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Prudential Financial, Inc. (PRU)

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MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by and welcome to the Prudential Quarterly Earnings Conference Call. At this time, all participants are in listen-only mode. Later, we will conduct a question-and-answer session and instructions will be given at that time. [Operator Instructions] As a reminder, today's conference is being recorded.

I would now like to turn the conference over to the Head of Investor Relations, Darin Arita. Please go ahead sir.

Darin Arita

Senior Vice President, Head of Investor Relations, Prudential Financial, Inc.

Thank you, Brad. Good morning and thank you for joining our call. Representing Prudential on today's call are Charlie Lowrey, CEO; Rob Falzon, Vice Chairman; Steve Pelletier, Head of Domestic Businesses; Scott Sleyster, Head of International Businesses; Ken Tanji, Chief Financial Officer; and Rob Axel, Controller and Principal Accounting Officer. We will start with prepared remarks by Charlie, Rob and Ken and then we will take your questions.

Today's presentation may include forward-looking statements. It is possible that actual results may differ materially from the predictions we make today. In addition, this presentation may include references to non-GAAP measures. For a reconciliation of such measures to the comparable GAAP measures and a discussion of factors that could cause actual results to differ materially from those in the forward-looking statements, please see the slide titled Forward-Looking Statements and Non-GAAP Measures in the appendix to today's presentation, which can be found on our website at investor.prudential.com.

With that, I will hand it over to Charlie.

Charlie F. Lowrey

Chief Executive Officer, Prudential Financial, Inc.

Thank you, Darin. Good morning, everyone, and thank you for joining us today. While equity market movements affected our fourth quarter results, our fundamentals remained strong across our businesses, as did our earnings, adjusted for the notable items that Ken will address later. We feel good about our outlook for our business and our ability to continue building the momentum in our business by helping our customers with their financial needs, especially through turbulent times. And we're going to dive into this subject in a little more detail today.

For the full year, 2018 marked another important chapter for Prudential. As we continue to generate meaningful value for our customers and to grow our business in a sustainable way. As a result, we grew operating earnings and adjusted book value per share, produced a double-digit return on equity and returned more than \$3 billion via dividends and share repurchases.

We also maintained a solid balance sheet, even amid the large equity market movements in the fourth quarter. Looking forward, we're excited about the opportunities to create more value for our existing customers and forge relationships with new customers. Our market-leading businesses, complementary capabilities and global reach allow us to expand markets and grow in a way that few others can.

At the highest level, we're bringing more financial opportunity to more customers. We accomplish this through our U.S. Financial Wellness businesses, PGIM, our asset management business, and our International business. We are also working with institutional clients and distributors around the world to help individuals adopt behaviors that enable financial security. By addressing evolving societal needs for financial advice, services and solutions, we seek a unique opportunity to reach new market segments across different income brackets, ages and other demographic groups, and to deepen our relationships with existing customers.

PGIM enables the success of our businesses through its investment capabilities, including proprietary private asset classes. This provides a competitive advantage for Prudential, which allows us to innovate new products and services, such as pension risk transfer, to support our customers. At the same time, PGIM benefits from continued growth in affiliate flows and assets under management, which supports its position as the top-10 global asset manager.

Our businesses have an established trusted presence in more than 40 countries, engaging in relationships with approximately 50 million individuals. In addition to this wide reach, our businesses create earnings and capital diversification for our shareholders.

Turning to slide 3. I'll provide some additional financial highlights on the fourth quarter and full year. Fourth quarter earnings declined from a year-ago period primarily due to equity market impacts. For the full year, adjusted earnings per share increased by 11% to \$11.69. We generated an adjusted return on operating equity for the full year 2018 of 12.7%, at the high end of our near to intermediate target of 12% to 13%, and our adjusted book value per share grew by 8.3%.

We deployed our capital in growing our business, repurchasing shares and paying dividends. And we achieved all of this while maintaining a robust capital position, consistent with our AA standard. As we look to 2019, our share repurchase authorization is \$2 billion and we increased the quarterly dividend by 11%.

This year's performance was supported by strong drivers across our businesses, including significant milestones. Within our U.S. Financial Wellness businesses, we achieved record account values in Institutional Investment Products supported by our pension risk transfer capabilities. We also had record Full Service retirement sales. Within PGIM, we achieved our 16th consecutive year of positive institutional net flows.

Within International, we reached a record level of Life Planners, our highly productive distributors of protection and retirement solutions. Maintaining this growth and executing on our strategy starts from within. We focus on culture and talent, enabled by technology, to achieve a meaningful purpose, which is a point I'd like to close with as we turn to slide 4.

There is a growing body of evidence that purpose-driven companies outperform their competition in recruiting and retaining top talent, in strengthening customer loyalty and in driving business performance, all of which are core elements of our strategy.

At the start of this year, we unveiled a new purpose statement to our employees that reflects their collective feedback of our vision for the future, which is: we make lives better by solving the financial challenges of a changing world. We recognize this is a bold and highly aspirational statement, but it reflects who we are and what we do through our U.S. Financial Wellness and Global businesses.

And to that effect, I'm proud to note that we continue to be recognized for our purpose-driven work. Prudential was, once again, ranked as number one on Fortune magazine's 2019 World's Most Admired Companies list for the fourth consecutive year in our sector with high marks in areas such as innovation and people management.

Additionally, as we noted last quarter, Prudential was named to Fortune's Global Change the World list where we are the only company in our sector to be recognized. Finally, we were cited as one of the Top 50 Companies for Diversity by DiversityInc in 2018 for the 17th year in a row.

These distinctions serve as a strong endorsement for the culture we cultivate at Prudential every single day and which we will continue to build on to drive shareholder value and make a positive contribution to society.

With that, I'll turn it over to Rob, who will provide an update on how our businesses are executing on their key priorities. Rob?

Robert Michael Falzon

Vice Chairman, Prudential Financial, Inc.

Thank you, Charlie. I'll begin on slide 5. Consistent with our aspiration to solve the financial challenges of our customers, as Charlie described, we are already advancing our purpose through our Financial Wellness initiative in the U.S. and through our needs-based selling approach in our International business. Our resiliency to the equity market fluctuations in the fourth quarter was the result of what we believe are the hallmarks of Prudential, thoughtful strategy and quality execution that build strong fundamentals and produce attractive financial outcomes. Our objective is to apply these strengths in ways that produce similar outcomes for our customers, who can benefit from our integrated solutions, market access and enduring financial strength.

In the U.S., we do this through Financial Wellness. We engage with individuals and, in particular, the employees of our Workplace clients to identify and solve their unique financial challenges through multiple channels and with simplified solutions. This also benefits our employer clients by enhancing the effectiveness and engagement of their employees. Our value proposition is resonating as we generate outcomes such as reduced financial stress, improved understanding and utilization of company benefit programs and increased productivity.

As shown on slide 6, U.S. Financial Wellness represents our Workplace and Individual Solutions businesses and produces a diversified source of earnings, including fees, net investment spread and underwriting income, delivered through our Retirement, Group Insurance, Individual Annuities and Individual Life platforms.

Workplace Solutions covers 20 million people and Individual Solutions serves over 5 million people. The capabilities we have in this platform enable us to engage with our clients through a continuum of channels, including with third-party distributors, directly with our in-person or phone-based financial advisors and with our digital tools. Our goal is to meet individual's needs where, how and when they want.

I'll highlight three of our key priorities for growth. First, we continue to develop solutions to address customers' financial needs. As an example, we recently launched emergency savings feature for our retirement plan clients. This solution allows individuals to access funds for short-term needs, while maintaining their contributions toward their long-term goals. Second, as we continue to provide our financial wellness solutions to our existing Workplace clients, these solutions are also contributing to new client acquisition efforts.

Since the launch of our Financial Wellness capabilities in 2015, we have generated about \$9 billion of Full Service retirement plan sales and over \$100 million in Group Insurance case wins that we can attribute to this initiative.

Third, we are working to deepen individual relationships in the Workplace. We activate these relationships through our Prudential Pathways program, our digital financial wellness platform and LINK by Prudential. Our Prudential Pathways program has been adopted by nearly 500 of our Workplace clients. In this program, employees of our Workplace clients can participate in worksite financial seminars on a wide range of topics delivered by Prudential's financial advisors. Employees can also request a personal consultation, which has helped drive new retail clients for Prudential advisors.

Our digital financial wellness platform has been adopted by over 3,000 clients representing over 5 million individuals. This platform provides a digital venue to address a variety of individual's needs including education on financial wellness topics, assessment of financial needs and tools to take action.

We launched LINK by Prudential in the second half of 2018. Our Workplace clients can make LINK available to their employees as part of our digital financial wellness platform. This is a highly personalized online experience that helps those employees customize financial goals, connect with advisors digitally or via phone, and obtain savings, investment, protection and income solutions.

As we continue to help employers and individuals, we ultimately believe our solutions can significantly expand our addressable market and enhance our long-term growth potential.

Turning to slide 7, which highlights our global asset management business, PGIM, PGIM continues to leverage its scale of over \$1 trillion of assets under management via a distinctive multi-manager model with broad asset class capabilities. 2018 marks the 16th consecutive year of positive institutional third-party net flows for PGIM. These positive net flows from third parties are in part driven by our strong long-term investment performance. I'd specifically highlight the five-year performance and note that 97% of the assets under management have outperformed their benchmarks over that period.

In the current quarter, we experienced net third-party outflows of \$3 billion, including a \$9 billion fixed-income withdrawal by a single institutional client. This was a client-specific decision and was not based on our investment performance. We serve many of the world's largest pension funds and other institutional investors and, as a result, will experience large idiosyncratic flows from time to time. These flows are generally to the benefit of PGIM's AUM.

Our third-party retail flows were affected by trends consistent with the industry during the quarter. Retail investors reduced credit exposure, held more cash and sold investments for tax purposes. Our total net inflows, including affiliated flows, were positive \$9 billion in the quarter. These flows included significant assets from pension risk transfer where PGIM's origination and differentiated asset management capabilities provide a competitive advantage.

Positive flows helped to keep PGIM's total assets under management fairly stable through the quarter despite the market decline and in contrast to significant declines experienced by other asset managers. Despite industry-wide fee compression, our overall asset management fee yield remains stable at 22 basis points, as we continue to diversify our products suite into higher-yielding strategies.

I'll highlight three other key priorities to grow PGIM's earnings. First, with respect to expanding our global footprint, as of year-end 2018, 29% of PGIM's assets under management were sourced from outside the U.S. We continue to grow organically driven in part by our strong International private origination capabilities. In fact, PGIM had a record year for non-U.S. private credit originations. In addition, PGIM's European mutual fund platform has grown to include 28 funds with assets under management in excess of \$3 billion.

Second, we've also made disciplined bolt-on acquisitions to strengthen our global presence and complement our capabilities. For example, we recently announced the acquisition of a London-based quantitative investment manager that will expand our alternative investment solutions. The manager will have significantly greater growth potential by tapping into PGIM's global distribution network. Third, with respect to products, we launched our first actively managed exchange-traded fund last year. And by year-end, the ETF platform has grown to six strategies across both equity and fixed income.

In addition, we continue to grow our market-leading alternatives capabilities and have established a dedicated group in our leading private client franchise, focused on mezzanine financing, energy finance and direct lending.

Now, turning to slide 8, our International business includes our world-class Japanese life insurance operation as well as other businesses, including in high-growth markets with large population, such as Brazil, India, Indonesia, China and Africa. Our differentiated business models and proven ability to execute our strategy has led to steady growth, attractive returns and significant capital generation. In addition, we continue to make strategic investments in digital, mobile and data capabilities to enhance our long-term growth prospects.

I will highlight a few operating metrics that reflect our strong fundamentals and continued growth during the fourth quarter. Life Planners sales, which were about half of total international sales in the current quarter, increased by 12% compared to the year-ago quarter. This was driven by higher U.S. dollar sales and the number of Life Planners in Japan increasing by 6% to a record level of 4,183.

Gibraltar sales were lower than a year ago as growth in Life Consultant and Independent Agency sales were offset by a reduction in bank channel sales. Bank channel sales reflect our disciplined on pricing and underwriting in response to a more competitive market. Life Consultant channel sales were 5% higher than the year-ago quarter, even as Life Consultant count was 4% lower, consistent with our continued focus on high-quality distribution. And Independent Agency channel sales increased by 10% driven by an increase in U.S. dollar sales, including a new term life insurance product rolled out earlier in the year.

In summary, our momentum remains positive across all of our businesses, U.S. Financial Wellness, PGIM and International. We have thoughtful strategies and quality execution that continue to build strong fundamentals as we serve our customers well and we are monetizing those fundamentals to generate profitable growth at attractive returns.

And with that, I'll hand it over to Ken.

Kenneth Yutaka Tanji

Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

Good. Thanks, Rob. Slide 9 includes the notable items, which had an impact on adjusted operating results in the current quarter. We highlight these items because they may not be indicative of future performance. There were three primary drivers of the notable items. First, the equity market movements resulted in \$109 million adjustment for the recognition of certain benefits and costs associated with variable annuities and variable life policies.

In addition, non-coupon investment income and prepayment fees were about \$140 million below our long-term expectations, driven primarily by hedge fund returns. Second, underwriting experience was generally in line with our average expectations, which highlights our complementary mortality and longevity profile as presented on page 22 in the appendix. And third, we recorded a provision of \$30 million for legal matters. In total, these notable items reduced pre-tax earnings by \$289 million or \$0.54 per share. Excluding the notable items, earnings per

share would be \$2.98, up 14% from the year-ago quarter. And then thinking about quarterly earnings patterns, please note that we've included a summary of seasonal items in the appendix.

Now, turning to slide 10, I'll provide an update on capital deployment, liquidity and leverage. As Charlie noted, we returned more than \$3 billion to shareholders during the year through dividends and share repurchases. And for 2019, we increased our share repurchase authorization by 33% to \$2 billion. And yesterday, we announced 11% increase in our quarterly dividend.

Our cash and liquid assets at the parent company amounted to \$5.5 billion at the end of the quarter. The sequential quarter increase of \$300 million was driven by cash flows from our businesses that exceeded shareholder distributions. Shareholder distributions of \$752 million in the quarter were roughly evenly split between dividends and share repurchases.

We also maintained a strong balance sheet. Our hedging programs were highly effective in mitigating the large equity movements in the quarter. Our regulatory capital ratios continue to be above our double AA financial strength targeted levels and our financial leverage ratio as of year-end 2018 remains better than our target. Also, as credit remains a topic of investor interest, we provided details of our high-quality CLO portfolio in the appendix.

In summary and turning to slide 11, our market-leading global businesses with complementary capabilities are providing integrated financial wellness solutions to more customers. For the year, we generated a strong adjusted operating return on equity, along with significant growth in adjusted operating earnings and book value per share and also delivered solid shares and net flows across our businesses. And we distributed more than \$3 billion to shareholders and sustained a robust capital position with capital flexibility.

Now, I'll turn it to the operator for questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Our first question today comes from the line of Humphrey Lee with Dowling & Partners. Please go ahead.

Humphrey Hung Fai Lee

Analyst, Dowling & Partners Securities LLC

Q

Good morning and thank you for taking my questions. Regarding PGIM's net outflows, I mean, the \$9 billion outflow from single client. I was wondering if you can elaborate in terms of the reason for the redemption, was it related to hedging costs being a foreign investors or maybe the client taking the investment in-house. I was just hoping if you can share a little bit more color. And then also, do you still have any more exposure to this particular client?

Stephen P. Pelletier

Executive Vice President and Chief Operating Officer, U.S. Businesses, Prudential Financial, Inc.

A

Humphrey, this is Steve. I will take your question. Thank you very much for it. I would say that the reason for this outflow was the client looking to consolidate managers. And that was really the main driving factor. It was not due to our performance either on a relative or on absolute basis. So, that's the story there. If you don't mind, even on a no-names basis, I don't think I'll talk too much about at the granular level of our dealings with an individual client. I will just emphasize, Humphrey that, as Charlie talked about, our PGIM business represents a top-10 global asset manager. In particular, I'd highlight that, on the institutional front, we truly have a world-class client franchise. We do business with 23 of the largest-25 corporate U.S. pension plans. We do business with eight of the top-10 Fortune 500 companies. We do business with over half of the 300 largest global pension funds.

We're very proud of and grateful for that client franchise, but it also means that business gets done in large blocks. And on occasion – on rare occasion, on a quarterly basis, we may have more outflows than inflows due to something like this, a single large case. However, on an annual basis, as mentioned earlier, we have had 16 positive years of institutional net flows. And also, I'd like to point out that on the quarterly basis, despite that one large outflow of \$9 billion, we almost [ph] brought (00:23:43) institutional net flows to a draw, which signifies that gross sales were actually very strong for the quarter. And that gives us confidence, as we begin 2019, in our ability to attract robust flows, both gross and net, and at a good and sustainable average fee level, as Rob mentioned in his comments.

Humphrey Hung Fai Lee

Analyst, Dowling & Partners Securities LLC

Q

Understood. And I agree the \$8.5 billion of other net inflows definitely speaks volume to the demand for your product. My second question is related to the weak non-coupon investment in the quarter. My understanding is that most of your hedge fund exposure has no reporting lag and the underperformance in the fourth quarter was fully reflected in the numbers in the quarter, so that include the weaker December results. And then, on that note, of the \$140 million of below-plan non-coupon investment income, how much of that was related to hedge fund underperformance and how should we think about the first quarter expectation? Like, obviously, private equity will be weaker, but I guess your hedge fund results could be an offset.

Robert Michael Falzon

Vice Chairman, Prudential Financial, Inc.

A

So, Humphrey, it's Rob. I'll take that question. So, first, yes, our hedge funds are not lagged. So, the full effect of the market performance in the fourth quarter is reflected in our hedge fund performance and, therefore, our overall alternatives performance. And if you look at the performance vis-à-vis our long-term expectations, the vast majority of that would be attributable to that hedge fund performance in the quarter. There were small pieces from other components, but I would say, again, the vast majority of it was related to the hedge funds.

Hedge funds are about 25% or so of the overall alternatives portfolio, Humphrey. And if you look at the performance in the quarter, just helpful to put some context around that, the performance in the quarter for our hedge fund portfolio overall was down around 2.5%. I would compare that to the overall market being down 14%, both the S&P and the MSCI World Index. If you look over a little longer timeframe, look at the full fiscal year, our hedge funds actually had positive performance for the year. They're up about 0.5% or so. And again, contrasting that to the S&P, which was down around 6% for the year, and the MSCI World Index, which was down over 10% for the year, I think it speaks to the diversification and quality of the hedge fund performance that we have and the portfolio that we've got.

It's a well diversified portfolio. We're in about 40 or so different funds and it's diversified by strategy, and its sources of alpha, including things like the asset class, its geography, sector and time horizons. Bigger picture, if you look at our alternatives performance, I think it's also helpful to keep in mind that that performance, over a longer time, has actually been quite strong. So if we go back to the inception of the program, which was back in the fourth quarter of 2012, and you look at that performance versus our long-term expectations, we've actually exceeded it by around \$550 million or about 20% of the total returns over that period of time. So again, it speaks to the discipline that we have around the management of that alternatives portfolio.

With respect to the first quarter of 2019 and PEs, as you sort of specifically asked, most of our PE funds are lagged and they're also about 25% of the overall alternatives portfolio. And our private equity, or PE, has some positive correlations with the market, but it's less direct than what you would see in the hedge funds, because it's influenced by things like realizations and there were a number of those in the fourth quarter. And also, a number of the hedge – of the private equity funds are mark-to-model versus mark-to-market, and you come up with different results as a result of that as well.

So, more broadly, if we look at the performance over the long term, we have the statistics that I mentioned before, and we think that that's the appropriate emphasis of this as opposed to kind of looking at a quarter-by-quarter kind of analysis. If I can just sort of head off a follow-on question, which I know is coming either from you or from some quarter or another, let me just sort of hit it, because I think as you're talking about the outlook for the first quarter on alternatives, there's sort of the broader issue of the 2019 outlook versus the guidance that we provided.

As you know, we don't provide forward-looking statements in the context of guidance, but I can make some observations about our current conditions. First, fundamentals, as you heard in our opening remarks for the fourth quarter, are actually quite strong across our businesses and they're demonstrating good momentum as we head into 2019. And adjusting for the impact of the December market decline, our fourth quarter financial results actually reflect that very strong performance.

With respect to the markets, we've provided the assumptions that underlie our guidance in our guidance deck that we went through at the end of last year. And while the markets swooned in December, the current levels are actually pretty consistent with the assumptions that underlie the guidance that we provided. So, I'll then leave you and others to draw your own conclusions from those observations, but I thought that that might be helpful additional context.

Humphrey Hung Fai Lee

Analyst, Dowling & Partners Securities LLC



Definitely appreciate the color and I definitely agree that the fundamentals in the fourth quarter, the underlying trend seems to be strong despite the market impact. But thank you.

Operator: And we do have a question from the line of Nigel Dally with Morgan Stanley. Please go ahead.

Nigel P. Dally

Analyst, Morgan Stanley & Co. LLC



Great. Thanks. Good morning. Broader question on the investment portfolio, can you discuss your views as to where we are within the credit cycle and what repositioning you're looking at making, in light of escalating concern about a turn in the cycle. Also, in light of that, just given the performance metrics that you highlighted for your non-coupon, would it be fair to say that they're performing as you originally intended? If so, you're not looking to change any of your allocation to hedge funds looking forward?

Robert Michael Falzon

Vice Chairman, Prudential Financial, Inc.



Nigel, its Rob again. So, let me take the second part of your question first, which is, yes, our performance is consistent with expectations given where we are in the cycle and our discipline around that portfolio construction is consistent, and we're not looking to make any significant changes in that, either with regard to sort of the ultimate size of the portfolio or the component parts of the portfolio and the relevant weightings that we have in there. Obviously, there is variability quarter-to-quarter or year-to-year depending on draw-downs that we get particularly from private equity and then real estate, but largely no strategic changes in that.

With respect to your first point in terms of the portfolio and positioning for the credit cycle, I'll start with two points. One, portfolio is really well diversified and we manage it within credit limit exposures for things like individual names, sectors, asset types and credit ratings. So, a lot of discipline around making sure that the diversification goes deep into the portfolio.

Second, the positioning of the portfolio for downturn is actually not new for us. We started this over the last year or two. And as we've gotten further into the cycle, we've been further taking risk off the table. Couple of example of that. First, we've been diversifying our corporate exposure, particularly in longer durations. So, I think, as we've noted multiple times in the past, we hold a larger-than-typical portfolio of government bonds, it's about 36% of the general account and almost half of our fixed maturities.

We've been adding to munis in lieu of corporates and we've been rotating out of bonds that have been at risk of credit migration ahead of the downgrades. And as we've also noted before, we're [ph] underweighted (00:31:48) in energy, finance and telecom and we're [ph] overweighted (00:31:51) in consumer, noncyclical, utilities and transportation.

We've also been selling our high-yield public exposure and shortening the duration of that portfolio. And where we've had appetite, we've been replacing it with privates, which now account for about 60% of our below-investment-grade portfolio and about 16% of our overall privates portfolio. Our history experience with our privates in below-investment-grade and actually in investment-grade as well is that they have significantly lower defaults and higher recoveries. Combination of that leads to loss experience, which is substantially in excess of the benchmarks on a credit quality equivalent basis that we find in the public marketplace. In aggregate, our below-investment-grade portfolio is only about 4% of the general account.

Our commercial mortgages are underweight, multifamily and industrial – I'm sorry, overweight in multifamily and industrial, and we've underweighted the more cyclically sensitive property types, like office and retail. And like our private placements, it's directly originated. So, it's a very high-quality portfolio with structural protections built into it by virtue of that direct private origination. And as Ken noted in his opening remarks and you see in the exhibit to our deck with regard to our structured investments, and particularly CLOs, we're focused on the highest-quality tranches with significant structural enhancement in those investments.

I think the broader point is that portfolio management is one of our core strengths. The portfolio is defensively positioned, as I just articulated. It's managed to the concentration limits that I spoke to. And we're also very disciplined around ALM, asset liability matching, which is sort of key to this as well.

We've highlighted in the past different issues that have come up. So, we talked about asset leverage during our guidance call and we provided an exhibit on that. And what we showed is that properly adjusted, our asset leverage is actually very comparable to our peers, and more importantly, our credit leverage is actually at the very low end of the range of our peers. And in this deck, as I just noted, we've included something on CLOs, and you can see that our exposure is entirely comprised not just of NAIC 1, but of AAA tranches, so even more high quality within the range of NAIC 1 that are well underwritten and benefit from significant subordination levels.

And then, I guess, the thing that's come up more recently that we haven't actually spoken to, so I'll take the opportunity to do it, is we're seeing some research around credit impairment history. Our own experience on that has been well below our benchmarks. It's below what we've been embedding in our pricing. And all of that includes our experience of the financial crisis, including the experience that we and others went through with subprime. If we replicate our portfolio for the calculation that's being produced out there, and that calculation is looking at after-tax impairments, and we've assumed that those impairments also include credit loss sales and comparing that to average total investment assets for the period from – I think the statistics that are out there, from January of 2008 through September of 2018. Our actual losses, excluding the closed block, are 0.73%, so 73 basis points in aggregate across that period.

If we roll that forward to the end of the year, it only moves by 2 basis points or 3 basis points. So again, I think what you would find is that's at the very low end of the performance of our peers or very high end, from a performance standpoint, low end from a loss standpoint.

None of this is to imply that we will be immune to our credit cycle, but we would expect, consistent with our historical experience through prior cycles, to weather it well. That's due to the defensive posturing of the portfolio, as I've gone through, and the investment advantages we derive from PGIM that Charlie spoke about in his opening remarks, specifically its ability to directly originate privates, which are now 11% of the general account and actually almost a third of our corporates, and its ability to originate mortgages that I spoke to before, as well as its strong track record of investment performance in publics. And that's evidenced by the size of our operation and by 16 consecutive years of positive third-party institutional flows coming into it.

And due to the broader financial strength we have, as in the last cycle, we would expect to have the flexibility to be opportunistic in taking advantage of the more attractive investment environment and the more attractive acquisition environment that typically accompanies those sorts of downturns.

So with that, I hopefully fully answered your question.

Nigel P. Dally

Analyst, Morgan Stanley & Co. LLC

Q

Absolutely. Thank you. My second question was just on the escalation of a competition in the bank channel in Japan. Just wondering whether that's new entrants or is that existing players in the marketplace? Get a little more color as to what's going on there.

Scott Garrett Sleyster

COO & Executive VP-International Business, Prudential Financial, Inc.

A

Hi. This is Scott, Nigel. I would say a couple of things about that. No, I don't think it's necessarily new entrants to the market, but it is new product offerings that they may be bringing to market, in particular, a number of people have been bringing in single premium and recurring premium to that marketplace.

I think, perhaps, on a broader basis, I should say, talk about our approach to the bank channel, out of all of the channels that we have in Japan, it really is the more opportunistic. Our core Life Planner and Life Consultant models are really needs-based selling channels. They're very much focused on protection-based life insurance. When you move into the bank channel, that's traditionally the most competitive. Various participants will come in throughout the cycle with aggressive pricing for one reason or another for various objectives that they might be achieving.

Our model, I think, is highly disciplined. We're traditionally still selling protection insurance. We've got a lot of pricing discipline. And as we stick to that, we would expect to see quarter-to-quarter volatility in that channel.

Nigel P. Dally

Analyst, Morgan Stanley & Co. LLC

Q

That's great. Thank you.

Operator: And we do have a question from the line of John Nadel with UBS. Please go ahead.

John Nadel

Analyst, UBS Securities LLC

Q

Hey. Good morning. Just a question on pension risk transfer for the year. Could you just tell us what the net flows, specifically for PRT, were? I think you mentioned [ph] \$16 billion (00:38:29) of gross sales.

Stephen P. Pelletier

Executive Vice President and Chief Operating Officer, U.S. Businesses, Prudential Financial, Inc.

A

John, this is Steve. Our annual run-off on PRT is consistent with what we've communicated before, which is about \$4 billion total...

John Nadel

Analyst, UBS Securities LLC

Q

Got you.

Stephen P. Pelletier

Executive Vice President and Chief Operating Officer, U.S. Businesses, Prudential Financial, Inc.

A

\$3 billion on the funded side and \$1 billion on the longevity risk transfer side. So, that gets you to the flows. I would say that in terms of looking at the year that we're in now, we still see a very, very robust pipeline. I'm sure that some people may be thinking that the market volatility in the fourth quarter and what that did to funding levels in the aggregate across all pension funds may have an impact. And I would just point out that while that observation about some pullback in funding levels in the aggregate is true, virtually, all the companies in the visible pipeline; first of all, are fully funded; and second of all, have taken steps to hedge their risk and to mitigate any capital markets impact.

So, we still see a very robust pipeline. We are still very confident in our ability to transact within the pipeline. I think that's borne out by our fourth quarter experience where we had very strong flows of \$7.5 billion in PRT total, \$5.5 billion funded and the other longevity risk transfer.

And I would also say that we see an opportunity given the strength and given the kind of configuration of the pipeline for this year's experience to possibly be less back-loaded than the past several years have been.

John Nadel

Analyst, UBS Securities LLC

Q

[ph] Interesting (00:40:34). Okay. Thank you. And then, just a question for, I guess, Rob or Ken, just specific to the fourth quarter results, could you just quantify for us how much was the seasonally higher expenses up relative to the average of the first three quarters? And then how much was offsetting that in the form of lower compensation-related expenses driven by your share price and the market decline, I think, that runs through corporate?

Kenneth Yutaka Tanji

Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

A

Yeah. Hey, John, it's Ken, yeah, we had given guidance that typically our fourth quarter expenses are seasonally higher and range from about \$125 million to \$175 million. And we thought they would come in at the high end of that range and they did, and about half of that occurred in corporate.

And then, in terms of the impact of our compensation expense from our long term and deferred comp plans that are either linked to our share price or other market indexes, that had a benefit of about \$90 million in the quarter and about \$70 million of that was in corporate and other.

John Nadel

Analyst, UBS Securities LLC

Q

Terrific, very helpful, thanks.

Operator: And we do have a question from the line of Ryan Krueger with KBW. Please go ahead.

Ryan Krueger

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Hi, thanks. Good morning. I guess, ahead of the statutory statements being filed, I wanted to get your perspective on what your target RBC ratio will be, I guess, going forward versus the historical 400% post-tax reform?

Kenneth Yutaka Tanji

Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

A

Yeah. So Ryan, it's Ken. We did adjust our RBC target and we provided that with our guidance for 2019. And just a little bit of reminder that with tax reform, we have a lower tax rate and that improves our earnings today and in the future and strengthens the value of our deferred profits that reside in our reserve. So overall, the impact of tax reform is positive for us. It does lead to higher regulatory capital requirements. And so when we put that all together, our improved financial strength, along with higher regulatory capital requirements, we did think an adjustment to our RBC ratio to [ph] 3.75 (00:43:04) was – made a lot of sense, and we've done that. And we would expect to – and we'll file our statutory financials at the end of the month and we would expect our RBC ratio for PICA to be of above our objective.

Ryan Krueger

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Thanks. And then on PGIM, I don't know if you can give us any perspective on January flows, if you've seen a rebound relative to the fourth quarter.

Stephen P. Pelletier

Executive Vice President and Chief Operating Officer, U.S. Businesses, Prudential Financial, Inc.

A

Ryan, this is Steve. Without commenting on results in the given month, I would just say that we entered the year with a strong sense of confidence about our ability to continue to generate flows, as Rob touched upon. We operate across a range of the asset classes, equity, public and private fixed income, real estate, and the mortgages and other sources of alternatives. So, we will feel – and also based on our strong investment performance, we feel very confident in our ability to generate flows this year.

Ryan Krueger

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Thank you.

Operator: And we do have a question from the line of Alex Scott with Goldman Sachs. Please go ahead.

Alex Scott

Analyst, Goldman Sachs & Co. LLC

Q

Hi. Thanks for taking the question. The first one I had was just on the comments made earlier on the call around being well positioned for potential M&A opportunities. I mean, the holding community cash is quite strong. It sounds like you're probably above your RBC target. So, that all makes sense. I'd just be interested on any color you'd have on what kind of M&A opportunities you'd be interested in. I mean, is it things that would target building out distribution and increasing volume growth? Would it be about expanding geographically further or maybe [ph] some of them is (00:45:05) cost synergies? I mean, where would your focus be?

Charlie F. Lowrey

Chief Executive Officer, Prudential Financial, Inc.

A

Sure. This is Charlie. Let me take a step back, if I may, and just talk about the stages of development of the company. And this will put your question into perspective and we'll answer it along the way. But I characterize our development over the course of the past 20 years as having kind of four stages. And the first is the elimination of the financial supermarket, and we spent a couple of decades clearing out the underbrush, if you will. And during that process, we sold about 40 businesses for about \$10 billion. And we discontinued several others. And we still are critically examining our businesses. So in the past number of years, we've sold the Wealth Management Services business, Retail Real Estate, Global Commodities and, most recently, our Insurance business in Poland.

So, we've honed our business lines down to three specific areas, right. Protection, Asset Management and Retirement, that's what we're focused on, which brings us to the second stage, which is in each of those businesses we wanted to build world-class businesses, right. So, we focused on the performance of each of those individual businesses and increased over time the ROE significantly of each business. We made about \$16 billion of acquisitions to augment the businesses we had, both domestically and internationally.

And we'll continue to look for acquisitions as we go forward to augment these three lines of businesses, whether that's internationally or domestically. We were also opportunistic in acquiring talent during this period, especially during the Great Recession, both in terms of individuals and lift-outs of teams and we continue to do that as we go forward.

So then the third stage is once we had developed those businesses and they were at scale, we considered the diversification benefits of operational efficiencies between the different businesses. This can be capital diversification, of which there is a great deal. It can be mortality or longevity balance, and as Steve talked about, we have a very, very good pipeline of longevity business. We're glad to have our insurance businesses because that can balance the longevity, which allows us to do the PRT business we do. And then, we focus on efficiencies such as shared services between the businesses that create better customer experience and also cost savings.

So, we consider ideas that make us far more efficient in terms of operations and in terms of the use of capital by our businesses and the deployment of our capital to our stakeholders. And you've seen that through the increase in buybacks and dividend increases.

And that really leaves the fourth stage, and that's the one we're in now, where we're fully integrating the entire business system to expand significantly our addressable market by completely focusing on our customer needs and reaching more of those customers through fully integrated workplace and digital channels. Hence, our focus on an increased discussion about financial wellness, which stems from our belief that we're uniquely positioned with our set of complementary businesses to solve the changing needs of our clients as they consider insurance, savings and retirement.

But to integrate the services we provide by combining elements from different businesses requires what I call real and selfless teamwork, which gets to the core of the success of this company, which is its culture. And it's our culture that enables us to work across businesses to provide relevant and timely solutions to our clients' most pressing financial needs and also to the communities in which we work, which is such an important part of who we are; in other words, giving back. So, it's this fourth stage that we are in and beginning to communicate to you about. And given that this is – we're in this fourth stage, the kind of acquisitions we look at would be ones that would augment these three lines of business, either by bringing additional capabilities to those businesses or additional distribution over time.

Internationally, you've seen us grow in South East Asia, in Latin America, in Africa, higher growth markets to balance off our presence in Northern Asia. And in the U.S., you would see us continue to consider transactions that would either, again, increase distribution or increase our capabilities in certain areas related to the U.S. Financial Wellness program.

Alex Scott

Analyst, Goldman Sachs & Co. LLC

All right. Thanks for that.

Q

Operator: And we do have a question from the line of John Barnidge with Sandler O'Neill. Please go ahead.

John Bakewell Barnidge

Analyst, Sandler O'Neill & Partners LP

Q

Thanks. Most of my questions have been answered, but maybe how has market volatility and the government shutdown changed the nature of conversations for your Workplace Solutions business over the last, call it, six weeks to a quarter? Thank you.

Stephen P. Pelletier

Executive Vice President and Chief Operating Officer, U.S. Businesses, Prudential Financial, Inc.

A

John, it's Steve. I'll answer your question. We do not see a significant impact of market volatility and the government shutdown, as you mentioned, in the group benefits business. Our engagement with corporate clients on that front continues to be very much around the strength of our value proposition and, in particular, the Financial Wellness value proposition.

On the Retirement side, the other part of Workplace Solutions, I would not that there has been a particular impact either, except to say that for those companies that are well-funded and that are well-positioned, from an ALM standpoint, and hedging their risk as it relates to capital markets movements, those – frankly, the movements are a reminder that the time to transact may be here and to take risk off the table in terms of any further capital markets movements.

I would say that overall, though, the real engagement on the Full Service retirement front and on the Group Insurance front has been around the strength of our Financial Wellness proposition. Rob mentioned some of the numbers. \$100 million of annualized group premium that stems directly from our Financial Wellness proposition and now \$9 billion – previously, the number we were citing to you last years was \$6 billion, now \$9 billion of Full Service sales directly attributed to the strength of that proposition. This is very much as we anticipated. As we developed this Financial Wellness strategy, we anticipated that the impact of it, in terms of our results, would first be visible at the top of the funnel, if you will, at our work, at the employer level with companies in their provision of retirement plans and benefit packages.

As we continue to develop the customer engagement funnel, we are seeing very, very strong levels of engagement with that value proposition. It's interesting if you compare our experience, for example, to a lot of the startups that have entered the space. Our customer engagement levels and our client acquisition costs are a fraction of some of those startups. And frankly, client acquisition costs are the issues that a lot of those startups run into. And the reason is that the people we're seeking to engage know that they're already doing business with Prudential. They're already part of a retirement plan or a group benefits plan that is administered by Prudential. So, we're confident that the engagement levels that we're seeing will lead to greater revenues from our engagement with individuals and are providing them the solutions that address their financial needs.

In fact, we're already seeing some flow of retail revenues. It's just the beginning of that process, but we're already somewhat ahead of where we thought we'd be at this point. So, all in all, we're feeling very, very strong about the ability to advance the Financial Wellness proposition and to differentiate ourselves in the market based on that proposition.

John Bakewell Barnidge

Analyst, Sandler O'Neill & Partners LP

Q

Thanks a lot for the answers.

Operator: And we do have a question from the line of Erik Bass with Autonomous Research. Please go ahead.

Erik James Bass

Analyst, Autonomous Research US LP

Q

Hi. Thank you. Can you provide some more detail on your variable annuity hedging performance this quarter and, in particular, in December?

Kenneth Yutaka Tanji

Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

A

Yeah. Hi, Erik. It's Ken. We were quite happy with our hedging programs, particularly and overall. They performed very well. Our variable annuity living benefit hedge program gained \$3 billion in value during the quarter, most of that in December, with a hedge effectiveness of 98%. And we also have a capital hedge program that was also very effective at offsetting the overall increase in our net GAAP liabilities due to equity markets. And that's reported in our non-operating earnings and that gained over \$600 million in value and more than offset the overall increase in our net GAAP liabilities due to equity markets. So, we thought our hedge programs did a solid job at protecting our balance sheet and capital position. And we think it demonstrates the resilience of our financial profile amidst difficult markets.

Erik James Bass

Analyst, Autonomous Research US LP

Q

Thank you. And you've highlighted the consistent cash flows from your annuity business, which I think, for the year, were above 60% of operating earnings. As your sales growth picks up there, will that cash flow ratio come down or is the bigger impact the run-off of the older block of policies that you're seeing?

Kenneth Yutaka Tanji

Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

A

Yeah. So, our capital position in annuities is very solid. We've designed our hedging program and our capital framework to withstand market moves. And as I mentioned, the hedging program perform quite well. We hold a capital in excess of our own standard and regulatory standards, and that enables cash flow to continue. You cited 60% that would, I think, be more on a pre-tax basis. We think of it more on an after-tax basis and it would be more like 80%. And it was \$1.2 billion for the year.

That's reflective of the solid fee stream that we have coming from that business that is both well-hedged and well-capitalized and profitable, and we find that attractive. If we are able to pick up sales in more profitable business and earn the returns that we target that we would think that would be a good use of capital and we would deploy capital towards that.

Erik James Bass

Analyst, Autonomous Research US LP

Q

Thank you.

Operator: And now, for closing remarks, I'll turn it back over to Charlie Lowrey, please go ahead.

Charlie F. Lowrey

Chief Executive Officer, Prudential Financial, Inc.

Thank you. Let me add just a few final thoughts. We feel really positive about how we can continue to make a meaningful difference in our customers' financial lives and deliver long-term value. By leveraging our capabilities across businesses, deploying technology and continuing to innovate, we can grow and expand our market, meaning that there are a variety of ways in which we can reach more customers and do more to help them achieve financial security and peace of mind.

We have the scale to invest for the long term and a rock solid balance sheet to provide our customers with comfort and knowledge of and confidence in our stability throughout the market cycles. With thoughtful strategies and high-quality execution by our talented employees, we deliver sustainable value for our customers, for the communities in which we operate and for our stakeholders.

Thank you for your interest in Prudential and for joining the call today. Have a good day.

Operator: And ladies and gentlemen, that does conclude your conference for today. Thank you for your participation and for using the AT&T Executive TeleConference Service. You may now disconnect.

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