industry INSIGHTS (Excerpt) 2020 | Q4

DDW
DUE DILIGENCE WORKS

View From the Top | BY MICHAEL FREEMAN • PRESIDENT, DDW

Private Equity and Asset Management Firms Continue to Come

Who are these new names buying their way into the insurance and annuity business? And who is really managing the assets behind the scenes?

Private equity is a common name used to answer the first question, but asset management firms are probably the more current answer. Firms are investing more and more in the insurance industry because they see attractive valuations and strategically see a path for additional growth. Typically, when these investments happen, we see a couple of changes; businesses

- become more efficient,
- more focused on their strategy, and
- have access to the capital to grow.

Efficiency is already well on its way as firms move through the COVID pandemic, but firms need to ensure their changes to enable "E" are sustainable. Gaining more focus will come in the area of product and channel distribution. How firms manage distribution channels will be a focus, including new looks at direct and the RIA channel. Most firms have been doing R&D for some time here. We expect this investment to be reviewed, which will result in more or less investment depending on the strategy and payback.

Product profitability is probably on top of the list; by product category and each individual product. We expect more clean up on legacy products and firms looking at their core focus and what that means. Is their competitive strength being a supermarket of products, or is it being more focused on one or two products? While accumulation products are certainly selling more these days, don't count out the income story needed more than ever in this market environment. Income benefits may be lower than a few years ago, but relative to other product types (funds, ETFs, fixed income), they still provide a nice benefit for clients.

Asset managers seem to be getting more press recently but have been involved in the insurance business for some time. The Life and Annuity business is no different than its Property and Casualty counterparts. Insurance companies have some of the most extensive asset manager relationships in the industry. As a whole, firms that outsource to an asset manager are playing to each of their strengths. Firms that invest and have maintained their investment discipline in-house need to have the scale to ensure they have the best and brightest (people, systems, and process).

The industry is becoming more componentized, playing to their strengths, and firms will continue to work through what those strengths really are (with a little help from private equity and activist investors).

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IN THIS ISSUE

VIEW FROM THE TOP, CONTINUED

Reinsurance – Good or Bad?

Reinsurance of annuity policies. This has been going on for years, but what does it really mean for your product shelf, your Broker-Dealer, and your clients? Why is it getting so much more attention now? How does this affect concentration risk?

When an insurance company reinsures a block of business, the legal obligation has now moved to the reinsurer. The first thing to note is that once a BD hears this news, it is in the past, and nothing can be done about it. In practice, reinsurance is typically a positive move for the industry. It allows the reinsurer to manage the book of business and enables the annuity company to continue to innovate and distribute product. We can all remember firms that may not have reinsured that came in and out for the market as their balance sheets became full. Allowing each firm to play to their core strengths is a good way to operate the supply chain.

When a reinsurance transaction is complete, does that change concentration risk? Well, it depends. Technically the originating company reduces its asset exposure for a particular BD, giving it more capacity to continue to grow. The legacy block is now exposed to the reinsurer, so the BD should open a concentration report on the new company.

So what is a BD to do, besides looking backward. When a reinsurance deal is reached, there are many covenants regarding how the business should operate and the capital reserve requirements. This is where the focus needs to be. Reviewing the process to consummate these deals by the BD's partner insurance company along with the State and the insurance guarantee fund is where the comfort lies. Carriers with a robust process and detailed covenants in selecting and managing the reinsurance transactions will continue to be strong partners and may help with concentration risks.

View From Product Management

Mutual Fund Family M&A Activity

On October 8, 2020, Morgan Stanley (Ticker: MS), which has an asset-management division overseeing $665 billion, agreed to acquire Eaton Vance (Ticker: EV), which manages $507 billion. The press release stated, "The transaction is attractive for shareholders and will deliver long-term financial benefits. Both companies have demonstrated industry-leading organic growth and have strong cultural alignment."

In 2020, investors have seen another massive mutual fund family merger with Franklin Resources (Ticker: BEN) purchased Legg Mason (Ticker: LM). And hedge fund manager Nelson Peltz acquired 9.9% positions in both Invesco (Ticker: IVZ) and Janus Henderson (Ticker: JHG), suggesting that the two businesses should combine.

These two mergers will probably prompt more fund mergers. Since the great recession, when passive investing began to take off (2009 through 2018), the number of annual mergers among publicly traded asset managers doubled, to more than 50 worldwide, according to a study by consulting firm Deloitte Casey Quirk. Including smaller private firms, the M&A number hit an all-time high of 253 deals.

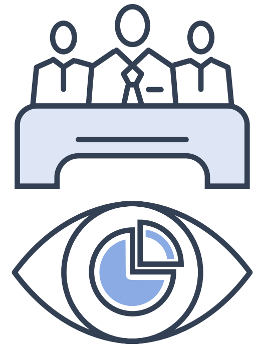
One of the reasons for the massive number of mergers has been the fee compression in the market with cheap beta ETFs. Investors over this time have benefited from lower fees. According to the Investment Company Institute, a trade group found that equity mutual fund expense ratios averaged 0.52% in 2019 compared with 1.04% in 1996 — a 50% decrease. Hybrid mutual fund expense ratios averaged 0.95% in 1996 and fell to 0.62% in 2019; and similarly, bond mutual fund expense ratios averaged 0.84% in 1996, falling to 0.48% in 2019. (https://www.ici.org/pdf/per26-01.pdf)

M&A is a way to build scale to offset some of that fee erosion. The benefit to the client that these organizations point to is a more streamlined cost structure to be more competitive in the market and retain investment talent. Mutual fund companies care about the mutual fund shareholders, but they ultimately answer to a single party, the shareholders of the company.

When two funds merge, the only performance record that survives is that of the fund considered to be the acquirer.

The company's shareholders are often benefiting the most from combining funds, so mutual fund investors need to be cautious. An investor needs to understand when the mergers of funds are announced that the weaker performing funds will be merged away into the better performing funds. When two funds merge, the only performance record that survives is that of the fund considered to be the acquirer. That means fund companies can essentially erase poorly performing funds.

The problem for investors is that the merger of those mutual funds means that the better performing track record will be displayed as prior performance, but the investor's personal performance in the weaker performing will not translate into the better performing mutual fund. Fund companies do not make the inferior mutual fund investors whole because past performance does not equal future results.



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Product Observations | Q4

ANNUITIES

The low interest rate environment continues through another quarter. With this, advisors and clients continue a desperate search for rates. In this search, we have seen a migration to shorter term products whether it is fixed or indexed annuities. The trend toward shorter durations are such that advisors and clients do not want to be tied up for longer periods of times at low rates just in case the rates increase in the near future.

A different trend this quarter is with the cooling of FIA sales. For the first time in a while, we have seen fixed annuity sales overtake indexed annuities. This may be considered a 'flight to safety' as rates are not that attractive to warrant this big of an increase in fixed annuity sales. DDW will continue to monitor the fixed annuity space and see if this will become an ongoing trend.

In addition to fixed annuities sales overtaking FIA sales and as we've discussed previously, the RILA market continues to increase their share. Similar to the VAs, sales are beginning to shift from FIAs and move to RILA products. As mentioned last quarter, advisors are already familiar with the FIA story and are having conversations with clients to take on more risk in exchange for higher cap rates.

STRUCTURED PRODUCTS

As stated previously, and previously and previously, the last quarter's (third-quarter) market environment continued to provide a set of challenges for structured products, especially for traditional offerings. The usual culprits remain; low-interest rates, cash-flush and risk-averse banks, and continued success of Registered-Index-Link Annuities ("RILA"), another contender emerged which was the 2020 Presidential election. Product availability continues to truncate, as banks sit on the sides waiting for the opportune time to reintroduce once common monthly offerings.

Not without saying, the Issuing Banks have been faced with exceedingly difficult choices. The economics of many once common issues are not feasibly given the conditions, and unfortunately, many have been suspended. In an effort to continue to offering products many issuing banks have utilized more complex offerings, or have had durations extended and/or buffers reduced to below some minimum standards of retail banks or broker-dealers.

Another challenge is that while issuing banks have created new offerings, some retail banks and broker-dealers have been hesitant to approve the newly built innovative products. Being new products, the track record is often non-existent and rely solely on backtesting. Retail banks and broker-dealers will often require a minimum incubation period to evaluate performance, sales, and consistency. The growth of new products that cannot be approved is reminiscent of a famous line from The Rime of the Ancient Mariner; "water, water everywhere, nor any drop to drink."

While broadly made available calendar offerings may be a more difficult fit, quasi-bespoke offerings built by issuing banks and distribution partners may be more appropriate. There have been interesting opportunities found each month, but it requires a nimble product approval process and may not fit all molds. While 2020 is nearly in hindsight, one can only hope that the situation improves, though as always, another set of challenges will most likely appear.

LIFE INSURANCE

2020 has been a monumental year for life insurance, mainly due to COVID-19. While forced to work from home and self-isolate from society, continued news regarding the current health crisis brought renewed interest to an individual's current and future life insurance needs. LIMRA recently published an article showing their consumer confidence research, which is titled "Amidst continued concerns about the economy and COVID-19, consumer confidence in life insurance industry at all-time high." Unsurprisingly, a health crisis is driving interest in life insurance protection.

Insurance policies have been sold to all age groups, and it has been shown that younger consumers have been purchasing more than other age groups. It is not surprising that this shift for this age group is due in part to the insurance carriers' shift more towards digital sales channels. This digital expansion perhaps is the remedy for the previously dwindling insurance sales, but given the nature of the business, there will need to be a form of human touch at specific stops when building cases. The digital technologies will help update and streamline the sales process, but life insurance experts will need to be included in discussions for each unique client's case and needs.

There remain challenges, and life insurance has not received a free pass. While 2020 has brought digital expansion which is helpful for growth, especially for younger clients, on the opposite end of the spectrum, older clients may be subject to less available products. With COVID-19, many potential clients have been affected by increased underwriting restrictions, which limits or even removes life insurance options. Additionally, the low-interest-rate environment has brought another set of challenges, which as lead to increased premiums which if continued may lead to increased lapses or forfeitures of policies.