

Investment Profile of the Life Insurance Industry

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Backdrop

- Between the beginning and end of our 1999-2003 study period, the life insurance industry's portfolio managers have been faced with rapidly falling interest rate levels, high-profile corporate defaults, and rating agency downgrades. Undoubtedly, these factors have made their tasks today much more difficult than five years ago.
- Interest rates have fallen sharply since mid-2000. After climbing throughout 1999 and peaking at 6.50% in May 2000, the Federal Funds rate plummeted to 1.75% by the end of 2001, fell further to 1.25% in 2002, and ended 2003 at 1.00%, its lowest level in more than 50 years. Likewise, yields on 10-year Treasuries fell from 6.45% to 3.37% between year-end 1999 and May 2003, before rebounding to 4.27% at year-end 2003. A-rated corporate bond rates dropped from 7.44% to 4.38% between December 1999 and June 2003, before increasing to 4.88% by the end of 2003.
- Several insurers were exposed, some much more than others, to corporate defaults such as Enron, WorldCom, and Global Crossing in 2001 and 2002. In addition, rating downgrades have considerably outnumbered upgrades as Moody's and Standard Poor's ratios of bond downgrades to upgrades were more than 5:1 and 3:1 for 2002 and 2003, respectively. The combination of these defaults and downgrades has led to deterioration in the quality of the industry's bond portfolio over the past three years.

Scope

Peer Groups

Life Insurers

Annuity Writers

&H Insurers

Life/Annuity Writers

Multiline Companies

Reinsurers

Study of Study

Assets

Investment Income

Bonds

Mortgages & Real

estate

Stocks & Schedule BA

Investments

- The purpose of this study is threefold. First, it examines how insurers have structured the asset side of their balance sheets and present allocations of the primary asset classes.
- Second, the report benchmarks the industry's investment income earnings (in overall dollars) by asset class for the entire study universe and each of the six peer groups from 1999 through 2003. Investment income return trends, in total and on a more meaningful "adjusted" basis, are also presented.
- Third, the final three chapters provide a more in-depth view of the industry's various asset types and their respective return performance over the same period.

Asset Allocations

Fixed-income assets have risen slightly each of the past three years and now account for 95.7% of the industry's investable assets as of 2003.

Bonds account for the overwhelming majority of life insurers' investable assets, increasing from just over 80% in 1999 to nearly 84% in 2003.

The decreasing allocation to mortgages and real estate come as no surprise as companies are wary of their limited liquidity.

Insurers wishing to maintain some exposure in these classes can do so now with greater liquidity by using CMBSs, MBSs, and REITs.

Allocation of Investable GA Assets, Study Universe

(as a % of total investable assets – statutory reporting basis)

	1999	2000	2001	2002	2003
Fixed Income					
Cash & Short-Term Bonds	3.5%	3.1%	3.4%	3.8%	3.2%
Long-Term Bonds	76.6%	77.1%	77.9%	79.2%	80.5%
Total Bonds	80.1%	80.2%	81.3%	83.0%	83.7%
Mortgages	13.5%	13.3%	12.6%	11.6%	11.0%
Preferred Stock	1.0%	1.0%	1.0%	0.9%	1.0%
Total Fixed Income	94.5%	94.5%	94.9%	95.6%	95.7%
Equity					
Common Stock	2.3%	1.8%	1.5%	1.1%	1.2%
Real Estate	1.2%	1.0%	0.9%	0.8%	0.6%
Schedule BA	2.0%	2.7%	2.7%	2.6%	2.6%
Total Equity	5.5%	5.5%	5.1%	4.4%	4.3%

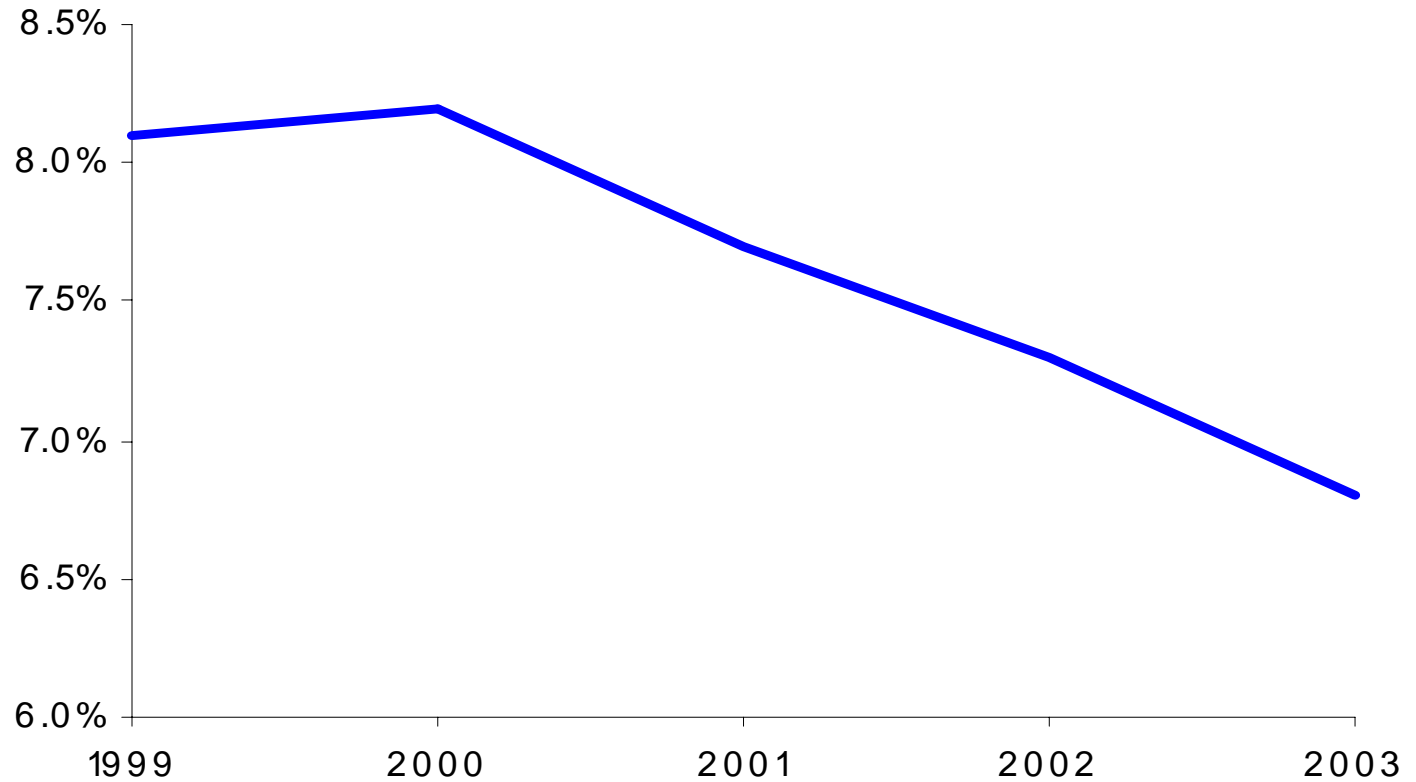
Source: Company filings, Conning Research & Consulting, Inc. analysis

Gross Investment Income Returns

Even by dropping interest rates, the Gross Investment Income Return of the industry (Gross Investment Income expressed as a percentage of average investable assets), has been declining in the past few years. After increasing modestly from 8.0% in 1999 to 8.2% in 2000, the ratio has fallen steadily throughout the remainder of the study's historical period, reaching a five-year low of 6.8% in 2003.

GIR, Study Universe

(as a % of investable assets)



Gross Investment Income Returns:

By Peer Group

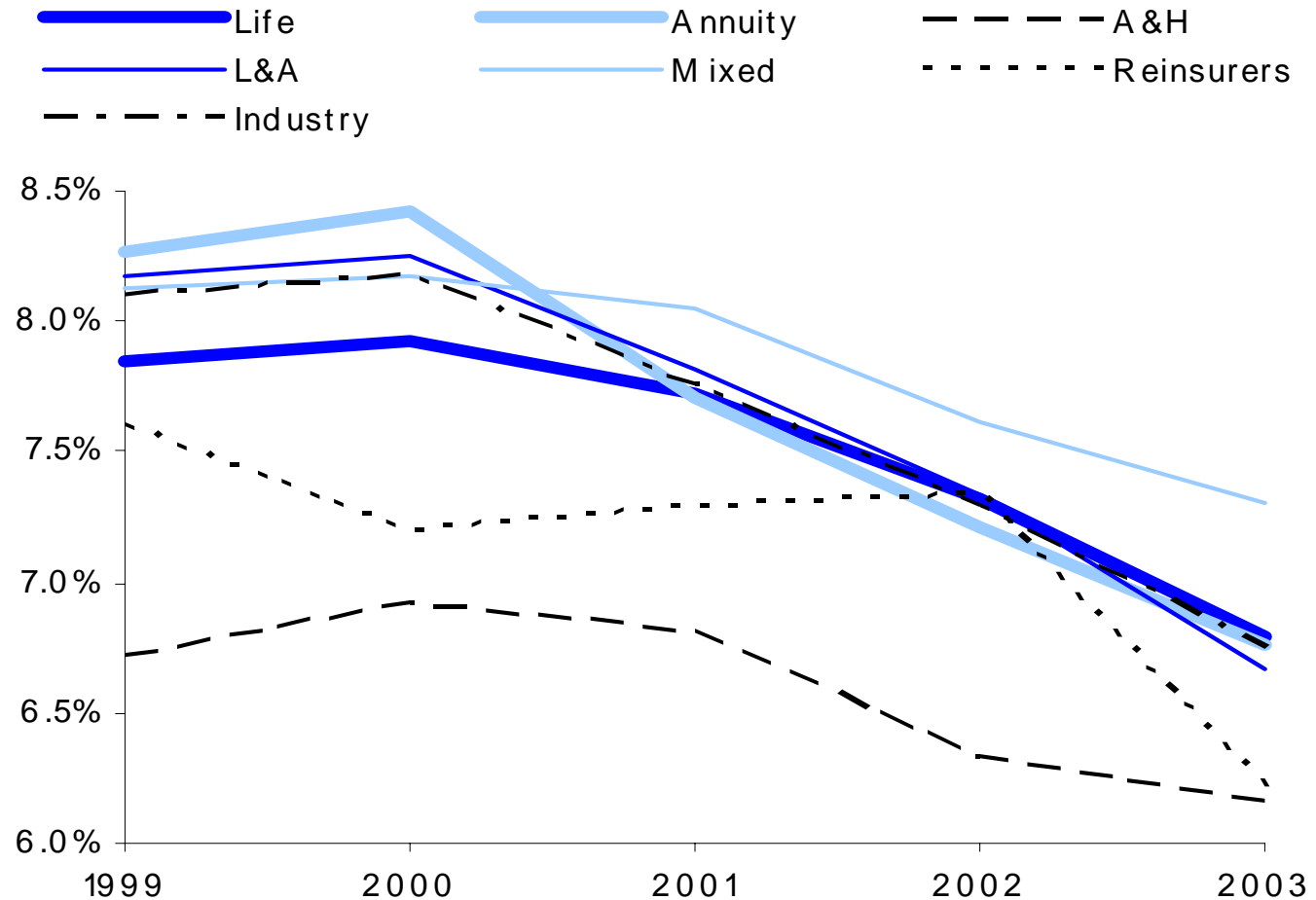
the declining pattern for the industry as a whole was generally reflected in the peer groupings. Sixteen finished the study period with lower returns than at the beginning.

Mixed companies have outperformed their peers over the last three years. They were the only group to exceed 8% in 2001 and 7% in both 2002 and 2003.

A&H companies have exhibited the lowest returns, averaging only a 6.5% over the past five years. These results are consistent with their higher allocation to cash and short-term bonds and higher bond quality.

GIR by Peer Group

(as a % of investable assets)

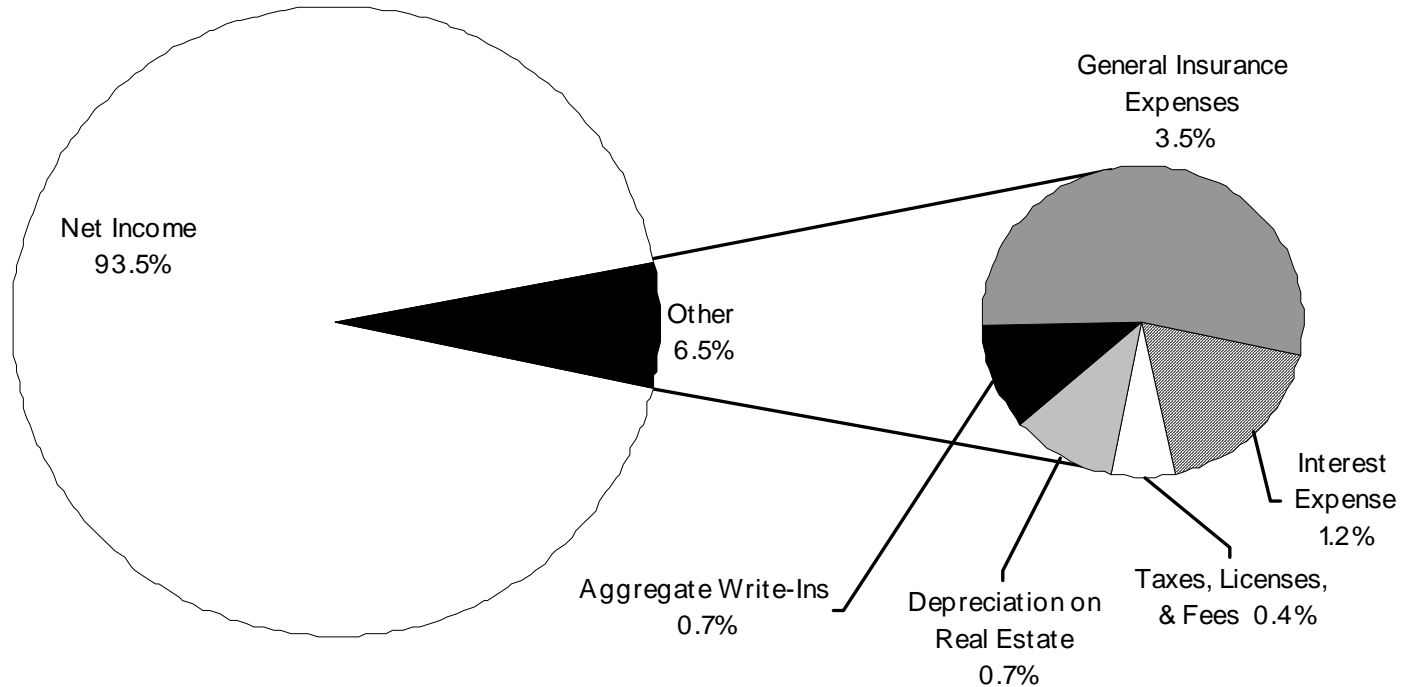


Expenses

expenses as a percentage of average invested assets improved each year during the study period, falling from 52 bps in 1999 to 40 bps in 2003.

On an aggregate basis, 3.5% of all gross investment income earned from 1999 through 2003 became net investment income. General expenses related to investments amounted to 3.5%, and interest expenses accounted for another 1.2%.

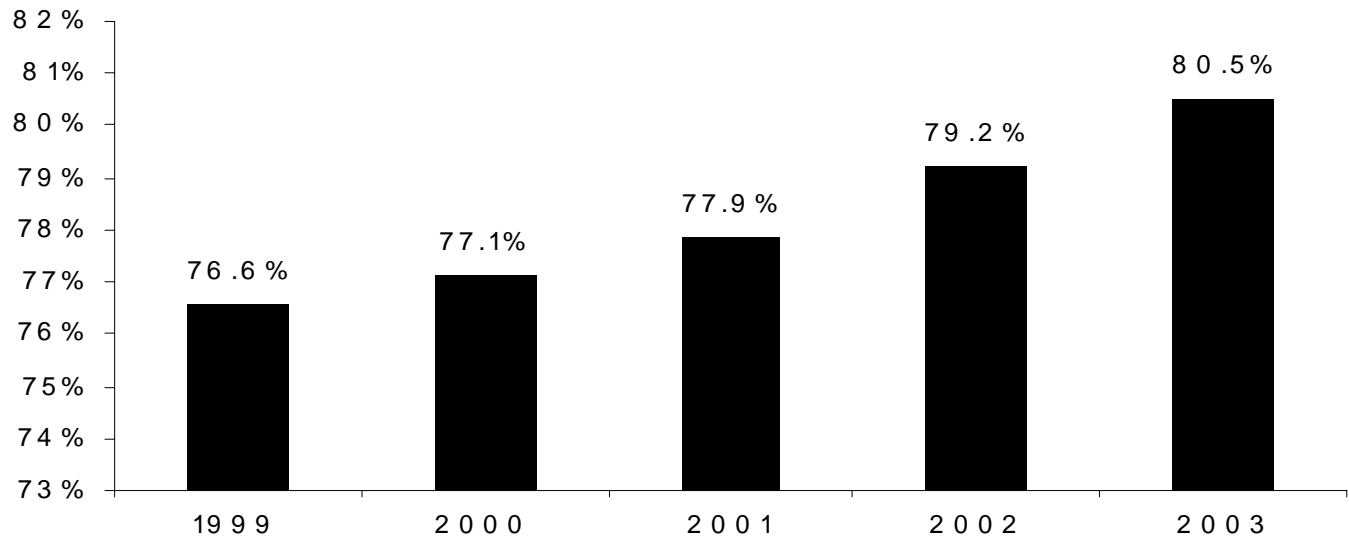
Gross Investment Income Components: 1999-2003 Weighted Averages



Bond Holdings

- At \$1.92 trillion, bonds—including short-term bonds and structured securities—make up the largest portion of life insurers' GA assets, accounting for more than 83.7% of investable GA assets in 2003.
- Long-term bond holdings, as a percentage of investable assets, have risen each year over the five-year study period, with the largest increases (1.3%) occurring in 2002 and 2003.

Long-Term Bond Holdings, Study Universe (as a % of investable assets)



Bond Holdings:

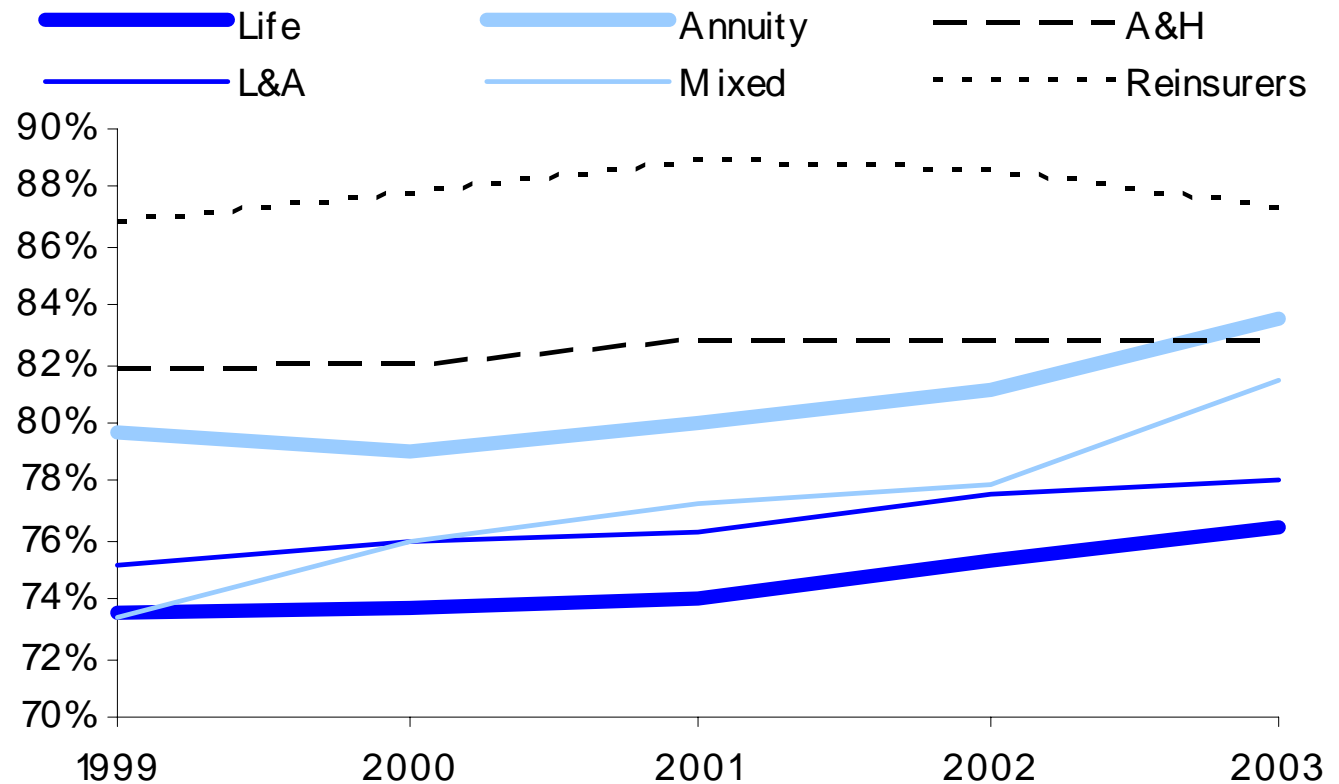
By Peer Group

Reinsurers and A&H companies tend to invest more heavily in long-term bonds, with reinsurers increasing allocation from 86.8% to 87.3% and A&H companies growing from 81.7% to 82.7% over the five-year study period.

Mixed companies increased overall allocation by the largest margin (nearly 11%), growing from 73.4% in 1999 to 81.4% by 2003.

Long-Term Bond Holdings by Peer Group

(as a % of investable assets)

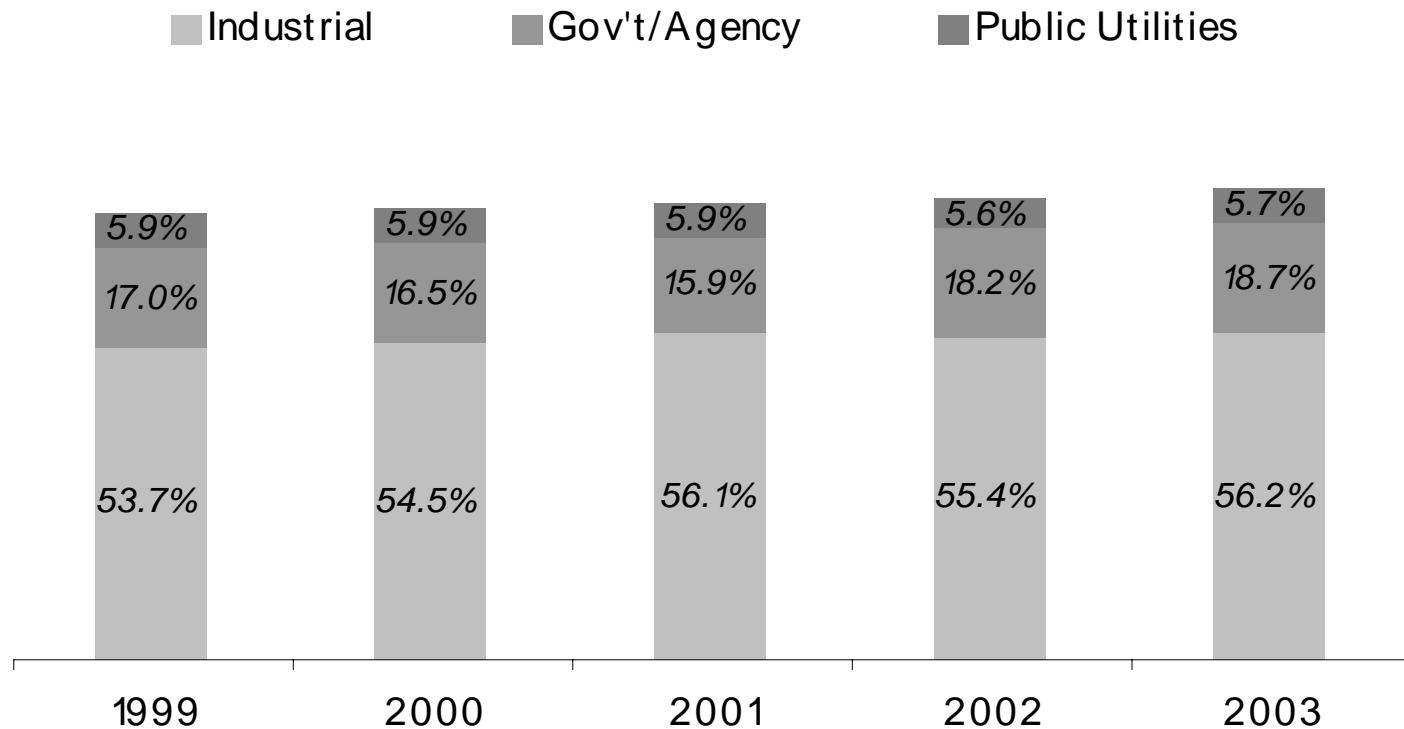


Bond Holdings by Sector

With the exception of 2002, the total allocation of industrial bonds has increased steadily, increasing from 53.7% to 56.2% over the study period.

After declining slowly in 2000 and 2001, the allocation to government bonds, including agency backed structured securities, surged to 18.2% in 2002 and further increased to 18.7% in 2003. This 2002 surge was the result of a "flight to quality" by the majority of the industry. Insurers began to divest large portions of "riskier" investments following the market decline in 2001 in favor of much safer government and agency bonds and structured securities.

Distribution of Bond Holdings by Sector, Study Universe
(as a % of investable assets)

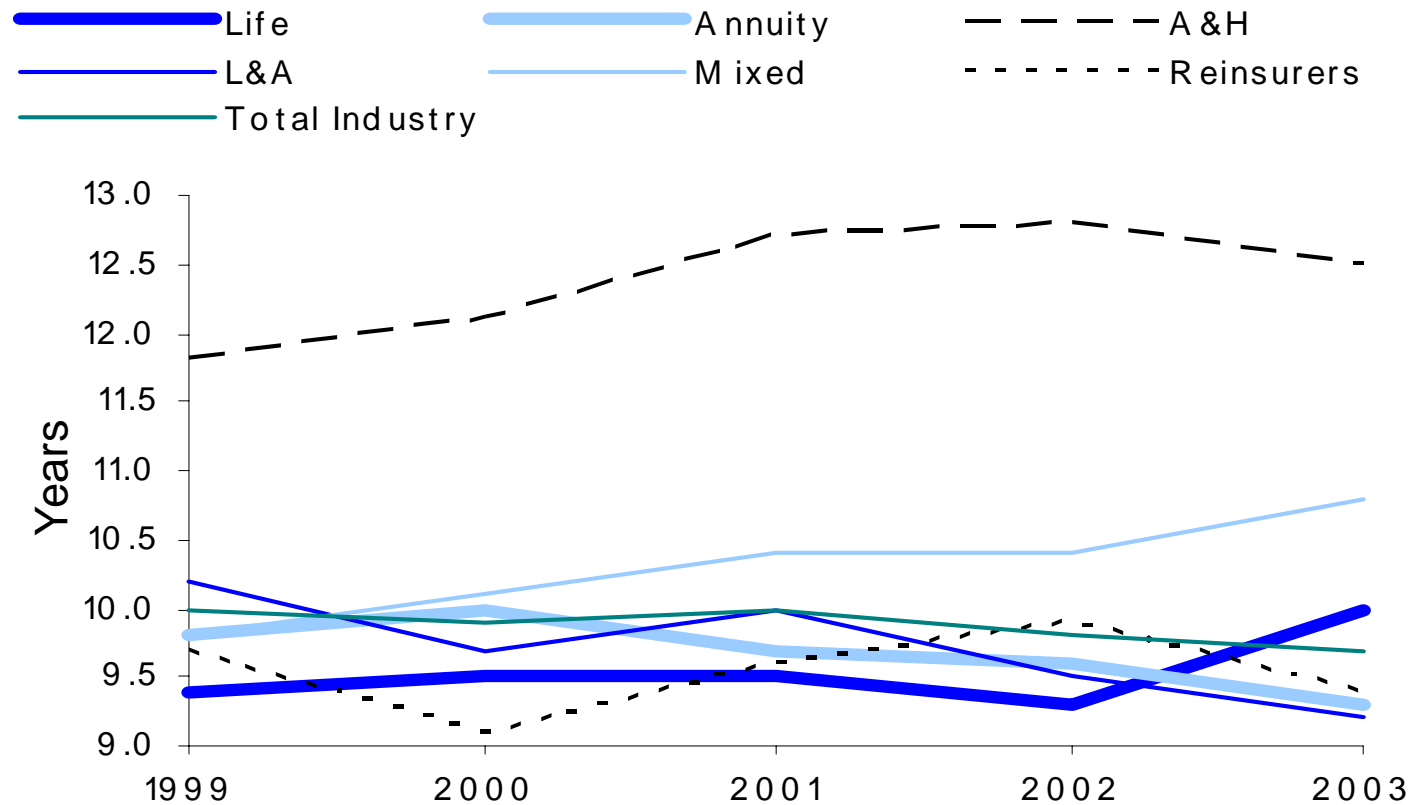


Bond Maturity

A&H and mixed groups have much longer average maturity lengths because virtually all companies with large blocks of DI and/or LTC are a part of these two groups. These companies invest much more heavily in longer-duration bonds due to the nature of the long-tailed liabilities associated with these products.

The A&H group also has the largest allocation of *long and short-term* bond holdings as well. The combination of “healthy” and DI/LTC insurers found in the A&H category cause a “barrelled” investment strategy for this group.

Average Maturity of Bond Holdings by Peer Group

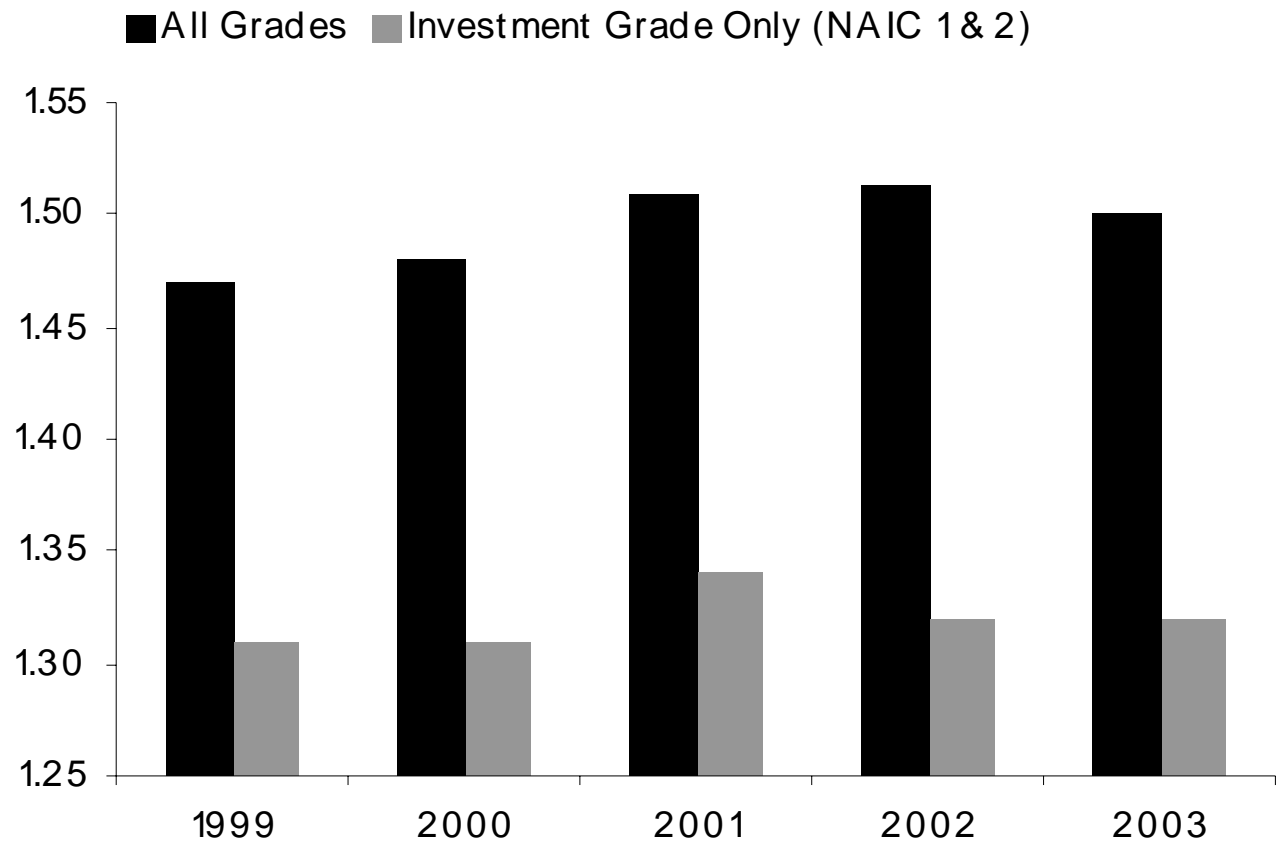


Bond Quality

Between 1999 and 2002, the quality of insurers' bond portfolios deteriorated consistently—most notably between 2000 and 2001—before improving slightly in 2003. Numerous downgrades from class A to BBB during 2001 are the main driver behind the drop in average quality for that year.

The percentage of the portfolio qualifying as investment grade bonds in 1999 was 92.5%, which remained relatively flat through 2001, fell 1.1 points to 91.4% in 2002, and then rebounded to its 1999-2002 level of 92.5% in 2003.

Average Quality of Bond Portfolio, Study Universe



BIG Bonds

With the exception of 2002, BIG bonds as a percentage of the bond portfolio has remained stable. The 2002 spike can be attributed mostly to the industry's exposure to high-profile corporate defaults.

The average quality rating of BIG bonds (3.52 in 1999 versus 3.64 in 2003) has slowly deteriorated. Most of this deterioration can be attributed to the percentage of NAIC 5 and 6 bonds steadily increasing from 7.5% in 1999 to 8.6% in 2002, and remaining relatively high at 8.6% in 2003. Insurers typically do not purchase bonds in classes 5 and 6—increases in these categories indicate that these bonds have experienced downgrades.

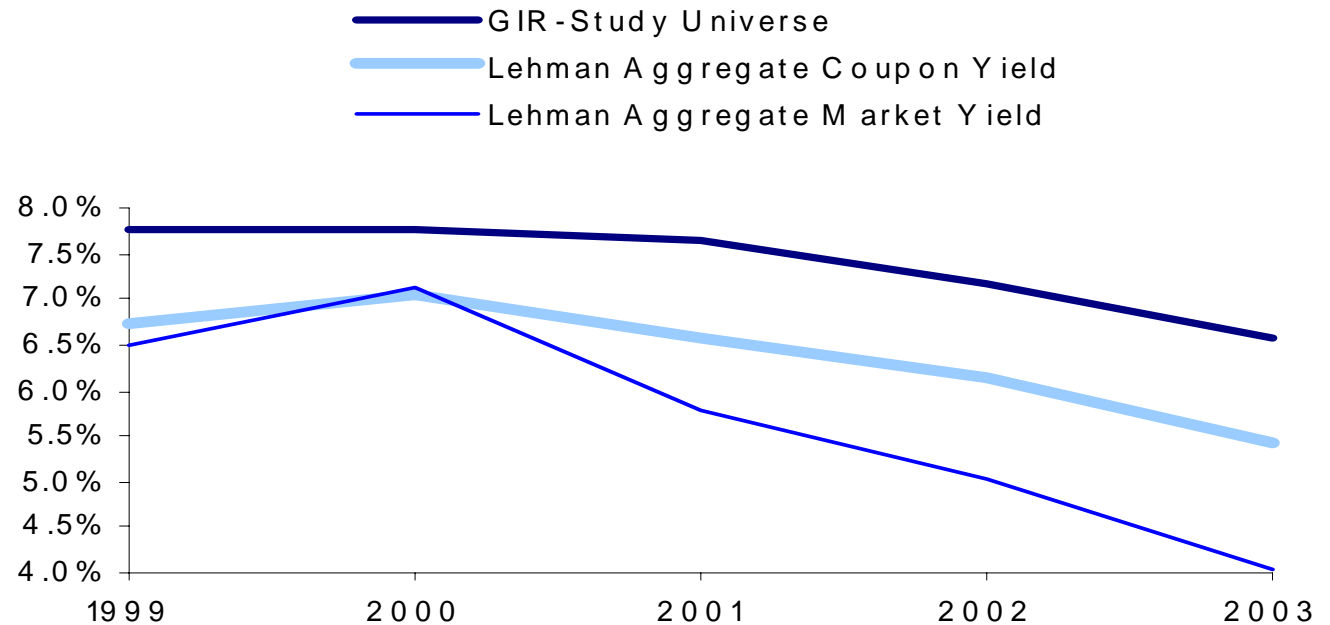
Below Investment Grade (BIG) Bonds, Study Universe

	1999	2000	2001	2002	2003
Investment Grade Bonds as a % of Bond Portfolio	92.5%	92.5%	92.4%	91.4%	92.5%
Average Quality of Bond Portfolio	1.47	1.48	1.51	1.51	1.50
BIG as a % of Bond Portfolio	7.5%	7.5%	7.6%	8.6%	7.5%
Average Quality of BIG Bonds	3.52	3.58	3.60	3.62	3.64
BIG as a % of Investable Assets	6.0%	6.1%	6.1%	7.1%	6.3%
BIG as a % of Modified Capital & Surplus	42.4%	42.3%	46.2%	58.7%	49.5%

Bonds: Gross Investment Income Returns

- Gross investment income returns on bond portfolios have fallen each of the past four years, with the steepest declines occurring in 2002 and 2003. Over the five-year period, the GIR on bond portfolios has dropped from a level of 7.76% in 1999 to 6.59% in 2003.

Gross Investment Income Return on Bond Portfolio, Study Universe



Sources: Company filings, Conning Research & Consulting, Inc. analysis & Lehman Brothers Global Family of Indices.

Mortgage Holdings

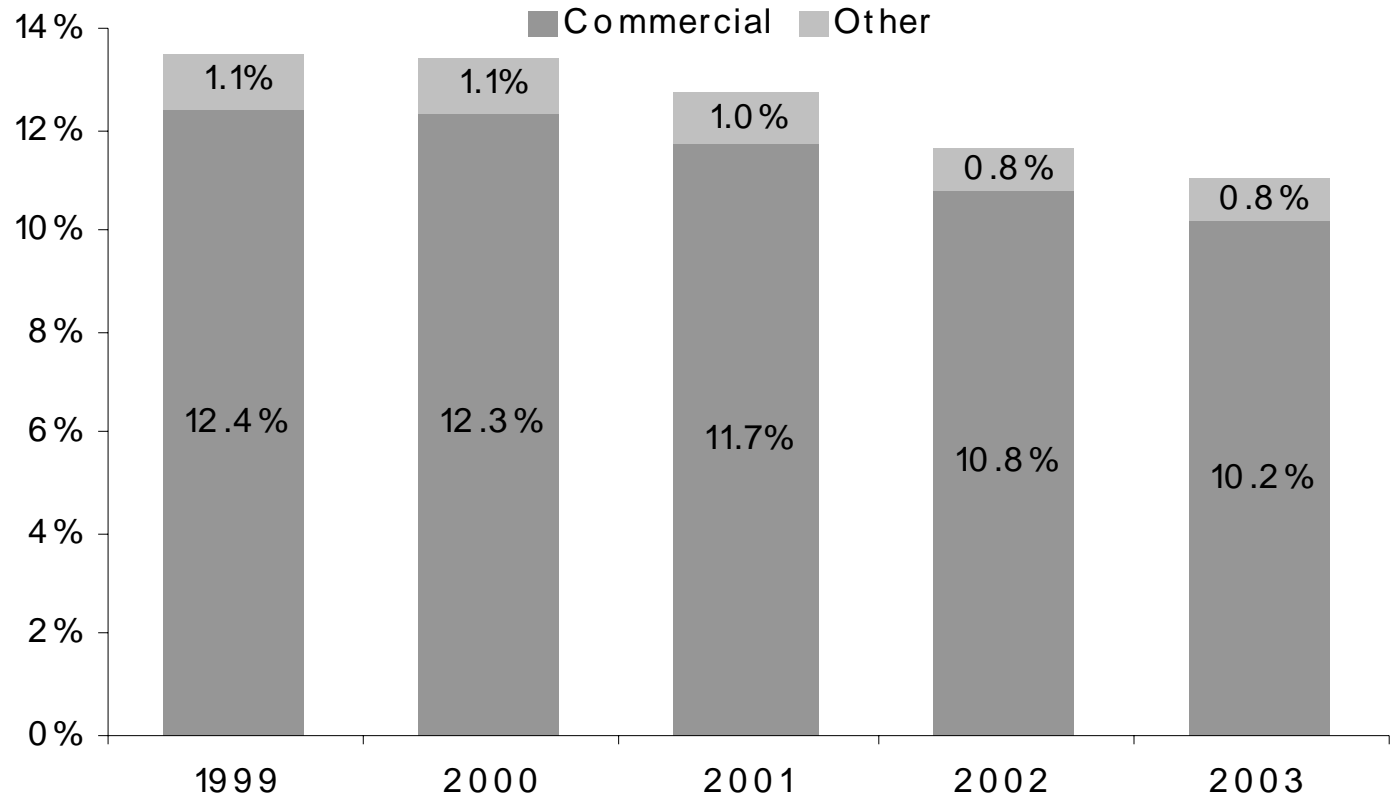
Two factors have driven the decline in mortgage investments:

First, as a privately negotiated transaction between the investor and the property owner, mortgages are illiquid assets. This creates a greater risk if cash is needed quickly. While there is a limited secondary market for mortgages, they are not as easy to sell as public bonds.

Second, insurers seeking to obtain diversification advantages associated with mortgages can instead invest in high-quality MBSs and CDOs with reduced liquidity risks and lower capital requirements.

Mortgage Holdings, Study Universe

(as a % of investable assets)

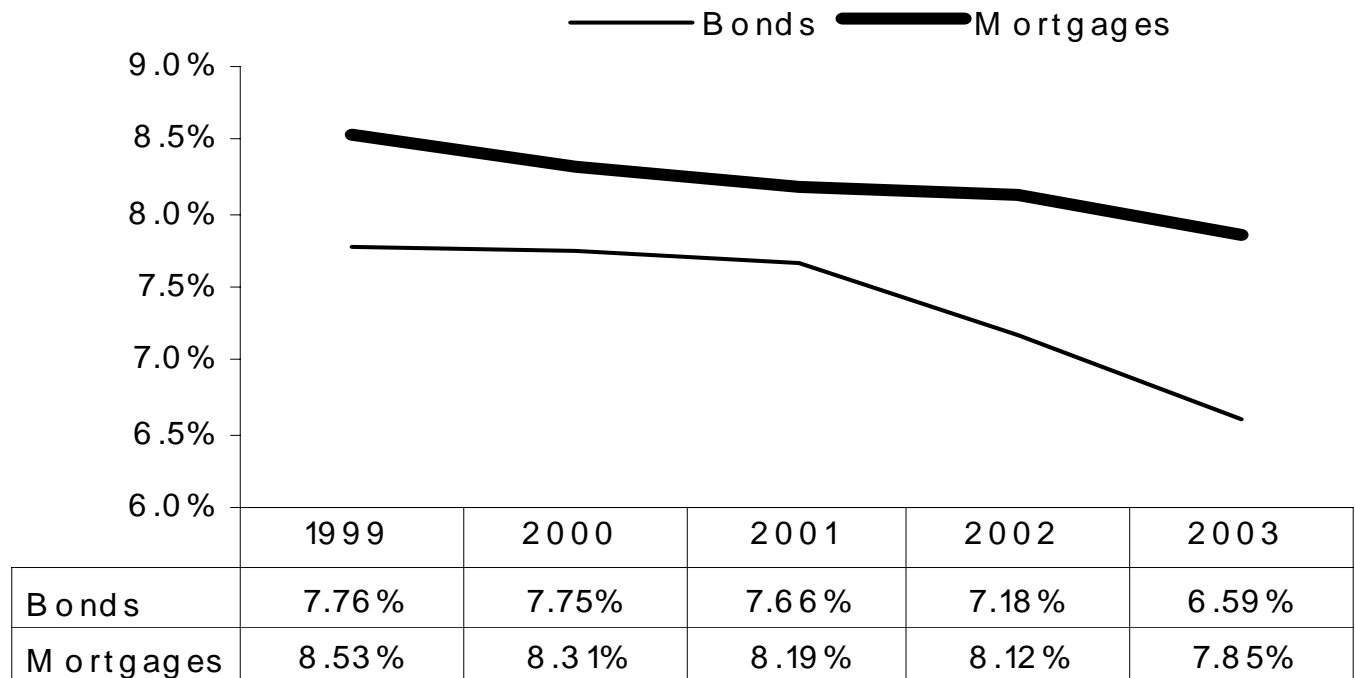


Mortgages: Gross Investment Income Returns

Mortgages historically have produced higher GIRs than bonds. However, higher expenses, illiquidity, and the additional capital needed to satisfy RBC requirements for mortgage holdings often outweigh the additional 0.75% to 1.25% of GIRs that mortgages produce over bonds.

Gross Investment Return, Bonds vs. Mortgages

(as a % of investable income)

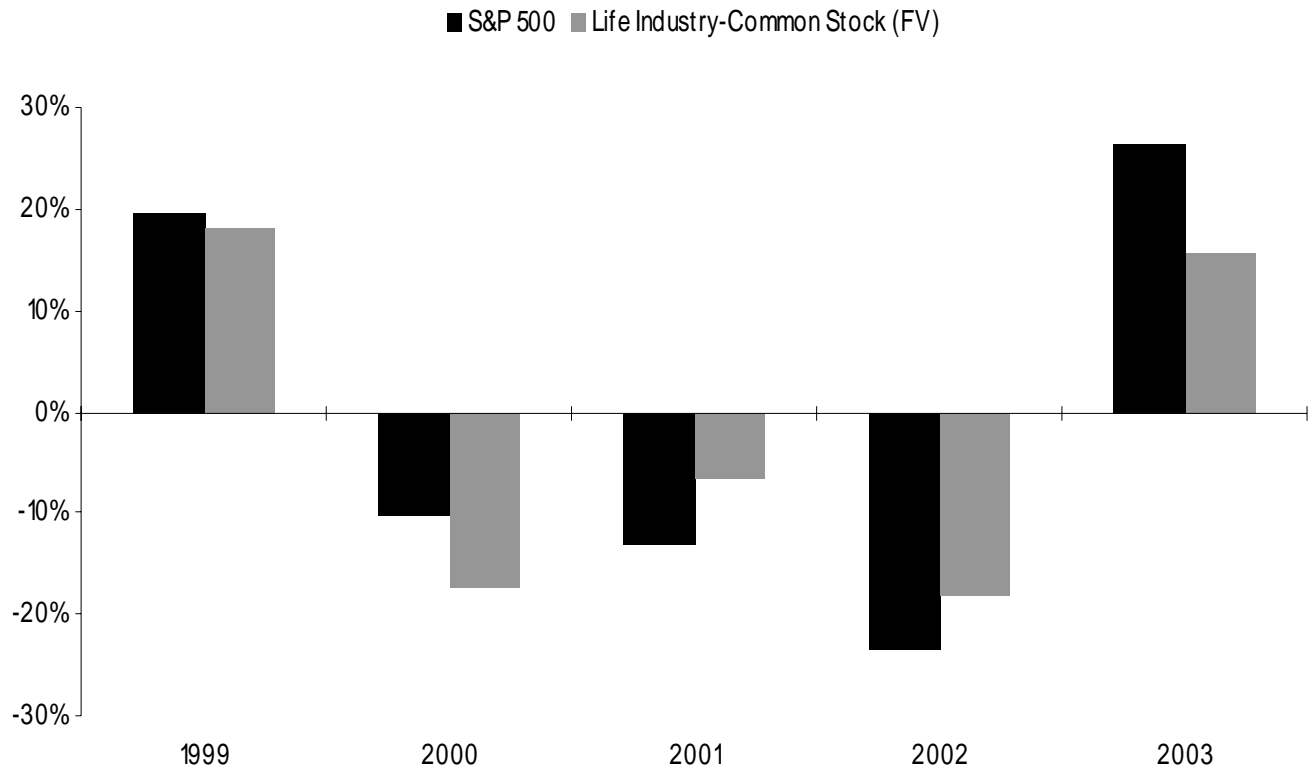


Common Stocks

investment allocation to common stocks (at market value), excluding common stock of affiliates, has been reported. It peaked at 2.3% of investable assets in 1999, dropped off significantly during the 2000-2002 bear market cycle, falling to 1.1% at the end of 2002. The ratio improved nominally in 2003 as the equity market began to show improvement.

Increases/decreases in the industry's asset allocations to common stocks have followed the same pattern as the improvement/decline in the S&P 500, indicating that most insurers do not actively purchase common stock. Changes in asset allocations to common stock have been attributed to fluctuations in market value of existing investments.

Common Stock Increases/Decreases in Fair Value (Excluding Affiliates), Study Universe



Conclusion

- As interest rates and investment yields begin to rise, the industry may find increasing opportunities in returning to a more diversified sector allocation. Some sectors, including mortgages and CMOs, may again prove attractive as gross yields rise and net yield margins improve. Alternative investment sectors including Schedule BA sectors, may prove attractive as yields overcome RBC constraints. Finally, new investment structures may emerge in packaging investment classes to provide better yields at acceptable expense and RBC costs.
- On the other hand, if investment yields do not rise, expense control and RBC management will continue to dominate the story, and sector allocations are likely to continue trending toward low-cost alternatives. This could have an impact on product development and premium growth as the industry becomes challenged in producing competitive credited yields. Larger companies, able to manage investment classes such as mortgages within acceptable cost factors, will likely gain increasing advantages of scale over smaller competitors.