FLASH Report

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Financial Services Focus
Freeman & Co. LLC

Low Interest Rates – Issues and Opportunities

The prolonged low interest rate environment creates issues and opportunities for financial services firms.

Interest rates in the US and globally have been at extreme lows since the financial crisis of 2007-2009. This environment, coupled with lackluster market performance across numerous asset classes, has squeezed out a lot of "easy money" that many investors and financial services firms lived on during the mid-2000's. The Fed has kept interest rates near zero for the past three years and has recently pledged to keep them there through at least 2014 – it is certainly time for financial institutions who have not done so already to commit to adjusting their business models to this environment.

However, the story is not all negative. Along with the issues created by the environment, many opportunities arise for firms to not only fill the gaps created by low rates but to thrive, using updated products and services to satisfy institutional and retail demand for higher yielding assets – in other words, the firms that can help solve the issues that are present in this low interest rate environment will be well rewarded.

This report summarizes these issues and opportunities for the following sectors within financial services:

- Asset managers
- Insurers
- Specialty finance companies
- Banks & brokerages

Figure 1: Global Interest Rate Benchmarks, 2006-2011

	Rate for Year End						
	2006	2007	2008	2009	2010	2011	Change '06-'11
1 Year Bill	5.00%	3.34%	0.35%	0.44%	0.27%	0.10%	(98%)
5 Year Note	4.69	3.44	1.55	2.68	2.01	0.83	(82)
10 Year Note	4.70	4.03	2.21	3.84	3.30	1.88	(60)
90 Day LIBOR	5.36	4.70	1.43	0.25	0.30	0.58	(89)
180 Day LIBOR	5.37	4.60	1.75	0.43	0.46	0.81	(85)
1 Yr. LIBOR	5.33	4.22	2.00	0.98	0.78	1.13	(79)

Source: Bloomberg, US Department of the Treasury

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Issues

Asset Managers

Low interest rates combined with underwhelming market performance, especially in equities, have severely hampered any firm needing to meet return targets in order to cover liabilities. The situation has had a particularly unfavorable effect on both public and corporate pension funds. A report published by Milliman[(1)] on January 6 states that a group of 100 large corporate pension plans ended 2011 with a funding shortfall of $464 billion. These plans had a funding ratio of 72.4% at year end 2011, down from 84.1% at the end of 2010, and not much higher than the historical low of 70.5% in May 2003.

This funding gap is growing, and the outlook for the next several years is poor due to several major factors:

- Continuing low interest rate environment through at least 2014
- Aging of the population and retirement of the baby boomer generation
- Expectations of equity market returns that have been tempered from historical levels of 8%-10%

People currently retiring, already hurting from real declines in their portfolios from the financial crisis, are now experiencing near zero interest rates for their fixed income investments.

Outside the world of pensions, money market and fixed income managers are having difficulty justifying management fees while providing such low net returns to retail and institutional investors. For example, with 6 month Treasury bills yielding just 8 basis points (bps) and 1 year bills around 10 bps, money market funds are subsidizing any return to investors after paying custody, audit, reporting, transfer agent and any other costs. At the same time, relatively safe fixed income funds have become less attractive for the same reason – asset managers can only offer, for example, approximately 140 bps in net return after fees and costs on 10 year Treasury notes yielding 180 bps. The difference between gross and net returns is enough to drive many clients into indexing, investing on their own or instruments with higher credit risk.

Insurance Companies

Insurance companies are extremely exposed to interest rate risk, and while they have sophisticated processes in place to protect themselves on the downside, prolonged low interest rates significantly hinder their profitability across many product lines. At the most basic level, insurers have similar issues to those that confront pension funds – generating yield sufficient to cover crediting rates on their liabilities.

Many retirement income products written by insurers, such as annuities, are priced to offer customers a given rate of return, while the insurance company aims to generate returns on its investment portfolio in excess of what is paid to the customer. These liabilities are generally long term in nature and can offer guaranteed minimum returns, so the longer that interest rates remain low, the harder it is for insurers to generate returns on their bond portfolios. Eventually the impact is felt on their income statements. Insurers can easily mitigate this risk by re-pricing products, but in an intensely competitive environment, declining sales are the other side of the equation.

(1) Milliman 100 Pension Funding Index. January 6, 2012

Specialty Finance Companies

Due to the low interest rate environment, the demand and availability of specialty finance product is relatively high. The main issue specialty finance firms face is a relative scarcity of funding, as banks have significantly scaled back on financing. Although bank funding and securitizations plunged during the financial crisis, certain asset classes, such as auto loans, are open for securitization again, and specialty lenders are successfully exploring alternative routes for financing (i.e., hedge funds) to supplement or replace the lack of funding from banks.

Banks & Brokerages

Low interest rates have compressed spreads on traditional lending, while deleveraging throughout the global economy has reduced demand for credit, causing lenders to offer more attractive rates. On the brokerage side, investors, especially those not able to go short, have been risk averse (a "risk off" environment), with no catalyst yet to drive them into higher yielding and riskier products (a "risk on" environment). This has reduced broker dealers' revenue streams associated with higher risk, higher margin products.

In addition, any broker with customer funds on balance saw interest revenues nearly evaporate as a line item three years ago. This line item will not likely reappear anytime in the near future.

Opportunities

Asset Managers

We believe an increased appetite for alternative strategies among institutional investors will be an emerging trend going forward, and that there will be an acceleration of the move of alternative investment strategies into the mainstream of investment products. The low interest rate environment and sluggish market performance are two major factors catalyzing these trends.

Regarding pension plans, the median expected rate of return for S&P 500 company pension plans is currently 7.8%, lower than the figure of 9.1% a decade ago[(1)], but still significantly higher than recent actual returns in traditional equity and fixed-income markets. Coupled with diminished expectations for returns in the near term, these assumptions mean that plans are likely to continue to increase their allocations to alternative asset classes in order to generate additional yield.

Whether it is pension funds working to close the funding gap, or foundations and endowments trying to match their expense bases, return objectives are not likely to be met using traditional 60% equity / 40% bond allocations. In 2010, investors allocated over $3.4 trillion of assets to alternative strategies, an increase of nearly $1.4 trillion over the past seven years.

Even with this uptick in allocations, there is still plenty of room for alternatives to grow. We estimate that only 12.3% of institutional and high net worth (HNW) money is allocated to hedge funds, private equity and real estate combined. As measured by Wilshire Associates[(1)], just 3% of large public pension funds is allocated to hedge funds. (Freeman & Co. will release its *Convergence in Alternatives* report at the end of February, which will provide much greater detail on trends in alternatives managers and allocations.)

(1) Credit Suisse: pension accounting analysis by David Zion. January 2012

To take advantage of these opportunities, alternatives managers at the larger end are rapidly gaining scale and diversification. Firms such as Apollo, Blackstone, Carlyle, KKR and Oaktree have moved from single asset class managers to fully diversified asset managers offering hedge fund, fund of fund, private equity, real estate, commodities and structured credit products in addition to traditional long only equities and fixed income. Through this transformation, they have increased their presence with institutional investors, lengthened their track records, built deeper relationships with the consultant community and further institutionalized their investment processes. They will aim to gain a larger share of the allocation pie, no longer satisfied with targeting the 10%-15% bucket traditionally reserved for alternative investments.

Insurance Companies

In a low interest rate environment accompanied by a sluggish economy, investors' main objectives are generally the preservation of principal and covering expenses rather than appreciation. Therefore, guaranteed income products such as annuities are in high demand. Unfortunately for insurers, this creates pressure on investment portfolios in addition to capital requirements associated with these products. However, for insurers with strong investment operations that can offer attractive rates to customers while maintaining investment returns in excess of liabilities, there is opportunity to gain share in the market. Several insurers have seen record sales of these products in 2011 – but the question remains if these sales will be a drag on profitability in the future. If equity markets begin to perform well in the coming years, insurers that have written annuities at relatively low levels over the past two years will reap the benefits.

Specialty Finance Companies

For similar reasons to the increase in demand for alternative investment strategies, esoteric asset classes that produce high risk-adjusted yields should become increasingly attractive for pensions, insurance companies and other asset managers. While these asset classes may ultimately receive relatively small allocations, any such increases could translate into significant dollar amounts in the $17 trillion retirement plan market(2). The flow of funds into the specially finance sector has improved since the financial crisis, and significant capacity has been taken out of the market as many firms have shut down.

In addition, asset returns for many specialty products are independent of interest rates, therefore wide spreads are available when low cost financing is obtained – specialty lenders can make money while still paying out high spreads.

Examples of asset classes that are originated by niche specialty finance companies include:

- Small balance commercial loans
- Small commercial and multifamily mortgages
- Equipment leases
- Venture loans / leases
- Structured settlements
- Litigation finance loans
- Lottery receivables

(1) Wilshire Trust Universe Comparison Service as of June 30, 2011
(2) Investment Company Institute as of September 30, 2011

Banks & Brokerages

Financial performance at banks and brokers has been severely impacted by the low interest rate environment and the structured product meltdown during the financial crisis. However, there are several opportunities for these firms to mitigate these lost revenue streams.

The search for yield by institutional and retail investors will result in the brokerage of high margin products on behalf of originators. Banks and brokers will be a conduit when investors move back to a “risk on” environment, helping them invest in products to meet their return objectives. We believe that higher yielding asset classes such as REITs, limited partnerships, business development companies and structured products (around higher rated, income producing assets such as brokered CDs and bank notes), much like other alternative asset classes discussed earlier in this report, will experience increased demand over the next several years.

Figure 2: Index Yields (1, 2, 3)

	Dividend Yield
REIT - Equity (1)	3.40%
REIT - Mortgage (1)	14.42%

	Dividend Yield
MLP (2)	5.60%
BDC (3)	8.51%

The ability for banks and brokers to create and to distribute these products for institutional and retail investors will generate significant underwriting and distribution fees and commissions.

Freeman & Co. Securities LLC

(1) REIT index data obtained from www.djindexes.com as of January 31, 2012
(2) S&P MLP Index as of December 31, 2011
(3) Wells Fargo BDC Index as of February 3, 2012

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