Corrected Transcript

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Lincoln National Corp. (LNC)

RBC Capital Markets Financial Institutions Conference - Panel

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MANAGEMENT DISCUSSION SECTION

Mark A. Dwelle
Analyst, RBC Capital Markets LLC

I'm going to start by thanking everybody for attending here. The RBC 2019 Financials Conference Day Two. So I guess we're the opening act for the second day. This is the first ever insurance investment panel. It's also the first time I've ever had a mixture of both life and P&C companies all on the same stage. Normally, we're so monolithic we do life panels, we do P&C panels we never really mix them together. But the thesis here this morning was really all of these companies are investors and we spend a lot of time focusing on the right hand side of the balance sheet. I thought we'd take the opportunity today to focus a little bit on the left hand side of the balance sheet and the people who do so much to kind of create value on that half of the equation.

So this morning I'm joined by three panelists. At the far end, we have Louis Marcotte of Intact Financial. He's the Chief Financial Officer there, has been there since – in that role, since 2012. Next to him in the center is Marty Hollenbeck. He's with Cincinnati Financial, Chief Investment Officer. Marty's been with Cincinnati Financial since the 1990s and moved into his current role about six years or seven years ago. I think that's right. And then to my immediate right is Ellen Cooper. She's been with Lincoln since 2012. She's a Chief Investment Officer there.

And with that, I think with – the format this morning we'll start off, I'll give them each a minute or two to kind of talk about themselves, their company, some investment style, whatever they want to say to kind of level set the playing field. We'll jump into some questions that I have, we'll take some questions from you all. And we'll try to make this as interactive as possible. I mean it's a room full of investors talking about investments; it ought to work, right? So maybe we'll start off with Ellen.

Ellen Cooper
Chief Investment Officer & Executive VP, Lincoln National Corp.

Sure. So good morning, everybody. And I am the Chief Investment Officer of Lincoln Financial. Lincoln is a U.S. – 100% U.S. domestic life insurance company for those of you who're not familiar in four major businesses. So we are in the Annuity business, the Life business, the Retirement Plan Services business and the Group Protection business. I oversee about – close to $300 billion now of assets. $100 billion that are in our general account and then another $200 billion that are in our separate account, that support our variable products. And so I'm going to spend most of my time and comments today on the general account. But just broadly speaking in that $100 billion of assets, we are putting on average around $12 billion of new money to work every year. And as many of you know that are familiar with life insurance companies, we invest relative to our liabilities. We have a disciplined overall ALM approach to investing. We predominantly invest in high quality fixed income assets and then we have

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a unique model and we'll get into talking about this a little bit more later. But one of the things that is very unique about Lincoln as a U.S. life insurance company is that we primarily use external managers for security selection in our general account and we'll get to that more in later Q&A.

Mark A. Dwelle

Analyst, RBC Capital Markets LLC

So going straight down the line.

Martin Francis Hollenbeck

Chief Investment Officer & Senior Vice President, Cincinnati Financial Corp.

Good morning. Marty Hollenbeck, Cincinnati Financial. We are a Midwest based top 25 P&C insurance company. We are no – we're about two-thirds commercial lines. We are known for our agent-centric model, independent agents. We have field folks who have a lot of autonomy. We believe in local decision making. We have had a long nice dividend streak with 58 consecutive years of dividend increases. We internally measure ourselves primarily by what we call the value creation ratio, VCR, which is basically its book value growth adding back or dividend paid.

And then on the investment front, we – distinguishing feature that we have is in a large cap high quality dividend growth strategy with plus or minus around 50 core names generally buy and hold and that's served us well for a number of years and we're about 35% equities.

Louis Marcotte

Chief Financial Officer & Senior Vice President, Intact Financial Corp.

All right. Louis Marcotte, good morning CFO with Intact Financial. We are Canada's largest P&C insurer and we're – a year and a half ago we made our first foray into the U.S. marketplace buying a company called OneBeacon. So about 15% of our business now is in the U.S. It's about CAD 10 billion of premium – annual premiums. For simplicity let's multiply that by point 0.7 to convert into a U.S., so that's $7 billion U.S. in terms of P&C premiums. Our asset portfolio amounts in total to about CAD 20 billion. So about $14 billion U.S. and our mix a bit similar to yours I guess we are also somewhat equity focused but still an 80:20 mix fixed income to equities. We have a fairly large a preferred share portfolio which is oriented towards dividend income. We are – so cross border, we have – we report under IFRS, which is slightly different and brings in a bit of a twist because that pushes us to discount liabilities on the right side of the balance sheet which makes for a different management of interest rate risk.

And then the cross border of course brings a few complexities as you can imagine whether it's capital, it's tax, which is fairly new to us now, and we've had a year-and-a-half to get used to it, but it brought some – some advantages to our management of the portfolio and diversification to a couple of currencies. That would be the – my introduction for day and the rest later.

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QUESTION AND ANSWER SECTION

Mark A. Dwelle
Analyst, RBC Capital Markets LLC

Q

Okay. Very good. I think when I – when I was putting together this panel, I mean, I was doing this back in December, early January, so I suppose top of mind for me and maybe top of mind for a lot of people in the room was the question, the topic of kind of credit quality. I think my phone rang every day with somebody saying who's going to get killed the most when credit quality goes to the basement. Everybody sort of immediately imagined that there's no in-between point between a booming economy and 2008 all over again. So let me put it to the group just how are you thinking about credit quality? What are you – what are you doing to position your portfolios? How do you monitor credit amongst some of the holdings? A few thoughts on how that's positioned? Maybe Ellen, we'll start with you.

Ellen Cooper
Chief Investment Officer & Executive VP, Lincoln National Corp.

A

Sure. So obviously we have a pretty significant fixed income portfolio where we are loan credit. And we – using our external Managers for us is a real driver of being able to have multiple lines of defense as it relates to credit risk management. So in public credit, for example, we have more than one manager that is covering the same name, and so they are first of all providing information for us analysis, stress testing at the name level, what we often see is that managers don't necessarily agree with a particular situation and then we internally also have an internal team of very experienced people with 25 plus years of fixed income research experience. And so we put all of that together and we are overseeing the entire portfolio name by name, evaluating those particular credits where we have a concern that under a stress scenario, under credit cycle scenario either the position size should be smaller or we should be reducing the position size.

We have since the end of 2015 as the credit cycle continues to extend and we do think that there's plenty of room for the credit cycle to continue by the way. But we have reduced $3.5 billion de-risking, $3.5 billion of credit securities that had the potential to deteriorate under stress.

Additionally we do significant name by name stress testing at the total portfolio level, we don't think that we're going to see a repeat of 2008 verbatim but we prepare ourselves to make sure that we're comfortable that in a tail scenario that we are comfortable with potential credit losses that we understand where the potential risks are, we're constantly looking across factors, et cetera. And then the final thing is that we also as we're putting new money to work. We also have been tilting toward more defensive sectors. And so we're using that to also drive the portfolio to be positioned somewhat more defensively while also proactively de-risking in particular names that we think could be under stress in a credit cycle.

Mark A. Dwelle
Analyst, RBC Capital Markets LLC

Q

I think that's interesting about having the multiple managers how that gets you know some kind of incremental perspective. A lot of times, I know just investors I talk to, I mean people tend to be – they're lone rangers out there, as far as thinking about things and their thought process is as rigorous as the number of opinions that they can find. So I think that's an interesting perspective to have to be able to, playoff isn't necessarily the right word, but at least benefit from...

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Ellen Cooper
Chief Investment Officer & Executive VP, Lincoln National Corp.

A

Yeah.

Mark A. Dwelle
Analyst, RBC Capital Markets LLC

Q

...the thoughts and experience of multiple probably all very smart managers.

Ellen Cooper
Chief Investment Officer & Executive VP, Lincoln National Corp.

A

Exactly. And then to bring it back home and to have an internal view of people with a lot of experience that have been through multiple credit cycles to say manager one said this and this is what they're thinking manager two said this. I think this, and then we put it all together and we ultimately decide whether or not to take an action. And this has worked extremely well for us, I mean case in point, we had enduring energy back in early 2016, we went through this disciplined approach and we were very successful in execution of de-risking in areas where we just wanted to have less exposure, and with pretty minimal losses.

Mark A. Dwelle
Analyst, RBC Capital Markets LLC

Q

Okay. Good thought, Marty. How about next.

Martin Francis Hollenbeck
Chief Investment Officer & Senior Vice President, Cincinnati Financial Corp.

A

Yeah, we have about say 32% of roughly a third of our entire portfolio of investment grade corporate bonds with an average rating of about triple B plus, so credit is certainly significant in our portfolio. We also are in a position where our fixed income portfolio's in total is about 126% of our insurance reserves. So we feel like we have some cushion there. So we tend to invest more for income than total return, and not concern ourselves too much with quarterly mark-to-market. Now the reality of credit spreads widening out as they did last year, I think about 60 basis points depending how you measure it. We've got about half of that back this year, I think. So the disconnect between what the market signals and ultimate default rates can differ, they did somewhat in 2008, 2009.

So we tend to look at it from the bottom up, generally sector specific we have four professionals dedicated to the investment grade portfolio. The last time I think that we really had to do significant pruning for credit reasons was as Ellen mentioned in 2016 in the energy sector, we took some hits there. But by and large unless we see real deterioration in certain credits, we do not act – we generally hang on to the bond. Beyond that it tends to swing, so we will oftentimes use selloffs as buying opportunities if we see we have confidence that their [ph] money good (00:12:39). So by and large we don't sweat the quarterly mark-to-market situation.

Mark A. Dwelle
Analyst, RBC Capital Markets LLC

Q

I think that's an – I mean that's another interesting aspect of most insurance portfolios, people are generally holding to maturity, and so unless there's ultimately a default or an actual impairment, I mean the market swings, I mean, yeah, nobody likes them but the fact is, is you can ride them out, and [ph] I'd say (00:13:04) you're driving in cash flows literally everyday unlike some of our investors in the group, I mean you don't have net outflows very often and in fact it should be the rare situation. So being able to – to kind of ride it through or use the opportunities that's an important part of the equation.

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Louis Marcotte
Chief Financial Officer & Senior Vice President, Intact Financial Corp.
A

Absolutely. You're right and I hope we don't have ongoing outflows. So we manage a bit the same way as you do, we don't sweat the quarterly, the portfolio structure is really the starting point, I would say, 92% of our bonds are A plus or A and above on average so we tend to take a bit less credit and one reason for that is we're heavily invested in preferred shares and the structure of portfolio again I mentioned driven towards investment income and driving operating earnings and therefore we take a bit more risk on the equity side, preferred equity and because of that we sort of reduce the fixed income risk.

So really the portfolio structure is really the starting point for us. And then we monitor obviously credits, specific credits or sector credits ongoing and monitor the main indicators in our case recently in Canada is yes housing has been has always been sort of headline news. Not that we have an overall concern over it but we are watching the leverage of consumers as an example. Obviously spreads in the U.S. We're watching more of the leverage of commercials. What's been interesting for us if you're based in Canada you're very quickly concentrated in the financial sector because if you want to generate dividends or interest income, the biggest issuers are obviously the banks and the lifecos.

So over time we've chosen to diversify into the U.S., to build a fixed income portfolio on the U.S. side, which gave us a lot more diversification in terms of sectors and we did a bit the same on the equity portfolio. So this was really fruitful from a diversification point of view and getting away from financials and government bonds. We were heavily invested in government bonds, again very focused on the Canadian economy. So going into the U.S. allowed us to diversify into the currency and into more sectors, which helps in terms of managing our credit risk.

Mark A. Dwelle
Analyst, RBC Capital Markets LLC
Q

Yeah. So I mean I guess amongst the panel you have kind of the unique position of – your multi-national, these two are primarily domestic although Cincinnati is working to change that. And likewise just the Canadian marketplace being relatively smaller. Yeah, you'll have to get some diversification from somewhere, otherwise you end up owning proverbially all the mining and bank stocks. And that's not very diversified

Louis Marcotte
Chief Financial Officer & Senior Vice President, Intact Financial Corp.
A

And energy.

Mark A. Dwelle
Analyst, RBC Capital Markets LLC
Q

Energy, yeah that's – energy too, [indiscernible] (00:15:55) RBC guy forgetting about energy, how could I do that.

Okay. Maybe we'll move on from credit quality to kind of the other thing that we saw in December, which was really just plain old volatility. There's a lot of different aspects again to managing volatility. Maybe talk about where – where within your portfolio you have the greatest concerns about that? What you do to manage, monitor, same kind of – same sort of question. Maybe this ends up being a little bit less tuned to your fixed income portfolio, a little bit more tuned to the non-fixed income portfolio, since you've kind of already covered that on the first one. Marty, why don't we start with you on this one?

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Martin Francis Hollenbeck
Chief Investment Officer & Senior Vice President, Cincinnati Financial Corp.
A

Well, that – obviously volatility hits home for us with over a third of our portfolio in common stocks, fourth quarter was difficult, worst quarter, I believe in the market since the third quarter of 2011. So it's been a while. But ultimately we choose our risk tolerance level, set it there, and that has changed over time, you go back prior to the financial crisis we were actually higher by a fair amount in common equities. We repositioned the portfolio, so we understand fully. Again you know the mark to market quarterly issue is not, say it's not of concern but we understand it will happen. We've had a nice ride for the last 10 years. As bad as fourth quarter was, so knock on wood, first quarter's done well.

Mark A. Dwelle
Analyst, RBC Capital Markets LLC
Q

Yeah, so far so good.

Martin Francis Hollenbeck
Chief Investment Officer & Senior Vice President, Cincinnati Financial Corp.
A

So far so good. And but there's a – as I mentioned there's an income aspect to our equity investing, the dividend received deduction while not as attractive as it was prior to the tax change. Still nonetheless it's compelling for us at about 10.5% at the corporate level. So we buy companies that have very consistent, they paid consistent dividends, grow those dividends we always have that to fall back on, the income statement, the impact or equity investing. And again somebody mentioned with bonds, market sell-offs can provide opportunity for us to build our positions or get new names. You know we have around 50 core names as I mentioned, diversified fairly well across sectors. So we – it will happen. Again you pick your risk tolerance, you said it, you understand it. Every so often it's going to get ugly for a little bit. You hang on and ultimately over the long run which [indiscernible] (00:18:22) everything in the corporation to the long term it pays off.

Mark A. Dwelle
Analyst, RBC Capital Markets LLC
Q

Yeah, I always thought that's one of the neat things about your portfolio is that, I mean you guys are dividend investors back before dividend investing was cool. And as a result you end up with a portfolio yield that has equity upside to it, but really with a net investment income return or a net investment yield whatever way you want to say it, that really resembles some of your peers that are just doing plain old fixed income. So it's kind of a nice position to be in, that you get the upside of the markets as well as still bringing across the plate, good NII.

Martin Francis Hollenbeck
Chief Investment Officer & Senior Vice President, Cincinnati Financial Corp.
A

I mean It's been a – from the [indiscernible] (00:19:05) of our company back in the early 1950s, it's been the philosophy of our company to pursue a high quality dividend growth strategy and it's worked through many markets, the early 2000s was a little tough, obviously 2008, 2009 was very difficult, but we stick with it.

Mark A. Dwelle
Analyst, RBC Capital Markets LLC
Q

Louis, what you guys do?

Louis Marcotte
Chief Financial Officer & Senior Vice President, Intact Financial Corp.
A

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So again I don't want to repeat here but we're a bit similar in terms of managing for dividend income. But let me focus a bit on volatility here. When we look at our risk appetite as well, so managing volatility is important, the capital factors are impacted when the markets are moving significantly. So this is an area that we monitor very closely, when we look at the different risk factors for example, we say for 100 basis points of interest rate movements, our book value per share would move by less than 2%. So that's an important aspect of limited risk of interest rate fluctuation. And you'll remember my comment at the outset, because we discount liabilities, this is a natural hedge to the fixed income portfolio, hence the limited risk for interest rate volatility.

Then you get into market risk, 10% move in the equities market would have about a 3% impact on our book value per share. So we're fairly comfortable to absorb 3% impact on book value per share should the markets move by 10%. So we were hit by the obviously the fluctuations in Q4 last year. So we were negatively hit on our equity portfolio. But then the U.S. dollar actually increased against or strengthened against the Canadian dollar, which is an offset. So there's a second natural hedge, which is the equities market in Canada actually tend to fluctuate in the opposite direction of the U.S. dollar. And so there's a second hedge, which limited the impact to our balance sheet and our capital position last year.

So this is part of the complexity now of managing across borders. [ph] My second (00:21:06) complexity, but once you've mastered it, you can play it to your advantage. And so we have currency now that's become a hedge to the equities market. And fundamentally in our asset portfolio structure, managing the sensitivities within this 2%, 3%, 5% range for us is acceptable. And as long as we stay within this, we're happy to be there.

Mark A. Dwelle
Analyst, RBC Capital Markets LLC

Q

Your first comment was interesting. I'm going to have to actually spend some time looking at how I mean, we are in the life insurance, we're looking forward a few years where companies are going to need to adopt a more IFRS like accounting related to their assets and liabilities. Right now it's all such a – it's so imperfectly matched that the accounting itself creates its own volatility. Whereas you actually have the situation where it works we'll say as intended, you get kind of the shock absorber effect on both sides of the balance sheet. And that probably does – I mean I guess it creates some challenges, but it also creates a certain amount of flexibility because you don't get the capital pressure of only having half move and the other half being static. So I mean I have to spend some time studying and [ph] lay that worked on (00:22:20) your results.

Louis Marcotte
Chief Financial Officer & Senior Vice President, Intact Financial Corp.

A

Come and visit, we'll show you. What it looks like.

Mark A. Dwelle
Analyst, RBC Capital Markets LLC

Q

Ellen, how about for you?

Ellen Cooper
Chief Investment Officer & Executive VP, Lincoln National Corp.

A

So as it relates to equity market volatility in the general count, we're much less of a story as a life insurance company. We have the place where we are impacted, we have a small but important alternatives portfolio. It's about 1.7% of the overall general account that is a place where we will see the equity market volatility, it's a highly diversified portfolio and it's not directly correlated to public equities. So we'll see some impact and by the way we

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have a one quarter lag in our alternative in our private equity one month lag for hedge funds which are very small inside of there.

So we'll see some impact of that, in the first quarter which we have talked about previously. Additionally, we also have the ability to when we see equity market volatility that is correlated with credit spreads wider. We also can opportunistically when we believe the credit cycle is benign and that it's an overreaction which we did, we can take advantage of that, as well as we're putting money to work. So we did achieve a very strong new money yield in the fourth quarter of 4.5% that was about 20 basis points higher than the average that we'd had for 2018. And so that's another example for us of what we think about as the internal natural hedge as well where spreads are wider, we get to take advantage of that during the same time that we've got some level of equity market volatility in our small, but meaningful alternatives portfolio.

Mark A. Dwelle
Analyst, RBC Capital Markets LLC

Q

It reminds me actually kind of the – I'll get the quote wrong, but – Warren Buffett always say the advantage of markets going down is this is a buying opportunity when you have assets to deploy, cash to deploy. So you get a situation like last month. One person's fear factor is another person's opportunity if you have the right timeline and the right discipline to kind of get after when things come your way so.

Anyway before we go to the audience, one other topic I want to hit on, just the whole question and you brought it up at the very beginning of kind of the in-house versus active versus passive versus external managers. I mean kind of everybody has their own way to skin this cat. There's obviously no right answer. But each of you has your own right answer, so maybe you can share that with me. Louis, start us off.

Louis Marcotte
Chief Financial Officer & Senior Vice President, Intact Financial Corp.

A

Sure, thank you. So in our case, we actually manage most of our portfolio in-house, 90% of it essentially. The part that we have outsourced now is one we inherited from our acquisition in the U.S., which is an MBS/ABS portfolio. We are not experts at that, so we left it outside. But for the rest of the portfolio fixed income, preferred shares, common equities, we manage that internally. The track record of the team is fairly strong over time. And in our case, so Intact is one company where the financial value is outperformance, it's all about outperformance. We try or we say we'll outperform the Canadian industry by 500 basis points on ROE.

And just for information, the investment portfolio, the operating income derived from the investment portfolio represents 600 basis points to 700 basis points of that ROE to start with. So we like to say, we started the year day one with 600 to 700 basis points of ROE in the bag at the start of the year and then we try to get to the mid-teens which has been our track record over time.

So the investment team has a big role in playing this. We actually ask the investment team to drive about 160 basis points of ROE outperformance, that's ROE outperformance and the expectation is they will do that – half of that will be passive, half of it will be active. And this is how we really push our teams to contribute to the ROE outperformance. And over time, they develop their strategies to support this whether it's been tougher on fixed income obviously, but they've been successful overall at achieving the outperformance target. So we really choose to do it in-house for most of the assets. As long as we have the expertise if not then we'll go outside because we don't want to – we don't think we can compete with experts if we don't have it in-house.

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Mark A. Dwelle
Analyst, RBC Capital Markets LLC

Q

That's interesting having the targets, you mean, you have your underwriters that are working hard every day to make ROEs on the right hand side of the balance sheet and you got your investing team that working hard to make ROEs on the left side, it seems like it makes sense to me.

Louis Marcotte
Chief Financial Officer & Senior Vice President, Intact Financial Corp.

A

Well, you add the two together and it's a decent ROE.

Mark A. Dwelle
Analyst, RBC Capital Markets LLC

Q

Exactly.

Louis Marcotte
Chief Financial Officer & Senior Vice President, Intact Financial Corp.

A

So...

Mark A. Dwelle
Analyst, RBC Capital Markets LLC

Q

And that translates back into valuation and we talk about all the time is the correlation between the ROE and the price to book multiples, so...

Louis Marcotte
Chief Financial Officer & Senior Vice President, Intact Financial Corp.

A

Absolutely.

Mark A. Dwelle
Analyst, RBC Capital Markets LLC

Q

...wins all the way around. Maybe with the counterpoint, we'll go to Ellen with the external management approach.

Ellen Cooper
Chief Investment Officer & Executive VP, Lincoln National Corp.

A

So in the $100 billion general account there is one asset class where we have an internal capability and that's in commercial mortgage loans place sort of we've had decades of internal to strong performance. That portfolio is about 12.5% of the portfolio, the rest of it is all externally managed.

So the way that this works and for us we really feel like this is the best and value differentiator for us on the investment side. So internally, we of course set the broad investment strategy. So we understand our liabilities. We are investing relative to the expectation of reliabilities. We also know our own risk tolerance and our risk capacity. So we broadly set the parameters around the amount of risk that we're willing to take. My team is also responsible for portfolio construction and so we also internally determine the asset classes that we like. Those where we believe that there are additional opportunities, we also think about diversification across asset classes, within asset classes, across geographies, sectors, et cetera.

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We then go out and we find the best managers, and what we often find is that we talked earlier about multiple opinions, but we also find that not every manager is good at everything. And so, we have the ability to pick and choose across various different managers, we have multiple mandates across a number of managers on platform. And additionally, the other place where we really capture value is that we invest in a number of less liquid asset classes and there where the assets might be more scarce or harder to access and there is direct origination involved in a number of areas.

If we like it and we want more of it, we're able to go to manager one, manager two and build out the overall capability for us. The managers then subject to all of our guidelines and parameters including very tight risk based limits that we provide to them are then responsible for security selection. So they're responsible for security selection. They're the first line of defense as we talked about earlier to be monitoring credits as well. And they're responsible for their own oversight of diversification and portfolio construction. And then I have a team that is responsible for holistically looking at the total portfolio evaluating risk and risk analysis.

Additionally one of the benefits that we have seen is on the fees side and so we've been able to use the power of the balance sheet to really reduce fees, so we can see in statutory filings for example, that our average investment expense is about 50% relative to the average of our peers. And again that comes from being able to just negotiate lower fees and so not only do we see value in terms of the investing side, the oversight of the credit risk side and portfolio construction, we get all the intellectual capital, but it also costs us less. And so we think that this is absolutely the right model for Lincoln.

Mark A. Dwelle
Analyst, RBC Capital Markets LLC

Q

You make a pretty strong case, Louis, you're paying attention right?

Louis Marcotte
Chief Financial Officer & Senior Vice President, Intact Financial Corp.

A

I am and I have to say again, it's a matter of expertise and if the expertise is not in-house, we'll go outside. So we do use outsiders for some asset classes. But we'd like to say – we talked about outperformance and the expense cost as part of that. We right now are running at 3 bps of investment management cost. So we're finding that hard to beat...

Mark A. Dwelle
Analyst, RBC Capital Markets LLC

Q

And Ellen can't be that that 3 bps, so maybe – that 3 bps is pretty good...

Louis Marcotte
Chief Financial Officer & Senior Vice President, Intact Financial Corp.

A

The other aspect I might raise here is what we like about it as well as the scalability. So we talked about being acquisitive. And the extra cost for us of also managing and extra portfolio is extremely limited. So, in a context where we know we'll be buying some other companies in the future. We actually like the leverage, it provides us in terms of potential savings or synergies from the investment management side as well.

Mark A. Dwelle
Analyst, RBC Capital Markets LLC

Q

Marty? Maybe a third way, the middle ground, help us out?

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Martin Francis Hollenbeck
Chief Investment Officer & Senior Vice President, Cincinnati Financial Corp.
A

Yes, we're even more internal about 98-plus-percent of our assets we manage internally. Areas that we do not or again areas that we either lack expertise or access, we do have a couple of mandates in private placement bonds both taxable and tax exempt, securities that we couldn't otherwise get access to generally speaking, they sourced the bonds to us, so they're very attractive. And then on the equity front, obviously we're big investors in public equity. So private equity is a natural add on.

In a recent years, we've looked to add a little bit in that regard. So we're drawing from a small number of sort of middle market type private equity managers. And as far as the active versus passive on the fixed income front, it's a little bit of both. I mean we are fairly passive in the sense that we don't trade frequently, it's generally buy and hold unless there's a credit event. But at the same token, we're not indexers by any stretch. As I mentioned in the corporate bond portfolio, we're BBB+. So we do a great amount of credit work on the front end and then monitor it.

On the equity side, again a very distinct non-indexing strategy, high quality dividend growth, do a lot of work on a frontend, tend to own for a number of years. We do we do trade the portfolio occasionally probably about an annual – turnover rate – excuse me – of roughly 5%. Our average position is fairly large. So we tend to stick with it, so primarily internal little bit of both on the other.

Mark A. Dwelle
Analyst, RBC Capital Markets LLC
Q

Okay. I'm going to take the opportunity at this point to ask whether the audience has any questions, anything, I can go on for hours, but maybe there's something that's on your mind that you'd like to ask about something to question the panelists on? Anybody? [indiscernible] (00:33:46). All right. I got it done.

Ellen, you had mentioned the private corporate debt, commercial loans, commercial mortgages. I was in a panel yesterday with some guy, it was a BDC oriented panel. And they said that – the gentleman commented that the markets generally completely misunderstood the CLO market. Maybe you can share some of what you're doing there? You've always been very successful. It's been backbone of the strategy, not the backbone, but an important part of the strategy. Share what you're doing there, how you see the market where you've been successful, kind of how it all goes?

Ellen Cooper
Chief Investment Officer & Executive VP, Lincoln National Corp.
A

Okay. So I'm going to focus on private debt and commercial mortgage loans. These are two strategies that where we have been actively deploying and investing for decades. There's nothing new for us either of these strategies as an asset class, but I'll talk about how we have expanded. So in the private debt space, where on average, we are purchasing somewhere in the neighborhood of about $1.5 billion per year, we traditionally for decades had always been in the investment grade syndicated private debt space. And this is an area where we also have moved with a number of managers into direct origination investment grade private debt. And so that's a place where we continue to see good value. We continue to get paid for illiquidity and we also get really good name diversification. So this gets back to portfolio construction and diversification.

And the sectors tend to be a little bit different as well. So it just really helps to round out the overall portfolio for us. On the commercial mortgage loan side, this is an area also where we are continuing to originate very much up in

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quality, very aware of what's happening in terms of overall cap rates in real estate, but there's still significant value in the space up in quality and in particular.

And so back about – we started really building out this strategy to increase its size and increase its origination about five years ago. About five years ago, commercial mortgage loans were 7.5% of the portfolio. And I mentioned earlier, that commercial mortgage loans are now 12.5% of the portfolio, that's considerable growth. So we are originating north of $2 billion per year. We are doing this again in very high quality space, I mean to give you a sense, debt service coverage on average well in excess of two times, average LTVs are in the mid-50s.

And for those of you that are familiar with the CML designations in terms of risk predominantly CM1 which is the highest quality equivalent to a single A and above and we're getting paid for it. And so there also, we think about portfolio construction, broad diversification across sectors and geographies, building a really strong portfolio. And so a great place to – that fits well into our overall ALN framework as well.

Mark A. Dwelle
Analyst, RBC Capital Markets LLC
Q

I know in some of these meetings with the bank managers, they sort of grumble about guys like you that are coming in and getting the quality, commercial, commercial mortgage loans and what would you say to those guys, are you pricing them better or you price [ph] thinner (00:37:36) spreads, I mean I know those guys grumble, I think it's just sour grapes, but I'm an insurance guy, so I would think about that?

Ellen Cooper
Chief Investment Officer & Executive VP, Lincoln National Corp.
A

Well, I haven't heard the grapes directly. But back to my earlier comment, I would say well maybe we were here first. I don't know. I mean we've been here, we've been doing this for decades. And again track record of strong, strong performance. In our particular space where we play, we predominantly see that we're up against the other life insurance companies. I think some of the places where maybe some of the banks are going is a little bit niche here that's not where we tend to play. So we're not really coming into play with that at all in where we're investing.

Mark A. Dwelle
Analyst, RBC Capital Markets LLC
Q

So I guess if they want something, they're going to have to bring their game because you're already there. Marty, let's go to you. I mean you guys have been equity investing for ages. It's obviously a big part of your portfolio. You've touched on a few of the different things. But when you're thinking about a new position or maybe thinking about a position that you have that's not performing the way you like it. I mean talk us through kind of the thought process, what are you guys thinking about – what's the art and science of your investing approach to some of the particular holdings that you have?

Martin Francis Hollenbeck
Chief Investment Officer & Senior Vice President, Cincinnati Financial Corp.
A

While you hit on, there actually is a lot of you – you can put any amount of science on it you want, but the art of the decision, right, the judgment on it. So as I mentioned, we have roughly 50 plus or minus core positions, three dedicated equity managers divided up by sector. So they monitor not only their individual names, but names within that sector, alternative investment ideas, names that generally fit our criteria but aren't quite in our portfolio yet. So we tend to send official list, but we might have a first-out, first-in kind of a concept within a given sector whether it's...

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Mark A. Dwelle
Analyst, RBC Capital Markets LLC

Q

Kind of like the brackets that we'll all be filling in about this time next week.

Martin Francis Hollenbeck
Chief Investment Officer & Senior Vice President, Cincinnati Financial Corp.

A

Yes. Going to be busted by Friday, right. Yes. Yeah, so we meet at least monthly as a group and kind of go over kind of who is on the hot seat, who don't you like these days, there's a hope, there's significant amount of judgment within that. I mean anybody can look at the various ratios and data, but at the end of day, there's a gut feel that you have for it, you make that decision, I ask for conviction on the investment managers part our portfolio managers and the dividend as I've mentioned several times critical for us and oftentimes that can be a key initial indicator.

Mark A. Dwelle
Analyst, RBC Capital Markets LLC

Q

Is it sort of a team approach within your investment managers, you have three, four, five guys whatever it is?

Martin Francis Hollenbeck
Chief Investment Officer & Senior Vice President, Cincinnati Financial Corp.

A

Well, there's three portfolio managers and I give them autonomy, they can make their own decisions. It's not that I don't ask them a lot of questions and judge – ask them how they came to this decision and measure that convictions I mentioned, but it is an individual decision and they're measured on at the end of the year, how that performs versus the broader sector. So...

Mark A. Dwelle
Analyst, RBC Capital Markets LLC

Q

You're the orchestra leader, they play the instruments.

Martin Francis Hollenbeck
Chief Investment Officer & Senior Vice President, Cincinnati Financial Corp.

A

Exactly. So yeah, it's not a real defined process in the sense that we have a black box, an algorithm per se, but a lot of judgment does go into it and always [ph] has (00:41:04)

Mark A. Dwelle
Analyst, RBC Capital Markets LLC

Q

Okay. Louis, you're the one with the international aspects to the portfolio, you mentioned briefly earlier some currency aspects to that, how do you manage both the currency aspects, maybe some of the cross-border investing, how will that maybe impact sometime in the cash flows, things like that, I mean obviously the mother ship is in Canada, but hopefully the downstream entities are bringing cash at least occasionally maybe talk about that whole process how that kind of all whole integrates together.

Louis Marcotte
Chief Financial Officer & Senior Vice President, Intact Financial Corp.

A

So let's tweak the word from occasionally to regularly.

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Mark A. Dwelle
Analyst, RBC Capital Markets LLC

Q

I hope so. I didn't want to put words in their mouth. They asked me not to.

Louis Marcotte
Chief Financial Officer & Senior Vice President, Intact Financial Corp.

A

But, so it's been an interesting journey, so we try to diversified about five years ago into a U.S. currency because we knew we had appetite to go abroad, wanted to cover a bit the U.S. or the Canadian dollar exposure which was 100% at the time. So we went into a fixed income portfolio in U.S. dollar and in equity portfolio in U.S. dollar. We hedged at that time the bond portfolio because we did not want to take currency exposure on the bond portfolio. But we accepted the equity portfolio then we buy OneBeacon and suddenly we have this new vehicle in the U.S. to [ph] hone (00:42:25) our equity portfolio and obviously had bond exposure in the U.S. from the acquisition.

So just a simple example, the equity portfolio in U.S. dollars from our Canadian business was shifted down into the OneBeacon operation. What does that do for us, the big advantage what was previously taxable at 26% in Canada from – for dividends became partially taxable in the U.S. because we got the exemptions – the dividend exemptions as well. So there was immediate tax savings. There was capital advantages of having the equity portfolio in the U.S. operations. So this turned out to be advantageous for our overall returns.

Now when you manage capital, we suddenly have a U.S. operation which is I would say overweight equities, so we have to manage a buffer at the holding company now to make sure that we can absorb volatility like we had in Q4 within our U.S. operation per se. So a bit of pressure on the RBC in the U.S. because of capital markets in Q4, but we manage that, we offset it with capital buffers and the Canadian operations or at the holding company such that we can absorb the volatility and get through, if needed we would pump more capital into the U.S. operation to absorb it and that was required and we keep a buffer – a cash buffer at the holding to be able to do that.

So this has brought, it's interesting, the returns are clearly better because we're able to really manage both currencies across geographies better more efficiently. But it does require a bit more management of buffers, I would say cash buffers at the holding company to be able to absorb different volatility on each side of the border. So overall it's been a win-win for us. I would say investment income last year, because of the optimization was really juiced up for the year and we see this very positively for the future.

Mark A. Dwelle
Analyst, RBC Capital Markets LLC

Q

I guess that's one other aspect of all of this, I mean you talked naturally about your general account and your investment portfolio, but I mean I guess the third leg of the investment stool is, the holding company cash and the liquidity to manage corporate needs whatever those might be, whether that's a buyback which everyone loves or just a regular dividend or fixed debt interest service or just the opportunities that you might have in the business whether that's acquisitions or anything else. So it's interesting the [ph] unit play (00:44:51) because you of course have the portfolios that are meant to match your liabilities. But then you have this other almost treasury function that sits over top, that has its own little investment dynamic on top of it.

Louis Marcotte
Chief Financial Officer & Senior Vice President, Intact Financial Corp.

A

Absolutely. So this is a bit new for us and we obviously manage it carefully. We need to get dividends out to pay dividends and interest payments from the holding. So we're extremely careful. We a cash buffer and a fairly sizable credit facility. The whole strategy around the credit facility was meant to say if we were stuck a crisis

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situation and couldn't pull out dividends for a year, we could use the credit facility to make our payments. So it was a bit of a protective layer that we gave ourselves, never had to use it but it's there, should we have any liquidity issues.

We're fortunate. Obviously, profitability is critical, but we get paid in advance. So generally speaking and it goes back to the liquidity opportunities. Regular cash flows cover for themselves what we need in terms of outflows. And so we can really leverage the portfolio with liquidity requirements that are very low and therefore allows us to invest whole to maturity or invest in less liquid assets, that's been fruitful. But then it's managing making sure that we can get dividends up to the holding on a quarterly basis to make our payment and we've kept a few buffers there to make sure that we're able to meet those requirements.

Mark A. Dwelle
Analyst, RBC Capital Markets LLC
Q

Anything else from the crowd. Anybody – okay.

Q

[indiscernible] (00:46:30-00:46:46)

Ellen Cooper
Chief Investment Officer & Executive VP, Lincoln National Corp.
A

Sure. So our alternatives portfolio is 1.7% of the overall general account. Within the alternatives portfolio, 83% of the portfolio is private equity, obviously 17% is hedge funds. This is an area where we have been – the hedge fund portfolio at one point in time was about a third of the overall Alt portfolio. And we have been trending that down as the performance of hedge funds. It's been okay as you all know. And we've – our hedge funds relative to benchmarks have performed fine. But we see more value in private equity.

Within the private equity portfolio itself, we've built a highly diversified portfolio and so it's across multiple strategies. We have been shifting into strategies outside of buyout for some period of time. And to give you a sense in terms of the overall portfolio, we have about 1,800 underlying investments in that 1.7%. So that's roughly $1.7 billion of portfolio, so highly diversified portfolio in there as well. And the performance has actually been quite good. So when we go and we look back since 2012, the overall average performance is in about the 11% range which is slightly higher than peers.

Mark A. Dwelle
Analyst, RBC Capital Markets LLC
Q

Marty, you guys don't really have that many, but if you want to comment, cool, if not we can pass it on to Louis, he has a few.

Martin Francis Hollenbeck
Chief Investment Officer & Senior Vice President, Cincinnati Financial Corp.
A

Sure. Yeah. We do very little in a way of alternatives. We have as I mentioned earlier, started to have a little bit further into private equity. Again it's a little bit of natural extension depending on how you look at, how it's measured roughly say 6% to 7% of the entire equity world is private equity. So for us, adding a little bit, we have still more room to do that. I don't know if we'd ever get to that 6% or 7% range. We're being very slow in deploying that capital more of a middle market – small to middle market type approach. Hedge funds, we've never done and

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do not have any intention of going down that path, probably some restructured products as well unlikely. But the private equity would be the vehicle for us. I would say none on our side.

Mark A. Dwelle
Analyst, RBC Capital Markets LLC

Q

Yeah. Okay. Anything? Okay. Running towards the end of the time. So I'm going to do something that I learned from CNBC. We're going to do a lightening round here. So real quick as lightening round first topic we're just going to go straight down the line, then the next time we'll come back the other way and we'll start with Marty the third time. Interest rates? Higher, lower, about the same.

Ellen Cooper
Chief Investment Officer & Executive VP, Lincoln National Corp.

A

In the short-end, about the same; on the long-end, higher.

Martin Francis Hollenbeck
Chief Investment Officer & Senior Vice President, Cincinnati Financial Corp.

A

I would agree with that.

Mark A. Dwelle
Analyst, RBC Capital Markets LLC

Q

Agree?

Louis Marcotte
Chief Financial Officer & Senior Vice President, Intact Financial Corp.

A

I would too.

Ellen Cooper
Chief Investment Officer & Executive VP, Lincoln National Corp.

A

That's not fair.

Mark A. Dwelle
Analyst, RBC Capital Markets LLC

Q

Consensus. I didn't think I could get consensus right off the bat I thought it would be like controversy. I was going to pit you against one another and make the bull-bear argument. I learned that on CNBC too. But, everything I learned about investing I got from CNBC, it's kind of sad. Industry sectors, favorite sector or alternatively a sector that you hate or avoid? Marty?

Martin Francis Hollenbeck
Chief Investment Officer & Senior Vice President, Cincinnati Financial Corp.

A

In the equity area, consumer staples, that's been a very tough go, the last couple years a lot of what we considered yield traps in there, certainly there's value but you've got to be very careful. So I think that's the most challenging sector we look at right now.

Louis Marcotte
Chief Financial Officer & Senior Vice President, Intact Financial Corp.

A

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I guess our view here is late cycle investing right now. So there's a sense of moving away from the cyclicals and being very careful about it, but not necessarily one sector or another. It's more just being in the late cycle environment that would – drives our investment choices.

Mark A. Dwelle
Analyst, RBC Capital Markets LLC

Q

Okay.

Ellen Cooper
Chief Investment Officer & Executive VP, Lincoln National Corp.

A

Cautious inside of retail particularly department stores, cautious inside of energy particularly offshore drillers.

Mark A. Dwelle
Analyst, RBC Capital Markets LLC

Q

Okay. And then the last one, equity markets; rising, falling, about the same? Louie, you're up first.

Louis Marcotte
Chief Financial Officer & Senior Vice President, Intact Financial Corp.

A

I'll say slightly rising.

Mark A. Dwelle
Analyst, RBC Capital Markets LLC

Q

Slightly rising. All right.

Martin Francis Hollenbeck
Chief Investment Officer & Senior Vice President, Cincinnati Financial Corp.

A

Slightly rising now that the Fed's kind of backed up a little bit, yes.

Mark A. Dwelle
Analyst, RBC Capital Markets LLC

Q

Slightly rising.

Ellen Cooper
Chief Investment Officer & Executive VP, Lincoln National Corp.

A

I think about the same.

Mark A. Dwelle
Analyst, RBC Capital Markets LLC

Q

About the same. All right. So at least we got a little bit of differentiated opinion here at the end. We'll leave it – we'll leave it to the audience to pick their brains on all of those particular points.

Mark A. Dwelle
Analyst, RBC Capital Markets LLC

Like to thank all the panelists for being with us here today, and hopefully you'd join me in a big round of applause.

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Martin Francis Hollenbeck

Chief Investment Officer & Senior Vice President, Cincinnati Financial Corp.

Thank you.

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