MANULIFE

Insurers find their market math doesn't work

BOYD ERMAN
STREETWISE
berman@globeandmail.com

There's a joke that says an actuary is someone who would rather be completely wrong than approximately right. Unfortunately for investors, insurance companies and their armies of actuaries are turning out to be dead wrong about markets far too often.

First, it was monoline bond insurers and American International Group blowing up because of the protection they sold against bond defaults. Now it's **Manulife Financial Corp.** destroying shareholder value because of its handling of what are essentially insurance contracts on stocks.

Manulife has a $114-billion portfolio of so-called variable annuity products that promised buyers certain returns from the stock markets. Since stock markets aren't providing those returns, Manulife is on the hook to make good on the promises unless markets come back.

The result in the second quarter was a $2.4-billion loss; Manulife took a $1.7-billion charge to cover reserves for future payouts on equity products after the Standard & Poor's 500 slid almost 12 per cent in the quarter.

Few companies can predict markets, but insurers may be among least qualified to try. Most of them build their cultures around adherence to actuarial tables. Actuaries are pretty good at predicting death rates, or even accident rates. But the past few years have shown that when it comes to forecasting investment returns, most mathematical models just don't work. Financial markets have too many dynamics that the models have trouble accurately capturing.

Stock and bond markets have correlations that death or accident or fire don't. When a person dies in Toledo, unless it's the beginning of an epidemic, their passing has no discernible knock-on effect on the death rate in Toronto. The same is true of a fire starting in Seattle, or a car accident in Paris.

When stocks or bonds in one part of the market start to move strongly one way, that can – and usually does pull – other markets along, all around the globe. Markets can also be moved en masse by human psychology and decisions in ways that fires and deaths and accidents never can.

Manulife executives have long held the view that markets would always bounce back and put the portfolios onside, so hedging against market losses was a needless cost. That's why the company didn't hedge for years.

Then came the financial crisis of 2008, when the markets got hammered and Manulife disclosed a $1.9-billion quarterly loss that was, until last week, a record. That loss prompted a capital raise and a dividend cut, as well as a newfound love for hedging.

But it's a half-hearted love. Buying insurance against the volatility in earnings variable annuities is never going to be cheap, something Manulife still seems to have trouble dealing with. The company hedged any new variable annuity business in the most recent quarter, but said that "prevailing market conditions" stopped it from continuing to put hedges on the roughly 50 per cent of its portfolio that is still naked and swinging in the market's breeze.

Those prevailing market conditions may be here for some time. A fundamental shift in supply and demand appears to be taking place in derivative markets, meaning Manulife is just going to have to get its corporate head around paying more for protection.

The supply of the long-term equity derivatives that Manulife needs has declined significantly. The main sellers have historically been investment banks and other insurers. Some of the investment banks have failed, while others have scaled back business lines such as derivatives sales because of losses.

On top of that, new financial regulations that require banks and insurers to hold more capital are making traditional sellers of those derivatives even more wary. Those that are still selling are building in more potential volatility, driving up prices.

On the demand side, Manulife must compete with other insurers that are looking to hedge their books as their sales of variable annuities begin to rise again.

Demand is up. Supply is down. Hedges seem unlikely to get cheaper soon.

For Manulife, it would be better to pay up now and get the hedging program done, because even if the actuaries are proved right in the end that it was cheaper to go it hedge-free, that simplistic view doesn't reflect one number that Manulife shareholders are now painfully familiar with: $32-billion.

That's the lost stock market capitalization for Manulife over the past two years. It's the cost of lost credibility and stability. It may not show up in the actuarial models, but Manulife shareholders know that it is real money all the same.

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