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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 2016 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 & Head-Investor Relations, Lincoln National Corp.

Thank you, Caylee. 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 and market conditions, including comments about sales and deposits, expenses, income from operations, share repurchases and liquidity and capital resources are forward-looking statements under the Private Securities Litigation Reform Act of 1995.

These forward-looking statements involve risks and uncertainties that could cause actual results to differ materially from current expectations. These risks and uncertainties are described in the cautionary statement disclosures in our earnings release issued yesterday and our reports on Forms 8-K and 10-K 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 income from operations and return on equity, to their most comparable GAAP measures.

Presenting on today's call are Dennis Glass, President and Chief Executive Officer; and Randy Freitag, Chief Financial Officer. After their prepared remarks, we will move to the question-and-answer portion of the call.

I would now like to turn things over to Dennis.

Dennis R. Glass

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

Thank you, Chris. Good morning, everyone. Fourth quarter results were strong with operating earnings per share up 15% compared to last year. This capped a solid year, which included record EPS, a 9% increase in book value per share, and a 12% ROE. Notably, we have a multi-year track record of similarly strong financial results, and more importantly, we continue to believe these results are sustainable over time.

Our financial success and stability are the result of our clear and straight-forward business model. As you know, we lead with distribution and product prep. Nearly 90,000 independent brokers, agents, and financial advisors have sold a Lincoln product in the past two years, and we consistently focus on expanding our distribution reach. Our 1,300 highly sophisticated wholesalers and reps provide our independent producers with customer solutions and product education. We match this distribution with one of the broadest product portfolios in the industry, and are at the forefront of product innovation. This strategy works throughout cycles and was successful once again in 2016.

This year, Individual Life Insurance sales increased 7%, Group Protection sales were up 17%, and RPS deposits reached a record $7.7 billion. 2016 was a challenging year for sales growth in the Annuity business, which reflects somewhat of an adjusting market, but I am confident in our distribution and the product initiatives we are putting into place to respond. We expect these actions will rebuild sales momentum and enable us to return to full-year positive net flows in 2018.

In response to our lower annuity sales, we increased our share repurchases as we said we would, executing on another one of our core strategies, which is to actively direct capital to the highest and best use. When combined with our solid capital generation, we returned $1.1 billion to shareholders this year.

I won't touch on all strategies within our business model, but I do want to note that this year, we're launching another dimension of strategy, and that is to accelerate our utilization of digitization to improve our customer experience and increase the efficiency. The born digital companies, such as Uber and Amazon, are raising customer service expectations, and we're moving to meet this expectation. Additionally, through increased use of robotics and other innovative tools, we intend to lower our cost. This will require some investments, and Randy will get into the financial details. But at a high level, after two years, the project will be self funding, and by four to five years out, we will see significant cost saves, as well as potential revenue enhancements.

Now turning to our business lines, starting with Individual Life. Our earnings were once again robust, and excluding notable items, we showed sequential improvement in earnings each quarter this year. Our sales were also outstanding, with total Life Insurance sales in the quarter of $231 million, a 17% increase from the prior-year quarter. Notably, nearly every product line generated double-digit growth. Individual Life Insurance sales increased 12% in the quarter, and a solid 7% for the full-year.

Let me spend a minute highlighting some product stories. MoneyGuard sales increased 19% in the quarter, as we are benefiting from continued demand for linked-benefit products and our multi-channel distribution approach. For the full-year, MoneyGuard sales reached a record $214 million. Term sales of $29 million increased 16%, as we continued to benefit from several product and process enhancements over the past year.

Index Universal Life sales increased 15% as IUL has seen outpaced growth over recent years due to an increase in GUL pricing. I would also note that the industry has settled into last year's IUL illustration regulation, which has brought more consistency to the marketplace. Overall, our mix of sales continues to achieve our strategic objectives, including diversification, as all Individual Life products represented between 10% and 30% of total Life Insurance sales. A tilt away from long-term guarantees, 66% of our sales did not have long-term guarantees, up slightly. And lastly, strong returns. As expected, new business returns are achieving our targeted range of 12% to 15%. Our outlook for the Life Insurance business remains strong, and we expect growth to continue, driven by our diversified product portfolio combined with our leading distribution.

Turning to Group Protection, we continue to see a positive trajectory in our growth and profitability trends. Fourth quarter sales of $263 million were up 18% from the same-period last year, and full-year sales were up nearly the same percentage, following two straight years of sales declines. We are pleased with this very strong sales rebound and it indicates the resilience of our distribution channel. Our pricing remains disciplined and our outlook for future sales growth is aligned with our long-term target of middle-single-digit increases.

Just as important to drive future premium growth will be persistency improvements and the fourth quarter continued to indicate positive renewal persistency trends. With sales growth and improving persistency, our top-line is also showing momentum, as our premiums grew sequentially for the second straight quarter, and we expect to re-establish annual premium growth in 2017. As we have noted recently, top-line growth will be critically important to drive the next leg of our margin improvement story, and we have seen many encouraging signs that support strong top- and bottom-line trends in our Group business.

Turning to Annuities, we posted strong operating results in the fourth quarter, as the power of our high-quality in-force business overcame a challenging year of variable annuity sales. Though, I would note that sales have largely stabilized in recent quarters. We continue to expect long-term growth in annuity marketplace, given demographic trends and the fraying of traditional government and corporate safety nets.

As I noted upfront, there is some adjusting taking place in the market, driven by shifts in consumer preferences. Importantly, many of the trends are ones we can address, and we actually see them as an opportunity to expand our distribution reach and the annuity marketplace over time. So let me describe our strategies to regain momentum in the Annuity business.

As you know, there has been a trend towards fee-based compensation. Historically, the annuity market has been mostly commission based, something we expect will continue. However, we are responding to this movement, as we refreshed all of our fee-based products in January. We expect this will enable us to reach new advisors, and we believe fee-based annuities present a significant long-term growth opportunity.

Another shift has been the increase in passive investments. As a result, we created a new product category. To this point, I hope you saw the announcement of our collaboration with BlackRock, where we designed a simple, transparent, and lower-cost fee-based annuity. We expect this product to help capture the shift towards passive investments, as it is comprised exclusively of ETFs. Additionally, this product positions us well in the growing RIA advisor space.

Lastly, we are responding to advisor feedback with product enhancements that provide clients more investment choice and flexibility, which should offer them better upside potential, aligning with our historical value proposition of lower initial income, but the potential for greater upside.

As you can see, we are leveraging our long-time successful playbook of expanding and developing distribution, coupled with product evolution. We expect all of these actions to contribute to our sales recovery, and build on our impressive track record of growth and profitability in our Annuity business.

In Retirement Plan Service, earnings were consistent with recent quarters, and net flows were in line with our outlook. Total deposits for the quarter of $2.4 billion were up 15%, as we benefited from strength in both the small and mid-to-large markets. Full-year results were a very good story, with record total deposits of $7.7 billion. Total net flows for the quarter were $386 million. This marked our best quarter for net flows since the financial crisis. Full-year net flows increased 25% to $565 million. The increase was driven by a combination of growth in deposits and improvement in our withdrawal rate.

Looking ahead to 2017, our outlook is similar to this time last year, in that we would not be surprised to see lumpiness quarter-to-quarter in net flows. However, we expect another year of net flow improvement. Our confidence is driven by our strategy, which aligns the fastest-growing markets with customers that value our high-touch service model. Importantly, we have a proven ability to distinguish ourselves in these markets while achieving our targeted returns, which is giving us a lot of positive momentum.

And briefly on investment results, alternative investments had another solid quarter as both our private equity and hedge fund investments contributed to a 12% annualized return, consistent with the third quarter. Looking ahead, we expect to increase our alternative earnings over time as we grow the portfolio and further shift mix towards private equity. In terms of new money, we have seen a meaningful increase in yield since the election. Post election, we have been investing new money at 4.1%. This has reduced the spread between new money and the fixed-income portfolio yield to 70 basis points and cut the headwind to earnings growth from 3% to 2%.

Overall, the investment portfolio remains in great shape, high quality, and broadly diversified. The low-investment grade assets represent just 5.2% of our fixed income portfolio, consistent with last year, as the de-risking actions we took earlier in the year, significantly reduced our exposure to negative ratings migration and improved our credit portfolio – profile.

Before turning the call over to Randy, I'd like to just touch on some potential impacts from the new administration, recognizing it is too early to reach specific conclusions. First, it is important to note we build our strategy, financial growth plans, and shareholder value creation around things within our control. But I would point out that some of the new administration policies and proposals have the possibility of providing us incremental tailwinds.

An increase in economic growth and possibly higher interest rates can help with margin compression, but just as important, would provide more flexibility in terms of our ability to offer consumers an even better value proposition for our products. Although, not assured, there is an increasing likelihood of a delay to the Department of Labor fiduciary rule, and a focus on improving the rule's ultimate objective. Something we support. If this were to occur, we believe it could remove some of the confusion in the marketplace that is contributing to the decline in annuity sales.

Lastly on tax reform, hard to pinpoint where this will land, but we also see this as an additional benefit. So again, still early, but there is potential for incremental growth levers, and we will be sure to update you on the impacts of these as we learn more.

So I'm pleased with our solid fourth quarter results, and our record operating earnings per share in 2016. Importantly, we are proving time and time again that our business model enables us to take advantage of emerging opportunities as well as overcome cyclical or structural headwinds. As we enter 2017, we have a lot of positive momentum and I like the fact that we continue to be on the offensive as key drivers of our financial success remain well within our control.

Notably, we're positioned to drive organic growth through our leading distribution channels and our broad set of customer solutions, we continue to find opportunities to leverage the strength of our in-force business, and we will continue our successful track record of returning capital to shareholders.

In closing, Lincoln's business model is simple, clear, and straightforward, and it produces solid and repeatable financial results. We're proud of our long-term performance and pleased that it continues to reward our shareholders.

I will now turn the call over to Randy.

Randal J. Freitag

Chief Financial Officer, Lincoln National Corp.

Thank you, Dennis. Last night, we reported income from operations of $409 million, or $1.77 per share for the fourth quarter. A 15% increase from the prior year. I would note a few items that drove some variability within the segments this quarter. On the positive side, were $8 million of benefit on the tax line and other operations, and $13 million of favorable, variable investment income spread across the businesses. These two items were completely offset by some expense items, including an increase in deferred comp-related expenses, associated with the $19 increase in our share price during the quarter, and higher variable expenses from strong sales growth in most of our businesses. Additionally, we had favorable mortality, which I will speak to later.

Now, let me touch on the performance of key financial metrics. For the full-year reported operating EPS of $6.50 was a record, and up 19%. Our EPS excluding notable items was also a record, up 7%. Book value per share, excluding AOCI, grew 9% to $57.05. Operating return on equity was strong at 12.7% in the quarter, and 12% for the full-year. Positive consolidated net flows have contributed to account values that continue to grow from depressed levels earlier in the year, providing a nice earnings tailwind. Our balance sheet remains an important source of strength, supported by solid liquidity metrics and strong capital generation. This enabled us to return $261 million of capital to shareholders in the quarter, and $1.1 billion for the full-year.

Further highlighting the strength of our balance sheet, our year-end cash flow testing continues to point to significant statutory reserve adequacy, and we do not anticipate any reserve deficiencies. And we completed our goodwill review, which did not have any impairment.

Net income results for the quarter were negatively impacted by a few items. The largest item was a $178 million net loss from variable annuity net derivative results, with more of half of this being a non-economic charge related to non-performance risks, which is the result of our own credit spread narrowing in the quarter. Fund basis risk made up the majority of the remaining amount. I would remind you that over time, this sort of breakage is summed up to essentially zero, so I wouldn't be surprised to see that come back at some point in time.

Taking advantage of that narrowing credit spread, we did complete an economically advantageous tender for some higher coupon debt in December, which resulted in a $41 million loss on the early extinguishment.

Before shifting to segment results, let me discuss the digitization initiative. In addition to the strategic benefits Dennis discussed in his remarks, I would note that we do see an opportunity to take significant expenses out of the business over the next several years. Now analogous to an M&A transaction, there will be integration costs or investments made to ultimately get the run rate savings. You can see in our statistical supplement, we have begun reporting a strategic digitization expense in other operations. In the fourth quarter, it was $8 million pre-tax. And we would expect roughly $10 million a quarter in 2017, but we could see some quarterly variability based on the timing of certain projects.

I would note we are trying to strike the right balance in terms of protecting near-term results while also capitalizing on efficiency opportunities, which will lower our expense base. To this point, during the first two years of this initiative, we would expect annual net costs of $40 million pre-tax. By year three, the earnings impact should be neutral, and in the fourth year, we will begin to see meaningful cost savings, which I would size at 6% to 10% of our $1.5 billion in addressable G&A expenses. Hopefully, this gives you a good sense of the positive long-term opportunity around digitization, and also the visibility and transparency to incorporate assumptions within your models.

Now I will turn to segment results. Starting with Life Insurance, we reported fourth quarter earnings of $154 million, compared to $119 million last year. Included in the current quarter's earnings were favorable mortality results, consistent with our expectations for the fourth quarter of any year.

I want to spend a minute analyzing 2016 mortality experience, as I believe it represents a reasonable proxy for how we think about long-term results and seasonality. For the year, we had good mortality results, with our actual to expected mortality coming in at 99%. Now, we did see quite a bit of variability in mortality quarter-to-quarter, much of which I would attribute to seasonality. For example, mortality negatively impacted earnings by $30 million in the first quarter, with roughly two-thirds of that related to typical seasonality. Ultimately, what we expect is to make up this negative seasonality during the second half of the year, and this is what occurred this year.

Shifting to spreads, base spreads, which exclude variable investment income, were down 6 basis points for the full-year, within the 5 basis point to 10 basis point range we have discussed in the past. Given the movement in interest rates, we would expect to be at the low end of that range in 2017. Earnings drivers remain steady for the quarter and year, with average account balances and Life Insurance enforced both up 4% to 5%. Overall, this year's earnings were consistent with our expectations, while our strong sales results and key driver growth support earnings growth looking forward.

Group Protection earnings of $16 million increased from $13 million in the prior-year quarter. Our loss ratios continue to show improvement, so this was somewhat offset by higher variable expenses tied to strong sales growth. Our non-medical loss ratio improved to 70.9% from 75.3% in the prior year quarter. This 440 basis point improvement was driven by better-loss experience in all of our product lines. Notably, our full-year loss ratio showed similar improvements, which resulted in an increase in annual earnings of over 50%.

As we have discussed, top-line growth is expected to drive the next leg of our margin improvement story, and as Dennis noted, we expect annual premium growth to reemerge in 2017. As you recall, we typically experience seasonally higher DAC amortization in the first quarter. This is tied to the first quarter being our heaviest renewal period. This year, given improvement in our persistency, we expect amortization to be roughly half of what we experienced in the first quarter of 2016. So overall, another solid quarter and strong year for the Group business, and we expect that positive momentum to continue.

In Annuities, reported earnings for the quarter were $242 million, flat versus the prior-year quarter. Average account values were down 1% for the year, as negative net flows more than offset positive market performance. Though I would note that end of period balances did increase 3% on the back of strong equity market performance over the last three quarters. As a result, we saw sequential growth in reported earnings during every quarter of the year.

Return metrics remain strong. Our ROA in the quarter was 78 basis points, while ROE came in at 21% for the quarter and full-year. Notably, return on equity has exceeded 20% for the past four years and has averaged 20% for a decade, outstanding results that highlight our differentiated and high-quality annuity book.

In Retirement Plan Services, we reported earnings of $34 million, in line with the prior year. Fourth quarter revenue was up 3% compared to the prior-year period, while spreads, excluding variable investment income, compressed 13 basis points for the full-year. This is near the midpoint of our 10 to 15 basis point guidance, and looking forward, we expect to be at the low end of that range.

Return on assets was 23 basis points for the fourth quarter and the full-year. Account values have benefited from several quarters of positive net flows, including nearly $400 million of flows in the fourth quarter. And combined with positive changes in equity markets over the past year, end of period account values increased 8% to more than $58 billion. 2016 was a good year for the Retirement business, highlighted by record deposits, a 25% increase in net flows, and consistent returns. As our outlook for net flows remains positive, we are well positioned for continued momentum in 2017.

Let me discuss our capital position and capital management before we turn to Q&A. First, the capital. We are extremely well positioned as our statutory surplus stands at $8.8 billion, up nearly $400 million from the prior year period. We estimate our RBC ratio ended the year at approximately 490%, consistent with the prior year. Our capital and liquidity profile is further bolstered by $561 million of cash at the holding company. In terms of capital deployment, I noted upfront we returned more than $1.1 billion to shareholders this year, up slightly from the prior year.

As you know, our mix of cash returned to shareholders has been weighted more towards buybacks than dividends. We expect that trend to continue as we see the current share price as undervalued, and an excellent use of capital.

We have a proven ability to generate free cash flow and a track record of getting that cash back to shareholders. For example, in the past six years, we have returned nearly $5 billion to shareholders, with $4 billion of this through buybacks at an average price of under $38, reducing our shares outstanding by nearly one-third. This year, we returned 72% of our operating earnings to shareholders, which is above our long-term free cash flow target of 50% to 55%. While our long term target remains unchanged, we expect to be approximately 10 points above that range in 2017, as we leverage the strength of our balance sheet. Notably, the board recently approved an increase in our share repurchase authorization, bringing it back up to $1 billion.

So to conclude, 2016 was an excellent year. We reported record operating EPS. Book value per share grew to over $57, a record, and up 9%. And our ROE was strong at 12%. Let me remind you this follows a period where over the past six years, EPS has grown at an annual rate of 12%, book value per share has increased at a 7% rate, and our ROE has expanded nearly 300 basis points.

As we look forward, we are excited about our digitization initiative, which will deliver real value to the bottom line. We fully expect to continue generating positive net flows and premium growth across all our businesses. And lastly, our balance sheet is as strong as it has ever been, and our ability to generate capital remains robust, which will enable us to continue our strong track record of returning capital to shareholders.

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

Christopher A. Giovanni
Senior Vice President & Head-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, please limit yourself to one question and just one follow-up, then re-queue for additional questions. And now I will turn things over to the operator.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Our first question comes from the line of Suneet Kamath with Citi. Your line is open.

Suneet Kamath
Analyst, Citigroup Global Markets, Inc.

Q

Thanks, good morning. I just wanted to start with the variable annuity flow picture. Can you talk about the timing of the rollout or the pace of rollout for that new product, the BlackRock ETF-based product? And do you see this in any way cannibalizing some percentage of your existing VA production?

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

A

No, the core income – the BlackRock product, I think – not I think, that I've said is a new product category. It has been approved in a lot of states. We're signing up with broker dealers. There is technology involved in executing with the broker dealers, and so I think we expect this to grow over time. The more significant sales results will probably be later part of this year, and into the next year.

Suneet Kamath
Analyst, Citigroup Global Markets, Inc.

Q

Okay. And then your comment on the positive flows in 2018, my assumption is that means you might still be negative this year. Does that assume no change to Department of Labor as it currently stands?

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

A

Correct.

Suneet Kamath
Analyst, Citigroup Global Markets, Inc.

Q

Okay. And then the last one for Randy. Just as we think about that new BlackRock product, is there any material change in the capital strain guidance that you have given us for VA? I think it's been like $0.05 for every $1.00 of VA capital strain on the old product. What is that for the new product?

Randal J. Freitag
Chief Financial Officer, Lincoln National Corp.
A

Suneet, I don't think of it as materially changing the guidance we've given. As I have talked about in the past, the profile for a product that is more of a fee-based product as opposed to a commission-based product is that you have less investment upfront, which drives two things. That drives typically a little lower ROA, but a little higher ROE. This product is going to be a percentage of our overall sales, and so I don't see it making a significant change in either of those return metrics, which I'd remind, our ROA is in the high 70s, and an ROE which has been running in excess of 20%.

Suneet Kamath
Analyst, Citigroup Global Markets, Inc.
Q

Okay. Thanks.

Randal J. Freitag
Chief Financial Officer, Lincoln National Corp.
A

You bet.

Operator: Thank you. Our next question comes from the line of Nigel Dally with Morgan Stanley. Your line is open.

Nigel P. Dally
Analyst, Morgan Stanley & Co. LLC
Q

Great. Thanks. Good morning. So with capital management being 10 points above the long term average of 50% to 55% in 2017, what's driving that? Is that a reflection of the somewhat weaker Annuity sales that we've been seeing this year? Or are there some reserve financings on the horizon? Just wanted to get some additional color there.

Randal J. Freitag
Chief Financial Officer, Lincoln National Corp.
A

Nigel, I'll talk about it in comparison to what we did this year. So this year, we ended up at 72% of operating earnings, which is roughly 20 points above the midpoint of our long-term range. Twenty points translates into about $300 million of additional share repurchases. If you broke that down, I would say about $200 million of that came from the reinsurance transaction we did earlier in the year, which generated a significant amount of capital. And about $100 million of it came from the fact that variable annuity sales were below where they had been in the past. As you look forward, and as Dennis talked about, I would continue to expect the VA sales to be below our long-term expectations. So I think that will drive some of the continued increase that I talked about, and then just the strength of our balance sheet will drive the other piece.

Nigel P. Dally
Analyst, Morgan Stanley & Co. LLC
Q

Okay. Then just a follow-up on the passive variable annuities. I know it's early on in the rollout prices, but just would be interested as to the kind of reception that you got from the various distributors that you've introduced it to.

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

It's probably one of the most exciting product concepts that we have ever delivered into the marketplace. So distribution partners, advisors are quite excited about it. But, Nigel, I'd like to repeat that it's technology based, and so the rollout is going to be effective and efficient, but just like any new product, it's going to take time to build sales.

Nigel P. Dally
Analyst, Morgan Stanley & Co. LLC
Q

Okay. Appreciate the color. Thanks.

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

Thomas Gallagher
Analyst, Evercore Group LLC
Q

Good morning, just wanted to discuss what is going on behind the scenes with – you know, what has been driving the variable annuity sales weakness? Is it – do you think it's that you've seen a big shift move away from front-load commission-type products broadly, and that's how predominantly how VAs have been sold? And the move to level fee commissions is kind of a tricky transition, because that's not historically a lot of the way those products have been sold? Can you talk a bit about, is that really what is driving it? And do you think that despite what happens with DOL that you think a lot of distributors have moved in that direction and they're going to stay there, so we're going to see a depressing impact for a while here?

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

Yeah, that's a multifaceted question. And let me talk about a couple of responses to the general trends that we have. And let me talk first about our core value proposition that has led to what we all know is the strongest in-force block of business from a quality risk and earnings perspective in the industry. And that quality was built off of a basic value proposition to the consumer of upside potential and lower initial guarantees. So that value proposition remains in the marketplace. It's been hurt a little bit by lower returns inside the sub-accounts, some of that related to risk-managed funds.

So our response to that, and we're able to be responsive inside of that category, because interest rates have moved up a little bit, giving us a little bit more flexibility. So what we're doing in that product category is providing more investment flexibility. So, for example, in the past, we may have had a requirement of 70% equity, 30% debt, and we're modifying that a little bit. Again, because of the interest rate environment, we're able to a little bit up the initial payout rates or the initial income payout rates. So you've got that block of business, and again, it's been affected a little bit by fund performance, but we're responding to that.

Then there's a second value proposition, which is even more investment flexibility, but with a lower initial income payout, and that's very exciting. Again, taking our initial equity debt relationship of 70/30 – or excuse me, 60/40 to 70/30, so there's an ability to get more equity into the account, giving more upside potential, and also the removal of the risk-managed funds in that particular product category. So lower income initially with more investment restrictions is one of them with upside potential, and the other one I just described.

Then a whole new product category is what we talked about in terms of the BlackRock product, both in terms of the structure of the product as well as the opportunity to go into the retirement income – excuse me, the registered investment advisor channel. And then, finally, the – there is a lot of activity in the – sort of the traditional deferred income annuity accumulation product space. Fixed income and fixed index annuities being a part of that, and we're strengthening that as well. So I can't say that there's one market adjustment, it's affecting the overall market, it's a whole series of things, and we have products and plans in place to address each one of them.

I do think, though, coming back specifically to the Department of Labor, and the whole issue around commissions, and the lack of – because there has been so much – what would I say – it's been unclear at the – our distribution partners exactly how this was going to turn out. Even if the existing rule was to turn out, the rule had to be interpreted, technology changes, and so the distribution partners have been slow – a little bit slow to communicate to their own advisors, where we're going to end up. So I think that the DOL issue has probably had a lot more impact, and whether or not it's delayed, I think that confusion will go away on April 17, when everybody has to implement their final plans.

So a lot of different effects on the marketplace. I'll finish with two things. One, I continue to believe that long-term the individual annuity market, whether it's for accumulation or for guaranteed lifetime income is going to be robust and vibrant, and our product development is addressing the issues that we can address, and confident that we'll recover our sales momentum.

Thomas Gallagher
Analyst, Evercore Group LLC

Q

Got it, thanks, Dennis. And then, just a follow-up. Do you have broad-level statistics in terms of what percent of your VA sales are front-load commission? I know there are different structures, but just broadly, front-load versus level fee. My understanding from an industry standpoint, the vast preponderance of sales have been front-load. Just curious if that is the case for you. And do you think that will be an evolution for the industry to make a big move in that direction? And do you see there being kind of a longer transition period, if it does move in that direction?

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

A

Yeah, I would – I mean, to your point, the entire industry has been built on commissions and active fund management in the sub-accounts. And so that's going to move – those two pieces are going to move a little bit. Instead of just commissions, you are going to have fee-based products, and as I mentioned, more passive opportunities for investments inside.

And let me differentiate that for a second. When I talk about commission in active, that's a set of financial advisors that exist and are selling annuities. And some of the refreshment activities we've had in our products that address that particular advisor cohort, such as reducing the fees within – on the fee-based part of it, reducing the fees, paying for that with lower payments out to the broker dealers. That'll move, I think, gradually over time, as between the amount of people that use commissions and the amount of people that prefer fees. And that's going to be in part based on what their customers' preference is, and so that's going to move forward.

The second issue is a little different, and that is the RIA market, which is a pretty significant market in the United States, where annuities haven't been a big piece of what they've provided. There's one firm that has been reasonably successful. I think that's the area for additional cohort of financial advisors expanding the distribution opportunity beyond what exists today.

Thomas Gallagher
Analyst, Evercore Group LLC

Q

Okay, thanks, Dennis.

Operator: Thank you. And our next question comes from the line of Erik Bass with Autonomous Research. Your line is open.

Erik J. Bass
Analyst, Autonomous Research

Q

Hi, thank you. Can you talk about how much margins on new business have improved in both Life and Annuities as a result of higher interest rates and lower hedge costs?

Randal J. Freitag
Chief Financial Officer, Lincoln National Corp.

A

Erik, let me sort of break it up by the products. I think the products most impacted would be in the Annuity and the Life business. In the Annuity business, as Dennis has talked about, the increase in interest rates has allowed us to make some changes on the products, which we believe will make them more attractive to consumers. So I don't think that the increase in interest rates has had a huge impact on the returns that we expect on those products. I think maybe on fixed annuities, you get a little bit of a boost because you get a little higher return on your surplus, so they get a little better metric there, but I wouldn't say it's a material impact.

On the Life side, we have been running strong returns, 12% to 15%, for some time now. And I don't expect that to change materially. I think the market will respond to rates with either benefit changes or premium decreases. So I wouldn't expect a material change in the returns we're getting on the Life business, which have been strong for a number of years now.

Erik J. Bass
Analyst, Autonomous Research

Q

Got it. And...

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

A

Yeah, I'd add a little bit – not change, but just add to what Randy said, and that is day in and day out, we try to get our required returns on capital on products. There's a lot of input to pricing, interest rates being one of them. As interest rates change, in terms of pricing, that gives us more flexibility. But we're driven by our return on capital requirements, no matter what the environment is.

Erik J. Bass
Analyst, Autonomous Research

Q

Got it, thank you. And I guess, just then thinking about the interest rate benefit, is it really that you get a recovery in spreads back to normal levels? So you'd lose the, I guess now 2% drag on earnings that way? But in terms of the returns, it sounds like a lot of the benefit of higher rates stops dropping to the bottom line once you've recovered that spread – is that the right way of thinking about it?

Randal J. Freitag
Chief Financial Officer, Lincoln National Corp.

A

Erik, it is a big deal if that spread compression goes away. I'd remind you if you just took one of our business, the Life business, it's a sum total over the last four or five years of nearly $100 million of impact from spread compression from its in-force. So you take that away, and that's a big deal, both for that business and the company in total. So the biggest financial impact, and the impact you're going to see immediately is because that spread compression number goes down. As you mentioned, we were at between 2% to 3%. We're now down at about 2%, so you've got a little bit less spread compression, and that's a benefit across the company and from that standpoint.

On new business – and Dennis mentioned this in his comments – it allows product to become – to get adjusted in a way that makes them more attractive to consumers. You are able to offer more benefit or lower premiums, which makes these products not only more attractive to consumers, but more competitive with other options they may have. So I think that's a big deal from a new business standpoint, if you can see those new sales levels move up. Factually, new business has never had a huge impact on the earnings we expect in the next year or two. That's more about the growth of the business. So anything, I think, that drives sales higher is a positive for the long-term outlook for the organization.

Erik J. Bass
Analyst, Autonomous Research

Q

Okay. So at a minimum, you get a 2% kind of improvement back to your normalized growth rate, and then additional sales volumes would be a long term plus to that as well.

Randal J. Freitag
Chief Financial Officer, Lincoln National Corp.

A

Yeah, absolutely. As Dennis mentioned, we're investing at about 4.1% right now. So that's about 70 basis points below our portfolio. So that would be the number that would eliminate that, but at the level we're at right now, we're at about a 2% headwind.

Erik J. Bass
Analyst, Autonomous Research

Q

Great. Thank you.

Randal J. Freitag
Chief Financial Officer, Lincoln National Corp.

A

You bet.

Operator: Thank you. And our next question comes from the line of John Nadel with Credit Suisse. Your line is open.

John M. Nadel
Analyst, Credit Suisse Securities (USA) LLC

Q

Hey, good morning, everybody. Jam packed morning. The first question is, for 2016 any reason to believe that the dividend received, the DRD benefit in your tax rate was significantly different from the roughly $190 million benefit it provided in 2015?

Randal J. Freitag
Chief Financial Officer, Lincoln National Corp.

A

No, it was actually almost perfectly level at about $180 million actually. So it did not change materially, John. And, John, it is good to know that you guys are working hard on a Thursday here in February.

John M. Nadel
Analyst, Credit Suisse Securities (USA) LLC

Q

Yeah, definitely working hard, Randy. Maybe not as hard as you guys are. So then the question is – the next question, just thinking about the drop in annuity sales, and I know you guys have done a great job of sort of redeploying the capital sort of not used to fund annuity sales into primarily buybacks. Am I doing the math right if I think about annuity sales in 2016 were down $4.4 billion, $4.5 billion year-over-year? Using the roughly 5% capital requirement or strain, I would have thought we would see something more along the lines of $200 million to $250 million of incremental capital deployment. It sounds from your earlier comments like about $100 million of your buybacks in 2016 was related to redeployment of capital not used to fund sales.

Randal J. Freitag
Chief Financial Officer, Lincoln National Corp.

A

John, I think one of the things in your math, which is largely correct as math goes, is that when we sort of gave that guidance, I think the run rate of sales was a little lower, so the amount of sales drop isn't – that went into that math isn't quite at that $4.5 billion level. So...

John M. Nadel
Analyst, Credit Suisse Securities (USA) LLC

Q

Got it, okay.

Randal J. Freitag
Chief Financial Officer, Lincoln National Corp.

A

That would be one aspect. You also saw a shift in some products to fixed annuity sales a little bit, which are a little more capital intensive than variable annuities. So that was a little bit of a drag on the math. But roughly speaking, what we said came true in that we were able to overcome the drag on earnings caused by the lower annuity sales through share repurchases in 2016.

I would note when you look forward, that math changes a little bit because of the increase in share price. We can't buy quite back quite the same number of shares per dollar that we use, so there's a little bit of drag just using that math. But in 2016, factually, we were able to overcome the drag from lower sales through share repurchases.

John M. Nadel
Analyst, Credit Suisse Securities (USA) LLC

Q

High quality problem. I don't think your shareholders will give you a hard time over that.

Randal J. Freitag
Chief Financial Officer, Lincoln National Corp.

A

Thank you.

John M. Nadel
Analyst, Credit Suisse Securities (USA) LLC
Q

Thank you.

Operator: Thank you, and our next question comes from the line of Jimmy Bhullar with JPMorgan. Your line is open.

Jamminder Singh Bhullar
Analyst, JPMorgan Securities LLC
Q

Hi, I had a couple of questions. The first one is just on the Individual Life business. You spoke about the seasonality in the business, but obviously earnings have moved even more so than the seasonality might imply. So do you view the 2016 earnings number for the business as more of a normal annual level going forward, or did results benefit from variable investment income or other items that might not repeat to the same extent?

Randal J. Freitag
Chief Financial Officer, Lincoln National Corp.
A

Yeah, Jimmy, I think of the year as almost perfectly in line with what I've said in the past, which is that this business is about a $125 million a year business, or $500 million for a full year.

Jamminder Singh Bhullar
Analyst, JPMorgan Securities LLC
Q

$125 million a quarter, yeah.

Randal J. Freitag
Chief Financial Officer, Lincoln National Corp.
A

Yeah, excuse me. And if you think about the year, we made $550 million, and that included a $17 million positive unlocking, so right at that $125 million guidance. In terms of the quarter, the $154 million, we had strong variable investment income. That was largely offset, as I mentioned, by expenses. So at the end of the day, what you just had was mortality. Really good mortality driving the $154 million of earnings, which just coincidentally was almost an exact mirror of the first quarter – so of the year. As I said in the first quarter of the year, about $20 million of expected seasonality, we had about $10 million of additional.

Jamminder Singh Bhullar
Analyst, JPMorgan Securities LLC
Q

Okay.

Randal J. Freitag
Chief Financial Officer, Lincoln National Corp.
A

Total of $30 million this quarter, about $29 million of benefit overall, compared to an average quarter from good strong mortality, which we expect to happen in that quarter of the year.

Jamminder Singh Bhullar
Analyst, JPMorgan Securities LLC
Q

Okay. And then on the variable investment income being strong, can you just give a little bit of color on what the drivers were? And also discuss where you are on your plan to reduce your hedge fund exposure?

Randal J. Freitag
Chief Financial Officer, Lincoln National Corp.

A

It was strong across all areas. So the PE and hedge funds, I think as Dennis might have mentioned in his script, the return was about 12% for the quarter, and we expect 10% long term. So we had good, strong performance from the alts portfolio. And then prepayment income was above what we have experienced over the last four to five years, and was over what I would expect over a much longer cycle. In total, it came up to about $13 million after tax, as I mentioned in my script. I would say that was fairly evenly split, probably -maybe a little skewed towards per-payment income.

If you broaden this out, and you think about alternatives and prepayment income over a longer cycle if you look at the last couple of years, what you have seen is that alternative in both those years were a little below our long-term expectations. So for the full-year, we were about $40 million lower than we would expect on the alternative side, whereas pre-payment income was a little stronger. When you add them together, I don't think we're materially different from what a longer-term expectation might be for the sum of those two items.

Jamminder Singh Bhullar
Analyst, JPMorgan Securities LLC

Q

Thank you.

Operator: Thank you. Our next question comes from the line of Yaron Kinar with Deutsche Bank. Your line is open.

Yaron J. Kinar
Analyst, Deutsche Bank Securities, Inc.

Q

Good morning, everybody. I had a question regarding capital deployment. So you mentioned buybacks as probably being so quite elevated or strong in 2017. One part that I was surprised, I didn't hear you talk about was the potential for M&A. I think in the past you've talked about being interested in morbidity business, the interest rates are higher, the Group business has turned around. You may see less of a regulatory risk here. Is that still something that you're considering or maybe looking at more carefully today?

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

A

M&A is always a tool and over the last 22 years, 20 years or so we've used it pretty effectively really to achieve what would otherwise be our plan anyway. And so, whenever we do M&A, it's because we're trying to accelerate our strategy to do it for the sake of doing it. You're correct, we have said that we have a longer-term strategy of increasing the percentage of our income that comes from mortality and morbidity, and that sort of in terms of our businesses, we would probably think of the Group business as the top priority. So that's the strategy.

Deals coming to market come episodically, we'll continue to look at things. We've looked at some properties in the last 24 months, and back to our allocating capital to the best use, it was a way more expensive. The properties sold for way more than what we think would make sense for our use of capital. It could have made a lot of good sense for the people who bought it. I don't know what their strategies were. So prices would probably have to come down a little bit before we got real interested in the deal. But we'll keep looking. We're good at assessing M&A. We're good at integrating M&A. And if something comes along that fits with our long-term strategy, all of which points we've articulated, we would take a look. I will say that we wouldn't do anything that would materially affect our share buyback program over time.

Yaron J. Kinar
Analyst, Deutsche Bank Securities, Inc.
Q

Okay. And then switching gears a little bit to the digitalization initiative, I just want to get a little more understanding of the numbers. So as – I'm assuming that 2019, that the break-even year, you expect to see some cost saves flowing in, and then those really ramping up in – beyond that. So can you give us a little bit of color as to where you see those cost saves coming in, which segments would be more impacted? I'm assuming that the related expenses will remain in the Corporate segment, or Corporate and Other. But where could we see the benefits?

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

Maybe let's back up a little bit as I answer that question. We have, over the past four months, have had an internal team at Lincoln, the core team, eight or ten people. We have had another 25 or 30 people from our outside consultant, and then we've involved, overall, probably another 100 people from Lincoln. And what we've spent our time doing is really trying to understand where the best opportunities are to both improve the customer experience – I don't want to lose that concept – Improve the customer experience, and then as we're doing that, make sure that we find ways to finance that investment. And so the numbers that we're talking about are not just pulled out of the pocket, but they are the consequences of four months of pretty hard work and detail and math.

Now, having said that, as we move into the execution, and repeating what Randy said, we're going to have to pay attention to short-term earnings as well as long-term opportunity. And the execution phase is very important, and I think it would be pretty premature to try to identify exactly what line of business is going to get the most benefit.

Yaron J. Kinar
Analyst, Deutsche Bank Securities, Inc.
Q

Okay. Thank you.

Operator: Thank you. Ladies and gentlemen, this does conclude the question-and-answer session. We will be able to follow up with those in the queue later this afternoon. I would now like to turn the call back over to Mr. Chris Giovanni.

Christopher A. Giovanni
Senior Vice President & Head-Investor Relations, Lincoln National Corp.

Thank you all for joining us this morning. As always, we will take your questions at our investor relations line, and we'll follow up with those that were remaining in the queue. You can reach us at 800-237-2920 or via email at investorrelations@lfg.com. Thank you again for your participation, 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.