest rates falling and credit spreads compressing and equity averages dithering, the market gods could hardly have done a better job of confounding the life insurance industry if they had tried. A MetLife annuity called "guaranteed minimum income benefit" illustrates the difficulties. "Let us say," says Peligal, "that you are 55 years old and you go to your MetLife broker and he offers you a $100,000 GMIB policy. Sold! So you write the check and the company invests it, basically in mutual funds. At the end of 10 years, let's say, you elect to convert that sum of capital into a stream of annuity payments; you get them for as long as you live. In essence, MetLife has guaranteed you a certain rate of compound growth of your principal. Had rates not plunged and the stock market flat-lined, the Met would have come out a winner. As it is, a sizable liability gap could be opening. When you speak to an executive at a life company, he or she might say, 'Look, we haven't had any significant losses yet.' The key word is 'yet.' Problems there will be unless interest rates rise. How severe might these problems be? As much as an investor would love to know the present value of probable future losses, the information doesn't exist. Managements don't provide it and, to a degree, can't predict it. Only consider that an annuity customer may choose not to convert his capital into an annuity stream at the end of year 10. He or she may instead elect to wait, and by waiting confer a small gift on the insurance provider. So 'policyholder behavior' does, in fact, figure importantly in insurance-company financial performance."

Colin Devine, a consultant to the life insurance industry and who once worked as a Citigroup equity analyst, points out that insurance management and the ratings agencies have learned a little something since the bad old days of the early 1990s. This was the era when panicked annuitants staged policyholders' runs on the likes of Executive Life and Mutual Benefit of New Jersey, sellers of guaranteed investment contracts supported by speculative-grade debt and commercial mortgages. The policyholders ran because the policies were essentially surrenderable on demand. Today's policies are run-resistant, Devine says. Read the fine print on your policy. You'll see that the company has six months to give you your money back. But while runs on the bank are unlikely, and credit risk associated with other investments is generally low, other perils are front and center—death by a thousand interest-rate cuts, not least.

Between a bank and a life company, Devine observes, there's this essential difference. Stuck with a bad asset, a bank can sell it. Stuck with a bad liability, an insurance company is just stuck. The policyholder doesn't have to surrender his policy. If, indeed, his annuity promises him 3% while market rates are 1%, he's highly likely to stick, or "persist"—hence the term in the insurance lexicon called "persistency risk."

"If I, an insurance company, get it wrong," he says, "first of all, if I charge you too little, what is persistency going to do? It's going to go against me, right? You're going to keep your policy even longer, because you know you got a good deal. But I also can't sell what I don't own. Who owns a life policy? You do, not the insurer. So the insurer can't sell what it doesn't own. That's why I say, bad assets you can sell, but bad liabilities, in a manner of speaking, are immortal. They are truly til death do us part. A perfect example of this is a company called Unum Group, which has an old block of individual disability policies. They stopped selling those back in 1994. And yet, here we are nearly 20 years later and they still hold about $12 billion in reserves for these policies, which also tie up about 18% of the company's capital. In a normal quarter, they make about a 2% return on these, in a great quarter 2.5%, and a bad one about 1.5%. Volatility of the claims is very low. But because policyholders recognize how great a deal these were, the lapse rate is only about 3%. How long can these policies last at that rate? A very long time.

"The industry is already seeing a similar example of this with individual long-term care," Devine goes on. "Most insurers priced these originally for about a 6% lapse rate. But guess what? Lapses are less than 1%. Does that matter? Absolutely, because instead of over 10 years having about two-thirds of their book being gone, only about 10% of it is. That means insurers are going to be paying a lot more in claims than they expected. That's why you see long-term care companies putting through 60%, 70%, 80% rate hikes. Which regulators are approving, much to my amazement, but what does that tell you? That tells you... how much they underpriced it by. In fact, that probably tells you they underpriced it by more—the 80% rate hike is what got approved. I expect we will see the same thing happen for variable annuities offering living benefits. They were generally priced assuming around a 6% annual lapse rate, and I suspect that what will ultimately emerge is something less than half of that. As with long-term care, you see companies aggressively looking to reduce features or increase what they charge because they realize their original pricing assumptions were too generous. The challenge, of course, is that they are largely stuck with what is on their books, and as is the case with Unum, will be for a mighty long time. The bottom line is that while banks can generally work through their mistakes in four or five years, for life insurers it can take two or three decades. Not surprisingly, that is longer than even the most patient investor can wait."

Or perhaps the limiting constraint isn't patience but understanding. Not only does the insurance industry speak its own language, but also it operates its own black boxes. Perhaps, muses an investor we know, some big annuity problem is lying in wait. Say it makes page one of *The Wall Street Journal*. Insurance investors, who never really did understand what they owned, now are confronted by their ignorance. "Do I understand the balance sheets of these companies?" they ask one another. "Do I understand the double sets of accounting that they have from a stat [as in statutory financials] vs. a GAAP perspective?" Confessing that they really don't understand, they sell. In the life business, tail risk—really, apropos of Knight's distinction, uncertainty—comes in many different forms, from "They cured cancer, how could they?" to, "Oh, no, America really is Japan, and the bad old days are only starting." You can't really hedge it.

Anyway, a set of rather more pedestrian disappointments awaits on the third-quarter horizon. The third quarter, Devine reminds us, is the one in which most insurers reassess their pricing assumptions, interest-rate assumptions included. Manulife Financial warned in August that such a rethink could cost as much as $1 billion. Principal Financial Group and Ameriprise Financial have warned of smaller hits in the offing in connection with downward ratcheting of interest-rate assumptions.

Which brings us at last to our featured subject. With $825 billion of assets, $62 billion of equity, $7 billion-plus (at a run rate) of net income and 90 million customers in more than 50 countries, MetLife is indisputably one of the great life-insurance franchises. As it is, Snoopy is the company mascot, but Carnac the Magnificent, Johnny Carson's television clairvoyant, might have served as a stand-in over the past decade. In 2004, MetLife bought derivatives to protect against a plunge in interest rates, a risk its management identified long before the average interest-rate observer, including your editor. In 2012, says management, this protection—$47 billion worth in notional value—will contribute almost $500 million to pretax income at current levels of interest rates. And it was MetLife that, in 2006, forehandedly offloaded Stuyvesant Town and Peter Cooper Village, the big middle-class housing enclave hard by the East River in lower Manhattan, at the top of the commercial property cycle. The price, some $5.4 billion, translated into a cap rate not much more than 3% (*Grant's*, Nov. 17, 2006). And—*and*—it was MetLife in 2010 that had both the heart and means to effect the $16.3 billion purchase of Alico, the foreign life-insurance business of AIG, with what appears to be immediately accretive results. Not least, it is MetLife that has the means—though not yet the regulators' blessing—to distribute redundant cash to the shareholders.

"Even under an extended low-rate scenario," Steven A. Kandarian, MetLife CEO, writes in the 2011 annual report, "we expect to continue to generate excess capital." These stirring words mark MetLife as an investment in a superb business. For a speculation on an imminent turn in interest rates, one would buy the shares of those un-superb businesses that didn't hedge against a rate collapse, didn't sell real estate and didn't buy Alico. MET would certainly rally in response to an upturn in bond yields. The shares of the un-prescient would probably zoom.

We say that a great, 145-year-old insurance franchise trading at tangible book (ex-accumulated gains from the unwanted bond bull market) and at 6.5 times the 2013 earnings estimate is a more than worthy investment. Now if only the geniuses in the front office hadn't gone and bought the naming rights to the football stadium at which the New York Giants and Jets play. Then, again, you can't have everything.

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