01-Aug-2019

Lincoln National Corp. (LNC)

Q2 2019 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and thank you for joining Lincoln Financial Group's second quarter 2019 earnings conference call. At this time, all lines are in listen-only mode. Later, we will announce the opportunity for questions and instructions will be given at that time. [Operator Instructions]

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, Corporate Treasurer, Lincoln National Corp.

Thank you, Gigi. Good morning and welcome to Lincoln Financial's second quarter earnings call.

Before we begin, I have an important reminder. Any comments made during the call regarding future expectations, trends and market conditions, including comments about sales and deposits, expenses, income from operations, share repurchase, 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 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 to the non-GAAP measures used in the call, including adjusted return on equity and adjusted income from operations or adjusted operating income to their most comparable GAAP measures.

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 prepared 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.

Second quarter adjusted operating earnings per share was a record and up 17% over the prior-year quarter. This quarter's results, once again, demonstrate our ability to deliver consistently strong financial performance with success of strategic actions and the benefits of our diversified and attractive business mix. All of these have and will build long-term shareholder value.

First on financial performance, strong growth in adjusted operating revenues and adjusted operating earnings in the second quarter aligned with the track record of success that we highlighted at our June Investor Day. This includes mid- to high-single-digit revenue growth and double-digit earnings per share growth when measured over 3, 5 and 10 year periods.

Additionally, this quarter we grew book value per share ex-AOCI by 9% over the prior year period and expanded our adjusted operating return on equity to 13.6%. Strategic actions by management, including maximizing our diverse product portfolio, participating in more market segments and leveraging our powerful distribution franchise, a competitive advantage for Lincoln, are accelerating growth. This resulted in strong top line results in the quarter, which contributed to operating revenue growth in every business segment. This momentum will drive future earnings and capital generation. We expect continued momentum as our sales pipelines remain robust.

It is important to note that we have not only consistently grown sales, but strategically tilted our sales mix. Over the last five years, at least 70% of our annual sales did not include long-term guarantees and year to date 81% do not have long-term guarantees.

Further, we have benefited from our diversified businesses, including growing our mortality and morbidity sources of earnings, which are not correlated with capital markets. These now represent 30% of total earnings, consistent with our target. Within our capital market-sensitive businesses, we also have some beneficial offsets that help contribute to a steady source of earnings and can support EPS growth.

We believe the business diversification is helpful to recognize, knowing interest rate levels and equity market growth rates change over time. For instance, in recent years, tailwinds from the equity market have more than offset headwinds from low interest rates.

Now, turning to the business segments, starting with Annuities, our strategic decision to broaden the product portfolio and participate in more segments of the marketplace enabled another quarter of robust sales as total deposits increased 22% and net flows were, once again, positive. We remain focused on providing solutions that meet different customer needs and have the ability to help us sustain our growth momentum as markets or consumer preferences shift.

In addition to growth, this strategy also helps us maintain a diversified sales mix and risk profile. The quarter sales were evenly balanced between variable annuities with living benefit guarantees, variable annuities without living benefit guarantees, and fixed annuities. Strong indexed variable annuity sales led to an 86% increase over the prior-year quarter in VAs without living benefits, and VAs with living benefit sales accelerated sequentially following the market volatility late in 2018 and into the early part of this year, consistent with comments we made on our last earnings call.

Our strategy of expanding shelf space and increasing wholesalers has resulted in fixed annuity sales momentum. Total fixed annuity producers increased 44% over the prior year, and sales were up 46%, as we generated sales gains in every channel, including significant growth in IMOs and broker-dealers.

So, another strong quarter for the Annuities business. Our formula for operating the business successfully is working: Offer a broad range of products, invest in powerful distribution, maintain a consistent market presence, disciplined pricing, appropriate assumptions and operating in industry-leading hedge program. All of these factors position us well for diversified sales growth and continued positive net flows, while delivering consistently strong operating results.

In Retirement Plan Services, our high-touch, high-tech, digitally focused model creates a competitive advantage in our target markets. This differentiated service model is driving higher participation and contribution rates and an increase in both employee and employer deposits.

In total, recurring deposits, which typically represent approximately 60% of annual deposits, were up 6% over the prior-year quarter. Total deposits were down from a year ago, primarily due to timing of first-year sales. Importantly, our sales pipeline is strong. And our latest product innovation, YourPath, which is our proprietary alternative to target-date funds, is providing a new avenue for growth.

Net flows were $307 million, as we returned to positive flows after last quarter, which was the first quarter of net outflows in over three years. Our outlook for net flows remains positive.

Overall, it was a solid quarter for the Retirement business and continued investment in distribution, product innovation, and improving the customer experience will drive both top line opportunities and bottom line growth.

Turning to Life Insurance, product breadth and distribution expansion are allowing us to protect and expand our market reach. Sales in the quarter were up 30% compared to last year's second quarter. Total individual life insurance increased 19%, as IUL, term, UL, and VUL growth rates were in the mid-teens and above, and were complemented by solid executive benefit sales, which can be lumpy.

Strategically, we're investing in select markets, including the fast-growing IUL space, where sales increased 79%; and in term, where sales were up 28%, attributable to product and process enhancements, along with growing a number of active producers. We continue to maintain leadership positions in VUL and MoneyGuard, with each representing approximately 25% of our total life sales.

We're using sales momentum and diversification, along with disciplined financial management, to overcome industry headwinds, such as low interest rates and higher reinsurance costs. Overall, it was a strong quarter for the Life business, highlighted by double-digit top and bottom line growth.

Turning to Group Protection, successful execution of our Liberty integration plan has led to sequential increases in premiums every quarter since closing the transaction, significant expansion of after-tax margins, and paved the way to benefit from the sustainable competitive advantages created by the acquisition. We are leveraging our larger book of business and expanded capabilities to achieve our strategic objectives, including cross-selling additional lines of coverage and further penetrating the fast-growing and highly profitable employee-paid market.

This quarter and year to date, over half of our sales have been sourced from existing customers, and the percent of employee-paid sales increased 6 percentage points over the prior-year quarter. Our sales pipeline is strong. With attractive opportunities in the large case segment of over 5,000 employees as well as down-market, especially in the 1,000 to 5,000 mid-market segment, as we are benefiting from the best of both companies.

The group business had another strong quarter. We expect to grow premiums by sustaining persistency and capitalizing on significant top line opportunities while maintaining disciplined pricing and achieving expense efficiencies. The combination of these factors make us optimistic that we'll continue to achieve attractive margins.

Shifting to investment results, during the quarter we invested new money at a pre-tax yield of 4.2%, 190 basis points over the average 10-year Treasury. As highlighted at our recent Investor Day, we continue to increase well within our risk tolerance our allocation to high credit quality less liquid assets, where we are achieving attractive illiquidity premiums. These assets represented approximately 60% of our purchases in the quarter, and we have ample room to grow these strategies.

The investment portfolio is in great shape. And as the credit cycle extends, we have been shifting up in credit quality. We continue to diversify and to decrease our exposure to positions with greater risk of deterioration under stress scenarios such as lower-rated BBB and below-investment-grade assets, particularly within the energy and consumer cyclical sectors. As we anticipated in the first quarter, the alternatives portfolio had a sharp rebound, generating a solid 15% pre-tax annualized return. We continue to target a long-term pre-tax return of 10%.

So in closing, we're very pleased with our second quarter results, highlighted by top and bottom line momentum. We recognize there is a focus in the market around low interest rates, but being later in the economic cycle, let me make a few points on this.

First, going back to my comments earlier about the benefits of having diversified businesses and sources of earnings, the current strength in the equity markets is a more immediate helper and has a larger offset than the current decline in interest rates. Also, the headwind from the decline in interest rates is gradual, which gives us time to respond. And we have a proven track record of taking actions to invest in our businesses and simultaneously reap efficiency benefits such as our digital initiative.

Lastly, I would note the quality of our investment portfolio as we have proactively derisked the general account and have strong capital and holding company cash positions. As a reminder, we regularly stress test equity market, interest rate, and credit scenarios, and are comfortable with our ability to handle significant stresses. So bottom line, I am confident we can sustain our track record of financial performance, and this was once again demonstrated this quarter.

So now, let's turn the call over to Randy.

Randal J. Freitag

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

Thank you, Dennis.

Last night, we reported second quarter adjusted operating income of $478 million or $2.36 per share, a record and up 17% over the prior-year quarter. There were no notable items within the current or prior-year quarters. However, there were a few items that resulted in some variability this quarter. The net impact of these items was zero.

On the positive side, alternative investment income was $0.09 better than our long-term expectation. However, this was offset by two items. The first was higher volume and performance-related expenses, in part related to the increase in Lincoln share price, and the second was modestly unfavorable mortality relative to our annual expectation.

Touching on the performance of key financial metrics in the quarter, strong sales, net flows and equity market strength resulted in all four businesses showing operating revenue growth over the prior-year quarter with total adjusted operating revenues up 10%, boosted by last year's acquisition. Adjusted operating return on equity increased 50 basis points to 13.6%. Book value per share, excluding AOCI, grew 9% to $70.32, an all-time high.

And finally, our balance sheet remains an important source of strength, highlighted by a high-quality investment portfolio, solid capital ratios, significant cash at the holding company and strong capital generation, which is enabling us to both invest in growth and return capital to shareholders.

Net income totaled $363 million in the quarter, in part driven by below-the line volatility from noneconomic impacts. However, as we expected, the net impact from these items was significantly lower than the first quarter, totaling $68 million, down over 50%. Excluding the noneconomic impacts, net income represented 90% of adjusted operating income, as the VA hedge program performed well and credit losses remained minimal.

Now, turning to segment results, starting with Annuities, reported operating income for the quarter was $266 million compared to $275 million in the prior-year quarter. The decrease in earnings is related to the reinsurance transaction completed with Athene, which reduced operating income by $14 million in the quarter. Return metrics remained strong with ROA at 81 basis points and a ROE of 22%.

Operating revenues increased 5% over the prior year period. End-of-period account values totaled $134 billion, 2% higher than average account values, which should serve as a positive driver for future earnings. Risk metrics were also solid and benefited from the growth in equity markets as net amount at risk sits below 1% of account value for living benefits and less than 0.5% for death benefits. So, another very good quarter for the Annuities business. Given the tailwind from positive net flows, combined with strong equity markets through the second quarter, we are well positioned to continue to provide dependable financial results.

In Retirement Plan Services, we reported operating income of $42 million compared to $43 million in the prior-year quarter, as benefits from higher account values were offset by spread compression. Net flows totaled $1.5 billion over the trailing 12 months, which when combined with favorable equity markets drove average account values to $73 billion, up 6%.

Similar to the Annuities business, end-of-period account values are 2% higher than average account values. Operating revenues increased 2% and the G&A expense ratio, net of amounts capitalized, improved 30 basis points compared to the prior-year quarter, continuing a theme of strong expense discipline as we leverage technology to drive down the cost of doing business.

Base spreads, excluding variable investment income, compressed 12 basis points versus the prior-year quarter, consistent with our expectations. The Retirement business reported strong results this quarter, and further momentum in sales and expense management should serve as positive drivers going forward.

Turning to our Life Insurance segment, operating income of $168 million increased 12% from the prior-year quarter, driven by new business growth and year-over-year improvement in alternative investment income. During the quarter, alternatives were $12 million favorable to our expectation. This was offset by unfavorable mortality relative to our 2019 expectation for mortality experience.

Underlying drivers were solid with average life insurance in-force up 6% over the prior-year quarter and average account values increasing 4%, both of which helped drive a 7% increase in operating revenues. Base spreads, excluding variable investment income, were down 7 basis points year-over-year, once again consistent with our expectations. So, a great quarter for the Life business, highlighted by double-digit sales and earnings growth. We expect sales momentum to continue and, historically, our annual mortality experience has been seasonally favorable in the second half of the year.

Group Protection reported operating income of $68 million compared to $45 million in the prior-year quarter with the increase coming from the Liberty acquisition and continued favorable risk results. Loss ratio in the quarter was 73.6%, consistent with the first quarter. As a reminder, the year-over-year increase in loss ratios reflect the impact of the acquisition as we combined two blocks of business with different loss characteristics.

Overall, business trends remained positive, which resulted in an after-tax margin of 6.6%. G&A expenses increased at a slower rate than revenues, which resulted in a 50 basis point improvement in the expense ratio compared to the prior-year quarter. We continue to benefit from acquisition synergies and are on track to generate $100 million of run rate savings by year-end. It was another excellent quarter for Group Protection with our pricing and claims management fundamentals performing well. These favorable factors should enable us to sustain attractive margins.

Turning to capital and capital management, statutory surplus stands at $9.4 billion and RBC ratio ended the quarter at approximately 430%. Holding company cash ended the quarter at $474 million, slightly above our $450 million target.

During the quarter, we've returned $225 million of capital to shareholders, including $150 million of share buybacks. Year to date, we have allocated $540 million toward buybacks and dividends, while continuing to invest in growth to support future earnings and capital generation, particularly through robust sales in the Life and Annuities businesses.

To conclude, second quarter results were strong and reflect many of the themes we highlighted at our recent Investor Day, including durable, dependable and differentiated financial performance, measured by our sales momentum and operating revenue growth, along with a 17% increase in adjusted operating EPS. Investing in the business to support growth and returning capital to shareholders led the mid-single-digit growth in pre-tax earnings compared to the prior-year quarter and an 8% decrease in average diluted share count.

And lastly, the balance sheet is well-positioned and our risk management framework is robust, highlighted by solid performance from our VA hedging program. As we look forward, we are well positioned to continue delivering strong financial results and driving long-term shareholder value.

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

Christopher A. Giovanni
Senior Vice President, Corporate Treasurer, Lincoln National Corp.

Thank you, Dennis and Randy. Gigi, 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 please re-queue if you have additional questions.

With that, let me turn the call back over to Gigi to begin Q&A.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] And our first question is from Humphrey Lee from Dowling & Partners. Your line is now open.

Humphrey Hung Fai Lee
Analyst, Dowling & Partners Securities LLC

Q

Good morning and thank you for taking my questions. A question for, Dennis, annuities definitely have a very strong quarter in terms of sales. Looking towards the second half, I believe the Allstate partnership is expected to ramp up kind of towards the later half of this year. But given the interest rate outlook, has your expectation for the sales contribution from this new channel changed from earlier this year?

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

A

We continue to see good potential from the Allstate channel. With respect to fixed annuities and interest rates, we have seen a reduction in our crediting rates. I think we're a little bit ahead – and I'm talking in aggregate, not just for Allstate. I think we're a little bit ahead of the competition on that. And so, that's why we saw a decline in sequential fixed annuity sales. But overall, we are optimistic about net flows continuing to grow over time in the total individual annuity business. And then, we talked about so much in our remarks, we are well-positioned in every product line in every market segment. So, there is going to be shifts in consumer appetite from one to the other, but we can take advantage of the shift because we have a product in each segment and meeting every consumer requirement.

Humphrey Hung Fai Lee
Analyst, Dowling & Partners Securities LLC

Q

Got it. And then, a question for Randy, you talked about, in Group Protection, you continue to see the expense synergies coming up and you're still on target to get to the $100 million. But do you see any reason why you can't achieve that run rate savings earlier than target?

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

A

Humphrey, thanks for the question. I think we're pretty much right on track with what we said and that we expect to get to $100 million by the end of 2019. We're well on track to that. We've hit the mid-80s. I think we're at actually $87 million, if you look at where we are through the second quarter. I think also, Humphrey, what we've said is that when we look into 2020, we think that is some additional capacity to go above the $100 million we initially thought we could get when we entered into this great transaction. So we're right on track with a little upside to what we actually originally thought, Humphrey.

Humphrey Hung Fai Lee
Analyst, Dowling & Partners Securities LLC

Q

Got it, 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 is from Ryan Krueger from KBW. Your line is now open.

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

Q

Hi, thanks. Good morning. On indexed Vas, you've had pretty substantial growth now since you launched that product. Just curious about how much additional runway you see for further growth there just given the market size of that product.

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

A

We think it's going to continue to take share. It's continuing to be a growing part of our overall sales plan. It's an important product in the marketplace. Consumers are reacting very well to it, and we expect continued growth.

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

Q

Thanks. And then G&A expenses were a bit higher in Annuities and Life this quarter. I think it was partly related to the volume growth. But should we expect that to continue if volumes remain at these levels?

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

A

Ryan, let me talk about expenses in total. If you look at expenses 2018 to 2019, second quarter 2018 to second quarter 2019, net G&A in total for the organization is up about $70 million. If you broke that up into its component parts, about a third of that increase would be the addition of Liberty for an additional month. About a third of it would be really linked to performance-related items, primarily the change in the share price of Lincoln. If you go back to second quarter 2018, G&A was actually reduced by $11 million, because the share price was down quite a bit, while this quarter G&A was boosted by about $6 million by that same factor.

And then the other third really represents normal growth, which is a little above where we've been for the last couple years, driven by exactly what you referenced, which is the very strong volume. So assuming performance and all those things continue to come in line, I think expenses we had this quarter are pretty much what we'd expect looking into the back half of the year.

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

Thanks, that's helpful.

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

You bet.

Operator: Thank you. And our next question comes from Suneet Kamath from Citi. Your line is now open.

Suneet Kamath
Analyst, Citigroup Global Markets, Inc.
Q

Thanks. My first question is just on interest rate environment. Given the pullback in rates, do you still feel pretty good about where you're pricing new business, particularly on the Annuity and Individual Life side, or do you think you need another round of the repricing like you did several years ago? Thanks.

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

We're still seeing good returns in the RPS, Life, and Group Protection business. In the Annuity business, I think I mentioned that we've reduced rates on the fixed annuities to get our returns back up to where they need to be, and we're doing that. Again, I think we're a little ahead of the market on it.

With respect to our variable annuity products, specifically with living benefits, we dropped the guaranteed rate income about 15 basis points at the margin. So we've taken what we think are the necessary actions. And depending on which way interest rates drift, we'll continue to do what needs to be done to get the proper return on new business. And I don't think – I think at the margin, it might affect the volume of sales levels, but we don't think the modest changes that we're making is going to have a significant impact on volume.

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

Suneet, on the Life side, it's an interesting year because unlike any year before us, this happens to be a year when we're repricing 100% of our Life portfolio because of the introduction of principles-based reserving in 2020, along with the transition to a new underlying mortality table 2017 CSO. So as we've gone through the year, we've been able to actually reflect some of the impact of lower rates into the pricing of those products. Of course, as we've gotten later in the year and rates have come down a little bit, that would be more reflected in the more recently priced products. But I would say we've been able to reflect lower rates in some of our pricing. That doesn't mean that there isn't a little bit more to go, but feel good about the returns we're getting across our Life portfolio and what we've been able to do in the face of these lower interest rates.

Suneet Kamath
Analyst, Citigroup Global Markets, Inc.
Q

Got it. And then just separately on sales, we've been reading of late some of the articles that have come out around regulators' view of Best Interest standards, NAIC reviews, and the like. Any comments about where you think we are in that process and how you think it's going?

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

A

That covers a lot of ground, but let me talk about a couple of things. The most important items for us is that the Best Interest standard should include choice between fees and commissions and a level playing field for various products and service models. The SEC's final ruling package, which included Regulation Best Interest, created an enhanced standard for BDs while preserving investor choice. So I think what's come out of the SEC is positive for our business model.

The other important regulation is the SECURE Act, which will give us opportunities, when it – we think it will get passed, but it will give us opportunities to put, for example, guaranteed lifetime income products within a plan. And I think that could be a great opportunity for growth for us. So I think the regulatory environment at the moment is moving – has moved pretty substantially in our direction from where it was or can still move there against SECURE Act.

The states, there was a little flurry of Best Interest, and the industry has been paying attention to that. That seems to have slowed down a little bit. We'll continue to, of course, react to the state regulation. But generally, I would say regulatory issues have moved pretty significantly in the industry's favor, and again, if the SECURE Act is passed, even more so.

Suneet Kamath
Analyst, Citigroup Global Markets, Inc.

Q

Okay, thanks.

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

John Nadel
Analyst, UBS Securities LLC

Q

Hey, good morning. I guess either for Dennis or for Randy. I'm just curious. Y our life insurance sales, even if I take out the executive benefit, which can be somewhat lumpy, were really strong, and they're strong across essentially every product category. What do you think is driving that? Are you taking share? I assume up 19% year over year, you must be taking share. I'm just trying to understand. Do you think this is a blip or some significant shift in market share and you're aggressively going after it?

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

A

Yes. The industry life sales are not up 19% and we are, so we have taken some share. We talked about this at the IRB. So, we analyzed the life business and really with a focus on what do we need to do to elevate the organic growth profile of a life business and that's drive more sales. So as we analyze the market, we found some pockets of the business where we really weren't participating in the way we should have, specifically, in the smaller face term and in the IUL space. And so, we had strategies, like I said, we talked about this at IRB, specifically in those areas. And if you look at term sales, they were up nearly 30% in the quarter. If you look at IUL sales, they were up over 70% in the quarter.

So, we had these specific strategies and I think the team has done a great job of executing upon them. And then, in our other products, I think you see more normal growth just driven by investments we've made in distribution and product. So, we're very happy with the results, but those results are right in line with the strategies that we had for the year and the expectations that we had coming into this year. The only product, John, that is facing a little bit of headwind is the MoneyGuard product, where sales are relatively flat year-over-year. I think, there is a number of factors in there, including increased competitive environment. There has been more companies enter the space.

I think the second biggest player in the space had some price increases and that may have created a little bit of a fire sale on their side. So I think there have been some MoneyGuard-specific factors. But we're very happy with what we see in the life space from a sales standpoint.

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

John, I might just add on to Randy's comments a little bit and come back to our digital efforts, and if I can use small face term as an example. We've made great strides in sort of digital app to digital issue and machine underwriting in between. So, we're able to attract some more of the distribution that is helped by that. So, digitally – we're seeing the digital effect across other product lines, but that would be an example of why we can take more share. It's a process, in addition to product.

John Nadel
Analyst, UBS Securities LLC
Q

Got you, that's really helpful. And then, Randy, if we could just – just quickly if we could just quantify, I know you said on a net basis, no notable item. Obviously, some moving parts, higher VII, I think you quantified that as $0.09. The other offset, could you just quantify those and maybe identify where they resided?

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

Yes. So, $18 million in total on variable investment income, which is $0.09. And that was offset by $12 million of adverse mortality in the Individual Life business, and then about $6 million of elevated expenses, as I said, related primarily to performance, especially the change in the share price. So, in total, $18 million of VII offset by the two items that I mentioned. Inside of the most impacted business, the life business, individual life business, that would've been $12 million of positive VII, offset by the $12 million of mortality.

John Nadel
Analyst, UBS Securities LLC
Q

Got it, perfect. Thank you so much.

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 is from Jimmy Bhullar from JPMorgan Chase. Your line is now open.

Jamminder Singh Bhullar
Analyst, JPMorgan Securities LLC
Q

Hi, good morning. I had a couple of big picture questions. First, just any thoughts on your upcoming actuarial reserve review. Obviously, interest rates are a lot worse, but then the equity market's done better than your assumptions. And I think you already had a cushion in your market corridor that you used for reserving. And then, also on the potential benefit of the SECURE Act, do you see most of the benefit in Annuities or in the Retirement business as well?

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

A

Jimmy, I'll take the first question, and not to sound like a broken record, but I'm not going to front run the process. There are a lot of people working across Lincoln as we speak on the third quarter unlocking process. With that being said, and you mentioned it, there are huge number of variables that go into the process. But one of the key capital market variables is the level of interest rates and they are down quite a bit from last year. So, we'll be very mindful of that as we go through the process. But we're way too early to talk about any overall expectation.

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

A

Jimmy, on in-plan protected lifetime income, we probably run that through the Annuity – excuse me, through the RPS business, so you would see the benefit in the RPS business. It would be a joint effort, of course. As you know, we have tremendous capability in that product line, inside the individual annuity business. That's where the mechanics of it is, so it would be a joint effort. But to repeat myself, we'd probably run that through the RPS business.

Jamminder Singh Bhullar
Analyst, JPMorgan Securities LLC

Q

And obviously, I think the SECURE Act gives you safeguards or safe harbors to be able to sell annuities into retirement plans. Do you have any thoughts on potential interest from plan sponsors, or is this sponsors or participants?

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

A

There have been some products inside the in-plan products over the years, but there's a fiduciary responsibility on the plan management people, the people, who run the plan, related to the solvency of the providers, which goes away in the secure plan. That also becomes, I think, a qualified default option. So the atmosphere would be tremendously more powerful for the product. And I think the lack of a defined benefit plan in the United States and all the pressure on the ability to have a secure source of income in retirement is going to make it very popular. But it seems like it should be. That, we'll wait and see.

Jamminder Singh Bhullar
Analyst, JPMorgan Securities LLC

Q

Thank you.

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

Alex Scott
Analyst, Goldman Sachs & Co. LLC

Q

Hi, I've a couple of follow-up questions. The first one is on the SECURE Act. I guess, it sounds like there is an interesting opportunity there. Could you talk about some of the things that you could potentially do in terms of – should I be thinking about partnerships with maybe asset managers that have 401(k) platforms, but no annuity offerings? Or should I be thinking about you looking to potentially scale up your operation to take advantage in a bigger way from some of these things? Is there any contemplation of those kind of actions?

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

A

So, I think the biggest opportunity is just selling a protected lifetime income product into existing plans. Some of that opportunity will come from our own 401(k) customers or our own defined contribution customers, because we have such qualifications in that product line or in that concept, I suspect we could go to plans that we're not the bookkeeper on. So, I just think it's a big opportunity in plan. Asset managers, there are some programs that have been announced by BlackRock working with, I think, Microsoft to do this already, because there is a demand out of Silicon Valley to create these defined benefit type of opportunities and annuity with protected lifetime income as retention strategies. So, I just think it's a huge opportunity and protected lifetime income is an important product for some portion of retirees' assets, and I think it's just going to get bigger.

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

A

Let me just add, Alex, as Dennis said, the opportunity is very large. The reality is, from a financial standpoint, this is not going to be what drives Lincoln over the next few years from a financial standpoint. That's going to be what we really have in place today. SECURE Act's going to be something that really is going to benefit the industry over an extended period of time.

Alex Scott
Analyst, Goldman Sachs & Co. LLC

Q

Understood. Maybe one follow-up, I guess back to actuarial review, I guess one of your peers adjusted mortality assumptions that ended up resulting in a charge, but also I guess materially changing the impact to go-forward earnings as well, to some degree. And so, I guess I was just interested to hear if – given your concentration in interest-sensitive life, if we have any risk there in mortality and any kind of changes that you'd potentially make?

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

A

Alex, it's really way too early for me to give you any insights there. As I mentioned, all of the assumptions get reviewed as part of the third quarter unlocking. Mortality is one of those. There are, obviously – we have a lot of mortality risk. So, it's definitely one of the major assumptions we look at. But really way too early to give you any overall insights on what we might see from that particular component. And at the end of the day, what becomes ultimately important is what do all of the impacts of all of the assumptions changes add up to.

Alex Scott
Analyst, Goldman Sachs & Co. LLC

Q

Got it. Okay, thank you.

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

A

Yes.

Operator: Thank you. Our next question comes from Tom Gallagher from Evercore ISI. Your line is now open.

Thomas Gallagher
Analyst, Evercore ISI

Q

Good morning. A few mortality-related questions as well. Randy, you mentioned the change in the mortality tables that you are, I guess, implementing. Was that this year? And what are those changes? Would you expect there to be any impact on cash flow or capital levels from that?

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

A

No, Tom. So, this change is in the mortality table that underlies new business from a tax standpoint. So, what it really drives is what is the amount of cash that can be put into a product and still qualify as life insurance before you become, let's call them, MEC, right, a modified endowment contract. So, what the products that are going to be most impacted are really products that are focused around accumulation. Now, most of our products today are more focused around protection. But this goes into effect the beginning of next year, all products will need to use this new mortality table and what it is going to primarily impact is the amount of cash that a consumer could put into a product, thus primarily impact accumulation-focused life insurance.

Thomas Gallagher
Analyst, Evercore ISI

Q

And, Randy, would that – so for more accumulation-oriented life insurance products, would that raise the initial strain on it for statutory, or is there some other impact?

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

A

No, it doesn't have much to a strain. Really, it's all about how much money a consumer could get into a contract and still qualify as life insurance. But it doesn't really have any impact on any of the other mechanics of the product.

Thomas Gallagher
Analyst, Evercore ISI

Q

Got it. And then I know – just on the mortality side, after going through, I would say, a good two to three-year stretch of no mortality volatility, you've had two negative quarters, not hugely negative, but modestly negative mortality quarters in the last three. Anything that you see changing right now when you do your evaluation of what's driving that, whether there's anything systemic or otherwise?

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

A

Let me talk broadly about mortality, and I think you talked about the last three quarter. I'll pull it out a little longer. If I take the fourth quarter last quarter and I lump it together with 2018, 2018 at the end of the day came in, in line with our expectations. I think we ended up at 101%, my recollection. If you look at 2019, we were $25 million to the good in the first quarter, $12 million to the bad in the second quarter. So, we're actually ahead of our expectations through the first half of the year for life insurance mortality.

I think the quarter-to-quarter numbers we talked about just say more to the fact that we're a large company, we issue a lot of life insurance. We have net death benefits that run through our financial statements in any given quarter that exceed $500 million. So the thought that you might be a little above or below that, there's nothing surprising about that. But when you view mortality experience over a more extended period of time, it continues to run, I would say, in line with our near-term expectations.

Thomas Gallagher
Analyst, Evercore ISI

Q

That's good perspective. Final question on – anything – I think in the past, you really haven't had much impact from cash flow testing because of aggregation benefits. Given where we're at now, would you still expect the benefits of aggregation of other businesses to minimize anything you may have to post from a year-end cash flow testing standpoint?

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

A

Way too early. Let me remind you, we have very strong cash flow testing results overall. The only item we've really ever had to focus on are the subtests associated with guaranteed universal life, otherwise known as 8C and 8D. We've passed those tests in the past, and I think that's our best estimate going forward. But those are the two areas that we have highlighted or alerted you to that could create some potential noise looking forward.

Thomas Gallagher
Analyst, Evercore ISI

Q

Okay, thanks.

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 now open.

Andrew Kligerman
Analyst, Credit Suisse Securities (USA) LLC

Q

Hey, good morning. First, a general question to Dennis and Randy. So what appears to have been a pretty solid quarter, as you highlighted, the stock is underperforming in a down market. And so my question is, do you do an acceleration of share repurchases as you did back in the fourth quarter? Is there some business mix change that might make sense? Do you want to go out and do an M&A? Strategically, does this prompt you to make a change, and what might that be?

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

A

Andrew, I don't think we can react to a two-hour change in our share price. Obviously, we're disappointed. You guys all do a great job for the industry with your remarks. Whether we're off $0.01 from estimates seems to be more of the focus this morning than the fact that we're up 17% with our operating earnings, the fact that we've compounded our earnings per share at 12% for five years, the fact that we have one of the highest ROEs in the marketplace. So our strategy is a good one. It's producing excellent results, and we can't be rethinking strategy because of one day.

Now, we are a little concerned about the multiple. And yes, we will look at every strategic option, although we don't have anything major in mind, to try to get the market to recognize the VA business as a better business than what it's currently being valued at, we think. I think right now, continuing to put up the excellent performance that we've put up. Again, I think sometimes we fight against some of the missteps of our competitors where there have been big charges mostly for assumptions around policyholder behavior. We haven't had any of that. We have an excellent hedge program.

So we're going to continue to emphasize the quality of the annuity earnings, the quality of the book of business. We're going to continue to emphasize 12% compounded earnings per share growth, the source of earnings mix, which gives us options no matter what happens in the capital markets or not – no matter what happens in the capital markets.

So we think we have a good strategy, we have a great franchise. And as I've said, lower interest rates over time will affect us, but we've got time to respond to them. I'll come back to our digital program. That was initiated for consumer experience. But it also came along with $120 million of expense reduction expectations, and we're on track for that. And that was in part motivated by the fact that we saw interest rates lower, lost earnings from interest spread, and we're going to replace it.

So we see this, again, a possibility and we'll take the necessary actions. But let me come back to 12% EPS share growth for five years, 17% this quarter, 13.6% ROE improvement, 8% or 9% increase in book value. Hopefully, the market will react to that more so than it has.

Andrew Kligerman
Analyst, Credit Suisse Securities (USA) LLC

Q

Got it. And I meant valuation as well, Dennis, and it sounds like you have a real confidence in the strategy that you're pursuing. Maybe more technically, so looking at normalized spreads as reported, they did come down in Retirement, but then interestingly they came up in the Annuity line. Is there any guidance or indication of where you see spreads going over the next year or two in both segments? Do you see pressure in both?

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

A

Hey, Andrew. Thanks for the question. I think what we did this quarter is we did a really good job of making sure that all our cash was fully invested, and you see that have a positive impact in the overall spread. I think any number between 1.65% and 1.75% is well within our range of expectations and is really reflective of primarily what I just talked about are we able to get the cash that comes into that business, especially that runs through like the hedge program, are we able to get that cash invested on a timely basis.

Andrew Kligerman
Analyst, Credit Suisse Securities (USA) LLC

Q

Got it. 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 John Barnidge from Sandler O'Neill. Your line is now open.

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

Q

Thank you. My question is about Retirement. First year sales were a bit light. Is this more a function of timing or demand? And maybe can you please talk about the backlog in the second half of the year?

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

A

Yeah. I think it's exactly what you said, timing. We have a very robust pipeline in both the small market sales and mid to large. Now, we have to convert that pipeline into sales. But we're starting with a robust pipeline. So, we expect better sales results in the second half. We're seeing some of that already.

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

Q

Can you maybe talk about what sectors you're seeing greater demand than others?

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

A

I think in the mid to large market, we focus on government, we focus on healthcare, focus on education. So, those would be the sectors where most of the pipeline is. And then in small case market, which we sell through predominantly the wirehouses, we're seeing a pickup in opportunity there as well. And I'd also come back to the point I made earlier, John, which is we're seeing 6% growth in recurring deposits, which is about 50% of total deposits in any particular year. So, that's a strong ballast. And again, pipeline opportunity is pretty good at this moment. We've got to convert it into sales and we're pretty confident that that will happen.

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

Q

Great. Thanks for your answers.

Operator: Thank you. Our next question is from Josh Shanker from Deutsche Bank. Your line is now open

Joshua Shanker
Analyst, Deutsche Bank Securities, Inc.

Q

Yeah. Thank you. Good morning, everybody. Two quickies. One, I saw a pretty big jump, over $1 billion in terms of investments in mortgage loans. As interest rates have come down, is there a pivot going on there? Is there – are you adjusting strategy a little bit? What I'm looking at?

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

A

That's part of the investment in less liquid, but higher-quality assets. I will tell you that I saw a statistic yesterday when we were going through some of the numbers, and I think we have, what, $14 billion worth of commercial loans and we have four loans with a face amount of less than $1 million that are a couple of months beyond their payments. So, that's just an example of how strong that portfolio is. But very definitely increasing our mortgage loan portfolio, which we've got very high quality results, and that statistics I gave you is great example of that, continues to be an emphasis for us.

Joshua Shanker
Analyst, Deutsche Bank Securities, Inc.

Q

And there was really a second quarter change, at least in my reading of it. Should I expect that to continue to accelerate going forward?

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

A

The origination in mortgage loans is – again, it's lumpy. And so, I'm going to just come back to my point that we have a strategy to increase the size of that portfolio. In a quarter, it might not have originations; in other quarter, it might have more. But I think the more important point is, longer term, that's a great asset class and we're growing to size of it.

Joshua Shanker
Analyst, Deutsche Bank Securities, Inc.

Q

And the second question, and I apologize if you already mentioned it, the drop in dental premium – or dental sales, I should say, is that seasonal? Is that a change in a large customer? What's happening there?

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

A

First of all, let's remember that that is a very important product for some segments, and particularly in the 100 to 1,000-employee segment, dental is bundled with other products. And so, you have to have a good competitive product. The product in the mid- to large-case size, you have to – it's still important, but sort of it's not sold as much on a bundled basis. So, the decline in sales has to do with some rated cases in the larger case market where we weren't getting our profitability expectations. And so, it moved elsewhere. There's a couple of other technical things in the marketplace that contributed to that.

But let me come back to strategy and importance. Dental remains important to us and it's a volume business. You have to have scale in it. And so, with a bigger opportunity we have in the larger combined companies, we'll continue to stress the importance of that and I think, over time, increase amount of sales and profitability, which at the moment is pretty minimal for that line.

Joshua Shanker
Analyst, Deutsche Bank Securities, Inc.

Q

And in that regard, should we expect that you might be not renewing other blocks near-term as you keep booking through the combined group business?

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

A

Could you say that again, please?

Joshua Shanker
Analyst, Deutsche Bank Securities, Inc.

Q

Given the lack of profitability there, would we see more sales decline as you try and reset the book and, get it right?

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

A

I'm not sure that would be the case. And again, I think the longer-term issue is building the scale in that business to meet our needs over time. So, we're focused on it, but it's a longer-term build to get where we need to be.

Joshua Shanker
Analyst, Deutsche Bank Securities, Inc.

Q

Thank you for running over and taking my question. I appreciate it.

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

A

Thank you.

Operator: Thank you. We will be able to follow up with those in the queue later this afternoon. I would like to turn the call back over to Chris Giovanni for closing remarks.

Christopher A. Giovanni
Senior Vice President, Corporate Treasurer, Lincoln National Corp.

Thank you all for joining us this morning. As always, we will take your questions on the Investors Relations line at 800-237-2920 or via e-mail at investorrelations@lfg.com. Thank you all for joining us today and have a great rest of the day.

Operator: Ladies and gentlemen, thank you for your participation in today's conference. This concludes the program. You may now disconnect. Speakers, please stand by.