Managing the Current Economic Environment

Don Burrows, Jr.
Sr. Vice President
Southwest Securities
November 15, 2012

SWS GROUP | SOUTHWEST SECURITIES
Building what you value.

1 ACSW – Nov 2012

Agenda

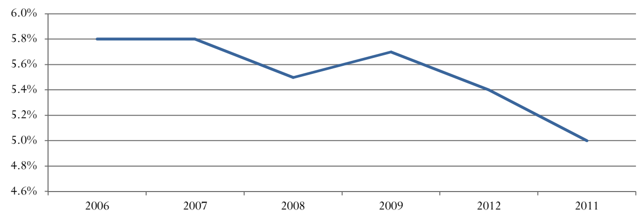
- Factors Contributing to the Low Interest Rate Environment
- Historical and Current Yield Curve for Different Asset Classes
- Opportunities to Increase Yield / Mitigate Interest Rate Risk
- What are the Risks?

SWS GROUP | SOUTHWEST SECURITIES
Building what you value.

2 ACSW – Nov 2012

In search of yield, Fitch believes that life companies might be taking on slightly more risk in 2012 through allocations to long-term bonds and alternative investments. Fitch also noted that insurer mortgage origination has also increased, and while insurers have found some value in non-agency residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS), exposure to such "risky" assets has not significantly increased.

U.S. Life Insurance Net Investment Yield Trend



Note: Net investment yield is GAAP net investment income divided by average cash and investment assets. Source: Company GAAP filings. Fitch

SWS GROUP | SOUTHWEST SECURITIES
Building what you value.®

Source: NAIC & The Center for Insurance Policy & Research
Capital Markets Special Report - October 12, 2012

3

ACSW – Nov 2012

Factors Contributing to the Low Interest Rate Environment

- **Weak Economy**
  - High Unemployment
  - Weak Housing
- **Quantitative Easing (QE)**
  - QE1
  - QE2
  - QE3

SWS GROUP | SOUTHWEST SECURITIES
Building what you value.®

4

ACSW – Nov 2012

Factors Contributing to the Low Interest Rate Environment

High Unemployment

SWS GROUP | SOUTHWEST SECURITIES
Building what you value.

Source: Bloomberg

5

ACSW – Nov 2012

Factors Contributing to the Low Interest Rate Environment

Weak Housing

SWS GROUP | SOUTHWEST SECURITIES
Building what you value.

Source: Bloomberg

6

ACSW – Nov 2012

Factors Contributing to the Low Interest Rate Environment

Quantitative Easing 1, 2 & 3

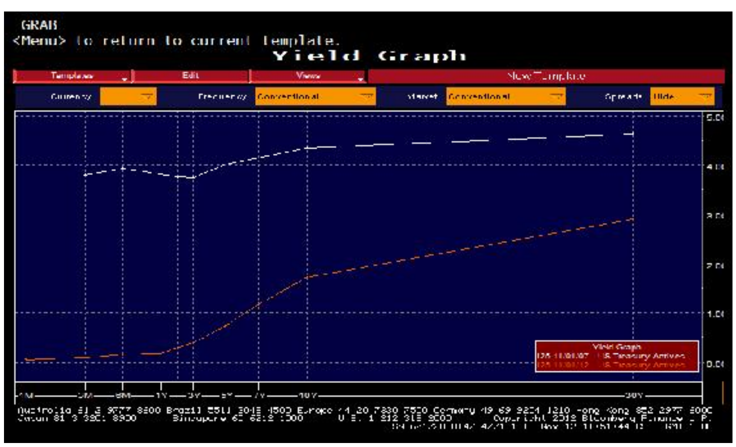
- The Fed purchased $1.725 trillion of bonds during Quantitative Easing 1(QE1) (11/2008 through 3/2010)
- The Fed purchased $600 billion of bonds during QE2 (11/2010 through 6/2011)
- The Fed announced 9/13/12 that it will begin purchasing $40 billion a month of mortgage-backed securities during QE3. The Fed will continue to purchase $40 billion of debt per month until a significant reduction in the nation's unemployment rate has been achieved.

SWS GROUP | SOUTHWEST SECURITIES *Building what you value.*

Source: Federal Reserve

7 ACSW – Nov 2012

Treasury Yield Curves - 2007 & 2012



SWS GROUP | SOUTHWEST SECURITIES *Building what you value.*

Source: Bloomberg

8 ACSW – Nov 2012

Single A Corporate Yield Curves - 2007 & 2012

Source: Bloomberg

SWS GROUP | SOUTHWEST SECURITIES
Building what you value.

9

ACSW – Nov 2012

Historical and Current Yield Curve for Different Asset Classes

- U.S. Corporate 7-10 Year Index
- Bullet Agency 7-10 Year Index
- PAC Agency 5-10 Year CMO Index
- FHLMC & FNMA 30 Year Collateral Index
- ABS Master Index
- HEQ ABS Index
- CMBS 7-10 Year Index

SWS GROUP | SOUTHWEST SECURITIES
Building what you value.

10

ACSW – Nov 2012

U.S. Corporate 7-10 Year Index

SWS GROUP | SOUTHWEST SECURITIES *Building what you value.*

Source: Bloomberg

11

ACSW – Nov 2012

Bullet Agency 7-10 Year Index

SWS GROUP | SOUTHWEST SECURITIES *Building what you value.*

Source: Bloomberg

12

ACSW – Nov 2012

PAC Agency 7-10 Year CMO Index

SWS GROUP | SOUTHWEST SECURITIES
Building what you value.

Source: Bloomberg

13

ACSW – Nov 2012

FHLMC & FNMA 30 Year Collateral Index

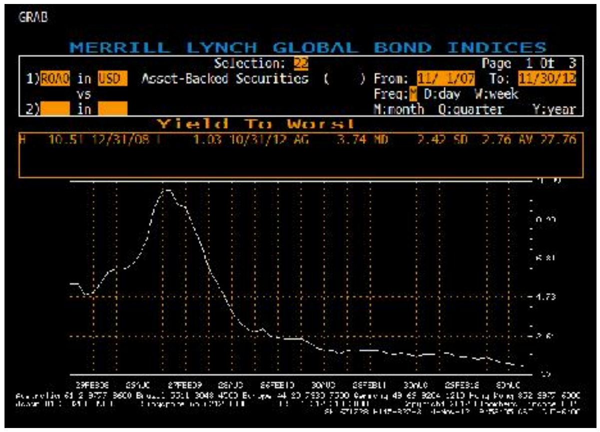
SWS GROUP | SOUTHWEST SECURITIES
Building what you value.

Source: Bloomberg

14

ACSW – Nov 2012

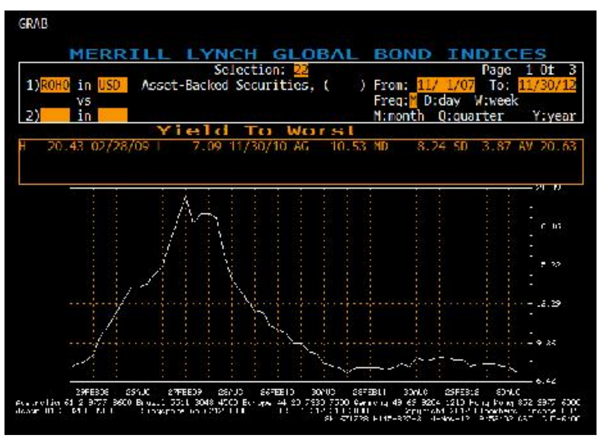
ABS Master Index



Source: Bloomberg

SWS GROUP | SOUTHWEST SECURITIES *Building what you value.*

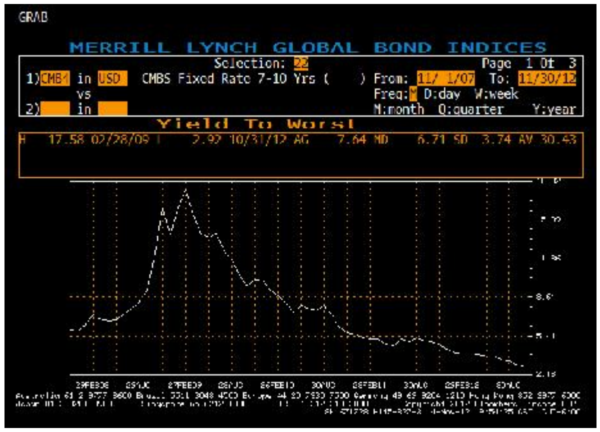
HEQ ABS Index



Source: Bloomberg

SWS GROUP | SOUTHWEST SECURITIES *Building what you value.*

CMBS 7-10 Year Index



SWS GROUP | SOUTHWEST SECURITIES
Building what you value.

Source: Bloomberg

17

ACSW – Nov 2012

Opportunities to Increase Yield / Mitigate Interest Rate Risk

- In-force Management
- Re-price Products
- Change Product Mix
- Cash Flow Management
- Increase Asset Duration
- Increase Allocation to Risky / Alternative Assets

SWS GROUP | SOUTHWEST SECURITIES
Building what you value.

18

ACSW – Nov 2012

Opportunities to Increase Yield / Mitigate Interest Rate Risk

In-force Management

- ➢Reducing interest crediting rates
- ➢Limiting premium dump-ins
- ➢Adjusting premiums, product charges or commissions

(All subject to contractual guarantees)

SWS GROUP | SOUTHWEST SECURITIES *Building what you value.*

Source: Ernst & Young – The Impact of Prolonged Low Interest rate on the Insurance Industry – October 2011

19

ACSW – Nov 2012

Opportunities to Increase Yield / Mitigate Interest Rate Risk

Re-price Products

- ➢Pricing products to reflect the current investment environment

SWS GROUP | SOUTHWEST SECURITIES *Building what you value.*

Source: Ernst & Young – The Impact of Prolonged Low Interest rate on the Insurance Industry – October 2011

20

ACSW – Nov 2012

Opportunities to Increase Yield / Mitigate Interest Rate Risk

Change Product Mix

- Refocusing sales efforts on products that are not heavily dependent on investment income

SWS GROUP | SOUTHWEST SECURITIES
Building what you value.®

Source: Ernst & Young – The Impact of Prolonged Low Interest rate on the Insurance Industry – October 2011

21

ACSW – Nov 2012

Opportunities to Increase Yield / Mitigate Interest Rate Risk

Cash Flow Management

Using cash inflows to pay cash outflows

- **Advantages:**
  - Minimizes the amount of reinvestment over the short term
  - Delays the impact on portfolio yield
- **Disadvantages:**
  - Not a long-term solution
  - Subject to asset allocation, asset-liability management and liquidity considerations

SWS GROUP | SOUTHWEST SECURITIES
Building what you value.®

Source: Ernst & Young – The Impact of Prolonged Low Interest rate on the Insurance Industry – October 2011

22

ACSW – Nov 2012

Opportunities to Increase Yield / Mitigate Interest Rate Risk

Increase Asset Duration

Longer term assets offer the potential of higher yield

- **Risks:**
  - Duration mismatching over extended periods will increase risk
  - Long-term interest rates are at near-historic lows

SWS GROUP | SOUTHWEST SECURITIES *Building what you value.*

Source: Ernst & Young – The Impact of Prolonged Low Interest rate on the Insurance Industry – October 2011

Opportunities to Increase Yield / Mitigate Interest Rate Risk

Increase Allocation to Risky / Alternative Assets

Investments in lower credit quality assets or alternative asset classes may lead to higher overall yields

- **Risks:**
  - Additional capital requirements
  - Investment limitations
  - Liquidity constraints

SWS GROUP | SOUTHWEST SECURITIES *Building what you value.*

Source: Ernst & Young – The Impact of Prolonged Low Interest rate on the Insurance Industry – October 2011

Opportunities to Increase Yield / Mitigate Interest Rate Risk

- Interest Rate Swaptions
- Total Return Swaps
- Credit Default Swaps

SWS GROUP | SOUTHWEST SECURITIES
Building what you value.

Opportunities to Increase Yield / Mitigate Interest Rate Risk

Specific Actions Companies Are Making

New York Life – limiting duration, hedged in the "event of a spike-up in rates"

Genworth – limiting duration of overall portfolio, higher quality bonds at longer durations, prefers asset-backed securities (ABS) to agency mortgage-backed securities (MBS) because that's a sector the Fed isn't buying and artificially pushing yields lower

Hartford – reducing risk by offering to buy out variable annuity clients; "we are making this offer because high market volatility, declines in the equity markets and the low interest-rate environment make continuing to provide the Lifetime Income Builder II rider costly to us"

SWS GROUP | SOUTHWEST SECURITIES
Building what you value.

Source: Bloomberg

What are the Risks?

- Political Risks
  - Fiscal Cliff
    - Recession

Fiscal Roadblocks: Lower Spending, Higher Taxes

Sizing up the Cliff: Estimated Impact of Selected Fiscal Policies	
	Annualized Run Rate ($Bin)
Bush tax cuts and AMT fix	$320
Payroll tax cut	$115
Spending cuts under Budget Control Act	$ 95
Extended Unemployment Benefits	$ 50
Investment Tax Incentives	$ 40
Medicare Tax Increases	$ 25
Doc Fix	$ 20
Total of Major Items	**$665**

Under current law, the federal government is scheduled to implement a fiscal tightening of unprecedented severity at the start of 2013. This is mostly attributable to the roll-off of over $400 billion of tax cuts and more than $200 billion of spending declines and in total approaches about 5% of GDP.

Source: Morgan Stanley

Fiscal Cliff

- Man-made disaster waiting to happen
- Starts to take effect in January

- Reduction in both defense and non-defense spending
- Expiration of the Bush tax cuts
- End of a payroll tax holiday and extended unemployment benefits
- Onset of reimbursement cuts to Medicare doctors

- Debt ceiling – legal limit on federal borrowing
- Needs to be raised by early next year from its current level of $16.394 trillion

To avoid, President Obama and Congress will need to act quickly to avert at least some parts of the fiscal cliff

Source: CNN Money – What's in the Fiscal Cliff – November 8, 2012

Fiscal Cliff

- Automatic spending cuts

- **Defense:**
  - $55 billion will be cut in 2013 from projected levels of discretionary defense spending
  - Translates into at least a 10% cut to every program, project and activity that's not explicitly exempt

- **Nondefense:**
  - $55 billion will be cut from projected levels on nondefense spending
    - Such as education, food inspections and air travel safety

Source: CNN Money – What's in the Fiscal Cliff – November 8, 2012

Fiscal Cliff

- Bush tax cuts
  - External partisan trip-wire set to expire December 31st
    - **Income tax rates**
      - Rise to 15%, 28%, 31%, 36% and 39.6%
        - Up from 10%, 15%, 25%, 28%, 33% and 35%
    - **Capital gains rates**
      - Rise to 20% from 15% for most
    - **Qualified dividend rate**
      - Rises to one's top income tax rate, up from 15% for most
    - **Child tax credit**
      - Falls to $500 per child from $1,000
      - Refundable portion also reduced

SWS GROUP | SOUTHWEST SECURITIES
Building what you value.

Source: CNN Money – What's in the Fiscal Cliff – November 8, 2012

31

ACSW – Nov 2012

Fiscal Cliff

- **Earned Income Tax Credit**
  - Expansion of eligibility for the credit expires
- **Marriage Penalty Relief**
  - Expires
  - Low or middle-income earner couple will owe more to the IRS than they would if they were single making same income
- **Estate tax**
  - Parameters revert to pre-2001 levels
    - Exemption level $1 million from $5 million
    - Top tax rate on taxable estates rises to 55%, from 35%

SWS GROUP | SOUTHWEST SECURITIES
Building what you value.

Source: CNN Money – What's in the Fiscal Cliff – November 8, 2012

32

ACSW – Nov 2012

Fiscal Cliff

- **Payroll Tax Holiday**
  - Expires
  - Social Security tax rate reverts to 6.2%, up from 4.2% on the first $110,000 in wages.
    - Someone making $50,000 will pay another $1,000 in payroll taxes next year
- **Unemployment Benefits Extension**
  - Federal extension expires.
  - Workers who lose their jobs after July 1, 2012, will only receive up to 26 weeks in state unemployment benefits
    - Down from as many as 99 weeks in state and federal benefits that had been available until recently
    - By one estimate, more than 2 million claimants will lose their benefits by January
- **Medicare Doc Fix**
  - Expires
  - Medicare payment rates for physician services drops by 27%

SWS GROUP | SOUTHWEST SECURITIES *Building what you value.*

Source: CNN Money – What's in the Fiscal Cliff – November 8, 2012

33

ACSW – Nov 2012

Questions?

SWS GROUP | SOUTHWEST SECURITIES *Building what you value.*

34

ACSW – Nov 2012