

A DEEPER LOOK:

Sun Life's Participating Account investment philosophy

Stephen C. Peacher, B.Sc., CFA, President,
Sun Life Investment Management

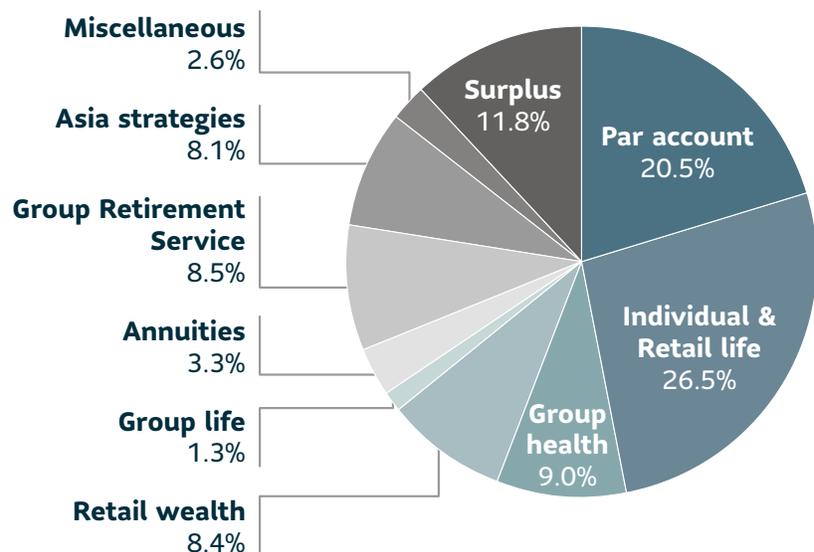
Advisors and Clients increasingly choose participating whole life insurance. Why? Because it can make the most of estate values while providing an alternative asset class that improves overall portfolio efficiency. In turn, investors and professional advisors increasingly want to understand why par has historically outperformed fixed income despite having lower volatility. To do this, we need to first understand how Sun Life manages the money it invests to support Sun Par policies. In my role as President of Sun Life Investment Management, I get to see the bigger picture of Sun Life's investment philosophy. This lets me appreciate the strength in our approach and how it applies to par.

Sun Life's General Account asset mix: how par fits in

We're one of the largest Canadian-owned investment managers with more than three quarters of a trillion dollars of assets under management (AUM). The General Account represents \$154 billion (at time of publishing) of the total AUM. These are the investments that we make to back the products that Sun Life sells globally.

Each segment within the General Account has a different investment profile. The portfolios within the general account are built to match assets to the liability characteristics of the products being sold in each segment. This asset liability matching is critical in optimizing the risk return profile of each segment. The Par Accounts globally represent nearly one fifth of these assets with around \$10 billion being used to support Sun Par policies sold in Canada. This size makes par an incredibly important piece of what Sun Life manages and is reflective of the strength of our balance sheet.

General Account asset mix – \$154 billion



Life's brighter under the sun



Sun Life

A strong and experienced investment team

| Investment team | Size of team | Average years experience | Average tenure of mgmt. team |
|----------------------|--------------|--------------------------|------------------------------|
| Public fixed income | 47 | 19 | 13 |
| Private fixed income | 54 | 17 | 10 |
| Commercial mortgages | 43 | 19 | 12 |
| Real estate | 15 | 19 | 14 |
| Asia | 33 | 11 | 5 |
| Investment strategy | 12 | 15 | 9 |
| Total | 204 | 17 | 11 |

Behind each asset portfolio is a proven investment team with over 200 people across the globe, mostly in North America and Asia. The investment team of each asset portfolio offers an average of 16 years of experience. And, their leadership has also been with the team for a long time. For instance, the management team looking after our private fixed income portfolio has been part of our investment team for 10 years. Investing in par is a long-term decision, and both the experience and stability of the investment teams are keys to success.

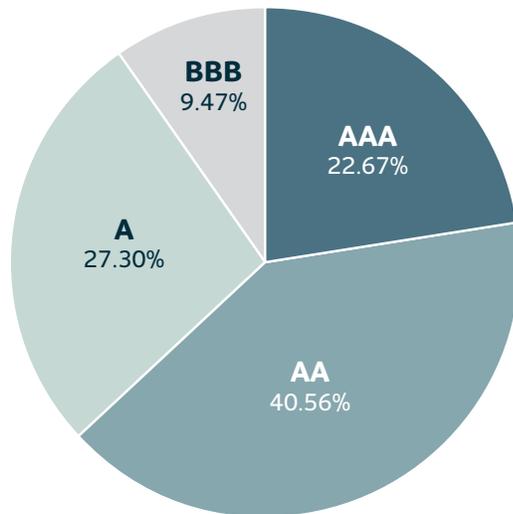
The asset allocation model

Asset mix guidelines

| Targeted asset mix | | | |
|-------------------------------|-------------|----------------|-------------|
| | Strategic | Tactical range | |
| | Target % | Min % | Max % |
| Cash & short term | 0.5 | 0 | 4 |
| Fixed income | | | |
| Public fixed income | 41.0 | 33 | 49 |
| Private fixed income | 12.5 | 5 | 20 |
| Commercial mortgages | 12.0 | 4 | 20 |
| Total fixed income | 65.5 | 43 | 89 |
| Real estate | 17.0 | 12 | 22 |
| Public equities | 12.0 | 8 | 18 |
| Private equities | 5.0 | 1 | 7.5 |
| Other assets | 0 | 0 | 2 |
| Total non fixed income | 34.0 | 21 | 49.5 |
| Total assets | 100 | | |

The Par Account contains a mix of various asset classes. For each asset class, there is a tactical range and a strategic target for how much we invest. These ranges and targets are the Sun Par Account's asset allocation model. We need to follow this asset allocation model when investing to support our par policies. The investment teams closely monitor the tactical ranges of each asset class to make sure that they stay within these ranges. If any allocation goes outside the range, the team is notified and they take action to get it back in. These ranges are determined by setting the optimum mix of assets needed to align with the liabilities that we are obligated to meet.

Fixed income: quality distribution



The Sun Par Account has a significant allocation of its fixed income in investment grade BBB bonds. Of course, it isn't exclusively in BBB. It has a lot of A, AA, and AAA government bonds. But, the fixed income investment team feels comfortable in the BBB market and have determined that this is a segment with opportunities to capitalize on given our levels of expertise and research.

| Total return on corporate bonds | |
|---|------------|
| <i>Barclays Corporate Index, ratings performance over last 30 years</i> | |
| | Annualized |
| Rating | Return % |
| AAA | 6.33 |
| AA | 6.41 |
| A | 6.58 |
| BBB | 7.17 |

This table illustrates the annualized return of corporate bonds by risk rating. It shows that it definitely paid off to be in the BBB sector within the last 30 years. By not investing in the BBB sector, we'd actually be giving up an opportunity.



The cornerstone asset: private fixed income

Currently, Sun Life's competitors do not use private fixed income to the extent that we do.¹ In fact, we have the biggest and strongest private fixed income team in Canada – by any measure. This is a real advantage for Sun Life in the Canadian marketplace.

Private fixed income deals are investment-grade deals that often have long durations. Being in the private market allows us to take advantage of our capital-rich position in Canada. It also lets us invest in areas that aren't well represented in the public market, such as hydroelectric, wind and solar energy, as well as public infrastructure. These are exciting investment opportunities that pay off well for us.

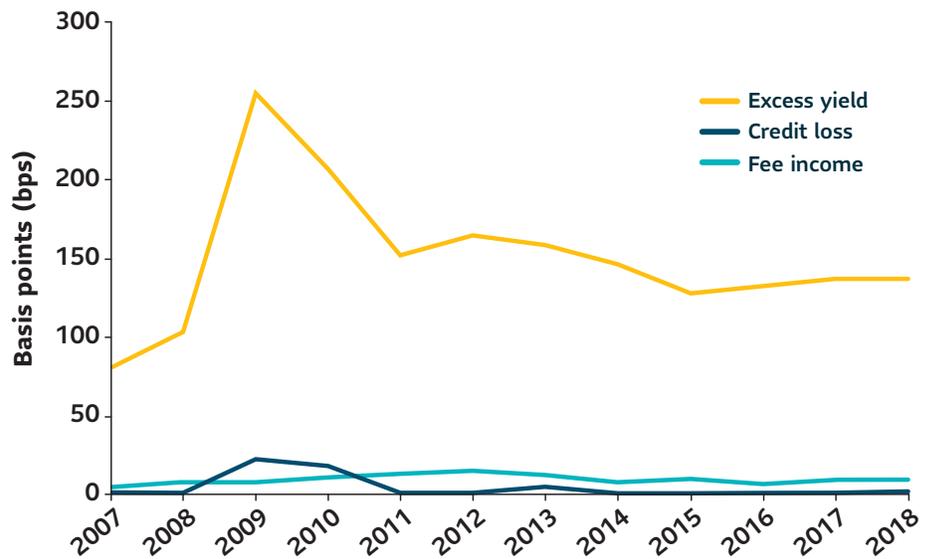
Here's the value proposition of private fixed income. In this 12-year chart, the yellow line highlights the return differential of the private fixed income investment vs corporate bonds with a similar rating and duration. On average, our private fixed income deals have picked up 150 basis points of spread. The light blue line represents extra fee return generated by the fixed income deals and the dark blue line the losses.

One example is the Ontario Solar Farm. This was a \$78.45 million infrastructure project where Sun Life Investment Management was the co-underwriter and lead lender, providing \$45 million of long-term financing. A major benefit is the 20-year contract with Ontario Power Authority, which is required to purchase all the energy the project produces.

It's often asked how liquid these investments are. The reality is that Sun Life never sells any of its private fixed income deals. They're bought and held for the full duration. These investments are perfect for par since par liabilities last for an average of 18-20 years. But, if needed, these investments could be sold. Participating whole life insurance is a great way for individuals to gain exposure to this type of investment.

Yield enhancements

Private fixed income: general account performance, credit loss and fee income

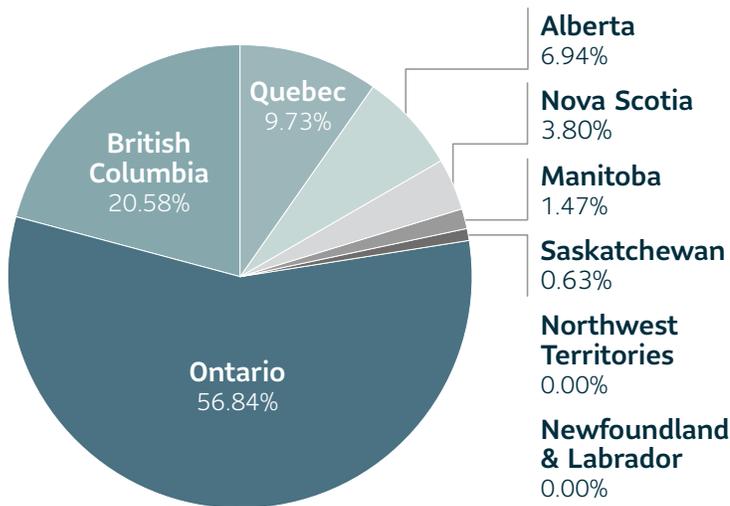


Performance for Sun Life's General Account private fixed income portfolio; sources are Bank of Canada, Sun Life. Spreads are dollar weighted. Past performance does not guarantee future results, which may vary. Credit losses are dollar weighted and basis points are estimated over the companion year's average asset base. These results are presented for illustrative purposes only and do not represent that which may be achieved by the fund. All private bonds are managed by the private fixed income team for Sun Life's General Account.

¹ Canada Life Financial Facts, 2018; London Life Financial Facts, 2018; Great West Life Financial Facts, 2018; Manulife Insurance Insights, 2018.

Commercial mortgages

Property location

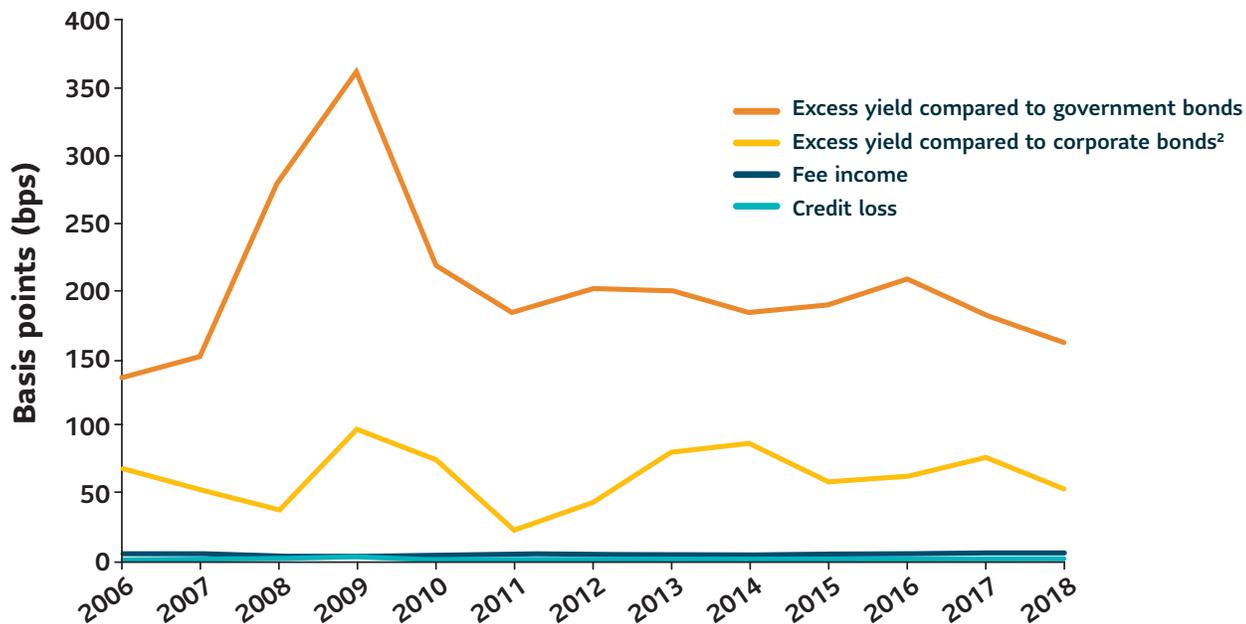


Mortgages are another important asset class for the Par Account. We regionally distribute our mortgage mix aligning with the GDP of each province. As a result, a heavy weight is allocated to Ontario. Our portfolio only has commercial mortgages, no residential.

There's not as much yield in mortgages as in private fixed income since it's in a more efficient market. But, mortgage yields compared to Government of Canada (GoC) bonds has an average spread of 175 basis points over the past 25 years. Moreover, the Sun Par Portfolio of mortgages has experienced very few losses in the last 13 years. This speaks to the expertise in underwriting these deals and makes mortgages a great asset class.

Yield enhancements – commercial mortgages

The excess yield of the Canadian commercial mortgage portfolio of Sun Life's General Account, displayed here next to comparable government and corporate bonds.



² Mortgage spreads to corporate bonds are derived using a quality match at acquisition and a 60%/40% weighting from indicatives in the FTSE Canada Short Term Overall Bond Index and the FTSE Canada Mid Term Overall Bond Index.

Yield spreads are Canadian dollar weighted. Past performance is not necessarily indicative of future returns. These results are presented for illustrative purposes only and do not represent that which may be achieved. Actual fund performance can be expected to differ from the general account performance shown. Sun Life Assurance Company of Canada General Account mortgage portfolio excludes NHA insured commercial mortgages. Data as at December 31, 2018 year end. Source: Sun Life.

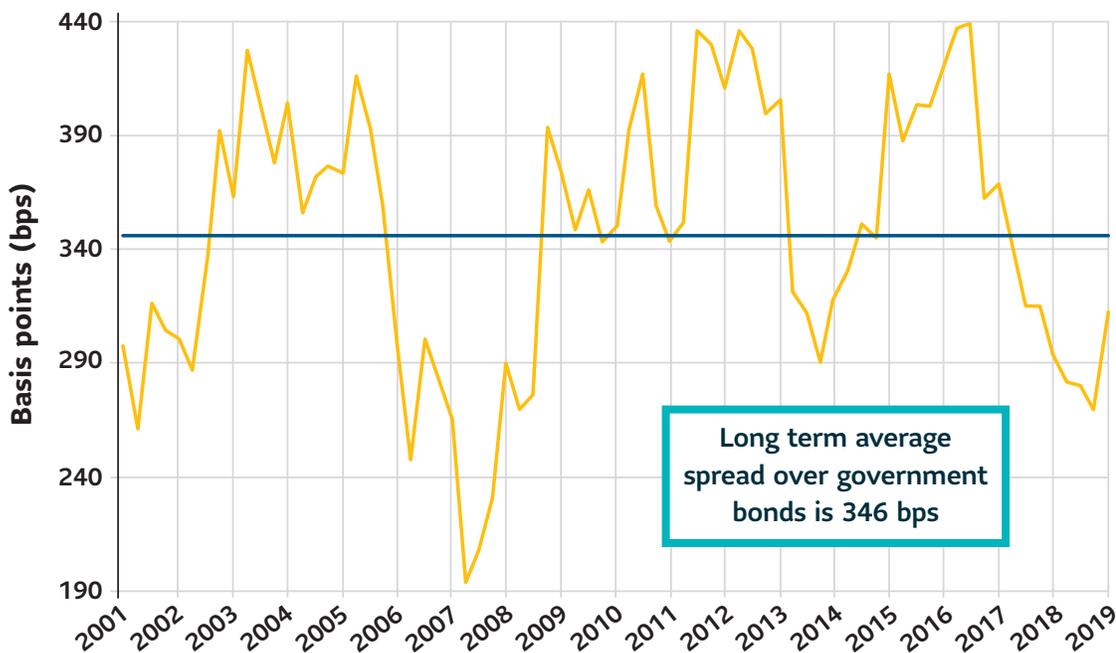
Real estate

Currently, Sun Life's Par Account Portfolio is more heavily weighted in real estate compared to most of our competitors.³ We don't use Real Estate Investment Trusts (REITs). Instead, we invest in high quality buildings through construction projects and acquisitions of existing real estate. Real estate is a great asset class for par because of the long duration of the liabilities. It thereby offers us an attractive return and inflation protection.

What's really great about real estate is that the returns can be enhanced over time. If a bond is purchased, it's going to pay the same amount of return year after year. There's no opportunity to get more money out of that asset. As for real estate, the return can be optimized by increasing rent over time and focusing on high quality tenants. It's a long-term play, and another great fit for the Par Account.

Real estate historically provided a generous and constant spread over the risk-free rate.⁴ Compared to a 10-year Government of Canada bond, the long-term average spread is 346 basis points in favor of real estate. This spread is maintained even as capitalization rates have fallen, because interest rates have fallen.

Real estate – Spread over 10-year GoC bond⁴



³ Canada Life Financial Facts, 2018; London Life Financial Facts, 2018; Great West Life Financial Facts, 2018; Manulife Insurance Insights, 2018.

⁴ MSCI/IPD, Bank of Canada.

To sum it up

The Par asset portfolio allows an insurance company to differentiate its par product and really deliver value to the policy owner. Understanding the underlying investment philosophy of the Par Account is a first step in understanding the largest driver of returns to par policyholders. With a proven ability to manage liabilities for the long-term, Sun Life's Par Accounts present a unique opportunity to benefit from seemingly riskier investments with limited risk. This allows us to push out the risk/return frontier for today's investors.



About the author

Stephen C. Peacher is President of SLC Management, Sun Life's institutional investment management business. He has more than three decades of investment management and credit experience in North American and international markets. This includes extensive experience managing teams, portfolios and research across a wide range of assets and strategies, including public and private asset classes, derivative markets and liability-driven investing.

This article is intended to provide general information only. Sun Life Assurance Company of Canada (Sun Life) does not provide legal, accounting or taxation advice to advisors or clients. Before acting on any of the information contained in this article, make sure you seek advice from a qualified professional, including a thorough examination of your specific legal, accounting and tax situation.

Sun Life Assurance Company of Canada is the insurer of these products and is a member of the Sun Life group of companies. © Sun Life Assurance Company of Canada, 2019. 810-4922-10-19



Life's brighter under the sun