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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 2018 Financial Outlook Conference Call. At this time, all lines are in a listen-only mode. Later we will conduct the question-and-answer session. Instructions will be given to you at that time. [Operator Instructions] And as a reminder, today's conference call is being recorded.

I would now like to turn the conference over to Mark Finkelstein. Please go ahead.

Alan Mark Finkelstein
Senior Vice President & Head-Investor Relations, Prudential Financial, Inc.

Thank you, Cynthia. Good morning and thank you for joining our 2018 financial outlook conference call. Please find our presentation for today's call on our website at www.investor.prudential.com.

Representing Prudential on today's call are John Strangfeld, CEO; Mark Grier, Vice Chairman; Charlie Lowrey, Head of International Businesses; Steve Pelletier, Head of Domestic Businesses; Rob Falzon, Chief Financial Officer; and Rob Axel, Principal Accounting Officer. We will start with prepared comments by John and Rob, and then we will answer your questions.

Today's presentation includes forward-looking statements. It is possible that actual results may differ materially from the predictions we make today. In addition, this presentation includes references to non-GAAP measures.

The slide deck includes 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.

And with that, I will hand it over to John.

John Robert Strangfeld

Chairman & Chief Executive Officer, Prudential Financial, Inc.

Thank you, Mark. Hello everyone. I'd like to welcome you to our 2018 financial outlook call. Before Rob takes you through the specifics, I want to provide some higher level observations. The key message is that we continue to believe that our differentiated business mix will produce steady growth and earnings and book value per share, strong cash flows and a sustainable high return on equity. There are clearly challenges, including the sustained low interest rate environment. However, we benefit from our complementary mix of Protection, Retirement and Investment Management businesses that are well-positioned to thrive even in the face of these challenges.

What gives us confidence looking forward is the success we have shown over time connecting strategy, innovation and execution to create differentiated financial outcomes. Examples include our unique International franchise, which has shown good growth and strong returns despite the economic and interest rate challenges in Japan; our Investment Management business, which has shown more than a decade of consecutive positive net flows in both our institutional and retail channels; and our Retirement business, which has produced exceptional results led by our innovative Pension Risk Transfer business.

Additionally, we remain excited about our financial wellness strategy, an initiative to connect with consumers in different ways, including through technology-enabled means. We believe these initiatives will accelerate our domestic growth rate. And while the impact will be seen over the longer-term, we are uniquely positioned to succeed given the strength of our Prudential Advisors distribution force, our broad product offering and our focus on the more than 20 million individuals we serve in our U.S. business.

Turning to capital generation and deployment. We have increased our expectation of the average level of free cash flow we generate as a ratio to earnings from 60% to 65% over time. This is the result of a higher level of cash generation across many of our businesses. Our increased cash flow, together with our robust capital position, has led our board to authorize an increase in our share repurchase program for 2018 to $1.5 billion. In addition, we anticipate that our quarterly dividend in 2018 will reflect this higher level of free cash flow.

Since the beginning of 2011, we've returned nearly $14 billion to shareholders in the form of dividends and share repurchases. Overall, we feel very good about the positioning of our businesses and our prospects to continue to generate strong value for our shareholders. And whilst uncertainties remain, whether economic, regulatory or tax policy, we are well-positioned to navigate them.

Turning to slide 3, this slide shows our return on equity since 2012. Recall that last year we lowered our near-to-intermediate term ROE expectation to 12% to 13% due to the multi-year impact of low interest rates, and to a lesser extent, initiative spending focused on producing longer-term growth. On a trailing 12-month basis, we have exceeded that ROE objective. This reflects favorable underwriting, market and investment performances compared to our average expectations as well as other positive factors.

Looking forward, we continue to expect to achieve a 12% to 13% ROE over the near-to-intermediate term. I would add that we expect to be able to achieve this ROE objective despite making certain positive one-time adjustments to our adjusted book value, which will increase the denominator in the ROE calculation and Rob will talk to this in a moment.

To sum up, we benefit from a differentiated return profile. This provides strong cash flow and opportunities to return considerable amounts of capital to our shareholders, while also enabling us to invest in our operation to continue to produce favorable outcomes over the longer-time horizons.

With that, I'll hand it over to Rob.

Robert Michael Falzon

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

Thank you, John. I will walk through a series of key business and other considerations and the principal assumptions underlying our outlook and 2018 earnings per share guidance. Before I begin, let me highlight that effective in the fourth quarter of 2017, our business segments are organized consistent with the new U.S. business structure we announced back in July.

This structure reflects our focus on leveraging our mix of businesses and our digital and customer engagement capabilities to expand our value proposition for the benefit of customers and stakeholders. The new organizational structure retains our existing segments, but realigns them under new divisions. Therefore, as you think about your financial models, there will be no changes to our reporting segments or to our measure of segment profitability. Rather, it just affects how these segments roll up into divisions.

So, I'll start now with the key business considerations and sensitivities on slides 4 and 5, beginning with the U.S. Workplace Solutions division. In Retirement, we remain optimistic about our opportunities for long-term growth.

Notably, our differentiated capabilities and demonstrated execution in our Pension Risk Transfer business will continue to generate attractive growth opportunities that are expected to exceed the $4 billion of combined, funded, and longevity-only business that is expected to run off in 2018. However, as we have said on numerous occasions, growth will not be linear given the episodic nature of larger cases, which is the segment of the market where we are most competitive and where the returns are most compelling.

In addition, embedded in guidance is the continuation of the spread and fee compression that we have been experiencing in our Full Service business and which will moderate the growth we expect to experience in other parts of Retirement.

In Group Insurance, we're focused on expanding our Premier market segment, while maintaining a leadership position in the National segment and deepening our customer relationships through our Financial Wellness platform.

We are benefiting from our multi-year underwriting efforts, especially in Disability where improved claims management and our continued pricing discipline have resulted in improvements to our benefits ratio. And as a result, we have lowered our benefits ratio target for the combined Group, Life and Disability business to a range of 86% to 90%, reflecting a 1% decrease on both the low- and the high-end of that range.

Turning to our U.S. Individual Solutions division. In the Individual Annuities business, we expect continued strong results with margins for 2018 above our long-term targeted return on assets or ROA of about 115 basis points. In addition, we expect our free cash flow to be high given the stability in our block and the challenged industry-wide sales environment.

On ROAs, as we have discussed on recent earnings calls, we have been enhancing our risk management strategy to optimize the mix of derivatives and cash instruments. This will cause some downward pressure on ROAs over time, but is expected to produce less volatile net income and cash flows, particularly in adverse scenarios.

Further, there is some natural fee rate reduction as the block matures and we would also expect our recent favorable hedging outcomes to normalize over time. Hence, in 2018, we expect to exceed our long-term ROA target of about 115 basis points, but expect the combined impact of hedging costs, contractual fee reductions and more normal hedging outcomes to cause our ROA to migrate to this level over a multi-year period of time.

On sales, we continue to execute on our product diversification strategy and focus on a broad range of outcome-oriented solutions for customers. Though over the near-term, we expect the challenged industry sales environment to persist, and given a more muted equity growth assumption than in prior years, we expect a slight decline in account values.

In Individual Life, we continue to execute on our diversified product strategy and deepen our relationships with distribution partners while developing a more customer-oriented experience. Product actions over the last several months could result in a slightly higher tilt towards term and variable Life sales over the next several quarters. However, we continue to emphasize a diversified product offering.

In Investment Management, we expect to complete our 15th consecutive year of positive institutional net flows and 13th consecutive year of positive retail net flows. As we look to 2018, we continue to see good prospects for growth in AUM and expect stable fields driven by payoffs from investments and products, distribution and our multi-manager model.

In International Insurance, we continue to focus on death protection products with returns largely driven by mortality and expense margins which help mitigate exposure to interest rates. Further, we have also seen a shift in our sales mix with a greater emphasis on U.S. dollar-denominated products in Japan. We expect this trend to continue. We're also focused on achieving scale in select growth markets outside of Japan.

In terms of distribution, we continue to target low-single digit growth of our Life Planner account in Japan. However, we do expect a decline in Gibraltar Life Consultants as we continue to focus on increasing quality and productivity standards.

Turning to slide 6. Here are some of the key assumptions and considerations that underpin our guidance for 2018. Our guidance assumes that the S&P 500 ends 2017 at about 2,600, appreciates by 3% during the year and ends 2018 at 2,675. Our 3% equity growth assumption is lower than what we have previously assumed, but it is consistent with the actuarial assumptions embedded in certain of our internal models.

In our International Insurance business, the yen and Korean won earnings are fully hedged for 2018 at ¥111 per dollar and at KRW 1,150 per dollar.

We base our interest rate assumptions on an average of recent forward yield curves. As a benchmark, we assume a 10-year Treasury rate of 2.4% at the end of 2018.

Our 2018 returns on non-coupon investments are expected to be in line with our long-term expected average of 5% to 6%.

On taxes, which I know is a hot topic – this guidance includes an effective tax rate of approximately 26%. Given the uncertainties with tax reform, we didn't factor the potential impacts into our 2018 expectations. When we have more clarity on what the tax reform package will look like, we plan to provide you with an update on its impact to our tax assumptions.

I also want to highlight two adjustments that we will be making to the balance sheet at the beginning of 2018, which will have a positive impact on equity excluding other comprehensive income. The first is the implementation of an accounting standard which will result in certain equity investments being measured at fair value with the changes in value recognized in net income. As we implement this accounting standard effective January 1, we will reclassify the remaining unrealized gains on equity investments from other comprehensive income to retained earnings, resulting in an increase in our adjusted book value.

Based on where we are today, implementation of this accounting standard is expected to increase our adjusted book value by about $900 million from the third quarter of 2017. In addition, beginning in 2018, we plan to eliminate the one-month reporting lag of our Gibraltar operations which is also expected to increase our book value, however, to a much lesser extent.

You should note that this will not result in an extra month of Gibraltar earnings in our 2018 results. Instead, we will essentially be recording the adjustment to opening book value. Between these two adjustments, we currently estimate book value will benefit by roughly $1 billion. As John previously mentioned, this is a headwind to ROE. However, we are not changing our near- to intermediate-term ROE target of 12% to 13%.

On capital deployment, as also mentioned by John, our board has authorized a 20% increase in the share repurchase authorization for 2018, up to $1.5 billion. This authorization reflects our expectation of an increase in free cash flow which we expect to be about 65% of our after-tax adjusted operating income on average and over time, as well as our strong capital position and our high earnings. And finally, we continue to operate at AA financial strength standards, including leverage ratios that are within our targets.

Turning to slide 7. To level set, since we haven't reported fourth quarter earnings yet, this slide starts with the reported results for the trailing 12 months ended September 30, 2017 and removes the impact of market driven and discrete items as well as net favorable variances from our average expectations in the key areas we call out each quarter, such as mortality experience and non-couponed investment returns. We've also adjusted the earliest quarter, included the fourth quarter of 2016 for the change in currency plan rates as we moved into 2017 so that the entire baseline gives effect to the 2017 currency plan rates.

This leads to a pro forma baseline earnings level of about $10.55 per share. While this should not be viewed as a projection of our full-year 2017 results, we believe it provides a useful frame of reference for discussing our 2018 guidance.

Starting from this baseline, we take into account a net drag from market factors comprised of a few items. First, consistent with our guidance last year, we estimate that there will be a further negative impact from continued low interest rates of $0.25 to $0.30 per share in 2018, mainly driven by reinvestment rates on portfolio turnover and lower investment yields on recurring premiums.

The net impact from continued low interest rates is modestly offset by the impact of our assumed 3% depreciation in equity markets. In addition, we estimate a positive impact of about $0.02 per share from the change in foreign exchange rates, including the hedged rate for the yen, going from ¥112 to ¥111. Otherwise, we expect continued core growth in our businesses with the key considerations I reviewed earlier and we expect an incremental benefit from our $1.5 billion of authorized share repurchases.

Putting all of this together, our 2018 earnings guidance range for baseline adjusted operating income is $11.20 to $11.70 per share, which represents a 6% to 11% growth over our trailing 12-month baseline results.

On slide 8, we review sensitivities to key market factors. You can see the estimated impact on our earnings per share from a plus or minus 10% movement in the equity markets and a plus or minus 100-basis-point change in interest rates.

In each case, these shocks are viewed in isolation and applied at the beginning of 2018 on top of our existing market assumptions. As shown, a 10% move in equity markets translates to about $0.30 per share and a 100-basis-point change in interest rates, defined as a parallel shift in the yield curve, translates to about $0.25 per share.

I would like to caution that these sensitivities are not necessarily linear nor entirely symmetrical and should not be extrapolated over more severe shock levels in either direction. That said, we believe they, along with the business-level sensitivities contained in the earlier slides, provide a useful frame of reference for some of the key assumptions that affect our results.

To sum up, we believe that our business mix and solid fundamentals will continue to produce attractive financial results, driven by steady earnings and book value per share growth, increased free cash flows and attractive returns to shareholders.

Based on what we know today about the potential outcome of tax reform, there may be consequences to capital levels. However, we do not expect that these would impact our capital deployment plans or our ability to meet our AA financial strength targets, while remaining within our leverage target ratios.

Finally, I want to cover one other topic. We are considering an alternative approach to how we present guidance next year. Notably, we are considering providing more robust metrics at the business segment level in place of our consolidated annual earnings per share guidance. While we've made no final decisions, we wanted to provide you with an early notice to avoid any surprises if we ultimately go this route.

Now, I'll turn it back over to John.

John Robert Strangfeld

Chairman & Chief Executive Officer, Prudential Financial, Inc.

Thank you, Rob. So, we will now open it up for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] And our first question will come from the line of Jimmy Bhullar with JPMorgan. Your line is open.

Jamminder Singh Bhullar
Analyst, JPMorgan Securities LLC

Q

Hi. Thank you and good morning. I had a couple of questions. First on – I don't know if you were able to disclose the RBC impact if taxes go down. And you mentioned that you don't expect this to affect your capital deployment. Is it because you've got a cushion in capital to begin with or is it that you've had conversations with the rating agencies and regulators and you don't -that gives you comfort that they're not going to change their metrics on capital if the tax rate, in fact, does go down?

Robert Michael Falzon
Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

A

Okay. So Jimmy, it's Rob, let me respond to the capital question there. So, reform will have an impact but due to the strength of our balance sheet and our capital position, we can absorb these changes and remain within our solvency leverage and liquidity and shareholder distribution targets as they stand today. So we defined solvency in terms of RBC ratios at our current standards for AA, which are at 400% to RBC.

However, to the point of the question that you asked, we believe that tax reform should give rise to a revaluation of the appropriate AA standard for RBC. The larger positive impact on the after-tax margins that we have from tax reform relative to the impact on our equity on an after-tax basis means that on an overall basis, we're actually stronger post-tax reform.

And that actually shows up in our economic solvency metrics that we use in running the business. We actually show that post-tax reform, we're in a stronger capital position and we think that from an RBC standpoint, what's reflected in our economic models is the combination of both capital and margins.

And when you look at that on the RBC side, you have to look up at the margins that are in the reserves in order to capture that. We've begun to have a dialogue on this with both the rating agencies and with our regulators. We think people understand this but having said that, the statements that we've made are in the context of today's standards around those ratios.

Jamminder Singh Bhullar
Analyst, JPMorgan Securities LLC

Q

Okay. And then just on your equity and interest rate sensitivity, I noticed it seems like the equity and the interest rate impact is a little bit higher than it was, like $0.05 to $0.10 higher than it was last year. And I recognize that the earnings base is higher as well, but what are the drivers of the increased sensitivity?

Robert Michael Falzon
Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

A

So, Jimmy, the point that you made, we have a higher – our book is bigger and our earnings are larger; that's a driver. Secondly, as we have discussed in the past, we've been going through large transformations in our systems, and we're getting increasingly sophisticated in our ability to do modeling and sensitivity analytics, and that gives rise to our ability to be a little bit more precise around those impacts. And the combination of those things has led to the adjustment that we've provided.

Jamminder Singh Bhullar
Analyst, JPMorgan Securities LLC

Q

Okay. And then if I can just ask a quick one, your equity assumption is fairly conservative relative to what most companies use. How – what's your view on or what's embedded in your guidance on alternative investment returns in the various businesses?

Robert Michael Falzon
Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

A

So our alternative investments are assumed to be in the range of the 5% to 6% that we expect on a long-term basis and despite the fact that our assumption about equity markets are in fact more muted.

Jamminder Singh Bhullar
Analyst, JPMorgan Securities LLC

Q

Okay. Thank you.

Operator: Thank you. Our next question comes from the line of Suneet Kamath from Citi. Your line is open.

Suneet Kamath
Analyst, Citigroup Global Markets, Inc.

Q

Thanks. Good morning. I think, as of the third quarter, you had about $4 billion of holding company liquidity. I just want to get a sense of what your plans are for that cash and what a normal sort of target would be at the holding company?

Robert Michael Falzon
Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

A

So Suneet, Rob. Our target minimum cash level is $1.5 billion. And so we look to hold that under sort of all circumstances. We generally operate with a higher level of liquidity than that and the kind of ranges that you've seen us in the cash that would range between sort of $3.5 billion and $4 billion dollars I think are pretty typical of what you might see at any point in time.

Suneet Kamath
Analyst, Citigroup Global Markets, Inc.

Q

Okay. But that's not being earmarked for anything, that's just happens to be where you sit today and you'll reassess over time? Is that what you think about it?

Robert Michael Falzon
Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

A

Yeah. I mean, if you look at where our cash levels have been over the last several quarters, I think they've been as low – as low $3 billion. They've been as high as $4.5 billion and I think that's a range within which we would – we tend to vary and there's no specific earmark for how we would go about deploying that beyond the things that we've talked about in the form of our higher level of stock repurchases and then the dividend distributions that we make.

Suneet Kamath
Analyst, Citigroup Global Markets, Inc.
Q

Okay. Got it. And then in terms of the fourth quarter earnings, I know you're saying that the baseline doesn't include a forecast for the fourth quarter, but it's a little bit lower than maybe where we were thinking. Is there anything unusual other than the normal expense seasonality in the fourth quarter that you're building in for the baseline?

Robert Michael Falzon
Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.
A

So just to be very, very clear on this, Suneet, do not confuse our baseline with any prediction as to what might happen in the fourth quarter. It is solely an exercise of looking at a trailing 12-month basis. So there's no messaging embedded in that baseline number with respect to the upcoming fourth quarter.

With regard to your specific question, seasonality in the fourth quarter – we've given the number on that. That's $125 million to $175 million worth of higher level of spending relative to the average for the year and I think that that's a range that we believe will also be reflected in this year.

Suneet Kamath
Analyst, Citigroup Global Markets, Inc.
Q

Okay. Thanks.

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

Thomas Gallagher
Analyst, Evercore ISI
Q

Good morning. Rob, just to circle back, could you guys give an update on what the expected RBC impact would be in the event of tax reform – even a ballpark estimate?

Robert Michael Falzon
Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.
A

So Tom, I think the range that we would expect it – first of all, there are lots of moving pieces on this. We have some hesitation about giving out ranges, given – while there appears to be progress on tax reform and more transparency on that, it does get to be around understanding a lot of the details of that.

Having said that, a range of around 100 basis points impact to RBC at the PICA level, which is sort of the primary entity that you're going to look at, given that PALAC is managed as funny-looking RBCs I think as you're very much aware. If you think about PICA – think about it being in the order of magnitude of about 100 basis points. As I mentioned in my opening remarks, we would, post-tax reform, still operate at the 400 basis points or above even with that kind of an impact given how strong our starting balance sheet position is.

Thomas Gallagher
Analyst, Evercore ISI
Q

Got you. And then the 65% free cash flow guidance, is that the expectation for 2018? I know it says – it sounds a little vague whether that's this year or more into the future because if I sell for 65% for this year, that would imply I think a common dividend increase of over 20%. I just wanted to see if that applies to 2018?

Robert Michael Falzon
Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.
A

So we're not formulaic about how we do these things, Tom, and so we don't have a defined dividend payout ratio. And so I would caution you on the math that you just did. Having said that, what I would reaffirm is our 65% is on average over time but it's a number that we've been migrating up to and hence felt comfortable giving the guidance for this year.

John Robert Strangfeld
Chairman & Chief Executive Officer, Prudential Financial, Inc.
A

Yeah. Just remember that it moves around some – the cash flows vary and sometimes there's more and sometimes there's less. So, again to Rob's point, don't be quite so linear.

Thomas Gallagher
Analyst, Evercore ISI
Q

Got you. And then in terms of tax reform, I don't know if I'm thinking about this the right way, but on a GAAP basis, I think you guys have a net DTL of $10 billion and I'm assuming if we get tax reform, there would actually be a very sizable step-up in your GAAP book value, just netting out the DTA versus DTL. Is that the right way to think about it and would you expect there to be a big step-up in your GAAP book value?

Robert Michael Falzon
Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.
A

I'm not sure where you're getting your numbers from, Tom. I have, in the third quarter our DTL – GAAP DTL was about $2.6 billion. So if you took a 20% ratio, I calculated that. I haven't done the 21% that's currently sort of in play, that would be something more like around a $700 million increase to our book value.

Thomas Gallagher
Analyst, Evercore ISI
Q

Yeah. So it may have to do with the valuation allowance, but we – I can circle back with that. But the – and final question is just on the Individual Life mortality. I think there was a step-up in the standard deviation guidance on that? Now it's up to $80 million, I think, on the high-end in the one standard deviation event. Are you using less reinsurance or is that driven by the model change from this year?

Robert Michael Falzon
Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.
A

All of the above, Tom. So the book is larger. We are reinsuring less because we like the mortality risk and the returns we're getting on our mortality risk. And we've updated our models and gotten more sophisticated about our ability to do those sorts of calculations.

Thomas Gallagher
Analyst, Evercore ISI
Q

Okay. Thanks.

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

Erik Bass
Analyst, Autonomous Research

Q

Hi. Thank you. I guess one more question on tax. I'm realizing there's moving pieces, but can you give an estimate of what you would expect the impact to be on your GAAP tax rate?

Robert Michael Falzon
Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

A

I'm going to defer doing that for the time being, Erik. I think when we've been able to work that through, we'll come back to you and update everyone on what we think that impact will be. There are enough moving pieces in that that we don't think it's prudent at this point to be providing a number.

Erik Bass
Analyst, Autonomous Research

Q

Okay.

Robert Michael Falzon
Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

A

It will be lower, but we've got work to do to quantify how much lower.

Erik Bass
Analyst, Autonomous Research

Q

Got it. And on the Group business, you commented that you moved the Group's target benefit ratio down by 1%. Can you just talk about what you're seeing in the business that you see the confidence projecting the improved benefits ratio going forward?

Stephen P. Pelletier
Executive Vice President & Chief Operating Officer - U.S. Businesses, Prudential Financial, Inc.

A

Erik, it's Steve Pelletier. I'll address that question. As we've spoken about over the past several quarters, we're very pleased with the performance and the trajectory of the Group business. This is a reflection of efforts to improve our underwriting over the past several years and our claims management practices. And the results we've experienced, combined with our continued focus on diversifying our business mix and really strengthening the value proposition that we're advancing into the marketplace, all of that gives us comfort in reducing that target range slightly to 86% to 90%.

There will be normal quarterly variability in those results, but we do expect overall improvement as expressed in that ratio and that will be driven by a combination of controlled growth, well-priced growth, strong underwriting and organizational efficiencies.

Erik Bass
Analyst, Autonomous Research

Q

Great. Thank you.

Operator: Thank you. Our next question will come from the line of Ryan Krueger with KBW. Your line is open.

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

Q

Hi. Thanks. Good morning. I have one more question on tax. On the 100 points to the PICA/RBC ratio, did that include both the impact of the BCA as well as an assumption for a change in the factors in the denominator?

Robert Michael Falzon
Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

A

Ryan, it's Rob. Yes, it did. So it's sort of a holistic view of all the moving parts as we understand and as they're currently in play.

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

Q

Okay. Thanks. And then just a question on Investment Management. Can you talk about how you're thinking about margins as you go into next year and if you expect positive operating leverage in some of the investments you've been making in the business start trailing off a bit?

Stephen P. Pelletier
Executive Vice President & Chief Operating Officer - U.S. Businesses, Prudential Financial, Inc.

A

Ryan, it's Steve. I'll address that question. Yes, we've seen so far in 2017 the clearer evidence than ever of the investments that we've made in the business from a distribution standpoint and from an investment platform standpoint really starting to pay off. And we expect that to continue in the year to come. We noticed that Rob spoke about strong flows. I'd also point out the fact that as we've discussed over the past few quarters, a lot of those flows have been coming into the fixed income business, and especially to address your point about margins, that's a business where our margins, where our whole business platform is particularly scalable and the scale economics are particularly attractive and where we're able to operate at robust margin. So we think all of those factors will contribute to a promising margin picture for the asset management business.

On the fee basis, we've been able to withstand kind of secular pressure on fee levels through growth in higher-yielding fee strategies. That hasn't made us immune from that secular pressure, but it's helped us mitigate it. And the combination of that, plus an unattractive margin picture bodes well for the near-term future in that business.

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

Q

Okay. Great. Thanks a lot.

Operator: Thank you. We'll go to the line of Humphrey Lee with Dowling & Partners. Your line is open.

Humphrey Hung Fai Lee
Analyst, Dowling & Partners Securities LLC

Q

Good morning and thank you for taking my question. Just to follow on Investment Management in terms of the – on net flows. Can you talk about what the institutional pipeline that you're looking at right now and how does that compare to where you were last year, just kind of from a standpoint of modeling?

Robert Michael Falzon
Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

A

I would say, Humphrey that our flows picture remains quite promising. I'd say, compared to last year, we've seen even further progress in the flows that we're attracting from overseas markets, particularly Japan, but not limited to Japan. And that, plus still very strong prospects in our core U.S. institutional markets and our retail markets, feels that that makes us look with confidence to the prospect for flows in the business.

Obviously, what we've already been accomplishing with the 15 years or coming up onto 15 positive years of positive institutional net flows is a very positive picture. But given the institutional pipeline we're looking at, and in particular given the multi-asset class nature of our Investment Management business, and the fact that we have different cylinders that can fire at different times depending on what market conditions and investor demand may be at a given moment, all of that looks – makes us feel confident about the prospect for continuing that success.

Humphrey Hung Fai Lee
Analyst, Dowling & Partners Securities LLC

Q

That's helpful. And then shifting gears to Pension Risk Transfer, I think in your prepared remarks you talked about you expect will be – the pipeline will be more than offset the annual runoff that you would expect in any given year. But can you talk about similar – from a similar perspective, how's your pipeline looking right now compared to where you were last year at the same time?

Robert Michael Falzon
Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

A

Again, Humphrey, I would say the pipeline looks very solid. Funding levels generally in the marketplace have improved as interest rates have ticked up modestly, but ticked up and that improves funding levels.

Also, the fact that corporate treasurers and plan sponsor decision-makers don't seem to have an expectation that rates will run off rapidly from here, increases propensity to transact as well. So we see a strong demand in the marketplace across segments. We note that 2017, we saw growth in kind of the middle markets segment of transactions ranging from $500 million to $1 billion.

But an interesting point there even that segment of the market, a lot of the growth was driven by actually very large plan sponsors offloading a portion of their liabilities. Portions that are usually characterized by a large head count in terms of participants, but low value per participant for that part of the liability and they're looking to transfer that part of the liability in order to reduce costs.

Overall, administrative costs and the per capita portion of PBGC Premiums. The reason I'm making this point is that while we've seen growth in that market segment, that's still being done by large plan sponsors to whom our value proposition is very strong. Certainty of close, a very effective management of the overall transaction arc, and in particular, being able to provide a really world-class service to plan participants immediately upon transfer of the liability and the responsibility for providing that service and cutting the monthly checks.

Humphrey Hung Fai Lee
Analyst, Dowling & Partners Securities LLC

Q

Got it. And then so just kind of – [indiscernible] (37:16). So I think some of the industry participants talked about 2017 was a very good year for Pension Risk Transfer, definitely much better than the past couple of years. Do you envision 2018 would be an even better year than 2017?

Robert Michael Falzon
Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

A

We think 2018 will continue to see a progress in both the marketplace and in terms of our competitiveness in it for the reasons for the reasons I just outlined.

Humphrey Hung Fai Lee
Analyst, Dowling & Partners Securities LLC

Q

Got it. Thank you.

Operator: Thank you. We'll go to the line of Sean Dargan with Wells Fargo. Your line is open.

Sean Dargan
Analyst, Wells Fargo Securities LLC

Q

Yes. Thank you. Good morning. I'm just wondering if you could give us an update on the Financial Wellness initiative in terms of take rates and if that's going to be the driver in any top line growth in 2018?

Stephen P. Pelletier
Executive Vice President & Chief Operating Officer - U.S. Businesses, Prudential Financial, Inc.

A

Sean, this is Steve. The Financial Wellness value proposition – over time, we expect to drive growth in a number of different ways. First of all, there's simply the advancing a more differentiated value proposition into the marketplace at the employer level by our Group and by our Full Service, Retirement businesses – that we're seeing already. We are seeing a case wins that are directly attributable to our Financial Wellness capabilities and to the proof points that we're advancing into the marketplace around those capabilities.

As you know, a big part of the strategy is to deepen and individualize our relationships with the tens of millions of people who come to us via the workplace over time. That part of the revenue stream that we expect from Financial Wellness, from that Individual engagement – that will emerge over the longer timeframe. But we do see positive results already at the institutional or at the employer level and we look forward to that continuing.

As I mentioned, a lot of that has to do with the tangible proof points that we're already advancing into the marketplace. In particular, as we touched upon at Investor Day, the Prudential Pathways program, whereby we're looking to offer financial planning and financial education seminars to the employees of our Group and Retirement clients, that Prudential Pathways now covers companies with employees ranging up to the 3 million mark and that is something that again is a very tangible proof point to employers of our commitment to this value proposition and we're winning attractive business on the basis of those proof points.

Sean Dargan
Analyst, Wells Fargo Securities LLC

Q

All right. Thank you. And just a follow-up question on how to think about interest rates. I think, in the past, you said the 10-year yield was at 3.1%. We would stop seeing year-over-year spread compression or pressure on net investment income. Given where corporate spreads are now, is that still the way to think about it?

Robert Michael Falzon
Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

A

So Sean, it's yeah, if you think about the gap today between – this is simplistic and overly simplistic, but I think it's a helpful kind of way to think of that in a rule of thumb. If you look at where our portfolio yield is and you look at our new money rates, you're going to see there's a difference between that of somewhere around 65 basis points to 75 basis points, something like that. And so you would think that rates would generally – if rates rose to close that gap, interest rates would cease being a drag on our earnings growth and would allow us to then build back toward our 13% to 14%.

Sean Dargan
Analyst, Wells Fargo Securities LLC

Q

All right. Thank you.

Operator: Thank you. And with that, that does conclude our conference call for today. Thank you for your participation and you may now disconnect.