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Lincoln National Corp. (LNC)

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning and thank you for joining Lincoln Financial Group's Fourth Quarter 2018 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. [Operator Instructions]

Now I would like to turn the conference over to the Senior Vice President of Investor Relations, 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 fourth quarter earnings call. Before we begin, I have an important reminder. Any comments made during the call regarding future expectations, trends in 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 are described in the cautionary statement disclosures in our earnings release issued yesterday and our reports on Forms 8-K and 10-Q filed with the SEC.

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.

Before beginning, 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 that 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 prepared remarks, we will move to the question-and-answer portion of the call.

I will now turn things over to Dennis.

Dennis R. Glass

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

Thank you, Chris, and good morning, everyone. Continued execution on strategic priorities produced strong fourth quarter and full-year results with adjusted operating EPS up 9% compared to the prior year quarter and 13% excluding notable items for the full-year. Adjusted ROE expanded another 40 basis points in 2018 to 13.5%.

As you know, we have a multi-year track record of equally strong financial results and are confident we can sustain this performance over time given the strength of our franchise and effective execution of key management initiatives including: maximizing our diverse product portfolio and distribution advantages to sustain profitable top-line growth; driving expense savings from both our digital programs; and synergies from the Liberty acquisition.

With the Liberty transaction, we also successfully increased the scale of our group business and the percentage of earnings from traditional insurance risks, maintain superior risk management, and leveraging the strength of our balance sheet and solid capital generation. Let me touch on each of these.

First on profitable top-line growth. Our powerful retail franchise benefited from management actions targeted towards expanding the product portfolio in attractive fast-growing segments of the market and increasing the breadth and effectiveness of our distribution force. These tactics drove solid growth within all four businesses, including the Annuity business returning to positive net flows in the fourth quarter for the first time since 2015, strong growth in Life sales in the quarter, contributing to the sixth consecutive year of individual life sales gains, three straight years of sales growth in Group Protection, and record RPS deposits and net flows in 2018. The near-term sales outlook is encouraging and we expect further momentum in 2019.

Moving to expense savings. We have initiated two significant programs. A few years ago, we made a strategic decision to accelerate our investments in digital, with a focus on enhancing the customer experience while also realizing expense savings. This initiative is progressing well, and we expect savings to largely offset expenses in 2019 consistent with our prior target and material bottom-line savings to begin emerging in 2020. Separately, we are on pace to achieve our targeted expense savings from the Liberty acquisition by the end of 2019, a year ahead of plan, and expect additional upside in 2020. When taken together, we ultimately expect total expense savings of approximately $250 million pre-tax.

Risk management has long been a strength of Lincoln and we continue to see strong performance. For example, in the fourth quarter, the variable annuity hedge program effectiveness was 95%, despite elevated market volatility. This is well ahead of pricing assumptions, and better than prior periods that experienced significant volatility. This continues our consistent track record of no material financial impacts from either the hedging program or our policyholder behavior assumptions. When you also factor in disciplined asset liability matching and active credit risk management, there is no doubt our overall risk management continues to be industry-leading.

Lastly, on balance sheet strength and capital management, in 2018, we deployed approximately $2.5 billion of capital towards strategic transactions, buybacks and dividends. As we enter 2019, we remain well-capitalized, have steady free cash flow, and are on stable or positive outlook with all the rating agencies. We are well-positioned to continue to fund new business growth at attractive returns while also returning a significant amount of capital to shareholders.

Now, turning to the business lines starting with Annuities. For the full year, earnings increased 3%, even after the effects of the Athene transaction, driven by our high-quality and growing book of business. Annuity sales were robust, as our strategic decision to participate in more segments of the marketplace is enabling us to reach more customers and advisors. For the full-year, sales increased 42% to $12.4 billion and, importantly, new products and expanded distribution represented 52% of sales during the quarter.

In addition to growth, our actions are also diversifying our sales mix and risk profile. This quarter sales were evenly balanced between variable annuities with living benefits, variable annuities without living benefit guarantees, and fixed annuities.

The last time total annuity sales exceeded this quarter was the second quarter of 2013 and at that time, a full 85% of sales were variable annuities with living benefit guarantees.

During the quarter, fixed annuity sales benefited from product and distribution expansion and more than doubled to $1.3 billion as every distribution channel generated sales gains, including significant growth in the bank and broker-dealer channels.

Variable annuity sales also increased in the quarter. VAs with risk managed funds remained the largest contributor to sales; however, our newest product, an indexed variable annuity we just launched in May, is not far behind, representing 25% of VA sales during the fourth quarter.

Notably, we accomplished our goal of returning to positive flows in the Annuity business in the quarter, with net inflows of $675 million, including both positive flows in both fixed and variable. For the full-year, we saw a nearly 200 basis point improvement in our organic growth rate.

So, a strong quarter and year for the Annuity business, as sales increased significantly and we returned to positive flows. Looking ahead, LIMRA forecasts industry sales growth to continue in 2019 and we will be adding more products and distribution, including our new distribution arrangement with Allstate, which has significant potential. We are confident sales momentum will continue and net flows will be positive for the full-year.

In Retirement Plan Services, earnings increased by double-digits in the fourth quarter and for the full-year. Total deposits for the quarter were $2.2 billion. This capped a very strong year, with total deposits up 18% to over $10 billion, driven by robust first-year sales and high single-digit growth in recurring deposits.

The fourth quarter marked our 12th consecutive quarter of positive flows. For the full-year, net flows totaled $2.5 billion, up 76% from the prior year.

Investments in our high-touch and high-tech digitally-focused business model are leading to better outcomes for both plan sponsors and plan participants. This is resulting in sales growth, increases in employee contributions and excellent retention in both the small and mid-large markets. Looking ahead, we are well-positioned to effectively compete in our target markets. While sales and net flows can be lumpy quarter-to-quarter, we expect another strong year in 2019.

Turning to Life Insurance, earnings growth was solid in the quarter and contributed to a strong year where earnings increased 20%. Total Life Insurance sales in the quarter were up 8% from the prior year, as results benefited from gains across most of our individual life insurance products, including VUL, IUL, UL and term. For the full-year, the total individual life insurance sales increased 2%, driven by strong growth in VUL. Total Life Insurance sales were down 4%, as executive benefit sales were softer this year.

As I have noted on recent earnings calls, we have initiatives in place to improve our competitive position and growth. And you began to see early success of this strategy in the second half of the year. As we enter 2019, the outlook for Life Insurance business remains strong and we expect our growth momentum to continue, driven by an increased focus on product diversification as we leverage our broad portfolio of customer solutions and distribution capabilities.

Turning to Group Protections results, earnings increased 150% over the prior-year quarter, driven by the Liberty acquisition, benefits from tax reform, and continued favorable loss ratios. For the full year, the after-tax margin was 5.5%, well ahead of targets we announced at the time of acquisition. Fourth quarter sales were up modestly and full-year sales grew 15%, attributable to the acquisition, which resulted in growth in the life and disability product lines and both employer and employee-paid sales.

Post-acquisition, premiums doubled compared to the prior-year quarter and also grew sequentially as persistency remains strong. We are optimistic about our ability to grow premiums by sustaining persistency trends and driving sales growth across all case sizes given our increased scale, broader distribution access, and expanded capabilities, while continuing to achieve our pricing targets.

In summary, we are pleased with another solid quarter and outstanding full-year results. The highlight of the year was our acquisition of Liberty. We have talked about our interest in acquiring a group property for several years to help increase the size and scale of the group business and accelerate our strategy of diversifying our sources of earnings. I am happy we were patient as we found the best partner with Liberty. The integration remains on track and we look forward to leveraging our scale to grow the top-line, maintain strong risk results, and improve expense efficiency.

Shifting to investment results. The investment portfolio remains in great shape and our differentiated multi-manager model is enabling us to proactively and successfully execute on key strategies. As the credit cycle extends, we have continued to focus on managing credit risk more defensively including some de-risking. Since 2015 we have sold approximately $3.5 billion within sectors and securities that have greater risk of deterioration under stress scenarios. Additionally, we have been increasing our diversification into asset classes and industries that are high-quality and expected to be less exposed to economic cycles.

Examples include reducing our consumer cyclical and commodity-related fixed income holdings, and increasing our exposure to consumer staples, infrastructure and municipals. We have also increased our allocation to commercial mortgage loans, constructing a portfolio that is well-diversified and high-quality with loans closed in 2018 having an average loan-to-value of 54% and debt service coverage over two times. These actions are contributing to our below-investment-grade assets representing just 4% of our fixed income portfolio while credit losses have been minimal.

During the quarter, we invested new money at an average yield of 4.5%. At this level, we are within 20 basis points of the portfolio yield and continue to expect spread compression to abate. And finally, our alternatives investment portfolio continues to perform well, achieving a 14% pre-tax annualized return for the year, above our long-term targeted return of 10%.

So, I am pleased with our solid fourth quarter results and record adjusted operating earnings per share in 2018. We enter 2019 with a lot of positive momentum. Notably, organic growth drivers are strong, and given our broad and growing product portfolio, combined with a large and expanding distribution force, we expect these trends to continue. Also, our expense savings programs will begin to contribute more meaningfully this year and really kick in next year.

When factoring in these targeted management actions, combined with other EPS growth drivers such as modest tailwinds from the capital markets and share repurchases, operating earnings per share growth could be above our 8% to 10% target beginning in 2020. We will be holding an Investor Day in June, and plan to update you on future drivers of our short and long-term financial results.

In closing, I'm very proud strategic management actions enable us to consistently deliver strong financial results and I am confident our strategy and execution of key initiatives will enable this to continue.

Now, I will 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 adjusted income from operations of $475 million or $2.15 per share for the fourth quarter, a 9% increase from the prior year. There were no notable items within the current or prior year quarter; however there were a few items that drove some variability within the Life Insurance segment which I will speak to later.

Now let me touch on the performance of key financial metrics for 2018. Adjusted operating EPS of $8.48 was a record and up 9% or 13% excluding notable items. As we combine growth and pre-tax earnings and benefits from tax reform with active capital management. Adjusted operating ROE increased 40 basis points to 13.5%. Book value per-share excluding AOCI increased 5% to $67.73, an all-time high. Consolidated net flows more than doubled to over $7 billion, primarily driven by the significant improvement in Annuities and record flows for RPS.

Operating revenues grew in every business segment. Expense management continued to be a good story as the G&A expense ratio improved 20 basis points. And finally, our balance sheet remains an important source of strength highlighted by a high-quality investment portfolio, solid capital ratios and liquidity, and strong capital generation which enabled us to deploy $2.5 billion of capital, well above our expectations going into the year.

Net income of $1.80 for the quarter was impacted by a $37 million loss from general account investments, with the largest impact coming from the mark-to-market on equity investments, and a $20 million acquisition and integration expense. Now turning to segment results starting with Annuities.

Reported earnings for the quarter were $258 million, compared to $265 million in the prior-year quarter. The most significant item impacting fourth quarter results was the reinsurance transaction completed with Athene, which reduced earnings by $15 million. Moving forward, we expect a similar impact in subsequent quarters and I will highlight the capital deployment benefits from the transaction later.

Total operating revenue decreased 7% from the prior-year quarter due to an 8% decline in average account values. Primarily attributable to the Athene transaction, average separate account values fell 3% in the quarter, but I would note that fee income fell less as we benefited from the fact that fees for living benefit guarantees are tied to the benefit base as opposed to account value, reflective of the high-quality product design in our living benefit portfolio.

G&A expenses net of amounts capitalized decreased for the quarter and full-year which resulted in the Annuities expense ratio improving modestly on an annual basis. Return metrics remained strong in the quarter with ROA at 83 basis points and a 21% ROE, both largely consistent with the full-year. So the Annuities business had an outstanding year, which culminated with returning to positive net flows in the fourth quarter, leaving us well-positioned to build on this momentum in 2019.

In Retirement Plan Services we reported earnings of $45 million, up 10% compared to the prior-year. The earnings increase is attributable to benefits from tax reform and expense management. G&A expenses net of amounts capitalized decreased over 2% for the quarter and full-year. When combined with an increase in annual operating revenues, the expense ratio improved 90 basis points in 2018. Positive net flows of $2.5 billion for the full-year helped drive average account values to $70 billion in the quarter, up 5%.

Base spreads excluding variable investment income compressed 11 basis points versus the prior-year quarter, at the low-end of our guidance range. ROA came in at 26 basis points, slightly ahead of the prior-year. 2018 was a great year for the Retirement business highlighted by consistently strong net flows and earnings, solid momentum in sales and further expense management should serve as positive drivers for the Retirement business.

Turning to our Life Insurance segment. Earnings of $175 million increased 15% from the prior-year quarter attributable to benefits from tax reform. Other items impacting earnings in the quarter include strong variable investment income offset by unfavorable mortality. Additionally, the quarter benefited from a $16 million adjustment to past deferrals, which was mostly offset by a basket of smaller one-offs. Combined, these items netted to a $4 million benefit to earnings.

As I noted, mortality was unfavorable in the quarter impacting earnings by $28 million relative to a more typical fourth quarter. For the full-year, mortality was uneventful as both frequency and severity came in at 100%. In fact, mortality has been within 1% of annual expectations in seven of the last eight years.

Underlying earnings drivers were solid with average account values and average life insurance in-force both up 3% over the prior-year quarter. G&A expenses net of amounts capitalized decreased 9% in the quarter and 7% for the year. When combined with a 6% increase in annual operating revenues, the expense ratio improved 90 basis points. Base spreads excluding variable investment income were down 10 basis points year-over-year, at the high-end of our expectations. So, a strong year for the life business as steady driver growth and good expense management drove an increase in pre-tax earnings and looking ahead, we expect sales momentum to build in 2019.

Group Protection reported earnings of $50 million compared to $20 million in the prior-year quarter with the increase primarily coming from the Liberty acquisition and benefits from tax reform. The after-tax margin was just under 5% in the quarter and 5.5% for the full year. Both well ahead of expectations we established when we announced the Liberty acquisition about a year ago. Compared to 2017, the full-year margin improved 30 basis points.

The loss ratio in the fourth quarter was 75.8%. Overall, risk results remain favorable. The quarter did reflect typical seasonality in the disability product line which drove the sequential increase in the loss ratio. As a reminder, the year-over-year increases in loss ratios reflect the impact from the acquisition as we combine two blocks of business with different loss characteristics.

It was an excellent year for Group Protection, as business trends remain favorable and the Liberty integration is going well. We continue to believe we can sustain margins within our 5% to 7% target and are optimistic that the upper half of the range is achievable over time as we execute on our pricing, growth, and expense saving initiatives.

Turning to capital and capital management, we ended the year with $9.5 billion of statutory surplus, and a RBC ratio of approximately 455%, which includes the previously communicated 4 point negative impact from the change in after-tax RBC factors. Additionally, our capital and RBC ratio include approximately $700 million and 35 basis points from goodwill associated with the Liberty transaction that will go away at the completion of a legal entity merger.

Holding company cash remains above our $450 million target. During the quarter, we returned $605 million of capital to shareholders. Share buybacks totaled $535 million, which included typical quarterly buybacks and 80% of estimated repurchases from our accelerated share repurchase program of $450 million that we commenced in December with the capital generated from the annuity reinsurance transaction. First quarter average diluted share count will reflect a meaningful benefit from the ASR, and as a reminder we expect the transaction to be accretive to EPS in 2019 and beyond.

Looking ahead, we expect free cash flow generation of approximately $850 million to $950 million this year, consistent with our prior guidance. We continue to focus on investing in new business growth at attractive returns while also returning a significant amount of capital to shareholders, both of which will help drive long-term shareholder value.

To conclude, 2018 was an excellent year and is consistent with the proven results we have reported for several years. In fact, over the past five years, adjusted operating revenues have increased at a 6% rate. Adjusted ROE has expanded 140 basis points. Book value per share, excluding AOCI, has grown at an 8% rate. And adjusted operating EPS has increased at an 11% rate, outperforming our EPS growth target. And as we look forward, we are well-positioned to continue delivering strong financial results.

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, Crystal, could we begin Q&A?

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] And our first question comes from Ryan Krueger from KBW. Your line is open.

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

Hi. Good morning. I had a first question on expenses. The $200 million total cost saves that you expect, that would be comparable to prior combined guidance, I believe, of $190 million to $250 million, so the high-end of that? I guess is that correct and is 2021 still the year you expect to achieve it?

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

Yes, Ryan. Let me walk-through and break that down into the two component parts. One half is the digital program and that program is running spot-on with what we originally guided you to. So what was that original guidance? We have an expectation that as we enter 2019, expenses will be in the $70 million to $80 million range and the benefits will equal that amount. So we'll be about net neutral in 2019. After that, the expenses will continue to trend down, the benefits will continue to grow and will grow ultimately to that $90 million to $150 million range.

On the other side, you have the integration savings associated with the Liberty acquisition. We experienced about $50 million of those savings in 2018. And as we move into 2019, we currently expect to exit the year at $100 million run rate. That's one year ahead of our original expectations. Additionally, as we've examined and tightened up the integration plan, we now believe that we can grow that original guidance of $100 million to $125 million in the out-years. So those are the numbers that get you to the total, Ryan.

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

Great. Thank you. And then, now that you've completed the fixed annuity reinsurance transaction, your stock still trades at a pretty low multiple. I guess would you consider a similar type of transaction for a piece of the individual life block if your valuation remains at these levels?

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

Ryan, we're always open to transactions that have a long-term improvement in shareholder value, so the answer is yes that we'll continue to look at them.

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

Thank you.

Operator: Thank you. 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 a question related to the ROA and Annuities and I think in Randy's prepared remarks, you talked about expenses were down and you have a good book of business and that's why it's pointing to the 83 basis point of ROA, which I find is still pretty strong given the adverse market and probably a little bit of higher fixed unit cost after the transaction. I was just wondering if you can go in more detail in terms of the strong performance and do you think the current level is sustainable in the current market environment?

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

A

Yes, Humphrey. Thanks for the question. Yes, we continue to expect and it's been a very consistent ROA story over the years. It has been in that 75 basis point to 85 basis point ROA range for as long as I can remember. As we look forward, we continue to see consistency in our ROA expectations going forward.

Humphrey Hung Fai Lee
Analyst, Dowling & Partners Securities LLC

Q

Okay. And then shifting to Retirement Plan Services, same thing, you talked about expense initiatives helping the G&A expense ratio and thus benefiting the ROA, but I think the 26 basis point is probably one of the highest [ph] without the benefits of VII (34:03). Do you think that 26 basis points for RPS is a sustainable number going forward?

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

A

I think it's in the range. I think it was a good quarter for the RPS business. As I said, $45 million of earnings was a good strong quarter and it led to the 26 basis point ROA. I don't think that the ROA as we look forward – there's a range of ROA expectations. I think 26 basis points is probably at the top-end of that range but it's not outside of the norm that we would expect from that business.

Humphrey Hung Fai Lee
Analyst, Dowling & Partners Securities LLC

Q

Okay. Thank you.

Operator: Thank you. Our next question comes from Randy Binner from B. Riley FBR. Your line is open.

Randy Binner
Analyst, B. Riley FBR, Inc.

Q

Hey. Thanks. Good morning. So I have a question on Group Protection, and I think this got addressed a little bit in the opening comments and I want to dig in because the – I guess, it's the timing of how the margin comes in in the Group Protection business and then kind of now that the Liberty deal is kind of in fully, how to think about the benefit ratio there, because the benefit ratio is a little higher than I thought it would be this quarter and I'm just wondering if there's a seasonality or any other kind of timing elements to how that margin and benefit ratio develops going forward?

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

Hey, Randy. First, I mentioned that there was a little bit of seasonality in our loss ratio, so let me dig into that a little bit. If you go back to the third quarter, we reported a loss ratio of 73.6%, but as we also mentioned, we had a benefit from our reserve review. So if you adjusted for that, the loss ratio in the third quarter was 74.5%. We experienced 75.8% in the fourth quarter.

One, I mean, those numbers, at the end of the day for a big business, that's not a big difference. So it's not like there was a real fundamental change in the loss ratio I would say. We do typically experience a little bit of seasonality in our disability business in the fourth quarter, negative seasonality.

If I had to pinpoint why exactly that is, I think as you think about claims management, especially around the holidays, whether it's staffing levels here at Lincoln or whether it's staffing levels at the doctors, either from our client standpoint or even our own doctors as you work with those, I think there's a little bit of a slowdown in the claims management process around the holidays. And if I had to highlight one thing, I think that's why we typically have a little bit of seasonality. So I think 75.8%, as we said, it's a good solid result and it's well within our – once again, our range of expectations for that business.

As a reminder, we came into the year saying we were going to have an overall margin in the group business of 3.5% for the year. We did 5.5%. So it was a really good year for the group business, and as I said, looking forward, we continue to think we can operate in that 5% to 7% range, ultimately growing into the upper half of that range.

Randy Binner
Analyst, B. Riley FBR, Inc.
Q

And expenses seemed like they're trending better, right? So is that a lever you continue to pull there as we look forward?

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

Yes, back to the answer on Ryan's question, we experienced about $50 million of the integration savings in 2018 and we expect to exit 2019 at $100 million run rate and ultimately move to $125 million. So absolutely, expenses are going to be one of the items that benefit earnings as you look forward.

Randy Binner
Analyst, B. Riley FBR, Inc.
Q

Okay. Perfect. Thank you.

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

Okay.

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

Thomas Gallagher
Analyst, Evercore ISI
Q

Good morning. Randy, the adverse mortality in individual life insurance this quarter, I guess that's the first time Lincoln has had that in about two to three years. The rest of the industry saw the same thing more or less. Any thoughts on what happened here? Any concerns for you? Do you think it's just normal volatility and have you dug in there a little bit?

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

A

Well, Tom, let me accelerate to the end and say yes, I think it was just normal volatility. I, like you and many others when I saw the result for the quarter, was disappointed and so dug into the quarterly results and what we found was nothing really extraordinary outside of just bad results. So frequency was a little bit elevated, severity was a little bit elevated. There wasn't anything inside from a type of cause of death standpoint. So there wasn't anything that stood out in terms of the quarter, other than just one of those quarters where experience came in a little worse than expected.

Now, as I expanded that view out and thought about it on a broader standpoint, I'd point out in the third quarter, we were about $20 million better than our expectations versus the $28 million negative that we experienced in the fourth quarter. So combined, those two quarters were pretty close to our expectations.

One of the other phenomena we saw in the fourth quarter – and this is really the first time we've experienced this in my memory, was that about a third of the experience in the fourth – negative experience in the fourth quarter came from third quarter claims lag. So we establish an IBNR at the end of every quarter and as we test that thing over time, typically we come within a few million dollars, but this quarter, as I mentioned, about a third of that $28 million came from an IBNR that was a little lower in retrospect than it should have been at the end of the third quarter.

So viewed from the last half of the year, I think you came much more in-line with our expectations and then when I viewed over a longer period of time, so as I got out of the quarter and I started to look into a much longer period of time, whether it's the full-year, as I mentioned, severity and frequency both at 100%. As I viewed over an eight year period, and as I mentioned, seven of the last eight years within 1 percentage point of 100%.

So when viewed over that longer period of time and viewed in reflection of what mortality is, I find the quarter to be unremarkable other than it was one of those quarters when experience just was a little worse than our expectations. But once again, we don't expect quarterly performance to always fall exactly within a particular range, but when viewed over longer periods of time, we do and that's what we experienced.

Thomas Gallagher
Analyst, Evercore ISI

Q

That's helpful. Especially the IBNR comment. That would make sense why when, if you smooth that piece of it out between 3Q and 4Q, it wouldn't have been as exaggerated between the quarters. The other – my follow-up is on variable annuity earnings and hedging. Can you comment on your variable annuity fees? How much is based on AUM versus guaranteed amounts? And then also has the recent market volatility altered hedging costs at all as we think about go-forward earnings and margins there?

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

A

Yes, Tom. The base fee, so the M&E, that's driven by account values. The fees for the living benefit guarantees on the vast majority of our products are linked to the guaranteed benefit base. So that's your differentiation between those two fees.

I think the primary driver – to the second part of your question, the primary driver of the cost of hedging is going to be the level of interest rates and so interest rates have come down a little bit and that has pushed the cost of hedging up a little bit, still within our range. If you expanded that out to what did we see across the industry, we continue to see a – I think, a reasonably-priced industry with most competitors behaving what we would call as rationally.

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 Jimmy Bhullar from JPMorgan. Your line is open.

Jamminder Singh Bhullar
Analyst, JPMorgan Securities LLC

Q

Hi. Good morning. So just a question for Randy on RBC ratios. Obviously, with tax reform, they've come down a lot for most companies and your RBC is considerably higher than peer levels, but I guess to some extent your business mix warrants that as well, but what do you view as a reasonable RBC threshold going forward versus where you stand right now?

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

A

Jimmy, thanks for the question. First, I want to reiterate because it was in my comments, but I want to make sure everybody understands that the 455% RBC ratio that we reported included a 35-point benefit from goodwill associated with the acquisition of the Liberty group business. In that acquisition we bought a legal entity and when you do a legal entity for statutory purposes, the excess of the purchase price over the book value of that entity gets recorded as goodwill which then gets amortized off over the next 10 years.

Additionally, if you merge that entity out of existence, which we intend to do over the next few years, that goodwill will go away. So that's what I would describe as a non-economic component of our 455% RBC ratio. You adjust for that and you're at 420%.

So let's talk about that number. Everything about that number is consistent, to a little better than our expectations when we went through a fairly rigorous review process with the rating agencies around the Liberty acquisition. And ultimately, it's the rating agencies who really drive required capital needs and expectations as we continue to operate as a AA company. So I find that 420% which, as I said, is a little better than the pro formas we put together at the time of the integration when our ratings were reaffirmed and as we sit here on stable outlook pretty much across-the-board with our agency partners.

So the upshot of that is that I would expect over time that about 400% is the right number for us during periods what I would call the good times and of course that ratio then drifts down a bit during times of stress and that gets built back up during the good times, but I think the number's probably about 400% ultimately driven by the rating agency models.

Jamminder Singh Bhullar
Analyst, JPMorgan Securities LLC

Q

Okay. And then just on sort of portfolio yields, I guess the new money yield's gone up over the past year, might have come down a little bit recently, but what's the difference between your portfolio yield and the bonds that are going off and when do you get to a point where you think the spread compression will cease to exist in your business?

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

A

Jimmy, so I mentioned in my remarks that we're putting new money on at about 4.5% in the fourth quarter and that the fixed income book – portfolio book yield's about 466%. As we've mentioned, in 2019 and into 2020, we're seeing a little higher yield on those assets that are running off, but we still expect spread compression to abate completely as we exit 2020. And I'd also like to mention that the amount of spread compression in terms of basis points is dramatically lower today than it was three years ago.

Jamminder Singh Bhullar
Analyst, JPMorgan Securities LLC

Q

Okay. Thank you.

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

John Nadel
Analyst, UBS Securities LLC

Q

Hey. Good morning. Thanks for taking my question. I guess if we set aside variable investment income which was elevated in the quarter, Randy, how would you characterize the impact of a pretty severe market decline in the fourth quarter overall on your earnings? And it's kind of hard to discern it, especially given some of the moving parts in the Annuity segment with the Athene deal, et cetera. Was there any real notable impact on your earnings this quarter?

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

A

Well, John, obviously, the average S&P came down in the quarter and that had a negative impact. I'd estimate that impact on the Annuity business, for instance, was $12 million, $13 million just on the quarter.

John Nadel
Analyst, UBS Securities LLC

Q

Okay.

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

A

As you exited the year, if you were sitting there on January 1, you would have had further negative impact as the end-of-quarter account values were below the average for the quarter.

Now, subsequent to January 1, we've had a recovery in the equity market. So as you sit here today, I think, if you looked at the average S&P and you took where the S&P is today and projected it out to the end of the quarter, held it level to the end of the quarter, you'd have a relatively modest decrease in the average level of the S&P. So there would be some additional headwind, but it's a lot lower than it was back at the beginning of the year.

There would have been less of an impact on the Retirement business, but there would have been a small negative impact on the Retirement business in the fourth quarter also from the level of the equity markets. And I'd have the same comment as you move into 2019.

So that's what I would say about both the equity markets and I think, as Dennis pointed out, as you move into the first quarter, it's tough to say exactly what the variable investment income portfolio will do, but one of the leading indicators for that portfolio is the level of the equity markets and so you would expect a bit of a headwind in the first quarter from that particular component.

John Nadel
Analyst, UBS Securities LLC

Q

Yeah, that's helpful. And then, if I think about that $12 million or $13 million, I know it's an inexact science, Randy, but if I think about that, how much of that was on the fee revenue side versus DAC amortization? I'm thinking about the cushion that you guys have in the corridor on the annuity DAC, and how much of that might have gotten eaten up?

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

A

I would say during the quarter about 100% of it was on fee income. So our corridor operated as it was supposed to during the quarter. We came into the quarter with a couple hundred million dollars of cushion. Most of that got taken away by the 15% downdraft in the equity markets. It's probably grown back up again as the markets have recovered here in the first quarter, but all of the impact, I would say, was on the fee income side.

John Nadel
Analyst, UBS Securities LLC

Q

Got you. That's really helpful and I just want to say I thought the prepared remarks and the commentary on the call were just terrific and I think some others should maybe pay attention to you guys.

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

A

Thanks.

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

A

Thank you.

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

Alex Scott
Analyst, Goldman Sachs & Co. LLC

Q

Hey. Good morning. I was just hoping you could provide an update on some of the things you're doing in the distribution channels in the Annuity segment. Could you just talk about how far down the path of building out the wholesalers and sort of expanding into IMOs? Is there continued momentum here? Have you gotten a lot of that work behind you? Any color would be helpful.

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

A

That's a pretty – Alex, broad question, but let me say that there's very significant distribution additions that we've made. One example of that being Allstate and we have already built the Allstate wholesaler team and I think that was 15 people about, so that's in place. Other areas where we've expanded distribution include IMOs and we built our wholesaler teams for that. The bank channel, we've increased our wholesalers for that.

So if I just look in aggregate, we've taken our wholesaler head count in the Annuity business from 236 in the fourth quarter of 2017 up to 285 in the fourth quarter of 2018, which is about a 21% increase. So that increase is consistent with the incremental addition of distribution opportunities.

Alex Scott
Analyst, Goldman Sachs & Co. LLC

Q

Okay. That's helpful. Follow-up question I had was just on the RBC. I know you already made some comments on it, which were quite helpful. I guess as I look at a couple of the peers, that are in variable annuities anyway, they have much higher RBC ratios and they're kind of telling us don't look at that. There's a lot of noise in there and as we adopt the VA framework changes, that'll come down.

Could you just talk about sort of how that'll impact your kind of thinking about that 420%? Is there anything related to VA changes that'll move that down or is that all sort of insulated from your offshore entity? Any way to think about RBC as we think about the next couple years, that would be great.

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

A

The short answer, Alex, is no, we don't expect any impact from the implementation of what has been called the Oliver Wyman approach. I want to reiterate that I think the whole process that we've gone through with the regulators and industry has been a textbook case in regulators and industry working together to create a better solution, both for the regulatory side and for the company side. So I applaud the states for the approach they took with that process. We don't expect an impact at Lincoln, other than that we believe that statutory reserving and capitalization will be improved by this new approach.

Alex Scott
Analyst, Goldman Sachs & Co. LLC

Q

Perfect. I just wanted to make sure. Thank you.

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

Erik James Bass
Analyst, Autonomous Research US LP

Q

Hi. Thank you. Can you just comment on group persistency trends around kind of the year-end renewals? And as we think about 1Q earnings, is there anything we should consider in terms of modeling the level of amortization?

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

A

Persistency generally is better than expectation and that has contributed to higher premiums than we have expected at this time from the combination of the companies. There is this amortization event that occurs in the first quarter. I think it's burning off a little bit but I'll ask Randy to speak to that. This is separate from the ongoing operations.

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

A

Yes, Alex (sic) [Erik], if you go back two to three years, we used to have amortization seasonality, that would lead to an additional $15 million to $20 million of amortization in the first quarter. We changed our approach a few years ago and so it's been grading down. I would expect a modest increase in the amortization in the first quarter due to that process, but I would describe it as modest.

Erik James Bass
Analyst, Autonomous Research US LP

Q

Got it. Thank you. And then can you remind us on the composition of your alternatives portfolio and should we anticipate some headwinds in the first quarter from private equity holdings?

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

A

Broadly speaking, 85% of our private portfolio is in private equities and 15% in hedge. Inside the 85%, we're well-diversified in the types of investments that are in the 85%. As Randy has already mentioned, I'll elaborate just one point. We record earnings on our Alt portfolio on a one-quarter lag so that the effect in the fourth quarter equity markets will show up in the first quarter Alts results, but again, we don't know exactly how much that is.

And then I will also say that given the fact that the equity markets have come back, some of what we might see in the first quarter is already going to turn around in the second quarter. So it'll be weaker in the first quarter than it was in the fourth quarter Alts in total, but again, for the full year, we still think we'll get to our target of 10%, just more of it will come in the last three quarters than the first quarter.

Erik James Bass
Analyst, Autonomous Research US LP

Q

Got it. Makes sense. Thank you.

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

A

Erik, this is Randy. Let me apologize. I think I might have referred to you by the wrong name and I apologize for that.

Erik James Bass
Analyst, Autonomous Research US LP

Q

No worries. Thanks.

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

Thank you. There was a pretty meaningful drop in first year sales for RPS. Is there any commentary you have on that?

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

A

Just the variability of sales in general, probably driven by the large case market where sales are lumpier just because they're large sales.

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

Q

Okay. And then how have conversations with producers changed over the last quarter from market volatility and the government shutdown?

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

A

I think across Lincoln, we haven't gotten too many specific comments about the impact of the government shutdown on our business.

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

Q

Okay. Thanks for the answers.

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

Josh D. Shanker
Analyst, Deutsche Bank Securities, Inc.

Q

Yes. Thank you. I just want to follow up on Alex's question and talk about distribution a little bit, but of course your sales and annuities, especially the variable kind, are much better than your peers. Is there a product cycle issue? Have you been changing your appetite to write stuff or is the market's appetite changing towards what you're selling? Is there a product design issue you think going on here or what do you think?

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

A

Yes, this is a very important question because it goes to sort of the theme in my and Randy's comments about us taking specific actions to improve top-line growth and the Annuity business sort of is the textbook example of that for Lincoln.

So if you go back three years, we defined our strategy in the Annuity business as essentially being a manufacturer of guaranteed lifetime income and I think in my remarks in 2013, 85% of what we sold, at least in the guaranteed lifetime income space, had guaranteed lifetime income – excuse me – in the variable annuity space, 15% [ph] different (58:52). Will and his team and the company at large decided very specifically that we were going to broaden our strategic view of what products we'd manufacture and sell in the broader annuity industry and we would first attack established market where there was significant volumes of sales taking place.

So as an example, we talked about this tremendous launch that we had this year with our index variable annuity. Well, the sales that we're getting in that total market aren't even at the market share that we would expect once we get to our full market share. So that's one of the drivers.

In the bank market, for fixed annuities, so of the same process. Yes, we did fixed annuities, but it wasn't a strategic focus. So we decided to focus more strategically there, helped with a quick start because of the Athene transaction, but now we're established in that marketplace.

So consistently, you've seen us pivot from product to product, but this is more broadening our view on where we're going to participate and getting what I would refer to as the normal share in existing established markets, products, value propositions.

Josh D. Shanker
Analyst, Deutsche Bank Securities, Inc.

Q

And do you think that – over the coming year, do you think that your relative share of the pie is going to grow or the pie will stay relatively stationary while you grow or will both grow?

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

A

I think the pie is going to get bigger – across all annuities. I mentioned LIMRA has an industry expectation of growth. So that's only the second time I think in the last five or seven years where they had a growth expectation for the broader annuity market. I think we'll continue to take share and in general, I think annuities are going to continue to become more popular with savers just because of the demographics of where we sell. That demographic bucket is growing quite a bit. So we're pretty optimistic about the top-line for the industry and very optimistic about our ability to take share.

And these comments are specific to the annuity as an example, but we're doing the same thing in the Life Insurance business. We're revisiting segments of the Life Insurance business where we don't have the market share as the number three provider, seller of Life Insurance in the United States that we should have, and so that's going to help to fuel our growth.

Josh D. Shanker
Analyst, Deutsche Bank Securities, Inc.

Q

Well, good luck in the new year and thank you very much.

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

A

Thank you.

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

Christopher A. Giovanni

Senior Vice President, Investor Relations, Lincoln National Corp.

Thank you all for joining us this morning. As always, we will take your questions on our Investor Relations line at 1-800-237-2920 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. Speakers, please stand by.