02-May-2019

Lincoln National Corp. (LNC)

Q1 2019 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and thank you for joining Lincoln Financial Group's First Quarter 2019 Earnings Conference Call. At this time, all lines are in a listen-only mode. Later, we will announce the opportunity for questions, and instructions will be given at that time.

Now I would like to turn the conference over to the corporate treasurer, Chris Giovanni. Please go ahead, sir.

Christopher A. Giovanni

Senior Vice President, Investor Relations, Lincoln National Corp.

Thank you, Crystal. Good morning and welcome to Lincoln Financial's first quarter earnings call. Before we begin, I have an important reminder. Any comments made during the call regarding future expectations, trends in market conditions, including comments about sales and deposits, expenses, income from operations, share repurchases, and liquidity and capital resources are forward-looking statements under the Private Securities Litigation Reform Act of 1995. These forward-looking statements involve risks and uncertainties that could cause actual results to differ materially from current expectations. These risks and uncertainties include those described in the cautionary statement disclosures in our earnings release issued yesterday, as well as those detailed in our 2018 annual report on Form 10-K, most recent quarterly report on Form 10-Q, and from time to time in our other filings with the SEC.

These forward-looking statements are made only as of today and we undertake no obligation to update or revise any of them to reflect events or circumstances that occur after this date. We appreciate your participation today and invite you to visit Lincoln's website,www.lincolnfinancial.com where you can find our press release and statistical supplement, which include a full reconciliation of the non-GAAP measures used in the call, including adjusted income from operations and adjusted return on equity to their most comparable GAAP measures.

I would also like to remind you that we will be hosting our Investor Day on June 12 in New York City and we hope many of you will join us in person. Presenting on today's call are Dennis Glass, President and Chief Executive Officer and Randy Freitag, Chief Financial Officer, and Head of Individual Life. After their remarks, we will move to the question-and-answer portion of the call.

I would now like to turn the call over to Dennis.

Dennis R. Glass

President, Chief Executive Officer & Director, Lincoln National Corp.

Thank you, Chris and good morning, everyone. We had a strong start to the year and momentum is building into the second quarter, as we effectively execute on key management initiatives. In the first quarter, all four business segments grew operating revenues. We had very strong sales growth, and a 9% increase in both adjusted operating earnings per share, and book value per share, excluding AOCI. Our strength in sales was broad-based and highlights actions taken to maximize our diverse product portfolio in attractive, fast-growing segments of the market and leverage our powerful distribution franchise, a competitive advantage for Lincoln to drive profitable topline growth. Notably, the near-term sales outlooks remains encouraging.

Most of our businesses also saw expense ratios improve as we continue to focus on expense efficiency through process redesign and expanding digital capabilities. We also deployed over $300 million of capital through buybacks and dividends during the quarter, and are well positioned to continue to fund new business growth at attractive returns while remaining committed to consistently returning capital to shareholders.

Now turning to our business segments, starting with Annuities. Operating income of $250 million decreased from the prior year quarter, predominantly from the impact of the Athene transaction. Our strategic decision to broaden the product portfolio and participate in more segments of the marketplace enabled another quarter of robust and diversified sales as we continue to reach additional advisors and customers. This resulted in sales increasing 39% to $3.5 billion, with net inflows of nearly $0.5 billion while continuing to achieve our profitability targets.

Fixed annuity sales momentum continued as we benefit from shelf space expansion, an increase in bank wholesalers and some customized FIA products. Sales of $1.6 billion more than tripled over the prior year quarter, as every distribution channel generated sales gains, including significant growth in the bank and the broker dealer channels. Variable annuity sales totaled $1.9 billion as sales of VAs without living benefits, which include our index variable annuity increased 47% compared to the prior year. Although sales of VAs with living benefit guarantees decreased, sales momentum increased during the quarter, and we expect sales to improve sequentially in the second quarter.

So a strong start for the Annuity business as sales increased significantly, and we delivered another quarter of positive net flows. Looking ahead, we expect growth and our more balanced mix of sales to continue, and when combined with equity market strength, we are well positioned for operating income to improve.

In Retirement Plan Services, operating income decreased $4 million over the prior year quarter on lower and variable investment income and spread income. Total deposits in the quarter of $2.5 billion were up 6% from a year ago, with growth coming from both first-year sales and recurring deposits. Our high touch, high tech service model continues to resonate in our target markets and drive increases in participation and higher contribution rates. In addition, product innovation and customer experience capabilities provide new avenues for growth going forward.

Net flows for the quarter were negative $381 million, and included a large case termination of approximately $800 million. This marked the first quarter of net outflows in over three years. Although results can be lumpy quarter-to-quarter, sales momentum coupled with low termination rates leads to a positive outlook on net flows moving forward. Continued investment in distribution, product innovation, and digital capabilities, give our Retirement business a solid foundation for future top and bottom line growth.

Turning to Life Insurance. Growth in operating income was solid. Up 9% from the prior year. Sales in the quarter were up 10%, highlighting the benefits of a broad product portfolio, we saw strong growth in executive benefits, term, IUL and UL sales allowing us to overcome declines in MoneyGuard and VUL. Strategically, we continue to focus on penetrating faster growing segments of the marketplace, where we are underrepresented, including term and IUL. The Life business got off to a great start this year, and the outlook remains solid, as we expect sales momentum to continue with strong bottom line results.

Turning to Group Protection, operating income increased 90% over the prior year quarter, driven by the Liberty acquisition. First quarter sales more than doubled, also attributable to the acquisition, which resulted in growth in all product lines and both employer and employee-paid sales. We remain optimistic about our ability to increase premiums by sustaining persistency and driving sales growth, given our increased scale, broader distribution access and expanded capabilities. We are pleased with another solid quarter for Group Protection. The integration remains on track with expense synergies developing ahead of our original expectations, and profit margins emerging positively and well within our target range.

Shifting to investment results, during the quarter, we invested $5 billion, at an average pre-tax yield of 4.4%. Our fixed income portfolio yield decreased just one basis point. The alternatives investment portfolio had a modest 1% return in the quarter. As you know, private equity results are reported on a one quarter lag so the decline in equity markets and energy prices at the end of 2018 negatively impacted performance. Hedge fund returns which are reported on a one-month lag were strong, providing a partial offset. Given equity market strength year-to-date, we expect significant improvement from our alternatives in the second quarter, and continue to target our long-term pre-tax return of 10%. Overall, the investment portfolio remains in great shape. We continue to focus on managing credit risk more defensively with below investment grade assets representing just 4.1% of our fixed income portfolio and minimal credit losses.

In closing, I am pleased with our solid start to the year, and the positive sales and operating income momentum we are carrying forward. Notably, organic growth drivers are strong as annuity sales, gains, should sustain positive net flows. RPS has consistently demonstrated its ability to grow deposits and net flows. Life Insurance sales are benefiting from product actions and distribution capabilities to grow and diversify our sales mix. And Group sales, combined with good persistency, are resulting in steady premium growth.

In terms of operating income tailwinds, equity market growth and an increase in the number of fee days and subsequent quarters should boost sources of earnings from fees on assets under management. As I noted, we also expect significant improvement and returns on alternative investments. Mortality experience is typically better over the remainder of the year. And our expense saving initiatives will continue to contribute more meaningfully to results.

2019 is shaping up to be another successful year, and we will use our upcoming investor day to provide more insight on why we are confident we can sustain our strong results.

I will now turn it over to Randy.

Randal J. Freitag

Executive Vice President, Chief Financial Officer and Head of Individual Life, Lincoln National Corp.

Thank you, Dennis. The first quarter reflects many of the themes that we have exhibited for nearly a decade. Strong topline performance, with all four businesses showing revenue growth and total operating revenues up nearly 20% over the prior year quarter, boosted by last year's acquisition. Expense discipline, as expense ratios improved in three of our four businesses. And a strong balance sheet with book value per share excluding AOCI growing 9%, allowing us to reduce our average diluted share count by 7%.

Bringing together these items drove adjusted operating income of $441 million, or $2.14 per share for the quarter. A 9% increase from the prior year, and a 12.6% adjusted operating return on equity.

There were no notable items within the current or prior year quarter. However, there were a few items that resulted in some variability within the businesses. The net impact of these items was zero, and I will speak to some of these within the business segments. Net income totaled $252 million in the quarter, as we experienced more below the line volatility than we have historically reported. Importantly, the vast majority of the difference between our adjusted operating income and net income was the result of $143 million in items we would consider to be noneconomic. With the impact primarily coming from the Athene transaction, where changes in fair value for most of the asset portfolio run through the balance sheet, while the offsetting change runs through the income statement. Over time, this noneconomic impact will reverse and subside.

Excluding the noneconomic impacts, net income represented 90% of adjusted operating income, as the VA hedge program performed well, credit losses were minimal, and acquisition and integration expenses were consistent with our expectations.

Now turning to segment results, starting with Annuities. Reported operating income for the quarter was $250 million, compared to $267 million in the prior year quarter. The most significant item impacting first quarter results was the reinsurance transaction completed with Athene, which reduced operating income by $14 million. Return metrics remain strong with ROA at 79 basis points, and an ROE of 21%.

Risk metrics were also solid and benefited from the growth in equity markets, as net amount at risk sits at 1% of account value for living benefits, and less than 0.7% for death benefits. GA expenses net of amounts capitalized were essentially flat year-over-year, which contributed to an 80 basis point improvement in the expense ratio. End of period account values were $130 billion, 3% higher than average account values in the first quarter. When combined with our strong sales momentum and additional fee days in subsequent quarters, the Annuities business is well positioned to continue to provide outstanding results.

In Retirement Plan Services, we reported operating income of $39 million, compared to $43 million in the prior year quarter. The primary driver of the decline was lower alternative returns and spread income. Positive net flows of $1.7 billion over the trailing 12 months drove average account values to $70 billion, up 3%. G&A expenses net of amounts capitalized decreased 1% for the quarter. When combined with an increase in operating revenues, the expense ratio improved 40 basis points, compared to the prior year. Base spreads excluding variable investment income compressed 12 basis points versus the prior year quarter, consistent with our expectations. Similar to the Annuities business, end of period account values are 3% higher than average account values. This coupled with a recovery in alternatives should serve as positive drivers for the Retirement business.

Turning to our Life Insurance segment, operating income of $157 million increased 9% from the prior year quarter. The most significant items impacting operating income in the quarter included $25 million of favorable mortality. As you know, within our annual mortality expectation, we typically see elevated experience in the first quarter. However, results were less adverse than expected. Largely offsetting this favorable mortality experience were weak results out of our alternative investment portfolio. Underlying drivers were solid with average Life Insurance in-force up 4% over the prior year quarter, and average account values increasing 2%. The expense ratio remains stable, and we had $15 million of favorable amortization expenses in the quarter. Base spreads excluding variable investment income were down 6 basis points year-over-year, at the low end of our expectations. So a great start to the year for the Life business. We are particularly encouraged given mortality is typically better over the remainder of the year and we expect significant improvement in returns on alternative investments.

Group Protection reported operating income of $55 million compared to $29 million in the prior year quarter, with the increase primarily coming from the Liberty acquisition. Consistent with prior first quarters we did experience elevated DAC amortization of approximately $11 million. This due to the fact that the first quarter represents our largest renewal period.

Overall, business trends remain positive, which resulted in an after-tax margin of 5.4%. The loss ratio in the first quarter was 73.7% as risk results continue to be favorable. Better loss experience in disability from lower incidents was partially offset by higher average claim size in [ph] group life (19:05). As a reminder, the year-over-year increases in loss ratios reflect the impact of the acquisition, as we combine two blocks of business with different loss characteristics. It was another excellent quarter for Group Protection. While there can always be volatility quarter-to-quarter, our pricing and claim management fundamentals are sound and trending well. And the Liberty integration continues to be on a positive trajectory. These favorable factors should enable us to sustain margins within our 5% to 7% target range.

Turning to capital and capital management, statutory surplus stands at $9.6 billion and our RBC ratio ended the quarter at approximately 445%, holding company cash ended the quarter at $481 million, slightly above our $450 million target. During the quarter, we returned $316 million of capital to shareholders. Share buybacks totaled $240 million, which included the remaining $90 million from our accelerated share repurchase program that we commenced in December, as part of the Athene deal. In total, the Athene transaction allowed us to deploy $450 million into share buybacks at an average price of $58 per share. Bringing average share count down 4%.

To conclude, an excellent first quarter from Lincoln, adjusted operating EPS increased 9%, consistent with our long-term target. Book value per share, excluding AOCI, was up 9% to $68.79, an all-time high. Adjusted operating ROE was 12.6%. Revenue growth was strong, while expense discipline remains a continued focus. And we are investing in new business growth at attractive returns, while also returning a significant amount of capital to shareholders.

Looking forward, we are well-positioned to continue delivering this type of financial results, which will help drive long-term shareholder value.

With that, let me turn the call back over to Chris.

Christopher A. Giovanni

Senior Vice President, Investor Relations, Lincoln National Corp.

Thank you, Dennis and Randy. We will now begin the question-and-answer portion of the call. As a reminder, we ask that you please limit yourself to one question and only one follow-up, and then re-queue if you have additional questions. With, that let me turn the call back to the operator.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator instructions] Our first question comes from Suneet Kamath from Citi. Your line is open.

Suneet Kamath
Analyst, Citigroup Global Markets, Inc.

Q

Thanks. I just wanted to start with RPS and the large case termination that you guys talked about. Any color on what drove that? Was it M&A or pricing? And then just thoughts on overall competition in the RPS market?

Dennis R. Glass
President, Chief Executive Officer & Director, Lincoln National Corp.

A

Yes, Suneet, you mentioned it. That was an outcome of an acquisition or a merger. And oftentimes not always the acquiring company who had a different provider than the acquired company will win in that situation. So that's what it was. M&A and our customer, the smaller client, and we lost the business. Now we did bid on it, but we couldn't match the other pricing.

Overall competitive environment, I guess I'd come back to where we participate first. We're active in the small case 401(k) market. We focus on the education, government markets, and health care. We have good market positions in those cases. Competition and the pricing is tough, but we think with what we bring to the table, with our strategy, we can continue to do very well.

Suneet Kamath
Analyst, Citigroup Global Markets, Inc.

Q

Got it. And then just pivoting over to Group Protection, we've been hearing a lot about voluntary benefits, some companies talking about price competition there, particularly in certain lines. So can you give us some color in terms of what you're seeing on in terms of new business, particularly on the voluntary side?

Dennis R. Glass
President, Chief Executive Officer & Director, Lincoln National Corp.

A

Yeah, I think I would answer the question a little more broadly. We think the pricing on both employee paid and voluntary is rational. We don't see any irrational pricing, to say it the other way. So we'll continue to do well in both of those markets. The Liberty acquisition gives us an opportunity to increase employee sales because they had less of that in their mix. So it's a big opportunity for us going forward.

Suneet Kamath
Analyst, Citigroup Global Markets, Inc.

Q

Okay. Thanks, Dennis.

Operator: Thank you. And our next question comes from Ryan Krueger from KBW. Your line is open.

Ryan Krueger
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Thanks. Good morning. Could you give a sense of how meaningfully VA sales improved during the quarter as markets normalized?

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Dennis R. Glass
President, Chief Executive Officer & Director, Lincoln National Corp.

A

Let me talk in terms of the percentage of sales. So back in January, we were selling fixed annuities and variable annuities at about a 50/50. The mix was 50/50. By the end of April, that has switched from 50/50 to two-thirds variable annuity sales and one-third fixed annuity sales. And so that's the trend that we expect to continue, and they're up overall so far, total sales.

....

Ryan Krueger
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Got it. Thanks and then on – in Group Protection expenses look to improve a fair amount. Randy, could you just give a sense of, I guess, where you are at this point relative to your expense save guidance?

....

Randal J. Freitag
Executive Vice President, Chief Financial Officer and Head of Individual Life, Lincoln National Corp.

A

Sure, Ryan. If you remember, we talked about exiting 2018 at a run rate of $75 million and expecting to exit 2019 at a run rate of roughly $100 million and then adding to that in 2020 and beyond. I'd say we're at a run rate now of roughly $80 million, right on track to get to our goal of a run rate of $100 million by the end of the year. I think the Group business did have a really good quarter from an expense management standpoint and executing on the synergies which we talked about. I think there may have been a little bit of timing in their expenses, but nothing that I would consider to be really out of line with outside of just good overall expense management and execution.

....

Ryan Krueger
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay. Great. Thanks a lot.

....

Operator: Thank you. And our next question comes from Elyse Greenspan from Wells Fargo. Your line is open.

....

Elyse Greenspan
Analyst, Wells Fargo Securities LLC

Q

Hi, thanks. Good morning. My first question is on the Annuities business. You did, obviously had stronger sales in fixed than VA in the quarter, but you did mention strong sales momentum and you'll get some additional fee days in subsequent quarters. So what I'm trying to – the outlook seems better overall for sales in that business than when you announced the Athene transaction. So I'm wondering if you will be able to earn back the earnings that you lost from that reinsurance [ph] block fields (27:12) sooner that you might have expected. Could you update us on some thoughts there?

....

Dennis R. Glass
President, Chief Executive Officer & Director, Lincoln National Corp.

A

When we did the deal, we always anticipated that we'd replace the sold liabilities in a 24-month period or so, maybe 36 months, and because of the increasing results that we've seen, better than what we had anticipated, that might come back a little bit quicker.

....

Elyse Greenspan
Analyst, Wells Fargo Securities LLC

Q

Okay. Can you quantify that or just want to wait and see?

Dennis R. Glass
President, Chief Executive Officer & Director, Lincoln National Corp.

A

It's difficult to quantify, because it's – as you saw last year – or excuse me, last quarter, the split between fixed annuities and variable annuities was different than it is today. Some of that is consumer preference. Some of that is capital market impacts, decisions the consumer and the financial advisors are recommending. But let me just say we don't think that – let me say it differently. We will replace that income in a reasonable amount of time.

Elyse Greenspan
Analyst, Wells Fargo Securities LLC

Q

Okay. Thank you. And then my second question on the Group business. Did the light flu season benefit your results in the quarter? Just some color there would be great. Thank you.

Randal J. Freitag
Executive Vice President, Chief Financial Officer and Head of Individual Life, Lincoln National Corp.

A

Elyse, thanks for the question. I think as I noted, our very strong loss ratio in the quarter featured lower incidents in the disability side and then a little higher claims severity on the life side. I don't think that was specifically related to the nature of the flu season. I think it's just overall consistent with what we typically or oftentimes will see in the first quarter. I don't think there was anything outstanding about the flu season and its impact on our Group business.

Elyse Greenspan
Analyst, Wells Fargo Securities LLC

Q

Okay. Thank you very much.

Randal J. Freitag
Executive Vice President, Chief Financial Officer and Head of Individual Life, Lincoln National Corp.

A

Thank you.

Operator: Thank you. And our next question comes from Tom Gallagher from Evercore. Your line is open.

Thomas Gallagher
Analyst, Evercore ISI

Q

Good morning. The first question, just on the net income volatility you saw this quarter. I think you referenced that was related to the reinsurance transaction. Can you comment whether you would expect that to remain higher level of volatility going forward or should we expect that to come down over time?

Randal J. Freitag
Executive Vice President, Chief Financial Officer and Head of Individual Life, Lincoln National Corp.

A

Tom, thanks for the question. I think I said at the end of my paragraph on that particular topic, I said we expect it to reverse and subside. So the amount we had in the first quarter, which was $94 million associated with that transaction, that will reverse and it should subside. Why will it subside? It will subside as Athene repositions the asset portfolio. The size of it just had to do with the change in interest rates in the first quarter and the amount of the assets that still remain in an available for sale classification, which gave you a fairly large change, positive change in the unrealized gain. That positive change in the unrealized gain which runs through our balance sheet, we don't own the economics of that business. So obviously that has to get reversed out. Where it gets reversed out is through net income. It's – I've asked a number of accountants about this. It's both noneconomic and bad accounting, but that's just the reality and it, as I said, it will reverse and subside.

Thomas Gallagher
Analyst, Evercore ISI

Q

Got you. And Randy, that's GAAP only, not statutory, correct?

Randal J. Freitag
Executive Vice President, Chief Financial Officer and Head of Individual Life, Lincoln National Corp.

A

Correct.

Thomas Gallagher
Analyst, Evercore ISI

Q

Okay. Just on the mortality experience, I think in 4Q, Individual Life had some adverse experience, and looks like you pretty much recovered all of that and then some with the favorable in 1Q. And I think – if I'm correct, I think the – what you're essentially normalizing to now seems to be a somewhat higher level than I recall for 1Q. Is that a fair observation and also can you talk a bit about how you see Individual Life playing out throughout the balance of the year? And the reason I'm asking is I – at least my – the way I was perceiving your Individual Life results last year was pretty favorable, but if I'm taking your 1Q run rate, maybe you're assuming some continued favorability or continued similar level of margins that you had last year. But anyway, sorry for the long-winded question, any thoughts there?

Randal J. Freitag
Executive Vice President, Chief Financial Officer and Head of Individual Life, Lincoln National Corp.

A

No problem, Tom. Look, we were very happy with the first quarter. As I mentioned it was $25 million last year. In the first quarter that was roughly $5 million. Now that's relative to our expectations, and as I've talked about before, we do have seasonality in our mortality – in our Individual Life mortality expectations. That seasonality at a high level is typically 110% in the first quarter, 100% in the second quarter, and roughly 95% and 95% in the third and the fourth quarter. So that's how the seasonality typically plays out in our business. Now, of course we've got a big business and you all can move around inside of those longer term expectations.

So with that 110% expectation first quarter, we did better than that. We did better than that to the tune of $25 million as I mentioned. I don't think it changes our longer term expectations on mortality, as I've said before. If you look back over the eight years, you can – every year, we're within 1% of 100%, either above or below or exactly at 100%, with the exception of the one-year, which I always have to caveat which was 2015, when we had a bad second quarter, my recollection is. So, nothing has changed about our longer term expectations. The one thing we know is that we will have volatility quarter to quarter but when you look over longer periods of time, like a year, you tend to find a strong reversion to that mean of 100%.

Thomas Gallagher
Analyst, Evercore ISI

Q

Okay. Thanks, Randy.

Randal J. Freitag
Executive Vice President, Chief Financial Officer and Head of Individual Life, Lincoln National Corp.

A

Yep.

Operator: Thank you. Our next question comes from Jimmy Bhullar from JPMorgan. Your line is open.

Jamminder Singh Bhullar
Analyst, JPMorgan Securities LLC

Q

Hi. So first for Randy, just on spreads in, both the Annuity and Retirement businesses, your spreads went down even if we exclude alternative investment income. So just any comments on what your expectations are and to the extent you can quantify where your new money yields stand with the drop in interest rates recently, or so far this year, versus where the sort of yields are on the bonds that are going off the books and when do you expect spread compression to abate?

Randal J. Freitag
Executive Vice President, Chief Financial Officer and Head of Individual Life, Lincoln National Corp.

A

Thanks, Jimmy, I think if you look at those two businesses and the Annuity business, there is no spread pressure. We have plenty of flexibility to manage spreads. You will see quarter-to-quarter volatility, but over time, you will see a strong consistency to our Annuity spreads. In fact, if you look year-over-year, we're at 1.56% this year, this is excluding variable investment income, versus 1.55% last year. So very consistent with our longer term expectations; in the Retirement business, we were down 12 basis points year-over-year as I noted in my script. We have a guidance out there of 10 basis points to 15 basis points, so we're at the lower end of that. I think looking forward we would expect that number to continue to decline over the next couple years before it eventually disappears. I think in terms of the new money yields, as Dennis mentioned, I think we were at 4.40% in the quarter. And Dennis, if you have anything to add to that?

Dennis R. Glass
President, Chief Executive Officer & Director, Lincoln National Corp.

A

No. We're at 4.40% in the quarter, rates has dropped off a little bit, Jimmy, so that might be lower as we speak today. Fixed income book yield is 4.65%. We will go into greater detail at the investor conference around the issue of what's rolling off, what the new investment rate is, and when we expect to see spread compression completely abate.

Jamminder Singh Bhullar
Analyst, JPMorgan Securities LLC

Q

And if I remember correctly, I think you have a lot of higher yielding securities that are maturing this year, right? So, beyond this year, the impact of spread compression, assuming stable interest rates abates a little bit purely for that reason?

Dennis R. Glass
President, Chief Executive Officer & Director, Lincoln National Corp.

A

You are exactly right, Jimmy.

Jamminder Singh Bhullar
Analyst, JPMorgan Securities LLC

Q

And then just one more on the variable annuity business. You mentioned you expect an improvement in sales in 2Q. Seasonally, 2Q tends to be stronger for the industry overall, but are there other reasons for you sounding optimistic on sales? Because they did decline a decent amount on a sequential basis?

Dennis R. Glass
President, Chief Executive Officer & Director, Lincoln National Corp.

A

Are you talking about individual annuity sales or just variable annuity sales?

Jamminder Singh Bhullar
Analyst, JPMorgan Securities LLC

Q

Yeah, variable annuity sales.

Dennis R. Glass
President, Chief Executive Officer & Director, Lincoln National Corp.

A

Yeah. Variable annuity sales again, for some reason, the mix between fixed and variable in the last quarter was different than it is in April, and we've seen that makes change going forward. So, same comments that we've been making. Our index variable annuity is continuing to gain traction, with both new distribution partners and them bringing financial advisors in. So that would create a spike. And we're adding in our other product lines additional distribution. I mentioned in the fixed annuity line, we've added some IMOs and provided some customized products. It's really very much us taking advantage of the strength of our distribution, participating in segments of the annuity market, both fixed and annuity, that we hadn't been in before. And that's why we think, over the next couple of years, we can drive better total annuity growth than what the industry averages would be.

Jamminder Singh Bhullar
Analyst, JPMorgan Securities LLC

Q

Thank you.

Operator: Thank you. And our next question comes from Humphrey Lee from Dowling & Partners. Your line is open.

Humphrey Hung Fai Lee
Analyst, Dowling & Partners Securities LLC

Q

Good morning, and thank you for taking my questions. Just to follow-up on annuity sales. You have talked about, in April, the mix is two-thirds VA, one-third fixed annuities. That's the mix that you were expecting going forward. But I guess from a longer term perspective, is that the desirable mix that you would like to pursue for your Annuity business?

Dennis R. Glass
President, Chief Executive Officer & Director, Lincoln National Corp.

A

Yeah, Humphrey, that's a very good question. And when you ask that question, there's a lot of considerations. And let me just say, as between fixed annuities and variable annuities, you have to manage ROA because they're different for both. You have to manage ROE because they're different for both. And then as we have discussed, over the long term, we have to manage the balance of long and short-term liabilities.

So all of those considerations go into where we are putting our efforts. To some extent, the market is going to determine what the gross sales of the two products are. But within our system, and with the strength of our – the strength of our distribution, permits us to migrate, to some extent, the sales to the categories that we want them in to maximize our ROA, ROE, and achieve our balance of short and long-term liabilities.

Humphrey Hung Fai Lee
Analyst, Dowling & Partners Securities LLC

Q

Appreciate the color. And then a question for Randy. In Group Protection, I was just wondering, can you talk about the progress of the repricing efforts that you have on the Liberty Block, and how should we think about that going forward as we progress?

Dennis R. Glass
President, Chief Executive Officer & Director, Lincoln National Corp.

A

Yeah, I think I'll take that one. And let me just start the comment by saying, we're well ahead of expectations on this. Let me give you some specifics on that. We had to reprice about $1.8 billion in premiums. We have already repriced $1.4 billion in premiums. On the repricing of that $1.4 billion, we had about 7% increase in rate on the business that stayed. And we got an improvement, including both the improvement from the lower margins on what left, plus the higher margins on what stayed, of about 7%.

And so that when you do the math on all of that, we picked up about $70 million of earnings from the repricing already. Some of that has showed up in 2018. The balance will show up in 2019 and 2020. We have the $400 million left to reprice. We expect we'll still get sort of similar results on that.

The other comment I would make is that at the time of the presentation of the Liberty merger, we indicated that it would take two three year cycles to get all of the pricing that we needed. Actually, we are pleased because what repricing started before Lincoln was involved, was very helpful. And now we think at the end of this first cycle, we're essentially done on repricing.

Humphrey Hung Fai Lee
Analyst, Dowling & Partners Securities LLC

Q

Great. Thank you for the color.

Operator: Thank you. And our next question comes from John Nadel from UBS. Your line is open.

John Nadel
Analyst, UBS Securities LLC

Q

Good morning. Randy, I will start with a comment. I think we all really appreciate the simplicity of the earnings and the lack of notable items, I guess on a consolidated basis, that's the case. I guess I'd ask for your help maybe a little bit more in terms of quantifying the larger offsetting items. I think obviously variable investment income or alternative investment income would flow. Mortality was favorable. There were some DAC items and maybe a little bit of tax rate. I guess I would just ask for your help in quantifying some of these larger items that netted zero.

Randal J. Freitag
Executive Vice President, Chief Financial Officer and Head of Individual Life, Lincoln National Corp.

A

No problem, John. As I mentioned in my script, as we see them, they add up to zero. So what are those items that add up to zero? Items in the Life business included, as I mentioned, $25 million of favorable mortality in Life, and then $50 million of favorable amortization expenses, which just has to do with experience coming in better than our assumptions in the model. So that's $40 million on the positive side of the ledger.

On the negative side, you have the lower alt returns, which across the entire organization, was $29 million. $21 million of that occurs in the Life business, and the other $8 million is primarily in Retirement and Annuity, with a little bit in Group. Additionally, you have the $11 million of elevated group DAC amortization. 40 positives, 40 of negatives, you get back to zero.

I think there've been some questions. I was reading some of the notes on the tax rate. I don't really see much there. So let me go over that. When tax reform was enacted, we guided to a 15% to 17% range. I think as you look at last year, so the full year 2018, we came in right at 15%. So the very low end of that range. And inside of that full year, what you will see is that all else being equal, the first quarter will have our lowest effective tax rate. Why will it have our lowest effective tax rate? It's because the tax preference items are largely level over the year, whereas the pre-tax income is typically lowest in the first quarter because of a lot of the seasonal items I have talked about. Higher Individual Life mortality, fewer fee days, and the Annuity and the Retirement business, et cetera, et cetera.

So, if you look at last year, we had a 13.9% effective tax rate in the quarter. This year, we were at 13%. You know that small difference. I would attribute it – we had a small amount of DRD true-up $3 million, spread across three businesses. And I would note that there were other small items I think that went against that. And then you had a little bit of other benefit. But very small numbers.

John Nadel Q
Analyst, UBS Securities LLC

Okay.

Randal J. Freitag A
Executive Vice President, Chief Financial Officer and Head of Individual Life, Lincoln National Corp.

Does that help, John?

John Nadel Q
Analyst, UBS Securities LLC

I understand your point. Absolutely. Yeah, it is helpful, Randy. Thank you. And then I understand the accounting that has this sort of geography differential between your AOCI and the realized gain/loss impact on the Athene co-insured portfolio – or reinsured portfolio, but I guess what I'm having trouble understanding is why – what is actually going to cause that to reverse? Mechanically, when is that going to happen and what does that?

Randal J. Freitag A
Executive Vice President, Chief Financial Officer and Head of Individual Life, Lincoln National Corp.

Sure. So as I mentioned it comes about because a significant amount of the portfolio, which we transferred to Athene is still classified as available for sale, in which unrealized gains and losses run through the balance sheet and there was an unrealized gain in the first quarter. Now, we can't have the economics of that because we don't own the business anymore, so there's this offsetting entry. So what can cause it to reverse are a number of things. If the unrealized gain went back down in the next quarter that would be one way you would get the opposite impact.

John Nadel Q
Analyst, UBS Securities LLC

Got it.

Randal J. Freitag
Executive Vice President, Chief Financial Officer and Head of Individual Life, Lincoln National Corp.

A

If the assets were held until maturity, of course the unrealized gain would drift away, and over time you would see the offsetting entries. Or if and when Athene repositions the asset portfolio, because when they do reposition, that available for sale asset becomes a trading asset and of course with a trading asset, the changes in value run through the income statement, just like the offsetting entry. So does that help, John?

John Nadel
Analyst, UBS Securities LLC

Q

Got it. Yep, that's helpful. And I've got one last quick one. It's just looking at the $1.6 billion of fixed and indexed annuity deposits in the quarter, is there really any true fixed deferred annuities in there or is that almost entirely or entirely fixed index annuities and is all of that under the coinsurance arrangement with Athene?

Dennis R. Glass
President, Chief Executive Officer & Director, Lincoln National Corp.

A

Yeah, so if you talk about [ph] fees (47:30) in...

John Nadel
Analyst, UBS Securities LLC

Q

Yeah.

Dennis R. Glass
President, Chief Executive Officer & Director, Lincoln National Corp.

A

...in that one category, it's about $180 million. The rest is in fixed rate, fixed index, about $1.4 billion. And of that $1.4 billion, I think that there's about $500 million associated in the quarter with the Athene transaction.

John Nadel
Analyst, UBS Securities LLC

Q

Okay. Thank you so much.

Operator: Thank you. Our next question comes from John Barnidge from Sandler O'Neill. Your line is open.

John Bakewell Barnidge
Analyst, Sandler O'Neill & Partners LP

Q

Apologies if I missed it, but on prior calls you talked about evaluating block transactions for the Life and Annuity book to free up capital. Is that something you're continuing to do?

Dennis R. Glass
President, Chief Executive Officer & Director, Lincoln National Corp.

A

Yeah, we look at every opportunity to advance shareholder value. And so those kinds of ideas remain under analysis. Whether or not they would mature into a transaction, we won't comment one way or the other.

John Bakewell Barnidge
Analyst, Sandler O'Neill & Partners LP

Q

Okay. And then my follow-up, sales across the board are strong. Is it your opinion that rumors of the economy slowdown have been greatly exaggerated or is there anything you're seeing that gives you pause either in the distribution channel, customer demand or anything else? Thanks for the answers.

Dennis R. Glass
President, Chief Executive Officer & Director, Lincoln National Corp.

A

I'll leave predicting the growth of the economy to the experts. I will say though that [ph] sort of (49:04) from the insurance business, what's more important is the flow of wealth, and the change in who's getting the wealth, and we'll show some statistics on this at our investor meeting, but there's a lot of people going into the cohorts that we sell to, a lot of wealth coming out of retirement plans and going into the hands of the cohorts of age that we sell to. So I think that drives our long-term opportunities more so than the ebb and flow of GDP.

John Bakewell Barnidge
Analyst, Sandler O'Neill & Partners LP

Q

Thank you.

Operator: Thank you. Our next question comes from Erik Bass from Autonomous Research. Your line is open.

Erik Bass
Analyst, Autonomous Research LLP

Q

Hi. Thank you. How much further scope do you see to expand distributions for Annuities or Life products? And do you see any other potential opportunities similar to what you were able to do with Allstate or are there other large distributors where you're not on the shelf currently?

Dennis R. Glass
President, Chief Executive Officer & Director, Lincoln National Corp.

A

Well, in the Annuities business, the only P&C company that we are now selling with is Allstate. So there would be opportunities there. I think we have the opportunity to penetrate further in the Annuity business on just about every channel that we participate in. We're talking some – to some additional banks at the moment. So I think there's more opportunity in places where we are not to get more sales. And when you go over to the Individual business, and Randy can speak to this, but we ought to have – we're the major player in Life Insurance in the United States other than the mutual companies. And so we should have a significant segment of every – we should have a significant share of every segment, and we typically do, except in the Individual – excuse me, in the IUL marketplace. We're 17th out of 20, I think. So there is an example where – and that happens to be the biggest market for Life Insurance sales in the United States, and Randy is going to correct me if I misspeak here, but if there's an opportunity to really increase our position, we've introduced a new product and an example of the kind of things that we're trying to do. And Randy, I'm sorry, I'm speaking on your behalf.

Randal J. Freitag
Executive Vice President, Chief Financial Officer and Head of Individual Life, Lincoln National Corp.

A

No, I don't disagree. Erik, thanks for the question. I think on the Life side, it's more a function of products and markets that we may not be fully participating in. So I'll give you a couple of examples because there's a connection somewhat to distribution in there. Term insurance, we're a little underrepresented in the aggregator space, and Will and his team are going a great job of getting us onto some of those platforms.

We're a little underrepresented in the smaller face term market, and we're doing things like with the term excel product to be better represented there. That all came together in really strong term sales growth in the first quarter. As Dennis mentioned, we're also underrepresented in the index UL space. And we did come out with a couple of products in February to improve that position, and I think that will – with those products, which represent an improvement from a competitive standpoint, that should give us access to some markets and distribution channels where those products are sold.

But broadly speaking, Dennis is absolutely correct with the size of our Life business, the broadness of our product portfolio. We have a pretty strong representation among the people who sell Life Insurance.

Erik Bass
Analyst, Autonomous Research LLP

Q

Thank you. And then questions on Group persistency, if you can comment on trends there. And I know you called out in Group that amortization was a bit higher. Is that due to lapses or is it more just kind of reissue activity where there's no sort of impact on the forward earnings of the business?

Dennis R. Glass
President, Chief Executive Officer & Director, Lincoln National Corp.

A

Yeah, our combined block persistency is holding pretty steady. It's maybe down a little bit in the first quarter, but not anything to worry about. And Randy, I turn over the question on this to the...

Randal J. Freitag
Executive Vice President, Chief Financial Officer and Head of Individual Life, Lincoln National Corp.

A

I couldn't agree more. I think absolutely our overall persistency is right in line with our expectations. Inside of there, there's some sub-segments where you may have had a little worse persistency. For example, we have an old voluntary book arising from the old Lincoln portfolio, where persistency was a little worse than expected. And that drove, actually some of the higher than expected DAC amortization. But overall, I think persistency continues to run right in line with our expectations, and we in fact have not seen the shock lapses that we priced into the Liberty deal.

Erik Bass
Analyst, Autonomous Research LLP

Q

Great. Thank you.

Randal J. Freitag
Executive Vice President, Chief Financial Officer and Head of Individual Life, Lincoln National Corp.

A

You bet.

Operator: Thank you. Our next question comes from Andrew Kligerman from Credit Suisse. Your line is open.

Andrew Kligerman
Analyst, Credit Suisse Securities (USA) LLC

Q

Hey, thanks a lot. Just kind of following up on the Group, you had a pre-tax – an after-tax margin of 4.8% versus the guided 5% to 7%, and if I took the midpoint of that 5% to 7%, that would imply close to $50 million of additional earnings pickup, probably due to the repricing and the expense savings on the Liberty acquisition. So I think Randy, you mentioned another $20 million or so coming on the expense side. I think Dennis was talking a little bit about continued benefits from repricing. So should I assume that repricing and the expenses just get another $50 million in pickup over the course of the next year, or is there more than that? Do we get closer to the 7%?

Randal J. Freitag A
Executive Vice President, Chief Financial Officer and Head of Individual Life, Lincoln National Corp.

Andrew, I believe that what you are using in your denominator is total revenues.

Andrew Kligerman Q
Analyst, Credit Suisse Securities (USA) LLC

Yes.

Randal J. Freitag A
Executive Vice President, Chief Financial Officer and Head of Individual Life, Lincoln National Corp.

And when we talk about margins, what we use in our denominator is premiums. So, the margin.

Andrew Kligerman Q
Analyst, Credit Suisse Securities (USA) LLC

Oh okay.

Randal J. Freitag A
Executive Vice President, Chief Financial Officer and Head of Individual Life, Lincoln National Corp.

The margin in the first quarter – which is an industry standard, by the way.

Andrew Kligerman Q
Analyst, Credit Suisse Securities (USA) LLC

Okay.

Randal J. Freitag A
Executive Vice President, Chief Financial Officer and Head of Individual Life, Lincoln National Corp.

The margin in the first quarter was 5.4%.

Andrew Kligerman Q
Analyst, Credit Suisse Securities (USA) LLC

Okay.

Randal J. Freitag A
Executive Vice President, Chief Financial Officer and Head of Individual Life, Lincoln National Corp.

I think as both Dennis and I have said, we expect over the long term to be between 5% and 7%. But given our improved scale, given the synergies that we have coming in, we expect we can move to the upper half of that range. So, another 1% would be another $10 million of earnings a quarter or so.

Andrew Kligerman Q
Analyst, Credit Suisse Securities (USA) LLC

Okay. So maybe another 40-ish to go. That's helpful. And then, I know there was a lot of talk on the call about yields and so forth. But maybe you can help me just a little bit with the trajectory in the Annuity business, which is the biggest spread area. You went from a yield of 3.99% to 4.02%. You went from a crediting rate, and I suspect this is due to the Athene transaction, of 2.31% to 2.41%. So the spread shrank by 7 basis points, and I'm just kind of wondering where – I think, Randy, you said that there's no spread pressure. You expect it to be consistent. Where should I be expecting this spread to go? And maybe you could give a little trajectory on the yield and the credited interest.

Randal J. Freitag
Executive Vice President, Chief Financial Officer and Head of Individual Life, Lincoln National Corp.

A

Andrew, I have a phrase where I say, the latest is the greatest. And so, I think I wouldn't move too far from what we reported in the quarter, which was 1.56%. Which, as I mentioned earlier, was very level with the year ago quarter. So I'm going to stick with my, the latest is the greatest.

Andrew Kligerman
Analyst, Credit Suisse Securities (USA) LLC

Q

Okay. That's great. Thank you.

Operator: Thank you. And our next question comes from Alex Scott from Goldman Sachs. Your line is open.

Alex Scott
Analyst, Goldman Sachs & Co. LLC

Q

Hi. Thanks for taking the question. So I wanted to ask you about the FASB changes that are coming in. And I know it's probably still far too early to talk about specific book value transition impact and specific volatility. But I guess just knowing investors have sort of appreciated Lincoln's simpler sort of reporting structure, consistency of earnings, et cetera, when you think about that volatility that we sort of know is on the horizon, what are the levers that you are looking at that are sort of on the table to maybe put you in a better position as you get closer to that? Whether it's uses of reinsurance, different hedging strategies, different product structures. Any color you can provide. Thank you.

Randal J. Freitag
Executive Vice President, Chief Financial Officer and Head of Individual Life, Lincoln National Corp.

A

Alex, I think we are too far off to give you any specifics. So with an aside, I appreciate your comment that investors appreciate our consistency of results. That's absolutely been what we have shown over the years. I wish it was reflected a little better in the valuation of the company. But as an aside, I think, Alex, you are going to see us use all the levers, everything we have at our disposal, to manage our way through the implementation of the accounting guidance. And I think when we get through it, well, yes, there may be a little noise. We're still working on getting there. I think you will see a similar Lincoln to what you've seen in the past, which is a company which has high quality results, returns, and consistency above our peers. And that's our expectations, and we will use all the tools we have at our disposal to get there.

Alex Scott
Analyst, Goldman Sachs & Co. LLC

Q

All right. Thank you.

Operator: Thank you. And that does conclude our question-and-answer session for today's conference. If there is anyone left with any questions, the company will be able to follow up with you later in the afternoon. And at this time, I would like to turn the conference back over to Chris Giovanni for any closing remarks.

Christopher A. Giovanni

Senior Vice President, Investor Relations, Lincoln National Corp.

Thank you, Crystal, and thank you all for joining us this morning. As always, we'll take your questions on our Investor Relations line at 800-237-2920 or via email at investorrelations@lfg.com. Thank you all and have a great day.

Operator: Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program and you may all disconnect. Everyone, have a wonderful day.