THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

BHF.OQ - Brighthouse Financial, Inc. - Special Call

EVENT DATE/TIME: DECEMBER 03, 2018 / 1:00PM GMT

OVERVIEW:

Co. provided an outlook update.

THOMSON REUTERS

CORPORATE PARTICIPANTS

Anant Bhalla *Brighthouse Financial, Inc. - Executive VP & CFO*

Conor Ernan Murphy *Brighthouse Financial, Inc. - Executive VP & COO*

David Rosenbaum *Brighthouse Financial, Inc. - Head of IR*

Eric Thomas Steigerwalt *Brighthouse Financial, Inc. - President, CEO & Director*

John Lloyd Rosenthal *Brighthouse Financial, Inc. - Executive VP & CIO*

Myles Joseph Lambert *Brighthouse Financial, Inc. - Executive VP and Chief Distribution & Marketing Officer*

CONFERENCE CALL PARTICIPANTS

Andrew Scott Kligerman *Crédit Suisse AG, Research Division - MD & Senior Life Insurance Analyst*

Elyse Beth Greenspan *Wells Fargo Securities, LLC, Research Division - VP and Senior Analyst*

Erik James Bass *Autonomous Research LLP - Partner of US Life Insurance*

Humphrey Lee *Dowling & Partners Securities, LLC - Research Analyst*

Jamminder Singh Bhullar *JP Morgan Chase & Co, Research Division - Senior Analyst*

John Matthew Nadel *UBS Investment Bank, Research Division - Analyst*

Ryan Joel Krueger *Keefe, Bruyette, & Woods, Inc., Research Division - MD of Equity Research*

Suneet Laxman L. Kamath *Citigroup Inc, Research Division - MD*

Taylor Alexander Scott *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Thomas George Gallagher *Evercore ISI Institutional Equities, Research Division - Senior MD*

PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to Brighthouse Financial's Outlook Conference Call. My name is Shannon, and I will be your coordinator today. (Operator Instructions) As a reminder, the conference is being recorded for replay purposes. (Operator Instructions)

I would now like to turn the presentation over to David Rosenbaum, Head of Investor Relations. Mr. Rosenbaum, you may proceed.

David Rosenbaum - *Brighthouse Financial, Inc. - Head of IR*

Thank you, operator. Good morning, and thank you for joining Brighthouse Financial's outlook conference call. Our presentation was released this morning and can be accessed on the Investor Relations section of our website at brighthousefinancial.com. We encourage you to review the presentation, and we will refer to it in our prepared remarks.

Today, you will hear from Eric Steigerwalt, our President and Chief Executive Officer; followed by Conor Murphy, our Chief Operating Officer; and Anant Bhalla, our Chief Financial Officer. Following our prepared remarks, we will open the call up for a question-and-answer period. Also, here with us today to participate in the discussion is John Rosenthal, Chief Investment Officer; and Myles Lambert, Chief Distribution and Marketing Officer.

Our discussion during this call will include forward-looking statements within the meaning of the federal securities laws and summarized on Slide 2 of our presentation. Information discussed on today's call speaks only as of today, December 3, 2018. The company undertakes no obligation to update any information discussed on today's call.

During this call, we will be discussing certain financial measures that are not based on generally accepted accounting principle, also known as non-GAAP measures. Reconciliations of these non-GAAP measures on a historical basis to the most directly comparable GAAP measures and related definitions may be found on the Investor Relations portion of our website. Reconciliations of these non-GAAP measures are not accessible on a forward-looking basis because we believe it is not possible without unreasonable efforts.

And now I will turn the call over to our CEO, Eric Steigerwalt.

Eric Thomas Steigerwalt - *Brighthouse Financial, Inc. - President, CEO & Director*

Thank you, David, and good morning. Thank you for joining us today for our first investor outlook call. Today, Conor and Anant and I will take you through the following: first, a company overview and business update; second, the assumptions and key drivers related to our financial outlook; next, the strength of our balance sheet and an update on variable annuity hedging; and finally, our financial outlook.

Let's begin on Slide 5. Brighthouse Financial became an independent publicly-traded company in August of 2017. However, we are not new. Brighthouse has a rich history that dates back to 1863. And today, we are one of the largest providers of annuities and life insurance in the United States. We are large by many measures, and as of the end of the third quarter of 2018, had $217 billion of assets. We have a well-established retail platform serving more than 2 million customers, and we distribute annuities and life insurance to individuals through over 400 independent distribution partners.

We have solid capitalization with statutory combined total adjusted capital of $6 billion and over $600 million of variable annuity assets above CTE98 both as of the end of the third quarter of 2018. We believe our financial strength ratings position us well to grow our sales and distribution footprint in the future.

We have a solid strategy in place and believe this strategy will generate long-term shareholder value. The key elements of our strategy are as follows: to offer a tailored set of annuity and life insurance solutions that are simpler, more transparent and provide value to advisers, their clients and our shareholders; to sell our products through a broad well-established network of independent distribution partners; and to leverage our financial discipline to manage our expenses and our balance sheet. We feel very good about the progress we are making relative to this strategy, and as the next slide shows, 2018 provided many examples of its effectiveness.

First, I am very pleased with our outstanding sales results. Over the course of the past 20 months, we rolled out a focused set of advertising campaigns designed to introduce our brand and showcase our flagship Shield annuities. These campaigns helped generate brand awareness in the market, allowed us to hit the ground running as a new public company and were instrumental in growing our sales footprint.

Annuity sales were up 40% in the first 3 quarters of 2018 compared to the same time period in 2017, led by Shield and fixed indexed annuities. I'm especially pleased with the success of Index Horizons, a fixed indexed annuity product created as part of our 10-year distribution agreement with MassMutual, which had sales of over $1 billion since its launch in July of 2017. We have a lot of sales momentum as we enter 2019.

In September 2018, we launched 2 new fixed annuity products that are already generating sales above our expectations, and we are continuing to see excitement from our long-standing distribution partners as well as seeing inbound interest from distribution firms with whom we do not currently have a relationship. And we're working with all partners, both current and prospective, to continue to make our distribution network as broad as possible as we help consumers in the United States achieve financial security.

Second, we have made significant progress exiting Transition Services Agreements, or TSAs, with MetLife. We began 2017 with 219 TSAs and have exited more than 100 through the third quarter of 2018. We expect additional TSA exits will facilitate further expense reduction in the coming couple of years.

Next, we continue to prudently manage our variable annuity capitalization. We are managing our VA business to CTE98 or higher, and at the end of the third quarter, had more than $600 million of VA assets above CTE98. Our hedging strategy continues to perform in line with our expectations.

And finally, the $200 million stock repurchase authorization that we announced in the third quarter reflects the progress we have made, the confidence we have in our strategy going forward and our commitment to returning capital to shareholders. This capital return commenced approximately 2 years ahead of our initial timeline as we communicated at the time of the separation. Through November 2018, we have repurchased approximately $83 million of our stock.

Let me set the stage for the rest of the presentation by discussing the evolution of our financial targets since the separation. First, at separation, we were targeting annual annuity deposits in excess of $4 billion by 2020, as seen on Slide 7. As of the third quarter of 2018, we have already surpassed $4 billion of deposits and now expect annual annuity deposits in excess of $8 billion in 2021, driven by the strength of our distribution relationships.

Second, our focus on reducing annual corporate expenses remains, and we are now targeting an additional $25 million of reduction in 2021. This results in annual run rate corporate expenses that are expected to be $175 million lower than the first 12 months postseparation.

Third, we were targeting an adjusted return on equity, less notable items, of approximately 8% and stable over time with mid- to high single-digit annual percentage growth of adjusted earnings per share, less notable items, post-separation. We are now targeting low double-digit annual percentage growth in adjusted earnings per share less notable items. And by 2021, we are targeting an adjusted ROE, less notable items, of approximately 11% and a net income ROE, excluding AOCI, of approximately 8%.

And finally, let me discuss capital return. At separation, we were expecting capital return to commence in 2020. And as previously disclosed, we began returning capital to shareholders in September 2018. We have made a lot of progress since the separation but recognize there is still much to be done to deliver on our commitment to maximize shareholder value. We believe executing our strategy is the best plan to achieve this, and we are committed to continuing to work diligently to deliver long-term shareholder value.

With that, let me turn the call over to Conor Murphy. Conor?

Conor Ernan Murphy - *Brighthouse Financial, Inc. - Executive VP & COO*

Thank you, Eric. The assumptions underlying our outlook are summarized on Slide 9. The equity market and interest rate assumptions are consistent with the base case scenario that many of you are familiar with.

I want to make 3 points: First, capital return to shareholders reflected in our outlook is $1.5 billion through 2021. This is inclusive of our current $200 million stock repurchase authorization. Second, we have incorporated an initial view of the impact of variable annuity capital reform for statutory reporting and risk-based capital assuming early adoption at the end of 2019. And third, our outlook does not incorporate any changes from GAAP accounting reform, which we expect to have more information on next year.

As Eric mentioned earlier, our sales performance this year has been very strong. We continue to believe that our strategy and positioning as a focused annuity and life insurance company in the U.S. resonates with our distribution partners, their advisers and the clients they serve. Our plans over the next few years reflect strong expected growth in annual annuity deposits, as can be seen on Slide 10, benefiting from our simpler product designs, strong demographic trends and increased wholesaler productivity. The annuity products we currently offer are priced with statutory internal rates of return in the mid-teens, and we expect to see a shift in our business mix profile in the coming years as we add more of this higher-returning, more cash flow-generating and less capital-intensive new business, such as Shield annuities and fixed annuities, coupled with the runoff of less profitable business.

Product diversification is important to us. We have a large block of life insurance with approximately $418 billion of face amount in-force, net of reinsurance, as of September 30, 2018. We are also focusing on growing new sales of life insurance and are following a strategy that we believe will help us re-establish a competitive foothold in this space.

As we previously mentioned, we've made good progress with the development of our forthcoming life product and are pleased that it has been approved in 47 jurisdictions so far. We are working with a number of firms and expect to launch this product in the coming weeks. As with most product launches, sales are expected to ramp up over time, and we are currently targeting life insurance deposits of at least $250 million in 2021 with expected statutory internal rates of return of at least the mid-teens.

Turning to Slide 11. Let's discuss steps we are taking to prudently enhance returns in our general account. We are focused on taking portfolio repositioning actions to generate an additional $125 million pre-tax of net investment income in 2020. As you can see on this slide, the primary driver is reducing our allocation to treasuries and increasing our allocation to higher-yielding spread assets, such as private assets where we can earn an attractive premium over public assets with comparable risk. These private assets include private placements, commercial mortgages, agricultural mortgages and residential mortgage loans.

When we separated from MetLife last year, our allocation to treasury assets was approximately 19%. With the migration to our new hedging strategy in the third quarter of 2017 in addition to optimizing our liquidity profile, we feel comfortable reducing our allocation to treasuries to less than 10% by the end of next year. During the first 3 quarters of 2018, we've rotated out of approximately $4.4 billion of treasuries and into higher-yielding spread assets. On a run-rate basis, this translates to an increase in investment income of about $80 million or approximately 65% of our 2020 target. The rotation out of treasuries is expected to have a modest impact on the average credit rating of the portfolio and the risk-based capital ratio.

Turning to Slide 12. We are projecting $150 million of corporate expense reduction on a run-rate basis by year-end 2020 with an additional $25 million targeted for 2021. We intend to be a best-in-cost company, which will enhance our ability to offer competitive products with appropriate risk-adjusted returns. A big driver of the expense reduction is exiting our TSAs with MetLife. Another tangible example is the management of our $80 billion-plus general account. In early 2019, we expect to begin transitioning from a single-manager to a multi-manager platform achieving meaningful cost savings with superior investment management capability. We will continue to look for ways to optimize our cost structure and maintain a best-in-cost expense level by applying a focused, nimble approach with reduced complexity.

Now I will turn the presentation over to Anant. Anant?

Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

Thank you, Conor. I will start with the balance sheet. We feel very good about our capitalization levels and the strength of our balance sheet. We manage our variable annuity business to CTE98 or higher and remain at or above that across most market shocks as of the end of the third quarter of 2018 as demonstrated in the table on Slide 14. As an outcome of our statutory-focused hedging strategy, the GAAP balance sheet is also very well protected in down-market shocks. These market shocks do not require us to change our hedging strategy nor do they change our intent to be a consistent returner of capital.

One of the primary drivers of growing GAAP net income and increasing statutory distributable earnings over the next few years is to lower our hedging costs. As previously disclosed, we fully transitioned to our variable annuity hedging strategy in the third quarter of 2017. Since that time, equity markets and interest rates were higher, and as a result of our hedging strategy, we have captured more than $1 billion of market upside through the third quarter of 2018. As Slide 15 demonstrates, our goal over the next few years is to lower hedging costs to where they are closer to more than $800 million of rider fees that we collect annually on our variable annuity contracts.

So how do we plan to do this? A key pillar of our hedging strategy is to allow the assets above our total asset requirement to act as a deductible to absorb modest declines in market levels. Our current deductible is $1.2 billion, up from $1 billion, driven by the capital contribution to one of our life insurance subsidiaries discussed on our third quarter 2018 earnings call. We expect to increase the deductible to $1.5 billion in 2019 and $2 billion in 2020. Increasing the deductible is expected to reduce the quantity of hedges we need to hold, thus, lowering hedging costs. We expect this will lower hedging costs to approximately $1 billion by 2021, which will be more closely aligned with the rider fees we collect.

With that, let me turn the call back to Eric.

Eric Thomas Steigerwalt - *Brighthouse Financial, Inc. - President, CEO & Director*

Thanks, Anant. Today, we have provided additional insight into key drivers of near-term performance and demonstrated how our financial targets have improved significantly since the separation. Let me summarize our financial outlook that is outlined on Slide 17 as well as making a few concluding points.

First, we have a solid strategy in place, and we believe this strategy will generate long-term shareholder value. Second, we believe we have an attractive new business growth platform and are focused on growing sales with solid returns, both in our Annuity and life insurance businesses. Third, our outlook reflects meaningful earnings growth and ROE improvement. By 2021, we are targeting an adjusted ROE, less notable items, of approximately 11% or an increase of 300 basis points from our expectation for 2018. Additionally, we are targeting an ROE, excluding AOCI, of approximately 8% by 2021. This equates to a net income ROE to adjusted ROE, less notable items, ratio of more than 70%. And finally, we are targeting low double-digit annual percentage growth of adjusted earnings per share, less notable items. Fourth, our hedging program is performing as we expected, and we intend to materially reduce hedging costs over the next few years. And finally, our outlook reflects returning $1.5 billion of capital to shareholders through 2021.

And with that, let's open it up for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from John Nadel with UBS.

John Matthew Nadel - *UBS Investment Bank, Research Division - Analyst*

First question is, if we think about the hedge cost coming down, it sounds like by 2020 or '21, the net of your rider fees, less the cost of the hedge program, should be about a $200 million cost running below the line. How does that $200 million cost compare to the cost that is running through 2018?

Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

John, it's Anant. Thanks for the question. When we said approximately $1 billion, that'll be approximately $250 million a quarter, just to clarify. And how does that compare? If you look at Slide 15, we had $1.8 billion for the year on Slide 15 for 2018. So that's how I would compare them.

John Matthew Nadel - *UBS Investment Bank, Research Division - Analyst*

Oh, got you. Okay. So that's the bottom line. Okay. Got you. And then the second question is, is that hedge cost, that net hedge cost, is that really the only primary item that's driving the difference between adjusted operating income and net income? Or are there other factors that you guys see as impacting net income over the next couple of years? I'm thinking about book value growth.

Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

And rightly so you are. So that, no, between 11% and 8% ROE, with 8% being the net income ROE, there are 2 primary drivers: hedge cost that you just mentioned on a post-tax basis, of course, so the rider P&L, as we talked about it, between hedge cost and change in reserves. And the second item is net investment gains and losses, which approximately 10 basis points a year.

THOMSON REUTERS

John Matthew Nadel - *UBS Investment Bank, Research Division - Analyst*

Okay. And then one last quick one, if I could. If we assumed over the forecast period that instead of the 6.5% separate account return assumption -- that, that were 0, how much does that change the overall outlook, holding all else equal?

Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

As we've shown in the past, our returns, our distributable earnings and cash flow return is sensitive to market, so it does change.

John Matthew Nadel - *UBS Investment Bank, Research Division - Analyst*

I'm just wondering if you can give some sort of order of magnitude, if we -- maybe even relative to the 11% ROE target by 2021, is it -- cost you 100 or 200 basis points of ROE?

Eric Thomas Steigerwalt - *Brighthouse Financial, Inc. - President, CEO & Director*

It's Eric. We'll present in the K the updated scenarios. I'm not going to give you a number. But look, you know it's lower. I mean, we've been very transparent with respect to that over time here. So I think you've got sort of a rule of thumb on separate account returns, and it's lower. I mean, if it were 0 returns, it would -- you know this, so between that and what you'll see in the updated scenarios, I think that'll be helpful. I think Anant wants to add one other thing here.

Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

One little thing to add to Eric's point and what we brought up, John, in the last quarter's earnings call is that the rule of thumb for every 1% change in quarterly separate account returns, you could change adjusted EPS, so then, obviously, adjusted ROE, you make your views on that, of $0.09 per share for the quarter. Most of that is DAC related, so I would give you that as a way to triangulate.

Eric Thomas Steigerwalt - *Brighthouse Financial, Inc. - President, CEO & Director*

And John, the only -- look, given our target on everything, that's all else being equal, right. You know that. And all else might not be equal, but hopefully, that's helpful.

John Matthew Nadel - *UBS Investment Bank, Research Division - Analyst*

Totally understand. Management is paid to manage. I understand.

Operator

Our next question comes from Humphrey Lee with Dowling & Partners.

Humphrey Lee - *Dowling & Partners Securities, LLC - Research Analyst*

A question related to the new balance sheet sensitivity related to the hedging program. I see at the time of the separation, the way the hedging program works is you're a little bit more sensitive to equity market movements and less sensitive to interest rates. But based on the new disclosure, a 100 basis point decline in interest rate will push you to below CTE98 or kind of maybe CTE97 plus. I was wondering, is there a change in terms of how you approach your overall hedging program?

Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

It's Anant again. No change in our overall hedging program, as we said in our prepared remarks. With our adoption or reflecting the adoption of VA reform, there's a lot lower mean reversion of interest rates. It's only mean reverting to 3.25% on a 10 year, so that's why it reflects that. But we feel very good about our balance sheet, and it would really take a combined stress of equities and rates to be using up our entire deductible.

Humphrey Lee - *Dowling & Partners Securities, LLC - Research Analyst*

Got it. And then shifting gears a little bit. So looking at the earnings outlook, you're kind of changing it to low double digit instead of the mid- to high single digit. How should we think about the moving pieces in contributing to the upward guidance? Is it more because of more new business being put on the books relative to your original assumption, and then to a lesser extent, the expenses are a little bit better?

Eric Thomas Steigerwalt - *Brighthouse Financial, Inc. - President, CEO & Director*

It's Eric. Yes, let me kind of summarize this, because you kind of get it from the presentation, but I think it's a good question. So there are a few drivers. First, we didn't know how successful branding of the company would be, right. I'm obviously, and I've said this a number of times, extremely pleased with where we're at. But there was no guarantee, okay. So that turned out far better than we expected, and as a result, you can see sales growth here meaningfully in excess of what we had previously talked about when we think about '20 and '21. Secondly, we have started repositioning the investment portfolio already. And now as you see in the presentation, we're looking to add $125 million on a run-rate basis. Third, remember our tax rate is lower as the result of tax reform, like many of our peers. And then finally, our capital return assumption is higher and, remember, starts 2 years earlier than our initial estimate. So that's a way to think of the building blocks. And of course, we included that last extra $25 million of expense cuts in 2021.

Operator

Our next question comes from Erik Bass with Autonomous Research.

Erik James Bass - *Autonomous Research LLP - Partner of US Life Insurance*

Could you just provide some more detail on what you're investing in as you restructure the portfolio? And I know you kind of gave some broad perspective, but maybe how do you think about credit risk appetite at this point in the economic cycle?

John Lloyd Rosenthal - *Brighthouse Financial, Inc. - Executive VP & CIO*

It's John. So I guess, let me take that in 2 parts. So I think as Conor alluded to, most of this repositioning involves simply trading out of what I'd say is an overweight or outsized position in treasuries to spread assets, particularly with a focus on private placements.

And we, coming to your second part of the question, we feel really good about this. Admittedly, we're probably in the later stages of the credit cycle, but you have to consider our starting point. We inherited a very conservative portfolio from MetLife. So when you looked at our portfolio versus our peers, again, we mentioned this in the past, but we were overweighted to treasuries and significantly underweighted to other spread assets, particularly credit. So one way to view this repositioning is we're simply moving closer to the average. And we're investing in the same high-quality assets we always invest in. And I think at the end of this repositioning, we would expect to continue to have a more diversified higher-quality portfolio than most.

Erik James Bass - *Autonomous Research LLP - Partner of US Life Insurance*

That's helpful. As we get further into the plan period, you'll have more of the Shield sales that you had in recent years coming up to the renewal period. Just curious, what's your assumption for persistency in policyholder behavior at the time for renewal?

Conor Ernan Murphy - *Brighthouse Financial, Inc. - Executive VP & COO*

Well, Erik, we've got the sales number include, obviously, a certain element of runover and change within the composition of the portfolio. So that's all included in the trajectory we're showing, that the growth going from -- actually what was quite recently only $4 billion to current run rate closer to $6 billion and getting to $8 billion at the end of the period. So we factored all of that in.

Erik James Bass - *Autonomous Research LLP - Partner of US Life Insurance*

Got it. I guess, I was thinking from a net flow perspective. So the deposits are going up. Should we also assume somewhat higher lapses, but some of that gets recycled, I guess, into new sales?

Conor Ernan Murphy - *Brighthouse Financial, Inc. - Executive VP & COO*

Yes. Certainly, some of it remains on the books, but look, let me take the opportunity to kind of step back a little bit. Obviously -- and I think this is maybe part of where you're coming from too. It's a large book of business to begin with, not just the fact that the Shield business has now been out there for kind of 7 years, and some of that is starting to reach the renewal period, but just the overall block to begin with. And obviously, look, we're very pleased with how much we're putting on the books in terms of volume, but also the quality of that and returns on that block. And yes, a meaningful amount is coming off the books as well, but remember, that's -- much of that is less-profitable business. And it's just normal course of business. That's annuitization, surrenders. And a reasonable amount of those surrenders are positive to us because they're in the money, some of them significantly, and that helps us from an overall profitability and capital perspective.

Operator

Our next question comes from Suneet Kamath with Citi.

Suneet Laxman L. Kamath - *Citigroup Inc, Research Division - MD*

Question on the $1.5 billion of capital return. Any color on the pace of that? And does that include the start of regular dividends from your variable annuity entity?

Eric Thomas Steigerwalt - *Brighthouse Financial, Inc. - President, CEO & Director*

Yes. It's Eric. So I think it was a two-parter there, right, Suneet? So part one, it'll ramp up over time. We've talked about a measured pace, but in the end, it will ramp up over time. So think about that as you factor that into your model. And yes, it would include us being sort of a regular dividender at -- in the back years, which should be no surprise. We've talked about being able to adopt VA capital reform in the stat reporting in 2019, so you can think about that for '20 and '21.

Suneet Laxman L. Kamath - *Citigroup Inc, Research Division - MD*

Okay. And then just given how you're generally ahead of your plan that you laid out at separation, one of the things we talked about at that time was trying to do something a little bit more structural with the legacy VA block. I think you had said at the time, you have a lot on your plate, which obviously, you still do. But given how much progress you've made, have you given any more thought to any solutions on that back book?

Eric Thomas Steigerwalt - *Brighthouse Financial, Inc. - President, CEO & Director*

Yes, we still do have a lot on our plate. But obviously, I agree with you, things are going very well. Look, I'm just going to repeat what I've said all along, okay. We'll consider things that are potentially executable, that we think will add shareholder value. Nothing is off the table, but we've laid out a lot of heavy lifting here. I think we can accomplish everything or I wouldn't have put it in the presentation, in today's presentation. But nonetheless, we've got a lot to do. But it precludes nothing. Obviously, we've included nothing in this particular presentation.

Operator

Our next question comes from Alex Scott with Goldman Sachs.

Taylor Alexander Scott - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

First question I had was on the hedge cost. Could you help me like sort of reconcile how these hedge costs looked relative to what was in your base case at the 10-K in the cash flow scenario? And how maybe those cash flow scenarios would be impacted, one way or the other, as we kind of look forward to the disclosure in this 10-K coming up?

Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

Yes, so we will share updated tables in our 10-K. The cash flow profile of the VA business is largely similar pre and post VA reform as of 9/30/2018. So hedge cost, the benefit of Shield, when I look at those things, they have pretty much similar cash flow profiles going forward. They move around a little bit, but the same ballpark.

Taylor Alexander Scott - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Okay. And so what do you have assumed in here in terms of volatility? I mean, do you have higher levels of volatility compared to what we're currently experiencing? Or is it sort of have a taper off? Like what kind of investments are in there for that?

Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

The short answer is, yes. We've always assumed the volatility to be in the 20s, not in the mid- to high teens, so we are well protected and have a long-dated option book. That's the other part to keep in mind.

Operator

Our next question comes from Tom Gallagher with Evercore.

Thomas George Gallagher - *Evercore ISI Institutional Equities, Research Division - Senior MD*

Just a few quick questions. The 11% ROE guide by 2021, can you talk about what the book value expectation is between now and 2021? Is that expected to be flat, meaningfully higher, lower? Just directionally, can you help us with that?

Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

It's Anant. So as we grow net income, right, meaning 8% net income ROE, you see book value accretion from that dynamic. And obviously, we said too early talk about GAAP accounting change, so you have to factor that in down the road.

Thomas George Gallagher - *Evercore ISI Institutional Equities, Research Division - Senior MD*

Anant, for 2019, is book value still expected to go down though? Because I believe right now, just based on how hedge costs have been playing out on a mark-to-market basis, you've seen a reduction.

Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

We expect to grow book value in 2019 because we expect to have positive net income ROE. That's the way I'd put it for that dynamic. And we've got the deductible up to $1.2 billion. We intend to get to $1.5 billion in '19, and that's meaningful for reducing hedge costs.

Thomas George Gallagher - *Evercore ISI Institutional Equities, Research Division - Senior MD*

Okay. And then variable annuity revenue sensitivity, can you just comment on how much are based on separate account values versus guaranteed amounts, where you have less account value sensitivity?

Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

Yes, around 1/4 of them are benefit-based driven. Think of the rider fees. So those are not very separate account market sensitive, and the rest are market sensitive. So around $3 billion is market sensitive, and another $1 billion is nonmarket sensitive.

Thomas George Gallagher - *Evercore ISI Institutional Equities, Research Division - Senior MD*

Got you. And then final question. In terms of the plan to reduce hedging costs, should we assume -- I think right now you have a combination of option premium versus, I'll call it, mark-to-market hedging cost through things like futures and the like. Should we expect a change in that mix? Or as we think about hedging costs going from $1.8 billion to $1 billion, should we think about a ratable reduction in the different types of hedges?

Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

Yes. So I love the way you frame the question. We think of cost really from the point of view of that option time decay. The rest is mark-to-market. And the fact that you don't have a GAAP liability that marks like our hedge target does, that's why you get that in the costs. It's $800 million to $1 billion of option time decay. And as hedge costs come down over the next few years, both mark-to-market sensitivity and time decay will come out. Because largely, we'll be buying more out of the money options.

Thomas George Gallagher - *Evercore ISI Institutional Equities, Research Division - Senior MD*

Got it. So that option premium, that's been -- I think it's been, what, a $200 million a quarter headwind. Would that get cut in roughly half then by 2021?

Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

It's pro rata to sort of the reduction, exactly the way you mentioned. It comes down pro rata as the cost come down from the current level. Yes.

Operator

Our next question comes from Ryan Krueger with KBW.

Ryan Joel Krueger - *Keefe, Bruyette, & Woods, Inc., Research Division - MD of Equity Research*

On the $125 million increase in investment income, can you give a sense of how much of that you've realized so far in 2018?

John Lloyd Rosenthal - *Brighthouse Financial, Inc. - Executive VP & CIO*

Ryan, it's John. As Conor mentioned, we rotated about $4 billion, $4.5 billion of treasuries through the end of Q3, and on a run-rate basis, generated about $80 million, which is about 65% of the total program. By the end of the year, we anticipate having completed, call it, about 80% of the program, with the rest in 2020 obviously. In terms of how this emerges into earnings, you can think about $50 million emerging this year, probably $110 million to $115 million emerging next year and the, obviously, the entire $125 million in 2020.

Ryan Joel Krueger - *Keefe, Bruyette, & Woods, Inc., Research Division - MD of Equity Research*

Okay. And then on the equity market sensitivity, I think you're showing now that a 40% decline, you'd still be at CTE98. I think in the original or maybe if we think back to the 10-K, you would have still been above the CTE95 threshold but below CTE98 I guess. Can you help me think about what has changed and led to the improvement there?

Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

It's Anant. I mean, largely because we're a very well-protected book. And with a large option book, you throw market stress on us on the equity side, it doesn't hurt that much relative to 98 level. It takes a correlated stress. So maybe I'll dimensionalize it for everyone. It really would take like a 25% decline in equity, then 100 basis points down in rates and rates in the low 2% area for us to use up our deductible and still have an option book that's out in -- measured in years. So that's the way we think about it.

Operator

Our next question comes from Jimmy Bhullar with JPMorgan.

Jamminder Singh Bhullar - *JP Morgan Chase & Co, Research Division - Senior Analyst*

Some of my questions are answered. But I wasn't able to get -- when you're talking about a 6.5% separate account assumption, what level is that off of? Is it off of September levels or October levels?

Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

Yes, it's for the year, so 6.5% separate account returns for the year, that would be like 1.6% every quarter you want that to be and...

Jamminder Singh Bhullar - *JP Morgan Chase & Co, Research Division - Senior Analyst*

And beginning since the end of the most recent quarter the numbers, Anant, right, beginning since -- beginning from September onwards.

Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

Yes. Exactly.

Jamminder Singh Bhullar - *JP Morgan Chase & Co, Research Division - Senior Analyst*

Okay. So then obviously, the decline since September, that is not part of it. And we can adjust based on your sensitivity, correct?

Eric Thomas Steigerwalt - *Brighthouse Financial, Inc. - President, CEO & Director*

It's Eric. I think we all know where you're going here so...

Jamminder Singh Bhullar - *JP Morgan Chase & Co, Research Division - Senior Analyst*

No, I'm just trying to get an idea because it wasn't disclosed what it is off of. So there's no -- nothing beyond that in the question.

Eric Thomas Steigerwalt - *Brighthouse Financial, Inc. - President, CEO & Director*

No, no, I know there's not, but I think we know exactly what your question is, and we'll try to help you out here. So yes, I think what you just said was as of the third quarter and then forward, so it's not in there. So think about it, right, the $8.50 to $9.00 range, I mean, that's still a good range for us. But let's be clear here. Given the volatility that we've seen through November, you're sort of thinking about the low end of that range. Now if futures are way up today, and I certainly don't want to get into a daily mark-to-market here thing. But I think you're thinking about this the right way. So hopefully, that was helpful between what Anant and I said.

Jamminder Singh Bhullar - *JP Morgan Chase & Co, Research Division - Senior Analyst*

Yes. And then on the capital return -- and you've commented a few times on it, but should we -- and you're giving a pretty optimistic number in terms of what you can do over the next several years. Should we assume that capital return is going to be an ongoing part of your strategy given what your capital position looks like? So once you exhaust the current program, you'd look to renew it. Or should we assume that's going to be more back-end loaded?

Eric Thomas Steigerwalt - *Brighthouse Financial, Inc. - President, CEO & Director*

Listen, as I've said before, I don't want to get ahead of my board. But look, we've got a big number in there. It requires us to execute, and it also requires the markets to cooperate. But having said that, the strategy is certainly to be a consistent returner of capital, both from the point of view of regular dividends up to the holding company, but also from sort of an overall strategic perspective with respect to management and the board of our desire to be a consistent returner of capital.

Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

And I'm just going to add in a little bit over there. As you think about -- you all think about our dividends out of BLIC, because a lot of you ask this question, I'd frame it up in 2 ways to think about it. First of all, we're not contemplating extraordinary dividends out of BLIC in 2019. As I mentioned to my answer to Tom, we're going to take the deductible up. We're going to get our hedge costs down and become a consistent returner of capital through ordinary dividends. So you should expect that in 2020 onwards, we will take ordinary dividends, and then from there on -- and I think this is the most relevant thing, statutory distributable earnings is dividendable out of BLIC and statutory distributable earnings and GAAP net income should be comparable.

Jamminder Singh Bhullar - *JP Morgan Chase & Co, Research Division - Senior Analyst*

Okay. And then just lastly, you've reported pretty strong sales of the Shield product, and MetLife and Brighthouse are sort of early in the market. But seems like more companies are coming out of -- coming out with buffer annuities. Are you -- have you seen more competition in that area? And how does it affect your views of sales of that specific product?

Myles Joseph Lambert - *Brighthouse Financial, Inc. - Executive VP and Chief Distribution & Marketing Officer*

Yes, this is Myles Lambert speaking. Thank you for the question. So we think new entrants into the marketplace is a good thing for the product category. We continue to like the competitiveness of our product, and we continue to add new distributors selling the product. So we feel really good about our competitive positioning in the marketplace.

Operator

(Operator Instructions) Our next question comes from Andrew Kligerman with Crédit Suisse.

Andrew Scott Kligerman - *Crédit Suisse AG, Research Division - MD & Senior Life Insurance Analyst*

Most of my questions have been answered. Just a little more clarity on the market sensitivity. I think last quarter, when the market was up, your capital and was 7%. Your capital in excess of CTE98 benefited maybe to the tune of $400-ish million. Could you give us an update on that sensitivity? I think Slide 14 is trying to capture some of it. But what would it take to erode the $1.2 billion of the deductible? Where would CTE98 be in the event that the market went down 10% as per that slide?

Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

It's Anant. So to answer the second part of the question, and I'll factor into your question about the prior quarter. The $1.2 billion deductible, for us to fully utilize that deductible, it would take a 20% to 25% decline in equities, combined with the 10 year being in the low 2% area, so like 100 basis points decline. Those 2 things need to happen in combination and still get a hedge program that's got options measured in years. So it's not like they're gone tomorrow. To your point about making $700 million or really having strong statutory adjusted earnings in the third quarter, when we have 3% separate account returns -- the market is what it is, but our separate accounts give us a 3% return, which was strong above our 1.6% assumption. So that $700 million of statutory adjusted earnings, which are 2/3 from the hedging program performing with sensitivities in line with what we expected, so us capturing market upside is a great demonstration of how in the last 5 quarters, we've captured $1 billion of market upside from the market. Now if the market's down, we're going to give that back somewhat, but that gives you a sense of like 3% return on the quarter, 2/3 of $700 million coming from the hedge program and how the book works. I'll pause and take any follow-on if you have.

Andrew Scott Kligerman - *Crédit Suisse AG, Research Division - MD & Senior Life Insurance Analyst*

Yes. So Anant, so basically this 20% to 25% market pressure and 100 basis points of interest rates, that would take out the capital. And likewise, that would affect the CTE98 number by the exact same amount, correct?

Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

That's correct. If your question is the sensitive the impact on 98, yes, it would be similar to that.

Operator

Our next question comes from Elyse Greenspan with Wells Fargo.

Elyse Beth Greenspan - *Wells Fargo Securities, LLC, Research Division - VP and Senior Analyst*

Just a couple of quick questions. In terms of the tax rate, I know you guys have said about the tax rate should be in the high teens. And I think in the past, you said the tax rate is higher as your earnings are higher. So should we think about the tax rate maybe being higher in some of the out years? Or just are you assuming a stable kind of high-teens rate as you think about growing your earnings from here?

Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

No, that's a great assumption to have as earnings grow and the tax rate should go to the higher end of that range that we've talked about. And also, I would think about it, we also have the establishment cost, which will be running off, which will be helping with earnings growth, right. So we expect for the full year to hit a high watermark in 2018 of $240 million to $250 million pretax, and then 2019 to 2020 onwards throughout the period, approximately $200 million more to go. So you factor that it in when you think of earnings exactly.

Elyse Beth Greenspan - *Wells Fargo Securities, LLC, Research Division - VP and Senior Analyst*

Okay. And then in terms of the capital return, the $1.5 billion plan that you guys have laid out and, obviously, that runs through 2021. Do you guys have kind of any M&A thoughts or aspirations? So could there be -- get to a point where you consider a deal that might add some diversification to your book and then push out some of the capital return? Or how do you just think about M&A when you balance the $1.5 billion of capital return that you laid out from here?

Eric Thomas Steigerwalt - *Brighthouse Financial, Inc. - President, CEO & Director*

It's Eric. Obviously, we have nothing in this presentation along those lines. Over time, certainly, like any other company, you could consider things like that. But right now, my #1 priority is to execute on this strategy. That means we've got to hit all our marks, all our waypoints, and we want to be a consistent returner of capital. So that's really the focus. Down the road, certainly, you could think about something like that, but that's not what's on our mind right now.

Operator

Ladies and gentlemen, I will now turn the call back over to Mr. Rosenbaum for closing remarks.

David Rosenbaum - *Brighthouse Financial, Inc. - Head of IR*

Thank you, Shannon. Thank you, everybody, for joining us today for our outlook conference call and for your interest in Brighthouse Financial. And we look forward to speaking again next quarter. Thank you very much.

Operator

Ladies and gentlemen, this concludes today's conference. Thanks for your participation. Have a wonderful day.