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EDITED TRANSCRIPT

BHF.OQ - Q1 2020 Brighthouse Financial Inc Earnings Call

EVENT DATE/TIME: MAY 12, 2020 / 12:00PM GMT

OVERVIEW:

Co. reported 1Q20 adjusted earnings (excluding impact from notable items) of $273m.

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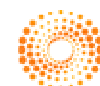

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CORPORATE PARTICIPANTS

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

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

Edward Allen Spehar *Brighthouse Financial, Inc. - Executive VP & CFO*

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 - Director & Senior Analyst*

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

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

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

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 First Quarter 2020 Earnings Conference Call. My name is Daniel, 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 first quarter 2020 earnings call. Our earnings release, slide presentation and financial supplement were released last night and can be accessed on the Investor Relations section of our website at brighthousefinancial.com. We encourage you to review all of these materials, and we will refer to the slide presentation in our prepared remarks.

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

Our discussion during this call will include forward-looking statements within the meaning of the federal securities laws. Brighthouse Financial's actual results may differ materially from the results anticipated in the forward-looking statements as a result of risks and uncertainties, including those related to the COVID-19 pandemic and others described from time to time in Brighthouse Financial's filings with the U.S. Securities and Exchange Commission. Information discussed on today's call speaks only as of today, May 12, 2020. The company undertakes no obligation to update any information discussed on today's call.

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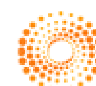

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During this call, we will be discussing certain financial measures used by management that are not based on generally accepted accounting principles, also known as non-GAAP measures. Reconciliations of these non-GAAP measures on a historical basis to the most directly comparable GAAP measures and related definitions may be found on the Investor Relations portion of our website, in our earnings release, slide presentation or financial supplement.

And finally, references to statutory results, including certain statutory-based measures used by management are preliminary due to the timing of the filing of the statutory statements.

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

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

Thank you, David, and good morning, everyone. I want to cover a few topics today. First, I will provide some perspectives on the current environment. Next, I will give an update on our share repurchase program. And finally, I will cover Brighthouse Financial's results in the first quarter.

Let's start with the current environment. I hope that you and your loved ones are safe and well as the COVID-19 pandemic upends our communities in the world. Brighthouse Financial's top priority at this time remains the well-being and safety of our employees and their families, our partners and our customers. Through the Brighthouse Foundation and Brighthouse Financial corporate contributions, to date, we have donated more than $500,000 to local food banks and other organizations in our communities to support those in need throughout this pandemic and beyond.

As cities and states across the country began to enact measures to help protect the health and safety of their communities, in March, we promptly implemented our business continuity plans and quickly and successfully shifted all our employees to a work-from-home environment, where they remain today. We have taken a number of steps to support our employees through this time, including flexible work arrangements and additional vacation days that are intended to allow them to spend time with family or to take care of personal needs while the work-from-home period remains in effect. And in the midst of these trying times, we continue to bring on outstanding talent to add to our team.

It is in uncertain times like these when our mission to help people achieve financial security becomes even more important. Please note that, despite the challenges created by the pandemic, thanks to the incredible adaptability and resilience of our employees, we remain steadfastly focused on our mission and strategy and on delivering for our partners, customers and our shareholders.

While the pandemic continues to impact the global economy, driving equity markets down, increasing volatility and leading to historically low interest rates, we believe we are well positioned to weather the current downturn.

On Slide 4 of our earnings presentation, we have provided a summary of certain potential ongoing impacts of the current environment on our business, which we currently believe are manageable. We entered this situation from a position of strength, and we remain confident in our focused strategy.

Finally, our balance sheet and liquidity position are strong, and our investment portfolio is well diversified.

The second topic I would like to cover is share repurchases. In 2020 through May 8, we repurchased approximately $316 million of our common stock, representing over 12% of our shares outstanding relative to year-end 2019. This was a significant value-creating action for our shareholders. And since the announcement of our first stock repurchase authorization in August of 2018, we have repurchased a total of approximately $864 million of our common stock through May 8 of this year, a reduction of more than 22% of our shares outstanding from the time we became an independent public company, and well ahead of our initial expectations.

Now you have heard us use the word prudence many times and given the unprecedented market environment in which we are operating, we are temporarily suspending repurchases of our common stock. We will continually evaluate our repurchase program and will resume repurchases of our common stock as circumstances warrant. Importantly, our target of returning $1.5 billion of capital to our shareholders by year-end 2021 remains in place.

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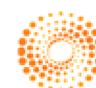

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Now let me turn to first quarter results. Our key highlights for the quarter are summarized on Slide 5 of our earnings presentation. First, we continue to prudently manage our statutory capitalization. Our hedging program performed extremely well in the first quarter of 2020. Importantly, we estimate that our combined risk-based capital or RBC ratio was 515% to 535%, even though we paid a $300 million ordinary subsidiary dividend to the holding company in the quarter. Ed will provide more details on statutory results shortly.

Second, we had very strong sales in this quarter. Annuity sales were approximately $2 billion, up 15% compared with the first quarter of 2019. Additionally, we generated approximately $16 million of life insurance sales in the first quarter of 2020, ahead of our expectations and up 33% compared with the fourth quarter of 2019 driven primarily by SmartCare.

I am very pleased with our sales results in the first quarter and the transition our teams made, moving from a face-to-face model to a virtual model in order to connect with and remain in front of financial professionals. And we remain focused on supporting our financial professionals and their clients during this time. Looking forward, it probably does not surprise you that the current market environment is a headwind to near-term sales of annuity and life insurance products for the industry and for Brighthouse. As a result, it may be challenging to generate sales growth in annuities for this year, coming off of a very strong 2019.

With respect to life insurance, we launched SmartCare last year and have been focused on building relationships with firms and advisers. Obviously, that becomes more challenging in a virtual world and may have an impact on the timing of when we achieve our life insurance sales targets. However, it is clear that our plan for 2020 was achievable, and that gives me great confidence with respect to our strategic goal for life insurance going forward. Even though we will be facing headwinds, we are laser-focused on growing our life insurance business.

As I've said previously, rising health care costs, unforeseen health care needs and insufficient income in retirement are pervasive retirement concerns for Americans. And we believe Brighthouse Financial is well positioned to help people achieve financial security and help address retirement concerns over the long term.

Third, let me turn to total annuity net outflows, which were approximately $900 million in the quarter, down from both the first quarter of 2019 and down sequentially. As we've said previously, we expect to see a continued shift in our business mix profile over time, as we add more cash flow generating and less capital-intensive new business, coupled with the runoff of less profitable business.

Fourth, corporate expenses, which do not include establishment costs, were $214 million in the first quarter, consistent with our expectations. We remain committed to reducing corporate expenses by $150 million on a run rate basis by the end of this year and by an additional $25 million in 2021.

Finally, we continue to make necessary investments in our technology infrastructure and in our business. We refer to these investments as establishment costs. In the first quarter, establishment costs were approximately $18 million before tax. We continue to believe establishment costs will be around $150 million to $160 million in 2020 and $25 million to $35 million in 2021, both on a pretax basis. As I have said before, we are being prudent in how we are managing our way through our expected final couple of years of TSAs. These TSA exits and associated systems transitions put us one step closer to our future state operating platform.

To wrap up, I want to thank our employees for their dedication and resilience they have shown in the face of this unprecedented situation. As a result of their adaptability and commitment, we are able to continue to support our customers and financial professionals, both now and into the future. Our balance sheet and liquidity positions are strong, and we expect them to remain strong, even in the midst of a stressed market. We continue to believe we have the right strategy in place to deliver long-term shareholder value, and we believe that we are well positioned to continue the execution of our strategy.

I'll now turn the call over to John Rosenthal, our Chief Investment Officer, who will provide an overview of our investment portfolio as well as details on several asset sectors of interest. John?

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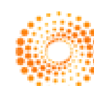

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John Lloyd Rosenthal - *Brighthouse Financial, Inc. - Executive VP & CIO*

Thank you, Eric. Let me start by saying that we believe our investment portfolio is well positioned for a downturn, as we have a very well diversified and high-quality portfolio. We've been preparing for a turn in the cycle since early last year and adopted a more conservative investment strategy as a result. This included limiting new investments into cyclical and weaker investment-grade credit, no longer allocating new money to below investment-grade credit and reducing the portfolio's exposure to the below investment-grade credit sector as well as higher risk investment-grade positions.

Let's start on Slide 6 of the presentation, which provides an overview of our investment portfolio. As you will see, this is a very good story. At March 31, we had approximately $105 billion of total investments, excluding cash and cash equivalents on a GAAP carrying value basis. The pie chart on the left illustrates the level of diversification and demonstrates that we are not overly concentrated in any one asset class. The chart on the right illustrates the ratings distribution of our fixed maturity securities portfolio. Approximately 3/4 of the investment portfolio is fixed maturity, of which roughly 96% is investment grade. With that as a backdrop, and given the current environment, I want to provide some perspectives on specific asset sectors, both corporate credit and commercial mortgage loans, that may be more exposed to COVID-19 risk. Overall, this is a good story for us with what we believe to be manageable exposure.

Turning to Slide 7 in corporate credit. On a book value basis, we had approximately $108 billion of total investment, including cash and cash equivalents. We have a high-quality credit portfolio with about 93% rated investment-grade at the end of the quarter. Importantly, our corporate credit allocation of approximately 40% of total investments is low relative to the industry, which we believe is an important distinction during an economic downturn.

Over the last several years, we have been putting more of our new money to work in private corporates as we believe these assets will generally perform better in a downturn due primarily to the structural protections. These assets accounted for more than 25% of our corporate credit portfolio at the end of the quarter. Our exposure to sectors, we believe, likely to be more impacted by COVID-19, including energy, retail, leisure, metals, autos and airlines, was approximately $6.3 billion at March 31, or less than 6% of our total investments. As I'll discuss shortly, most of this exposure is to higher-quality energy and retail credits. Of the $6.3 billion, only $3.1 billion, or approximately 3% of our total investments, have NAIC 2 ratings for publics for below investment-grade ratings for publics and private. So again, a very good story with what we believe are manageable exposures.

I'd like to now provide a little more detail about our holdings in the energy and retail credit sectors as well as our retail and hotel exposure that we have in our commercial mortgage portfolio. Moving to Slide 8. We've provided an overview of our $2.8 billion energy exposure at March 31. Overall, our exposure is higher quality with 67% rated Baa2 or higher and 88% rated investment-grade. Approximately 50% of our energy holdings are a midstream energy companies, which are generally less volatile as a result of having less commodity price risk and contractual cash flows.

Our integrated energy company holdings, which accounted for another 16% of our energy sector exposure, had an average rating of high A at March 31. Finally, we believe that our independent exploration and production company exposure is manageable at slightly less than $600 million, or about 20% of our energy holdings at March 31. Of the $600 million, only about 30% is rated below investment-grade.

A $1.7 billion retail exposure related to corporate credit at March 31 is detailed on Slide 9. Almost 2/3 of these holdings were retailers. This exposure is high quality, with 96% rated investment-grade. In fact, our top 5 corporate retailer exposures are Walmart, Home Depot, Lowe's, Walgreens and Target, which together accounted for about 50% of this exposure and had a weighted average rating of single A at March 31. Importantly, we have no direct department store exposure. The remaining 1/3 of our holdings are retail real estate investment trust. These holdings are geographically diversified and highly rated.

Before turning the call over to Ed, let me touch on our commercial loan portfolio. In total, our commercial loan portfolio was approximately $9.5 billion at March 31. Overall, we believe that our commercial mortgage portfolio is well diversified across vintage, geography and property type. It is also high quality with an average loan-to-value of 53% at March 31.

The 2 subsectors that we believe will be most impacted by COVID-19 are retail and hotel and are summarized on Slide 10. Like our overall portfolio, these mortgages have strong credit metrics. Our retail commercial mortgage loan exposure was approximately $2.1 billion, covering 70 loans.

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These are high-quality assets with strong sponsors and located in affluent markets. Our hotel commercial mortgage loan exposure was approximately $923 million covering 22 loans. These assets are also well diversified geographically and are generally located in prime areas with major brands.

To summarize, our overall investment portfolio is high quality and well diversified, and we believe our exposure to asset sectors likely to be more impacted by COVID-19 is manageable.

With that, I'll turn it over to Ed to discuss our financial results. Ed?

Edward Allen Spehar - *Brighthouse Financial, Inc. - Executive VP & CFO*

Thank you, John, and good morning, everyone. I hope you are all staying safe and healthy.

I would like to start by repeating something I said on our March business update call. Prudence and flexibility are 2 words you will hear frequently from us, and recent market movements was a reminder of the value of both for a financial services company. Because of our focus on prudence and flexibility, we entered this challenging environment with a strong statutory balance sheet and a material reduction in our equity market risk profile. And as I believe our first quarter results illustrate, we have maintained a strong capital and liquidity position, despite the steep decline in equities and interest rates in the first 3 months of the year.

I will begin my prepared remarks with comments on our statutory results. I will then discuss holding company liquidity and share repurchases and finish with comments on adjusted earnings.

At the end of the quarter, combined statutory total adjusted capital, or TAC, was $7.2 billion, down from $9.7 billion at year-end 2019. There were 3 primary drivers of the change from year-end. First, an increase in variable annuity, or VA, reserves as a result of the decline in equity markets and interest rates, which was only partially offset by the benefit from hedge gains and lower reserves for our Shield annuity product. Second, a $300 million ordinary dividend paid from Brighthouse Life Insurance Company, or BLIC, to the holding company. And three, unfavorable results for our nonvariable annuity business.

It is important to point out that we expected VA reserves to increase substantially in an environment like we experienced in the first quarter, and that this increase would have a negative impact on total adjusted capital. As I said on our March 5 business update call, and as also discussed in our 2019 10-K, the impact on total adjusted capital could be greater than our maximum loss target for our hedging program. But if it was, we would expect a substantial offset in required capital, which would diminish the impact on the RBC ratio. This is how VA reform works and exactly what we saw in the first quarter.

We estimate that our combined RBC ratio was in the range of 515% to 535% at March 31. This compares to 552% at year-end 2019 and includes an approximately 20-point negative impact from the $300 million ordinary dividend paid by Brighthouse Life Insurance Company in the quarter.

We had a normalized statutory loss of approximately $800 million in the first quarter. However, we did not use any of our up to $500 million first loss position, which is the revised hedge target we discussed with you on our fourth quarter earnings call and the March 5 business update call.

Gains on our previously out of the money low interest rate hedges fully offset the negative impact of other market-related items. Approximately 2/3 of the normalized statutory loss was attributable to increased volatility in tax liabilities associated with our adoption of VA reform. We view this impact as nonrecurring as we have incorporated this into our hedging program going forward. The remaining 1/3 of the loss was driven by nonvariable annuity results below the levels seen over the last 2 years, which was a function of unfavorable mortality and an impact from low interest rates on our market value adjusted annuity book.

To summarize, our hedging program performed extremely well during a challenging market environment. Our total asset requirement for variable annuities at CTE98 increased by $8.1 billion in the quarter, or almost 90%. This was more than offset by an $8.3 billion increase in our variable annuity assets. The real test of hedge effectiveness is during a stressed market environment, and we believe that an $8.3 billion increase in assets relative to an $8.1 billion increase in asset requirement suggests a very effective hedging program. Success on variable annuity risk management

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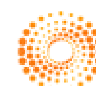

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is the key reason that we are reporting an RBC ratio in a stressed market environment that is well above our long-term target of 400% to 450% in a normal market environment.

I'd now like to discuss our holding company liquidity. We ended the first quarter with holding company cash of approximately $1 billion or almost 5x annual fixed charges. Since the end of the first quarter, the holding company received an additional $500 million dividend from Brighthouse Life Insurance Company. So even after considering the shares of common stock repurchased in the second quarter to date, we would anticipate a significant increase in holding company cash at the end of the second quarter. Looking forward, we will continue to emphasize prudence and flexibility when evaluating dividend plans from our operating subsidiaries, including the $450 million remaining of our 2020 planned Brighthouse Life Insurance Company dividend of $1.25 billion.

Also as a reminder, we expect more than $200 million of annual inflows to the holding company before consideration of any operating company dividends, which covers most of our holding company fixed charges.

Additionally, we have a robust liquidity stress testing framework that helps ensure we maintain the liquidity necessary to support our business. We comfortably exceed our liquidity coverage targets under a scenario-based analysis, which includes a capital stress scenario similar to the 2008 financial crisis as well as a spike scenario for interest rates and equity markets.

I'd now like to take a moment to talk about our common stock repurchases. We have taken significant action to create value for our shareholders. As Eric mentioned, in the year-to-date through May 8, we repurchased $316 million of common stock at an average price of $24.26 per share, representing over 12% of our shares outstanding relative to year-end 2019. Approximately 84% of the 2020 repurchase amount as of May 8 was completed after our March 5 business update call at an average price of $22.51 per share. As you heard from Eric, we have temporarily suspended our repurchase program, and we will exercise prudence as we continually assess when to resume share buybacks.

Moving to adjusted earnings. Last night, we reported first quarter adjusted earnings, excluding the impact from notable items, of $273 million, which compares with adjusted earnings on the same basis of $265 million in the fourth quarter of 2019 and $259 million in the first quarter of 2019. There were 2 notable items in the quarter, which decreased adjusted earnings by $62 million. The notable items on an after-tax basis were: a $48 million unfavorable impact in runoff related to a reinsurance recapture and a onetime adjustment from the transition to a new vendor; and establishment costs of $14 million in corporate and other. Sequentially, adjusted earnings less notable items were driven by lower corporate expenses in the first quarter, along with favorable net investment income, partially offset by unfavorable market impacts and an unfavorable underwriting margin.

Starting with corporate expenses. Corporate expenses were $214 million, down approximately $69 million compared with the fourth quarter. As Eric mentioned, we remain committed to reducing corporate expenses by $150 million on a run rate basis by year-end 2020 and an additional $25 million of corporate expense reduction in 2021.

Moving to investment performance. Net investment income increased sequentially. Alternative investment returns were 3.7% in the first quarter, which compared with 2% in the fourth quarter. Keep in mind that alternative returns this quarter reflected the favorable market returns in the fourth quarter of last year, as alternatives are reported on a one quarter lag. Given equity market performance in the first quarter, we expect second quarter alternative returns to be negative, but it is too early to provide a meaningful estimate. Also we continue to see asset growth, which contributed to the positive sequential change in net investment income in the quarter.

Turning to market performance. Separate account returns were negative 14.3% in the quarter driven by the significant decline in the stock market. Separate account return performance drove an increase in DAC amortization for variable annuities and life insurance, along with an increase in VA reserves. However, the increase in VA DAC amortization was offset by lower Shield DAC amortization.

Moving on to our life insurance businesses. Sequential results were impacted by unfavorable underwriting, which was driven by higher severity of claims in the first quarter. Claims frequency was relatively flat compared with the fourth quarter of 2019, but above historical levels. While the data we've seen does not suggest a significant impact from COVID-19 to date, cause of death reporting is imperfect. In addition, there is still uncertainty around timing of the first U.S. infection and death related to this pandemic.

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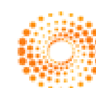

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Turning to adjusted earnings at the segment level, starting with annuities. Adjusted earnings, excluding notable items, were $316 million in the quarter. DAC amortization and expenses were lower sequentially, which had a favorable impact on earnings. This was partially offset by higher reserves and lower fees.

Life segment adjusted earnings, excluding notable items, were $11 million in the quarter. Sequentially, results were impacted by higher claims and higher DAC amortization, partially offset by lower expenses and higher net investment income.

The Run-off segment reported an adjusted loss, excluding notable items, of $22 million in the quarter. Sequentially, results were driven by higher claims, partially offset by alternative investment income. Sequentially, Corporate & Other had an adjusted loss, excluding notable results, were driven by lower expenses.

Overall, I am very pleased with our results this quarter. We have a strong capital and liquidity position, and we continue to emphasize prudence and flexibility, as we manage the balance sheet to protect the franchise through stressed markets.

With that, we'd like to turn the call over to the operator for your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Erik Bass, Autonomous Research.

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

How should we think about the future dividend capacity from BLIC as well as the captive and then how this is affected by on the recent equity market and interest rate movements? And related to that, can you just provide an update on unassigned surplus of BLIC as of March 31?

Edward Allen Spehar - *Brighthouse Financial, Inc. - Executive VP & CFO*

Yes. Eric, it's Ed. So I guess I'd refer you back to the March update call when we talked about what we thought potential dividend capacity was or -- I'm sorry, distributable earnings in our bear scenario, and we had talked about $1.3 billion. So if you look at the dividends we've taken to date, we've taken $800 million out of BLIC. We will assess over the coming months what to do with the remaining $450 million. We haven't taken the dividend that we normally take from NELICO, which I know you know is a -- is not a real market-sensitive business and kind of more of a run-off block, more predictable dividend capacity.

I think in terms of BRCD, we were happy to get the $600 million dividend up at the end of last year. We told you that, that had no impact on our dividend plans in the near term, that we would assess that over time. In terms of the capitalization of BRCD, we are very well hedged for low rates, and our cash flow testing margins at rates lower -- actually much lower than where they are today is not materially different than what it is in our base scenario for BRCD. So we feel very good about the cash flow testing margins of BRCD, which is, as you know, the way that we think about the capitalization of that end.

Finally, on unassigned funds, it's around negative $100 million -- a little bit more than a negative $100 million at the end of the first quarter is our estimate. As you know, that does not impact dividend capacity for this year, which is a function of year-end 2019 capital unassigned funds and prior year operating gain.

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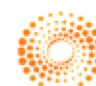

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Erik James Bass - *Autonomous Research LLP - Partner of US Life Insurance*

Got it. And then maybe moving to just the operating earnings. Can you just provide a little bit more details on the movements in annuities in the interplay between Shield and the legacy VA block? And how should we think about the equity market sensitivity of your earnings going forward relative to, I think, the $0.07 to $0.11 per kind of 1% move in separate account returns that you've given previously?

Edward Allen Spehar - *Brighthouse Financial, Inc. - Executive VP & CFO*

Sure. So we're reassessing that sensitivity. I don't have an updated rule of thumb to provide to you. It is different than what we had been assuming. And it's really driven by the increased importance of Shield as a percentage of our total in-force book. I think if you look back at our business update call, we had talked about how Shield had gone from something like 2% of our annuity block back in 2016 to 11% at year-end 2019. What we saw in the quarter was, while we did have a negative DAC impact from our VA block, we had a greater positive DAC impact from our Shield block.

I think a couple of things I can provide for you to hopefully help you out on how to think about DAC amortization going forward. The first would be, if you look at the last 5 quarter average for DAC amortization for the Annuities segment, it's a -- I believe -- and adjusting out for the third quarter assumption update, it's a -- I think it's $103 million a quarter. If you look at the first quarter of this year, it was $38 million. So I think you could look at the difference between that 5 quarter average and $38 million, and that is roughly the net positive impact of Shield relative to the net negative impact of the VA DAC.

The other thing I'd say about DAC is that we're still looking into this, but it appears that the negative impact you saw throughout 2019 for Shield is not that far off of the positive impact we saw in the first quarter, which isn't surprising if you consider that our separate account returns were above our baseline for full year 2019 by about the same amount that they were below our baseline for the first quarter.

Operator

Our next question comes from Tom Gallagher with Evercore.

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

Eric, first question is just want to get a little more behind the thinking of the decision to be aggressive with buyback kind in the earlier part of the second quarter, getting to almost $200 million and then deciding to pause. Was that just more just the opportunity where you saw the value and maybe just a little more color behind the pause versus deciding over the last 1.5 months to be more aggressive?

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

Tom. Yes, you've kind of got it. Let me flesh it out a little bit. Look, in a nutshell, maybe we came into this situation with the flexibility to buy, which we did. And now we have the prudence to pause. So we knew we were well positioned coming in with respect to capital and liquidity. As a result of all of our stress testing, we also felt good about buying back roughly the amount of stock that we bought through early May. Now obviously, this was a value-creating exercise for our shareholders. But having repurchased what we sort of said we wanted to, we feel it's appropriate to pause at this point just to survey the economic market landscape, et cetera, over the coming months and see where we're at. We're going to be constantly monitoring this, so it's pretty straightforward, what we are able to do.

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

Got you. And so Eric, there was nothing new that you found out within the last week or so that has changed your view. Really, it's just a matter of, we'll say, the opportunity and now having done a lot taking a pause. Is that a fair way of describing it?

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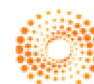

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Eric Thomas Steigerwalt - *Brighthouse Financial, Inc. - President, CEO & Director*

Yes. Nothing new and nothing out of the ordinary that -- I mean, you're hearing this from a lot of companies, obviously, right? We're thrilled to have been able to buy back the shares that we bought back at the prices that we were able to buy them at. And we're just taking a pause here, like many other companies, as we survey the economic landscape. Ed, do you want to add anything?

Edward Allen Spehar - *Brighthouse Financial, Inc. - Executive VP & CFO*

Yes, I would. I'd just like to go back to, I think, comments you made, Eric, about the amount of stock that we bought was over 12% of our shares outstanding at the end of 2019. So I think it's important to highlight that number because while we're taking a pause, along with so many others, the -- I think that number, 12%, is a very substantial amount relative to what we would consider to be, obviously, any type of normal pace. And so the ability to spend the amount of money that we spent to buy back as much stock as we would thought we would buy -- actually more stock than we thought we would buy for the full year, I think, is noteworthy.

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

No, that makes sense. The -- can you guys just -- my follow-up is, can you provide some perspective on your kind of updated view on consolidated excess capital? Because on one hand, your RBC remained quite solid, flattish if you adjust for the dividend out. But then on the other hand, when I think about solving for excess capital, it's kind of a proportion or percentage of TAC, and TAC went down by 25%. So there's some puts and takes there. But what is your -- what was your overall view on sort of updated excess capital company-wide?

Edward Allen Spehar - *Brighthouse Financial, Inc. - Executive VP & CFO*

Yes. Thanks, Tom. So let me step back and talk about the TAC movement that you mentioned because, as I said in my prepared remarks, we've been talking about this potential disconnect between the movement in total adjusted capital and our first loss position relative to our hedge target. So I mentioned this in prepared remarks. Recall, on our business update call, and we also spent a reasonable amount of time talking about this in our 2019 10-K. So we've been giving this as a sort of an indication of what would happen in an environment, like we just saw in the first quarter, and it's exactly what happened. So remember, we managed to a total element of variable annuity reform, which we adopted at year-end capital and reserves. And as you know, it's a key element of variable annuity reform, which we adopted at year-end 2019. So when markets decline, there is a shift from capital to reserves as a potential adverse event, which was reflected in capital has become an actual adverse event, which is now reflected in reserves.

So this is what happens with VA reform, and because this actual adverse event is now reflected in reserves, you don't have to hold capital against it. And so there's a decline in the required capital. So when you think about the movements in these factors, you really need to look at RBC ratio because the change in the TAC and the change in the required capital, the combination of those 2 is going to be more analogous to what we talk about when we talk about our first loss position. So you referenced the RBC ratio ending 515% to 535% after you consider about 20 points related to the dividend we took out, you're essentially unchanged from where you were at the end of the year. So when (inaudible) in VA reserves and, therefore, an increase in total with the rebound in the market in the second quarter-to-date (inaudible) capital. There would also be an increase in required capital, most likely, because of the dynamic that I just mentioned. But TAC is going to move based on the market environment. And it's not surprising that when you have a bear market, you're going to have this negative impact on TAC. To the extent you see a reversal over time, you'll see TAC follow suit as well.

Operator

Our next question comes from Elyse Greenspan with Wells Fargo.

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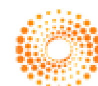

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Elyse Beth Greenspan - *Wells Fargo Securities, LLC, Research Division - Director & Senior Analyst*

My first question, can you just give us a sense of the macro environment or for the sensitivities that you would need to see for that remaining $450 million (inaudible).

Edward Allen Spehar - *Brighthouse Financial, Inc. - Executive VP & CFO*

Elyse, it's Ed. Yes, we're not going to get into any specific factors that might influence our decision on the remaining $450 million. Clearly, we're in an uncertain environment. And in abundance of caution and, again, emphasizing prudence and flexibility, we're going to sort of see how the balance of the year develops and then make a decision about the remaining $450 million. I mean, obviously, with taking $800 million up, even after adjusting for the buybacks that we did in the second quarter to date, in my prepared remarks, I said we expected a substantial increase in holding company cash, I mean, I can tell you that our probably best guess, and you could probably get there is, it's probably around $1.3 billion at the end of the second quarter. So we feel really good about where we are at the holding company today, and we're going to sort of assess the second half of the year and make a decision.

Elyse Beth Greenspan - *Wells Fargo Securities, LLC, Research Division - Director & Senior Analyst*

Okay. That's helpful. As we think about life insurance sales, you called out, right, some kind of headwinds there. Can you just help us think about levels of sales that you could see for the balance of the year given just the COVID-related headwinds?

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

It's Myles speaking. So as Eric mentioned earlier on in the conversation, we do expect to see an impact on life sales. And if you really think about our life franchise, it was very much in start-up mode. We began to bring on distributors selling the product last May, and that really continued on through October. So the distributors that we're working with, they are really new to selling the product. The life insurance team has been highly focused on establishing relationships with advisers, and they were doing that very successfully. And I think you can look to our results over the last several months to see that. But because the base of advisers is still relatively new, because we've just started selling a product not even quite a year ago, it's going to be difficult for our life insurance wholesalers to prospect in this environment, as they work remotely. But our strategy was absolutely working, and we remain committed to our distribution strategy, which has proven to be successful. And we look forward to getting back to more of a normal environment, where we could start to grow sales again.

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

It's Eric. I'll just jump in for one second, too. I just got to say a shout out to all of our wholesalers and the advisers that they work with. They have been tremendous taking care of their clients, and we're taking care of them. This is an important business for us. It was very exciting to see the results develop in January, February, March in the life business. And look, we're just going to keep pushing. It's not like we're not in a virtual environment, where we're not talking to financial advisers. We're talking to them all the time, and they're trying to take care of their clients. But I do think it's fair to say that we'll have a little slowdown here. But the overall targets and the strategy of getting back into the life insurance business from a new sales perspective is unchanged.

Operator

Our next question comes from Ryan Krueger with KBW.

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

From the lower expected sales activity this year, do you expect, I guess, any material amount of additional capital generation due to that?

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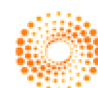

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Edward Allen Spehar - *Brighthouse Financial, Inc. - Executive VP & CFO*

Ryan, it's Ed. So I don't think we want to put a number on anything like that right now. I think you recall that at our business update, we talked about the sort of the strain from new business on our distributable earnings, and we have said it might be in the neighborhood of $400 million and that, over time, that obviously flips. But we're not going to get into any specifics around how that might change going forward.

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

Ryan, it's Eric. I'll just add one thing. Look, it might end up that we do free up a little capital because it's not used to back new sales. But we want to sell, we want to be there for advisers and their clients. So I think, as we move further down the road in the year here, we can give you a number if it materializes. But frankly, I'd like to get back to selling as quick as possible.

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

And then, Ed, you had provided an RBC sensitivity to equity markets down 25%. I think interest rates is at 1% in credit. And I think the total is about 100 points of RBC. Can you just -- can you break out how much of that was credit versus markets and interest rates, so we can think about them separately?

Edward Allen Spehar - *Brighthouse Financial, Inc. - Executive VP & CFO*

Yes. Sure, Ryan. So I'll start, and then I'll pass it over to John for some more color. But in our business update call, we provided the stress, and it included, as you said, equity market shock, interest rates down and credit losses and migration. So we obviously saw 2 of the 3 occur in the first quarter. As I'm sure you're not surprised, there was a very minimal impact in the quarter from impairments and credit migration. But I guess, what I would say is that with 2 of these 3 items playing out in the first quarter and sending up at a 515% to 535% RBC ratio and holding company cash of $1 billion, I think it's fair to say that we have the cushion to absorb the losses that we had anticipated when we gave our business update as well as something beyond that if you want to overlay some more stress type of scenario. So I'll pass it over to John now to maybe provide some specifics on what we had talked about in terms of the impact back in March.

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

Ryan, I'll just remind you of the assumptions we used for the March data. We assumed corporate credit losses consistent with actual experience during the financial crisis. Specifically, they're based on 2008 to 2010 Moody's data from migration and defaults. With respect to structured finance, we used assumptions from our outside managers based on their best estimates of expected losses and migrations during that kind of scenario. And for mortgage -- our mortgage loan portfolio, we used 1990 to 1993 data to estimate shocks for LTVs, which informed expected credit migration losses there. Now maybe to your question, this stress scenario for credit losses and migration would account to -- for approximately a 50 percentage point impact on RBC over 2 years.

Operator

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

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

I was wondering if you can provide some updates on kind of interest rate sensitivity, especially in a sub-1% 10-year environment? I think in the business update call, you kind of stopped at 1%. But how should we think about in the sub-1% environment?

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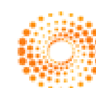

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Edward Allen Spehar - *Brighthouse Financial, Inc. - Executive VP & CFO*

Yes. Humphrey, it's Ed. So I guess, let me talk about what we saw in the quarter and then maybe just qualitatively give you some assistance here. So the reason that we did not pierce -- or not pierce, did not use up any of our first loss position relative to our hedge target in the first quarter is because substantial gains on our previously out of the money interest rate protection offset all the other negative impacts from the markets. So we have talked about significant out of the money protection for interest rates. And obviously, in the current environment, that has become pretty valuable. However, we also showed you at our -- on our business update that we clearly benefit from higher interest rates and higher separate account returns. And you saw that when you looked at our base scenario versus our lower separate account return, lower interest rate scenario. So I'm not going to provide an update on what are the distributable earnings numbers with a 10-year treasury at 70-some basis points, but I would just say, qualitatively, we feel very good about where we are today from a capital position, we feel very good with the interest rate protection we have and the gains that it's provided, and we'll have to see where we go from here in terms of the markets. But obviously, we're in a very uncertain environment right now.

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

That's helpful. And then just to follow up early -- your earlier comment about you feel very comfortable with the cash flow casting margin in a low rate environment. Should I kind of take that as you don't expect any meaningful kind of statutory impact on capital from the current interest rate environment? Or is this just something that's going to be manageable? Like, how should we think about that?

Edward Allen Spehar - *Brighthouse Financial, Inc. - Executive VP & CFO*

Yes. So let me clarify. So my comments were specific to the question on BRCD, our life insurance captive. And I said that the cash flow testing margin, which is what we focus on when we think about the capitalization of that entity, is very strong even at rates that are substantially lower from where we are today. So that's obviously a key piece of our life block.

In terms of overall cash flow testing margins, I'm not going to get ahead of our fourth quarter process for cash flow testing. I mean, obviously, last year, at year-end, we were fine. I think the question about where we are with a third quarter assumption update or a fourth quarter cash flow testing, I don't think it's prudent to get ahead of ourselves. There's a lot of work that goes into calculating those impacts, and we're going to have to wait for the second half of the year to provide those.

Operator

Our next question comes from Alex Scott with Goldman Sachs.

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

I had a followup on, I guess, just the TAC and the excess capital. When I was trying to assess the quarter, I was just looking at the amount of TAC you have sort of in excess of how much you would need to be at your RBC targeted, I guess, minimum levels that you've communicated. And when I do that calculation, there has been some decline quarter-over-quarter, and I don't think that's unexpected or something. But I guess just, how do I square that with what you're saying about the first loss position having not been touched? Is there something about that thinking that's not -- that's different from the way that you guys think about managing capital and your excess capital position?

Edward Allen Spehar - *Brighthouse Financial, Inc. - Executive VP & CFO*

Alex, it's Ed. So the first thing I would say is that we adopted VA reform, as you know, at year-end '19. So I think when you look at the framework for VA reform, it is a total asset requirement. And as I mentioned before, there is a shift between capital and reserves, depending on the market

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environment. So I know you're a technical guy, so let me get a little bit more technical on this one. So when adverse market events occur, like we saw in the quarter, there's convergence between CTE70 reserves, which is the basis -- basically the basis for VA reform reserves, and CTE98, which is the basis for capital under VA reform. So you see a convergence between CTE70 and CTE98 because CTE70 does not reflect the potential adverse events to the same extent as CTE98. And just to underscore this for you, if you think about the average of the 30% worse scenarios, that average really isn't a bad outcome overall. So to illustrate this, if we didn't hedge, our CTE70 reserves would be less than what they are today, and the reason for that is because hedging is a cost, not a benefit when you look at the average of the 30% worse scenarios. Pretty interesting. So I think if you look at what happened this quarter is that when this potential adverse event becomes a real adverse event, right, your CTE70 reserves go up because the average of the 30% isn't so bad. So when an actual event happens, you have a bigger increase in CTE70 than you have in CTE98.

And so I don't think that's any different than what anybody else is going to face if they look at VA reform and manage the company do a CTE framework. And as a reminder, CTE98 for a pure VA company under VA reform is a 400% RBC ratio. So I hear what you're saying about the shift between -- in TAC between capital and reserves. But when you're thinking about total asset requirement and managing the risk of this business, I think you need to be looking at the change in the RBC ratio as more indicative of a first loss type of concept than looking at any one component.

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

Got it. Okay. And then I have a followup just on the credit stress. I would think the total adjusted capital, one of the implications there is just that I think credit losses would eat a bigger part of your go-forward TAC at 3/31. So were those credit stresses as of year-end or as of March 31? And does it change much the sensitivity to credit losses and impairments in downgrades?

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

It's John. The stresses were based on our 12/31 portfolio, actually. Things haven't changed much since then. And I would say that a greater proportion of the use of capital is actually coming from downgrades and not losses, probably something in the range of 55%, 45%.

Operator

Our next question comes from John Barnidge with Piper Sandler.

And our next question comes from Andrew Kligerman with Crédit Suisse.

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

I think it's kind of fascinating that you never use the first dollar loss of $500 million. I'm curious -- and now with the equity markets rallying back, it doesn't seem that you'll even get close to having to use it. So I'm wondering what might be a scenario where it would kick in and it would start to get utilized? And then with that question, could you specify what your hedging effectiveness was in the first quarter regarding variable annuities?

Edward Allen Spehar - *Brighthouse Financial, Inc. - Executive VP & CFO*

Andrew, it's Ed. You've cut out a little bit on the second part of your question. I wonder if you could just repeat that.

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

Yes. So I'm -- given that you never exercised or used the first loss of $500 million, would you provide a scenario in which that would occur? And then secondly, with respect to hedging effectiveness, what -- could you put a number on that? It sounds like you said 2/3 of $800 million, so maybe a little north of $500 million was the statutory loss. Was that the hedging effectiveness?

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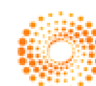

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Edward Allen Spehar - *Brighthouse Financial, Inc. - Executive VP & CFO*

Yes, yes. Okay, Andrew. So let me start with this hedge effectiveness question because I know a number of people talk about this, and I find it fascinating because I think the real measure of hedge effectiveness occurs, I think, relatively infrequently. And it occurs in a quarter, like we saw that we just lived through. So just to restate what I had commented on in my script, our total asset requirement at CTE98 was $9.4 billion at the end of 2019. That number went up to $17.5 billion at the end of the first quarter. So we had an $8.1 billion increase in CTE98. This is the quarter when you assess hedge effectiveness. And the fact that the combination of our derivative gains, which were $5.3 billion, our benefit from the Shield product, which is $2.5 billion, and our VA product cash flows, which was $500 million, you had an $8.3 billion increase at variable annuity assets before the dividend. So I mean, I don't know how people calculate percentages but, I would say, if your total asset requirement goes up by 90% and it's $8.1 billion increase and your VA assets go up by $8.3 billion that, that's a pretty effective hedge program.

So to the first loss, the comment I made here was that we had significant gains on our interest rate protection. So a scenario where if interest rates go back up, obviously, some of those gains might go away. But I'd say what, I don't think any of us would mind seeing interest rates go back up. So that's not necessarily a negative thing. And I guess I would just say that this target of up to a $500 million first loss, it's just that. It's up to a $500 million first loss. So we've never been -- we haven't said exactly what the target is, but I think we're pretty happy with how things played out in the first quarter.

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

Yes. It sounds like you're in a very strong position there. And maybe lastly on that reinsurance recapture of $48 million. A lot of companies saw that spike up a few years ago. I think we saw Lincoln recently do a recapture. What's your sense going forward? Is there any major risk that you may have to recapture on any other individual life treaties? Or do you think that's it?

Edward Allen Spehar - *Brighthouse Financial, Inc. - Executive VP & CFO*

Yes, Andrew. So we have had some of these. I think it's impossible to predict what other ones we might see. When they come up, we have to make a decision about what's the right economic thing to do. The right decision here was to recapture. And so unfortunately, I'm not going to really be able to provide you any guidance on how to look at that. But the notable item that you mentioned, remember, the $48 million was not all the reinsurance recapture. I mean there were 2 items in there. One of the items was related to a TSA exit and a vendor change. And so the reinsurance recapture was probably -- it was around 2/3 of that $48 million number. So just to give you a little sizing on that.

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

Andrew, it's Conor. Let me just add a little context. The recapture, it's a little over 1% of the ULSG in-force, and it's about 1/4 of 1% of the overall in-force block of over $1 million policy. So it's not a significant amount in the context of the overall in-force.

Operator

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

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

Thanks, everybody. So hopefully, you got a sense here. You know we entered the current climate from a position of strength. Our balance sheet and liquidity position are strong, and we expect them to remain strong even in the midst of the stressed markets. Our overall investment portfolio is high quality and well diversified. As you heard today, our hedging program performed extremely well during a challenging market environment.

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And we continue to believe we have the right strategy in place, and we're going to execute on that strategy. So I hope you and your loved ones stay safe and healthy, and we look forward to talking with you again.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect.

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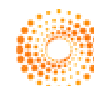

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