BY JOHN KINGHAM

DIVIDEND HUNTER

BAG A PREMIUM INCOME FROM THE INSURANCE MAJORS

As dividend stocks go, life insurance companies have a mixed track record. On the one hand, they operate in a sector which is relatively immune to the economic cycle (people don't typically cancel their life insurance just because there's a recession). On the other hand, dividend cuts are fairly common within the sector, despite its blue chip credentials. However, if you can spot the safest insurers and buy them at reasonable prices, I think the potential yield plus growth rewards can be worth the risk.

With that in mind, this month I'm going to pit two of the UK's biggest life insurers against each other to see who comes out on top.

Two high quality, high growth insurers

So why pick **Legal & General (LON:LGEN)** and **Prudential (LON:PRU)**? The main reason, other than that they're high profile large cap blue chips, is that they both have impressive histories of steady dividend growth. Okay, neither of them is perfect; Prudential cut its dividend after the market crash of 2003, and L&G cut its dividend after the market crash of 2008. But both companies rebounded quickly and, other than those two blips, their recent performance has been impressive, as the accompanying charts show.

Over the past decade both companies have grown at double digit rates, 11% for Prudential and 13% for L&G. Yes, L&G was recovering from a post-2008 slump, but its current dividend is still more than twice its pre-crisis high. In contrast, the FTSE 100 has only managed to grow earnings and dividends at about 2% per year, on average.

Consistency has also been good during that period, with both companies increasing their net asset values (an important measure for insurers), earnings and dividends more than 80% of the time. (That's also better than the FTSE 100's less consistent record, where earnings and dividends have increased only half the time.)

Another favourite measure of mine is profitability, or in the case of life insurers, ten-year average return on equity (ROE). As a group, UK-listed life insurers have managed an average ROE of about 13%, while Prudential has managed 19% and L&G 17%. In fact, they fill two of the top three slots for most profitable dividend-paying UK life insurer.

So that's the initial picture. These are two blue chip stocks with track records of highly profitable and

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mostly steady dividend growth. The next step is to find out how those financial results were achieved.

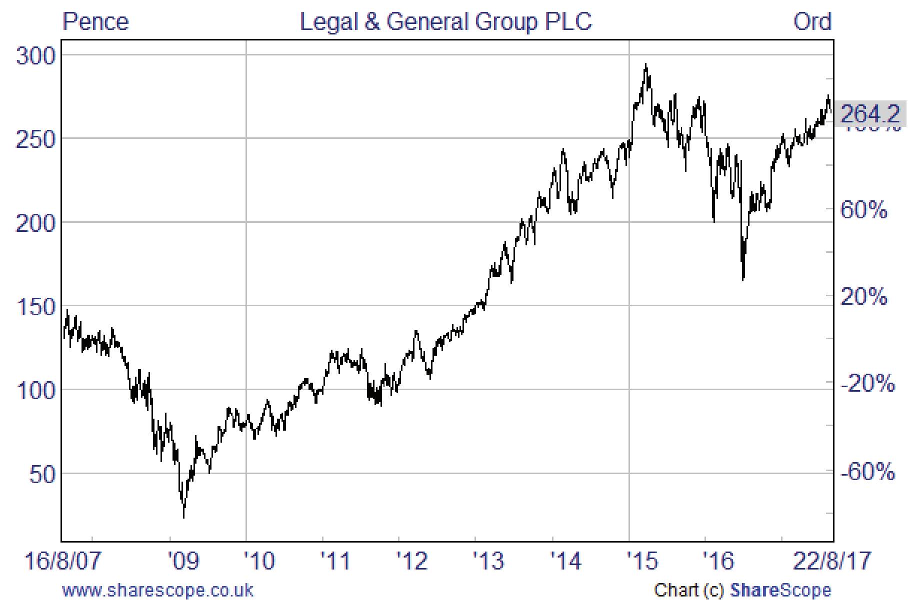
Same sector, different focus

Both companies operate in the life insurance sector, but they also generate significant profits from closely related areas such as annuities and investment management.

L&G focuses on the corporate retirement market, generating 43% of operating profits from managing retirement assets (mostly de-risking corporate pension schemes and underwriting annuities for corporate retirees), 19% from investment management (managing corporate pension funds and retail investment funds), 17% from life insurance and 13% from its capital investment business (directly investing long-term annuity assets into housing and infrastructure projects).

Prudential focuses on individuals rather than corporations, generating more than 80% of its operating profits from individual life insurance policies and variable annuities. The remaining 20% comes from its asset management businesses in the UK and Asia.

As well as focusing on different products and services, they also focus on different geographic regions. Legal & General operates primarily in the UK and generates about 80% of its profits here. Prudential is far more international, generating about 25% of its profits from the UK, 43% from the US and 30% from Asia.



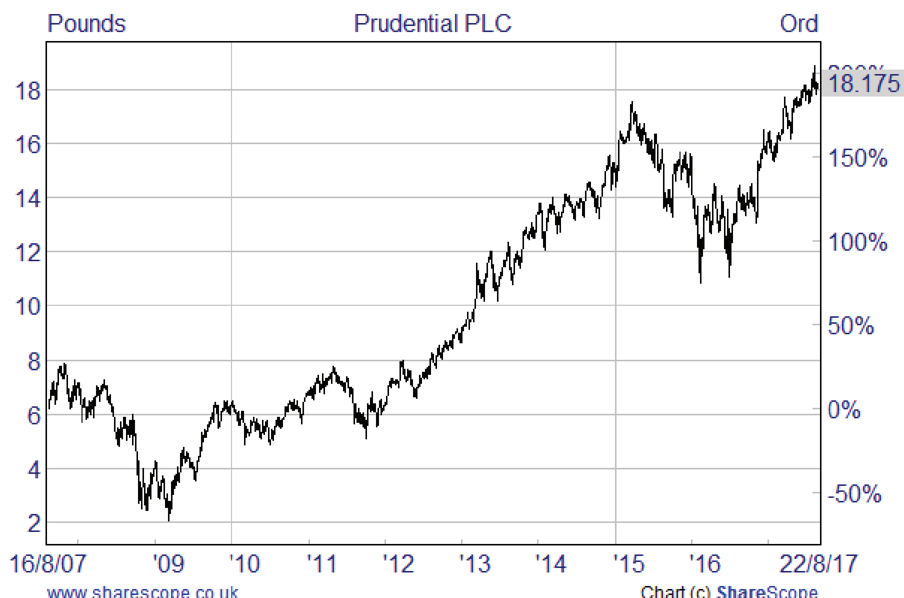
Despite these differences, both companies are fundamentally focused on later-life and end-of-life insurance, which is a market where changing demographics are creating huge opportunities.

Longevity, baby boomers and the emerging Asian middle class

Years ago the "average" man retired at 65, lived another 10 years and then died. Today the average retirement period for a man is over 18 years and could soon be as long as 20 years (the average retirement for a woman is even longer). Longer retirements require larger pension savings, which means more assets for asset managers and larger annuities for annuity providers; two areas which form a big chunk of L&G's and Prudential's businesses.

A longer average retirement also means the ratio of workers to retirees will continue to tilt towards retirees. At some point the working population will not be able to comfortably support the retired population and the state pension will have to shrink. That's partly why the UK government introduced pension auto-enrolment, where all employees have some of their wage redirected into defined contribution pensions by default. Total assets under management within UK defined contribution pensions are growing at double digit rates, which I'm sure makes L&G and Prudential very happy.

Another demographic tailwind is the baby boomer generation who, having been born in the two decades or so after World War II, are now beginning to enter retirement. With more than 40 million boomers expected to retire over the next decade in the US alone, this huge shift represents a once in a generation opportunity for retirement income providers like Prudential and L&G, as both companies have a large exposure to this market. L&G for example, currently manages more than £54 billion of annuity assets, while Pruden-



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tial generates around 40% of its operating profits from its US annuity business, Jackson National Life.

One final tailwind, which relates primarily to Prudential but also to L&G to some extent, is the massive expansion of middle class wealth in Asia.

For both companies, this massive increase in wealth represents a huge opportunity. Millions of new middle class citizens are starting to save towards their retirement, and both Prudential and L&G are looking to manage those savings and investments. Prudential is well ahead of L&G in this respect as it has been operating in Asia for over 90 years and already generates about 30% of its operating profits from across the region. That percentage is likely to increase in future as Asia has long been the fastest growing area within Prudential. In 2010 for example, operating profits from Asia came to just over £500 million. By 2016 that figure had grown to more than £1.5 billion.

As a result of this rapid international growth, Prudential's UK and European business now generates just 25% of total operating profit. In fact, there's a lot of speculation at the moment about a potential split between Prudential's high growth US and Asia businesses and its low growth UK business. But for now that's just speculation.

Overall, I've painted a relatively rosy picture so far. These are two companies with long histories of high profitability, good growth and (usually) reliable dividends. They both have scale, market leadership and strong brands, and they operate in markets which could grow at a heathy rate for the next few decades.

However, there are always risks, two of which stand out in my mind.

Risk 1: Large and unpredictable regulatory changes

Finance is a heavily regulated sector and companies within it rely on regulatory stability in order to make long-term plans. Politicians, on the other hand, often make massive regulatory changes as they try to improve society and attract voters. These regulatory changes can have a dramatic impact, either positive or negative, on the affected companies.

A good example of this occurred in the UK recently, when the then Chancellor of the Exchequer, George Osborne, announced a raft of new pension freedoms in 2014. These freedoms included the freedom to not buy an annuity. Instead, retirees would be allowed to keep their pension pot invested and draw it down in whatever way they see fit (more or less).

This sparked a massive change in the UK annuity market and now more than 90% of L&G's defined contribution

pension accounts end up being transferred to cash rather than annuities. For UK annuity providers this change was a major headache, but not for L&G or Prudential as selling individual UK annuities is not a major part of either business.

Another example of regulatory change is the new US "fiduciary rule". This will classify any US financial professional as a fiduciary, with the obligation to act first and foremost in the client's best interest (which seems reasonable enough). In some ways it's similar to the Retail Distribution Review which took place in the UK a few years ago, as both rule changes make it harder for advisors to be paid a commission by financial companies in return for putting their clients' money in the hands of those companies.

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Personally I think the fiduciary rule is a good thing, but how it will affect Prudential's very significant US annuity business is unknown. Either way, this sort of major regulatory change is a serious business risk.

Although regulatory change is a major risk, I think a far more important risk, and one which is far easier to quantify, is balance sheet weakness.

Risk 2: Volatile markets and an insufficient capital buffer

When you pay an insurance premium, the insurance company puts most of that money to one side, ready to cover the cost of any claims that arise. This means there is a large asset of collected premiums sitting on the company's balance sheet, which is largely offset by the liability of expected future claims.

Rather than simply leaving your premiums in cash for a few decades waiting for you to die, life insurance companies will invest it in order to reduce the amount of premiums needed in the first place for a given amount of cover (which makes them more price competitive). And as a bonus, excess returns from these investments are often used to pay special dividends to shareholders.

This means life insurers are willing to invest in equities, which as we know can be volatile. The risk is that if equity values fall, the value of the premium assets may fall below the expected value of future claims, and that is a definite no-no as far as the regulator is concerned. If that were to happen, a dividend suspension and rights issue would be virtually unavoidable.

To avoid that unpleasant situation, the regulator insists that insurance companies have assets a certain amount above and beyond their liabilities, with that certain amount being known as regulatory capital. Each insurer will then look to hold surplus capital beyond their regulatory capital as this gives them a further margin of safety in case equity markets go down the pan.

But even then, things can go wrong, as Prudential cut its dividend in 2003 and L&G did the same in 2008. The eagle eyed will have spotted that both 2003 and 2008 were bear market years, and that's no coincidence. So a robust balance sheet which is able to withstand equity market declines is an absolute necessity if dividends are to be sustained.

Fortunately, insurers will report their capital surplus and capital requirement, so it's usually easy to work out their capital coverage ratio, i.e. the ratio between the two. Unfortunately, there is no obviously "safe" level for this ratio. Different insurers invest their premiums into different asset classes, with different hedging strategies and other complicating factors. So a capital coverage ratio of 150% may be safe for one company, but extremely risky for another.

A more usable ratio, in my experience, is the premium to surplus ratio. This is the ratio between net premiums written during the year (net of reinsurance premiums) and the surplus capital of

the company (i.e. the surplus of assets over liabilities, measured using net tangible assets). In my experience, a premium to surplus ratio of less than two is usually prudent, with values above that tending to be associated with companies that eventually cut their dividend.

INVESTMENT RULE: Only invest in an insurance company if its five-year average premium to surplus ratio is below 2

Using that ratio, L&G's balance sheet looks relatively cautious, with a five-year average premium to surplus ratio of 1.6. In terms of the regulatory capital cover ratio, L&G's is currently 171% and has averaged 204% over the last five years. So L&G typically has twice as much capital as required by regulation, and that's more than almost all of its peers.

> **"BOTH COMPANIES ARE FUNDAMENTALLY FOCUSED ON LATER-LIFE AND END-OF-LIFE INSURANCE, WHICH IS A MARKET WHERE CHANGING DEMOGRAPHICS ARE CREATING HUGE OPPORTUNITIES."**

Prudential does not come out quite so well, with a premium to surplus ratio of 11. That's way above my preferred maximum of two, which can only mean one of two things: either a) Prudential's balance sheet is recklessly undercapitalised or b) the premium to surplus rule of 2 is not applicable to Prudential for some reason or other.

To get a better idea of which it's likely to be, we can use the regulatory capital cover ratio as a sanity check. In this case, Prudential currently has a capital cover ratio of 201%, and over the last five years the average has been 244%. As with L&G, that's twice the regulatory minimum. In this case I think the regulatory capital cover ratio is more reliable than the premium to surplus ratio, which means I do not think Prudential is obviously undercapitalised.

Potentially good investments, but only at the right price

Having looked at the pros and cons of these two insurance giants, I would say that they're both potentially good investments. They both have good track records of highly profitable dividend growth, they both appear to have strong balance sheets and they both operate in markets with strong tailwinds. I would be happy to invest in either of them at the right price.

Of the two, L&G is more attractive at first glance. At 267p it has a 5.4% dividend yield to go along with its double digit growth rate. Prudential, at 1811p, has a yield of just 2.4%. That's below the FTSE 100's yield of 3.9%, which is what I'd normally expect for a high growth company. Looking at my stock screen, which favours stocks with the best combination of growth, consistency, profitability and value, L&G still comes out on top. Out of 223 dividend-paying stocks on the screen, L&G is ranked eighth while Prudential comes in at eighteenth. However, that's a tiny margin of victory for L&G, and both companies are comfortably within the top 50, which is where I look for new investments.

On that basis then, I think both companies are attractive businesses trading at attractive prices. If I had to choose one today then I would choose L&G. In fact, I've already chosen L&G as I bought it back in April when the yield was 5.8%, and if Prudential stays at its current price for much longer I might end up with another life insurer in my portfolio.

About John

John Kingham is the managing editor of UK Value Investor, the investment newsletter for defensive value investors which he began publishing in 2011. With a professional background in insurance software analysis, John's approach to high yield, low risk investing is based on the Benjamin Graham tradition of being systematic and fact-based, rather than speculative.

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