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Understanding Insurance & China

The Insurance Sector

The insurance sector consists of various companies offering risk management services, in the form of insurance contracts. There are many different types of offerings within the sector, including life insurance, reinsurance, captive insurance, property and casualty insurance, supplementary health insurance etc. As an industry, investors view insurance as slow-growing and defensive.

The insurance business model is:

- To assume and diversify third party risk,
- Generate revenue through charging premiums, in exchange for insurance coverage,
- To reinvest premiums into other interest-generating assets, and
- Re-imburse policyholders for losses suffered.

Net premiums held, is known as *float.* This may be invested into treasury bonds, high grade corporate debt and interest-bearing cash equivalents, to earn income via interest, dividends and/or capital appreciation. Insurance firms may also invest in higher-risk assets (equities, properties, private equity, and alternative investments etc.). However capital preservation is an all-important consideration.

Some insurance firms engage in reinsurance to reduce risk. One of the largest reinsurance companies is Swiss Reinsurance Company Ltd, commonly known as Swiss Re (Swiss Re is covered in Rockman Capital's investment universe, of over 350 counters). Re-insurers provide cover to insurance companies to protect them from potential insolvencies and defaulting.

In times of market drawdowns, insurance stocks are considered defensive additions to investors' portfolio, as they provide steady long-term returns on capital at favorable valuations. This is illustrated by the performance of the stocks year-to-date (2022), compared to indexes like the S&P 500 (-16,20%) and the Euro Stoxx 50 (-8,68%):

- Zurich Insurance (SWX): + 10,67%
- Hanover Re (SWX): + 9,25%
- MetLife (NYSE): +15,82%
- United Health (NYSE): +7,16%
- S&P Insurance Index: + 2,44%

Email: roscoecj@rockmancap.com | http://rockmancap.com | Telephone: + 230 214 2251
3 River Court, St Denis Street, Port Louis, Mauritius

The 1-year Return of the S&P Insurance Select Index vs S&P 500:

During 2020/21, Rockman Capital rotated client portfolio holdings out of the bond sector, because of significant downside risk to capital from rising interest rates and low yields. In the search for real yield, we allocated to the insurance sector. Counters included: Zurich Re, Swiss Life, and Swiss Re – all of which historically have paid dividend yielding between 5-7%. In 2022 we have maintained this strategy and continue to hold these counters widely across all portfolio mandates.

Is China investable?

Chinese equities experienced a significant drawdown during 2022, declining by over 20% since January 2022. Whilst falling in sympathy with global markets (the S&P500 fell by 13%), Chinese stocks have pulled back considerably, particularly those listed in Hong Kong or via US American Depository Receipts (“*ADR*’*s*).

Sceptics and advocates alike, have argued for or against investing in China. Arguments include regulatory changes, the Evergrande property default, the potential delisting of US Chinese companies held via ADRs, geopolitical tensions and most recently COVID-19 lockdowns, all of which are good reasons for Chinese equities to underperform.

As quarantine and testing rules in China loosen, markets remain eager for an end to China’s stifling zero-Covid era. They are not waiting to buy: the MSCI China index increased 10 per cent in the past couple of weeks and is up 32 per cent since the October 2022 bottom.
With the Chinese government loosening its Covid containment strategy, it is expected that China’s economy will re-open in the coming months. It also remains crucial to understand the underlying logic and reasoning, which has driven various far sweeping regulatory moves that Beijing has undertaken since early 2021, to address key structural challenges. These include:

- An aging population and dwindling workforce, compounded by a sharply declining birth rate,
- A speculative bubble in the residential property sector,
- Inequality within the tertiary education sector, and
- Deteriorating Sino-US relations.

These challenges have galvanized Beijing towards building a self-reliant, self-sustaining economy, shifting the focal point of innovation away from applications in internet, to breakthroughs in deep tech.

The repressed consumption of the past three years also means that households have plenty of spare cash. If domestic investors join in, the rally could have real legs. However, policy shifting unpredictably between partial reopening and lockdowns and the impact thereof, on consumption and consumer confidence, can't be ruled out.

Following November's rally, p/e ratios remain low by historical standards, with the MSCI China at 11.7 forward p/e. However, given the above-mentioned risks and the risk reward of other markets (for example, the Taiwan stock index's p/e is 12.4 and/or the UK at 10), Chinese equity valuations don't yet appear compelling.