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Sun Life Financial, Inc. (SLF)

Q2 2018 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, ladies and gentlemen. My name is Carol and I will be your conference operator today. At this time I would like to welcome everyone to the Sun Life Financial Q2 2018 Financial Results Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks there will be a question-and-answer session. [Operator Instructions] Thank you.

Greg Dilworth, Vice President of Investor Relations, you may begin your conference.

Gregory A. Dilworth

Vice President-Investor Relations, Sun Life Financial, Inc.

Thank you, Carol, and good morning, everyone. Welcome to Sun Life Financial's earnings conference call for the second quarter of 2018. Our earnings release and the slides for today's call are available on the Investor Relations section of our website at sunlife.com. We will begin today's presentation with an overview of our second quarter results by Dean Connor, President and Chief Executive Officer of Sun Life Financial. Following Dean's remarks, Kevin Strain, Executive Vice President and Chief Financial Officer, will present the financial results for the quarter. After the prepared remarks, we will move to the question-and-answer portion of the call. Other members of management will also be available to answer your questions on today's call.

Turning to slide 2, I draw your attention to the cautionary language regarding the use of forward-looking statements and non-IFRS financial measures which form part of this morning's remarks. As noted on in the slides, forward-looking statements may be rendered inaccurate by subsequent events.

And with that, I'll now turn things over to Dean.

Dean A. Connor

President, Chief Executive Officer & Director, Sun Life Financial, Inc.

Thanks, Greg, and good morning, everyone. Turning to slide 4, the company reported underlying net income of CAD 729 million or CAD 1.20 per share. We generated a strong underlying return on equity of 14% and maintained a strong capital ratio and balance sheet with leverage below our target ratio. Sun Life U.S., Asia, and MFS each delivered strong earnings growth over last year and our Canadian business delivered good results. In constant currency, insurance sales grew by 15%. Asia individual insurance sales were up 33% and Canadian individual and group insurance sales were up 16%.

Wealth and asset management sales were down 12% in constant currency from lower sales in Asia and at Sun Life Asset Management including MFS and our alternatives business, Sun Life Investment Management.

For the value of new business or VNB, this quarter a combination of higher insurance sales volumes and favorable mix of business helped drive a 17% increase in VNB over prior year notwithstanding lower wealth sales. With a LICAT ratio of 149% for Sun Life Financial Inc. and a 21.8% financial leverage ratio, we have a strong capital position. Last night, we announced the continuation of our share repurchase program with a non- (sic) [normal-] (03:07) course issuer bid for up to 14 million common shares.

When we consider our strong capital position and the level of cash generated after funding organic growth and dividends, this repurchase program allows us to maintain a strong ROE and leaves us with ample excess capital availability. And this in turn allows to play both a strong defense and a strong offense in the later stages of this economic cycle.

During the quarter, we continued to make progress on growing our business pursuing strategic investments and achieving a number of milestones along the way. In Canada where we're a leader in insurance and wealth solutions, we continue to strengthen our competitive position. Our Group Retirement Services business crossed the CAD 100 billion mark in assets under administration with growth of over 8% versus prior year. GRS is number one in the market with 1.4 million Canadians now members of the Sun Life pension or savings plan. Our Group Benefits business is also number one in the market covering 5 million Canadians and business in-force grew 5% over prior year.

And in individual insurance, we've led the industry in insurance sales now for the past five consecutive quarters. We launched, personalized smart shopper tips on our mobile platform where our digital interactive coach, Ella, informs clients of opportunities to save. We point clients to recent claims, and we show them how they could have saved money. They can search for dentists, physiotherapists, and other providers and not only see five-star quality ratings from other Sun Life plan members, but we've now added a cost comparison feature as well.

So these new capabilities are a triple win. They will help bend the cost curve for employers; they save the employees money; and they're helping us win new clients and deepen relationships with existing ones. We continue to improve our outreach to new joiners and in-plan GRS members to encourage higher contribution levels and to transfer in assets from other sources and in the quarter, we generated CAD 392 million of additional flows, up 60% from a year ago.

In the U.S., the after-tax profit margin in Group Benefits increased to 6.5% on a trailing 12-month basis. In stop-loss, we grew the business by 22% over the prior year and reached $1.5 billion of business in-force. In the quarter, we launched an innovative stop-loss product with collective health that also seeks to bend the cost curve on medical costs for our clients. The stop-loss offering provides financial protection from high-dollar claims with seamless claims reimbursement, convenient employer reporting, and improved risk management.

We also acquired Maxwell Health an innovative insurtech that will help us transform the benefits experience by making it easier for people to understand and choose the right benefits for themselves and their families. The addition of Maxwell Health also gives us a total benefits solution that advances our strategy with small and mid-sized employers.

Asia results were strong with underlying net income up by 18% sales in our Mandatory Provident Fund or MPF business in Hong Kong increased by 64% over the second quarter of last year and our MPF business ranked first in net flows this past quarter and we've now moved into the number four spot in the industry based on assets under management.

In addition to investing in and building our traditional distribution, we continue to test innovative ways to reach clients across Asia. In the Philippines, we signed a distribution partnership with Lazada, the leading e-commerce platform in Southeast Asia that makes it easier for clients to purchase insurance online.

In Indonesia, we launched telco insurance campaigns with Telkomsel's TCASH to reach clients quickly and easily. And in Malaysia, we launched SunActiv, a wellness mobile app that rewards clients for staying active and healthy including a search and book feature to book appointments with healthcare professionals right from their mobile devices.

In Sun Life Asset Management, we ended the quarter with CAD 684 billion in assets under management. Sun Life Investment Management generated net inflows of approximately CAD 200 million. At MFS, the pre-tax operating profit margin was 36% and assets under management increased 3% from the prior year to us $474 billion.

Net outflows for the quarter were outsized at $11.5 billion. The majority of the net outflows came from institutional separate accounts as clients de-risked and rebalanced their portfolios. But we also saw net outflows in retail as investors reacted to market volatility in the quarter.

On the other hand, MFS continues to deliver consistent long-term results that are helping our clients to meet their investment objectives. 81%, 80% and 90% of MFS' U.S. retail mutual fund assets ranked in the top half of their Lipper categories based on 3-, 5-, and 10-year performance, respectively. Mike Roberge, President and CEO of MFS, is here on the call with us today and will comment on MFS' net flows after Kevin's remarks.

So, to wrap up, we've made very good progress this quarter and for the first six months of 2018. So far this year, our underlying EPS is up 20%, up 11% if you exclude the par seed capital income earned in Q1. We grew VNB by 25% year-to-date, and we've achieved an underlying ROE of 14.5%. We continue to track well against our medium term objectives.

This organization is galvanized around clients, on improving the client experience and on using digital and data analytics to drive proactive, helpful, timely, relevant contact. This obsession with clients is coming through in terms of higher client experience scores, easier client experiences, and more sales to existing clients. And ultimately, this will help us deliver on our purpose, which is to help our clients achieve lifetime financial security and live healthier lives.

With that, I'll now turn the call over to Kevin Strain, who will take us through the financials.

Kevin D. Strain

Chief Financial Officer & Executive Vice President, Sun Life Financial, Inc.

Thank you, Dean, and good morning to everyone on the call today. Turning to slide 6, we take a look at the financial results from the second quarter of 2018. We saw strong earnings and ROE results this quarter across the business. Reported earnings were up 23% and reported earnings per share of CAD 1.16 were up 25%, reflecting business growth, favorable experience gains, and the impact of share repurchase activity over the past year. Reported ROE was 13.5%, up from 13.1% last year.

Underlying earnings, which excludes the impact of market factors and assumption changes, were at CAD 1.20 per share, up 7% over the second quarter of 2017, reflecting strong business growth and favorable morbidity experienced in the quarter. These results were achieved against the headwind of a strengthening Canadian dollar, which reduced underlying net income by CAD 22 million relative to the same period a year ago. Our underlying ROE for the quarter was 14%, at the upper end of the target range of our medium term objectives of 12% to 14%.

Our capital positioning continues to be an area of strength. We ended the quarter with a LICAT ratio for Sun Life Financial, Inc. of 149%. The LICAT ratio for Sun Life Assurance Company of Canada was also strong at 134%. The higher ratio at the SLF level largely reflects the excess cash of CAD 2.6 billion held by SLF, Inc. At the board meeting yesterday, we approved a dividend of CAD 350 million to SLF from SLA, reflecting the continued strong earnings growth and cash generation at SLA.

We repurchased and canceled 3.8 million common shares for the first six months of 2018 at a cost of CAD 206 million. As Dean noted earlier, we announced a continuation of our share repurchase programs with a normal course issuer bid program of up to 14 million shares, which is reflective of our strong capital position. These strong capital ratios are supported by a leverage ratio of 21.8%, which is below our target level ratio of 25%. Our dividend payout ratio was 40% of earnings, at the lower end of our medium-term objective range of 40% to 50%, reflecting our strong earnings growth.

Turning to slide 7, we provide details of underlying net income by business group for the quarter. In SLF Canada, underlying net income of CAD 245 million was down slightly from the prior year reflecting lower gains from credit experience and lower new business gains primarily in Group Retirement Services, which experienced strong new business gains on strong sales result in the second quarter of 2017. The underlying return on equity for Canada was 14.5%.

In SLF U.S., underlying net income was up 24%, 33% in U.S. dollars reflecting improved morbidity experience and the stop-loss business, the benefit of the lower income tax rate. Our Group Benefits after tax profit pushed through the high end of our target range of 5% to 6% increasing to 6.5% in the second quarter from 3.3% in the prior year. Underlying return on equity in SLF U.S. was also strong at 14%.

SLF Asset Management had underlying earnings growth of 9% on higher average net assets at both MFS and Sun Life Investment Management and a lower income tax rate in the U.S. partially offset by the impact of a stronger Canadian dollar and lower returns on seed capital at MFS. MFS pre-tax net offering profit margin was 36%, in line with the prior year.

In Asia, underlying net income grew by 18% over the last year. SLF Asia expected profit was up 23% year-over-year, new business strain was down CAD 19 million or nearly two-thirds and earnings on surplus was up 14%. SLF Asia's underlying return on equity was 11.8% for the quarter, reflecting earnings growth as well as a change in our capital allocation model made earlier this year that saw us move our Asian business to a fully levered basis, consistent with our other business groups across Sun Life.

Turning to slide 8, we provide details on our sources of earnings presentation. Expected profit of CAD 732 million increased by CAD 30 million over the same period last year. Excluding the impact of currency and the result of SLF Asset Management, expected profit grew by 14%, driven primarily by strong business growth in Asia. We had new business gains this quarter of CAD 13 million, up CAD 4 million over the same period last year from improved levels of new business strain in SLF Asia, on strong volume and improved business mix, partially offset by lower levels of gains in SLF Canada on lower GRS sales.

Experience items were largely favorable this quarter with positive net market impacts, strong morbidity results stemming from our stop-loss business in SLF U.S., as well as the Group Benefits business in SLF Canada, strong investment gains and favorable mortality experience, partially offset by unfavorable lapse and policyholder behavior and expense experience. The majority of this quarter's expense experience relates to accruals for incentive compensation from strong performance in the first half of 2018.

Other, which amounted to a negative CAD 48 million in our sources of earnings disclosure includes the fair value adjustment on MFS share-based payment awards, acquisition and integration costs, and the impact of hedges at SLF Canada that do not qualify for hedge accounting.

Earnings on a surplus of CAD 153 million were CAD 19 million higher than the second quarter last year, reflecting higher levels of investment income and real estate fair value gains. Our effective tax rate on reported net income for the quarter was 19.1%. On underlying basis, our effective tax rate for the quarter was 17.1% in line with our expected range of 15% to 20%.

Slide 9 shows sales results across our insurance and wealth businesses. Total insurance sales were up 12% or 15% on a constant currency basis. SLF Asia individual insurance sales were strong growing 33% on a constant currency basis with double-digit growth in the Philippines, Hong Kong, India, China, and the high net-worth International segment. SLF Canada insurance sales were up 16% mainly driven by a higher volume of large case sales in our Group Benefits business and growth in individual insurance. Sales in SLF U.S. were down 2% in U.S. dollars where our lower large case sales in employee benefits were partially offset by a 5% increase in stop-loss sales.

Total wealth sales of CAD 30.8 billion were down 16% from prior year or 12% on a constant currency basis. SLF Asia wealth sales were down 9% compared to the same quarter in the prior year primarily from lower fund sales in India and the Philippines. We continue to see strong sales in our Hong Kong MPF business which reached number four in the market for assets under management and number one for net sales.

Sun Life Asset Management sales were down 12% mainly from lower institutional sales at MFS as well as lower fund sales at Sun Life Investment Management. SLF Canada wealth sales were down 20% as the second quarter of 2017 included a large case annuity sale in Group Retirement Services.

Individual wealth sales in Canada were up 7% on continued growth from our wealth manufactured products including Sun Life Global Investment Mutual Funds. We had a strong quarter for VNB, which increased 17% to CAD 266 million on strong insurance sales and positive sales mix.

So, to conclude, we are pleased with the financial results for the second quarter. We delivered strong earnings and ROE at the top end of our target range and our capital strength positions us well as we look ahead.

With that, I'll turn it over to Mike Roberge to say a few words on MFS before we start the Q&A portion of the call.

Michael W. Roberge

Chief Executive Officer and President - MFS Investment Management, Sun Life Financial, Inc.

Thanks, Kevin. Good morning, everyone. I'm going to spend a few minutes talking to you about MFS outflows in the quarter, provide some perspective relative to what we're seeing across the industry. As you know, our net flows are a product of two large numbers, and they're both gross sales as well as redemption activity on behalf of clients.

Our gross sales at MFS this quarter are $18.6 billion, that's down from last quarter where we saw record level sales in U.S. retail. This is consistent with U.S. retail industry trends where we saw meaningfully slowdown in net inflows in the quarter. In addition, these flows were also more heavily directed toward fixed income products which had an unfavorable impact on active equity managers like MFS. Even with that, as rates went up in the quarter, we actually saw fixed income flows come down versus Q1 as well.

On institutional side, we saw elevated levels of outflows in the quarters, rebalancing was the primary reason given by clients for redemptions, it was not performance related. There have been a number of questions around portfolio management retirements and what impact that's having on flows. When you look at those pools of assets relative to the overall book, redemption rates are not meaningfully higher on that. So really is what clients are doing in terms of de-risking, rebalancing within their overall plan has drove the outflows in the quarter. Broadly across the industry, we do continue to see elevated levels of industry redemption rates, and we've talked about this historically. It is something that we don't believe will persist over the long term.

A number of questions as well around capacity and how we're thinking about capacity, what I would say is we are carefully managing that and reopening strategies where appropriate. We currently have 12 strategies or approximately 40% of our assets under some form of capacity constraints. I'll remind you, our first priority is to deliver strong returns to clients. That's what the capacity constraints are all about. And we've been able to continue to do that as the assets have grown in those strategies over the last several years.

Our view is as long as we're adding alpha on behalf of clients; clients will continue to hire us. We've kept strong investment performance to the bull market given the strength of our research platform and we expect to continue to drive strong performance through the inevitable market correction, wherever that might be.

We have to ensure that we have the right products on behalf of clients. Part of that is offering products that we have today and some of that is building out capabilities that we've talked about in [indiscernible] (20:11) fixed income. Our view is if we do that successfully, it's a great business, generates higher returns, high cash generation, and will grow earnings through this cycle.

So with that as context, I'll turn it back to Greg, who'll start the Q&A portion of the call.

Gregory A. Dilworth
Vice President-Investor Relations, Sun Life Financial, Inc.

A

Thank you, Mike. To help ensure that all of our participants have an opportunity to ask questions on today's call, I would ask each of you to please limit yourself to one or two questions and then re-queue with any additional questions.

And with that, I'll now ask Carol to please pull the participants for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] And our first question today comes from Gabriel Dechaine from National Bank Financial. Please go ahead.

Gabriel Dechaine
Analyst, National Bank Financial, Inc.

Q

Good morning. Actually, Mike, I want to kick it off with you on the MFS. You talked about the strategies that are that have been closed to new inflows, I think, it was [ph] 12 (21:10) funds. And you also alluded to the fact that you are reopening some strategies. Can you dive into that a little bit more? I didn't get a full picture, I guess, of what exactly you're doing and how you expect that to evolve over the next little while?

Michael W. Roberge
Chief Executive Officer and President - MFS Investment Management, Sun Life Financial, Inc.

A

Yeah, I mean we are flexible in terms of restrictions on products. So where there is some ability to relax some restriction on a comingled or a retail product, we will and have done some of that. What I would say more broadly though is capacity as a function of total asset size that we're managing, cross-ownership across strategies across the organization, size of ownership in terms of what percentage of companies that we own. And then finally it's a function of trading volumes in the market. So even as organic asset levels have come down in some of the strategies; trading volumes have actually come down pretty dramatically.

And so while we can be somewhat flexible with capacity, we don't think it's going to be a significant driver of gross sales. We'll look at the overall book. So what we're doing is diversifying the strategies that have capacity, diversifying into asset classes and [indiscernible] (22:21) like fixed income that's a little bit newer for us in that channel. And so, we think that we'll continue to be somewhat capacity-constrained in the equity book that is currently closed. And what we need to do is to continue to diversify the product set.

Gabriel Dechaine
Analyst, National Bank Financial, Inc.

Q

And the rebalancing, that's a term we've heard for a number of years on the institutional side. Is that really – I mean, how much of that rebalancing is the clients that are – they've got too much money for you or however you want to put that with you, I mean, or versus they're going to be passive or private equity route or whatever other alternatives, what's the mix like there?

Michael W. Roberge
Chief Executive Officer and President - MFS Investment Management, Sun Life Financial, Inc.

A

Yeah. I mean, what we don't – the institutional channel's been able to buy passive the forms of managements for decades. And so we don't see the institutional book significantly impacted by that passive pressure. We are seeing them more on the retail side. The rebalancing really is you've got a big equity book, much of it is de-risking. And so in this quarter in Q2 where interest rates went up and equity markets were actually – depending on where you were on the world, but equities were relatively strong particularly over a one-year basis we see clients de-risking. And so they sell down equities and they reallocate to fixed income.

And so because our institutional book is skewed to equities, that has an impact on us. And so, it really is what clients are doing in their overall asset allocation relative to what's happening in MFS.

Gabriel Dechaine
Analyst, National Bank Financial, Inc.

Q

And then apologies to Greg, I'm going to sneak one more, a quick one though, and this is for Steve in the mortgage and loan investment portfolio. Looks like you had roughly CAD 70 million impairment, it's not a big number, but I just want to understand it a bit more. Is that part of why you didn't have the credit experience gains you normally do? And what sector and geography was that particular mortgage exposed to?

Randolph Brill Brown
Chief Investment Officer, Sun Life Financial, Inc.

A

Hi, Gabriel. It's Randy Brown, the CIO, so I'll take that one.

Gabriel Dechaine
Analyst, National Bank Financial, Inc.

Q

Oh.

Randolph Brill Brown
Chief Investment Officer, Sun Life Financial, Inc.

A

The credit experience this quarter was lower. It was really about one or two idiosyncratic credits that went down. So, I'd say it's not anything that represents the broader book. In fact, the broader book is doing quite well. With respect to sector, one in particular was a government-related security for a loan that went down. So, nothing that I would call out there to project forward.

Gabriel Dechaine
Analyst, National Bank Financial, Inc.

Q

In the U.S., I imagine?

Randolph Brill Brown
Chief Investment Officer, Sun Life Financial, Inc.

A

No.

Gabriel Dechaine
Analyst, National Bank Financial, Inc.

Q

No?

Randolph Brill Brown
Chief Investment Officer, Sun Life Financial, Inc.

A

Not U.S.

Gabriel Dechaine
Analyst, National Bank Financial, Inc.

Q

Thank you.

Randolph Brill Brown
Chief Investment Officer, Sun Life Financial, Inc.

A

You're welcome.

Operator: Our next question comes from Humphrey Lee from Dowling & Partners. Please go ahead.

Humphrey Hung Fai Lee
Analyst, Dowling & Partners Securities LLC

Q

Good morning, and thank you for taking my questions. Just to follow up on MFS, so you talked about what you saw in the quarter, maybe can you talk a little bit about like what have you seen since the quarter end? How is the pipeline shaping up for the balance of the year?

Michael W. Roberge
Chief Executive Officer and President - MFS Investment Management, Sun Life Financial, Inc.

A

Yeah. Humphrey, we don't – as historically has been the case, we're going to talk a lot about what we're currently seeing, what our expectations are in flows. What I would say more broadly is if you look in July and you look at industry flows, they don't look dissimilar from what we saw in Q2. And so, irrespective of the fact that the market is sort of approaching and making new all-time highs, at least here in the U.S., is the trade backdrop has clearly got people cautious, sitting on their hands a little bit, and if you look at flows, de-risking to some extent. And so, if the backdrop remains as it is, we would expect that Q2, from an industry perspective, would continue to look the same.

We do think that Q2 from an institutional side was more outsized, if you look historically, that's been the case. Occasionally, you get hit in a quarter by redemptions that are higher than you would anticipate cross-cycle and so, the retail environment doesn't look significantly dissimilar. The institutional environment, we think was outsized in Q2.

Humphrey Hung Fai Lee
Analyst, Dowling & Partners Securities LLC

Q

Got it. And then can you talk a little bit more – or give us an update on those new strategies that you have rolled out over the past couple years, like the Blended Research, the [ph] Fixed Income Assets (26:41), like, what are the size of those strategies right now in terms of AUM and can you just give an update on those?

Michael W. Roberge
Chief Executive Officer and President - MFS Investment Management, Sun Life Financial, Inc.

A

Yeah. I mean it's broader that – broadly diversified. Where we are capacity [ph] un-constrained (26:59) emerging market equities, regional equities, mid to small cap equities, those are strategies that have long term track record, strengthened management team, stability of management teams. And so we're actively offering those into the marketplace. Blended Research we've had now for a number of years and those we're positioning relative to some of the passive or quasi passive alternatives and then fixed income, our strategies that are now a number of years older and we're in the process of getting consultant ratings, getting them in front of prospects, starting the sales process. The institutional sales process is a much longer process in the retail sales process. And so in the retail channel this year, fixed income sales will represent about a quarter of our sales, so we're well known in the U.S. as a fixed income manager.

What we need to do is create that same brand and product identity outside of U.S. as well. We're in that process. It's going to take us some time. We've had some traction but we're – it's relatively nascent from an institutional perspective. And if you look at the overall assets of the firm, fixed income represents about 20%. We want to make that substantially higher over the next 3, 5, and 10 years.

Humphrey Hung Fai Lee
Analyst, Dowling & Partners Securities LLC

Q

Got it. Thank you.

Operator: Our next question comes from many Meny Grauman from Cormark Securities. Please go ahead.

Meny Grauman
Analyst, Cormark Securities, Inc.

Q

Hi. Good morning. Just a question on non-market experience gains, a good result, just wondering if you could remind us sort of what your view as more of a run rate when it comes to that specifically.

Kevin Morrissey
Senior Vice President & Chief Actuary, Sun Life Financial, Inc.

A

Hi, Meny. It's Kevin Morrissey. Thanks for the question. We really don't think of the non-market experience in terms of run rate. They're quite variable. They go up and down. We sometimes see longer term trends. But in any given quarter, they're up and down. This quarter overall was net positive experience, so we're pleased to see that.

Meny Grauman
Analyst, Cormark Securities, Inc.

Q

I guess to put it another way. Is there anything in there this quarter that you would highlight as being unusual or not sustainable in your view?

Kevin Morrissey
Senior Vice President & Chief Actuary, Sun Life Financial, Inc.

A

Maybe I'll highlight the morbidity gains. Morbidity gains for the quarter were quite strong. About half of that was in Canada, about half of that in the U.S. In Canada, we had positive morbidity experience related to drug claims and LTD incidents. We also – in the U.S., most of that was driven by the stop-loss business. So, I'd say it was significantly positive. I wouldn't think of that as kind of a run rate. So, that would be one I call out as being probably over longer-term expectations.

Meny Grauman
Analyst, Cormark Securities, Inc.

Q

Thank you.

Operator: Our next question comes from David Motemaden from Evercore ISI. Please go ahead.

David Motemaden
Analyst, Evercore Group LLC

Q

Hi. Thank you. I have a question on your capital position and just thinking about your dry powder that you have for a deal whether that's excess at holding company debt capacity. And maybe even, your view of excess that's within SLA, just wondering if you could comment on that?

And then I guess just any update on your acquisition strategies particularly within Asia would be helpful?

Dean A. Connor
President, Chief Executive Officer & Director, Sun Life Financial, Inc.

A

David, it's Dean. Thank you for the question. Kevin will talk about the first part of it, and I'll comment on the second part of it.

Kevin D. Strain
Chief Financial Officer & Executive Vice President, Sun Life Financial, Inc.

A

So, we had excess cash of CAD 2.6 billion at the hold-co level at the end of the quarter and this reflects the strong capital position and the strong LICAT ratio. SLA increased its LICAT ratio to 134% this quarter. And our board, as I mentioned in my [ph] speaking remarks (30:52), approved a dividend of CAD 350 million from SLF to SLA which would increase our excess cash to just over CAD 3 billion and reduce the LICAT ratio at SLA back down to the 132%. And, as you know, our leverage ratio we disclosed at around 21.8% so...

Dean A. Connor
President, Chief Executive Officer & Director, Sun Life Financial, Inc.

A

Yeah. And just one last point on the leverage, as you may know, each point of leverage and we're just a little lower than 22% but at each point is about CAD 300 million of debt capacity there is – to get us back to a 25% leverage ratio, that's circa CAD 1 billion. So on your question, David, around M&A strategy, if you look – the best way to look forward is actually to look backwards at what we've done, what we've done in the past four, five years. We've deployed around CAD 2.5 billion of capital towards acquisitions across all four pillars.

And the criteria we have, first of all, the business has to fit the strategy, has to fit the four-pillar strategy. We ask ourselves, what do we bring to this business beyond a checkbook? How do our capabilities help lift this business up and vice versa? How does this business, when we add it to our existing platform, how does it actually accelerate the growth, not just make it bigger but actually help us grow faster? It also obviously has to tick the box in terms of hurdle rate, the long-term leveraged ROE has to clear our hurdle rate. And on that sense, we've remained disciplined as we deployed capital.

I would say to you that we're very active, continue to be active at seeking out opportunities. The average gestation period is measured in – usually in years, not months, in terms of from when we start talking to somebody to when we can actually make something happen. But I would – one thing I would tell you is that we're spending a tremendous amount of time, as we have over the past number of years, out talking to acquisition targets and candidates. And I think we've been pretty disciplined at it and we'll continue to be.

David Motemaden
Analyst, Evercore Group LLC

Q

Great, thanks. And then just a question in Group Benefits in the U.S. where the margin remained strong, I understand this quarter, there was some morbidity experience that was a bit favorable but even taking that out, you're still at the high end of the range. Do you think that this is a sustainable level that we can operate at going forward? And also I guess just any commentary you have on new business pricing and any pressure there because it seems like the industry is also experiencing peak margins in that business.

Daniel Richard Fishbein
President-US Business, Sun Life Financial, Inc.

A

Yeah. We have set out a target margin of 5% to 6%. And remember, we also have a 75-basis-point tailwind that will phase in during the year because it's a trailing 12 months basis from U.S. tax reform. So, we're very pleased with the 6.5% number this quarter, and that's pushing up against the high end of the range if you adjust for tax reform. As you mentioned, we did have some favorable morbidity in stop-loss. We actually had some unfavorable morbidity in our disability line, and we'll expect to see those items fluctuate over time.

However, overall, we are continuing to build margin. Pricing is strong. We've been able to get good increases both in the group business and in the stop-loss business. We're achieving our new pricing especially in the stop-loss business where our position remains very strong. So, overall, we think we'll be able to remain in the range that we had set out previously.

David Motemaden
Analyst, Evercore Group LLC

Q

Great, thanks. And maybe if I can just sneak one in for Mike. Just on MFS, and I know you guys gave the funds that are in the top half on a 3-, 5-, and 10-year basis. Just wondering if you had those on a top quartile basis?

Michael W. Roberge
Chief Executive Officer and President - MFS Investment Management, Sun Life Financial, Inc.

A

Yeah. I don't have it in front of me, so we can certainly provide that after the call.

David Motemaden
Analyst, Evercore Group LLC

Q

Okay, great. Thanks so much.

Operator: Our next question comes from Steve Theriault from Eight Capital. Please go ahead.

Steve Theriault
Analyst, Eight Capital

Q

Thanks very much. A couple of questions. Maybe starting with MFS. So, Mike, the one thing that I was curious about was U.S. equity markets were strong. So, I was surprised to see that the market movement impact on AUM was such a modest positive this quarter. I think when I look across institutional and retail, it was CAD 3.5 billion. In quarters like where we've seen like the S&P 500 was up a few percent this past quarter.

In those types of quarters, we often see CAD 15 billion to CAD 25 billion of market movement. So, why is it lower this quarter?

Michael W. Roberge
Chief Executive Officer and President - MFS Investment Management, Sun Life Financial, Inc.

A

If you look at the non-U.S. markets in 2Q, U.S. markets were up over 2% than non-U.S. market. If you look at the MSCI EAFE was actually down over 2%. So, it was a significant bifurcation in markets during that quarter that would drive the vast majority of that difference.

Steve Theriault
Analyst, Eight Capital

Q

Okay. And just a follow up on Gabe's question. If rebalancing is a function of de-risking big equity books as you mentioned in answer to his question, should we expect this issue broadly to potentially worsen the longer – the current bull market persists or do you think this is as bad as it gets in kind of a rough bumpy quarter?

Michael W. Roberge
Chief Executive Officer and President - MFS Investment Management, Sun Life Financial, Inc.

A

It's pretty hard to say given that every clients got different funding ratios and asset allocations. I mean, if you look at prior quarters even during – you look over the last year, even periods with the equity market had relatively strong periods, we didn't see the same de-risking activity. And so, I think it's very hard to predict. And so, we'd a very difficult time ourselves trying to understand what it could be and then certainly trying to give you any comfort around that as well.

The bigger issue is, I think, if you saw a significant spike in interest rates that could drive a de-risking – more of a derisking activity. But I think you'd need a pretty sizeable increase to drive significant de-risking from here.

Steve Theriault
Analyst, Eight Capital

Q

Okay. Thanks for that. And then on turning to Canada, for Jacques, I think, looking at Canadian insurance sales, the mix has been more third-party versus [ph] career (37:55) agency the last couple of years and I think that's been part of the plan. So a couple of questions, so the [ph] career (38:01) agency forces down about 350 over the last year, are you managing that lower from here or are we starting – or is that going to start to level off at this point?

And then secondly, we're hearing about the reentry of one of your large competitors into the par space. Does that give you much of any pause? Do you think there is much in the way of vulnerability on the market share front, especially given that your momentum has been quite good in third party the last couple of years.

Jacques Goulet
President-Sun Life Financial Canada, Sun Life Financial, Inc.

A

Thanks for the question, Steve. In terms of the overall distribution for insurance, I'll start by saying that fundamentally, we're more focused on outcomes than the actual number of advisors, although that's important. We're seeing good outcomes across the board and as pointed out by Dean, our interim sales are leading the market for the fifth consecutive quarter, so we're pleased with that. Both channels remain strategic for us.

As you said, we've seen nice growth in third party. I think I mentioned in the previous call that we're really looking at what I would describe as an omni-channel strategy. So it's not just about our own sales force and the third party but also how do we use technology and digital to engage with clients. So, overall, not any change from prior.

Your question about our competitor, I mean, we always watch what competitors are doing. They have been out of the par market for a number of years. We've been strong there. It's probably a bit too early at this stage to point out to what's that doing to [ph] sales (39:51). We continue to have good results, as you know. So, something to watch, obviously, it's important but nothing major at this stage.

Steve Theriault
Analyst, Eight Capital

Q

Okay. Thanks for that.

Operator: Our next question comes from Sumit Malhotra from Scotia Capital. Please go ahead.

Sumit Malhotra
Analyst, Scotia Capital

Q

Thanks and good morning. Mike, I missed some of your prepared remarks. I had to jump off the line, so I apologize if you addressed this. But with MFS, I wanted to ask a question about revenue. On a U.S. dollar basis, I see on a year-over-year basis, average AUM is about 6%, but the revenue growth is only 1%. Obviously, there's a lot to talk right now in the industry about fee compression and some more moves recently. So is that what we're seeing in an exaggerated way here, or is there another item that impacted revenue? And if you wouldn't mind, maybe, we've talked a lot about flows, but some of these recent actions we've seen from some of your large competitors at least on the index or ETF side, what is your view on the impact that has on MFS' pricing power?

Michael W. Roberge
Chief Executive Officer and President - MFS Investment Management, Sun Life Financial, Inc.

A

Yeah. The biggest delta between that year-over-year would be lower performance fees would've driven some of that and then some lower sales revenue on [ph] A (41:16) shares would've driven some of that as well on the revenue line.

As to fees, we've – it's been pretty consistent over the last really four or five years now on the active side where we've seen fees decay across the industry about 1.5% a year. We've not seen that accelerate. And so, we're planning for continued fee erosion over a longer period of time. We don't see anything that would catalyze at least at the moment that to occur faster. With number of questions around what Fidelity's move and what that could do to pricing in the industry, clients make a decision around where they want to be active or passive and that's clearly going to have an impact on the passive players. We don't believe that that fee move is going to substantially change the fee dynamic on the active side. And so, we continue to think that firms are going to have to being at scale like we are, it's incredibly important in this environment. And running discretionary expenses well which we have been able to do will allow us to maintain decent margins through the cycle.

Sumit Malhotra
Analyst, Scotia Capital

Q

Particularly as – and you've made some reference to rebalancing and the efforts that MFS has made to add scale or add capacity your fixed income operation. Is it reasonable to expect that the revenue growth for the unit is going to trail the level of AUM growth we see going forward?

Michael W. Roberge
Chief Executive Officer and President - MFS Investment Management, Sun Life Financial, Inc.

A

Over a longer period of time, as we ramp up fixed income, that's correct.

Sumit Malhotra
Analyst, Scotia Capital

Q

All right. I want to go to other part of the asset management operations, the Investment Management. We don't talk too much about this business given its smaller size. But I did notice the earnings contribution dropped off pretty noticeably this quarter from what had been a steady run rate. You did have an Investor Day for this unit a few years ago. You talked about getting earnings up to around the CAD 60 million range by 2020. We're obviously trailing that right now. What happened this quarter?

And maybe this one's for Dean. You said what's happened in the past is a good indicator for what happens going forward. That was on the buyback. But the last time you were in a very strong capital position you also did allocate or deployed capital towards investments in this space. Is that 2020 objective achievable without further acquisitions in this area?

Stephen Clarkson Peacher
President, Chief Investment Officer & Executive VP, Sun Life Assurance Company of Canada, Sun Life Financial, Inc.

A

Hi. This is Steve Peacher. I'll take the first question. In terms of earnings at Sun Life Investment Management for the quarter, we had some – basically one onetime expense that's nonrecurring that accounts for the earnings decline and but for that expense, we would have been on par with last year and recent results. So, it was really a onetime expense.

And I would say in terms of growth toward longer-term targets, we're very pleased. Every business that we bought or started, assets have grown meaningfully. If you look at AUM just over the last 12 months, AUM at SLIM is up over 9% and over 25% on a two-year basis. And I think we've had quarterly positive flows now since we started. So, we've got aggressive targets out there, but I'm very happy with the momentum that we've got in terms of new sales and also importantly investment performance, which continues to be strong across the board.

Dean A. Connor
President, Chief Executive Officer & Director, Sun Life Financial, Inc.

A

And Sumit, it's Dean. I mean I would just say regarding the 2020 goals, they're still out there that Steve and his team are still accountable for those goals. And I think there's – as Steve said, we're pleased with the progress on assets under management growth. We have been investing in distribution to help build out those sales and to help get the AUM base and the net income base up by 2020 and beyond. And so, we continue to be very focused on those goals.

Sumit Malhotra
Analyst, Scotia Capital

Q

And they're achievable without – organically without further acquisitions?

Stephen Clarkson Peacher
President, Chief Investment Officer & Executive VP, Sun Life Assurance Company of Canada, Sun Life Financial, Inc.

A

Yeah. That's definitely our goal. One of the things that we've done, for example, within Ryan Labs is brought in a – lifted out a team with their expertise and leverage loans. So, we think there could be continued opportunities to do that. But I really view that as trying to bootstrap the existing platform organically.

At the same, we're also looking at acquisition opportunities. We think – our goal for this business ultimately is to be many multiples to the size that currently is and I think that'll be a function of both organic and inorganic growth.

Sumit Malhotra
Analyst, Scotia Capital

Q

Thanks for your time.

Operator: Our next question comes from Paul Holden from CIBC. Please go ahead.

Paul Holden
Analyst, CIBC World Markets, Inc.

Q

Thank you. Good morning. So, first question is related to the U.S. group business. So, given where margins are today, it would seem like top line growth should return for this business. Employee Benefits, if I just look at the in-force numbers still down Q-over-Q but the pace of decline is slowing. Should we expect that Employee Benefits business to return to growth going forward?

Daniel Richard Fishbein
President-US Business, Sun Life Financial, Inc.

A

Yeah. As you noted, especially the most recent couple of quarters, it's pretty much flattening out on the BIF. As you know, we've been very disciplined about pricing, that was the choice we made, was to make sure that we were pricing both new business and renewals at the right place and we've made that trade off against some growth for a period of time. The business is stabilizing. I would also point out, though, that we've been converting business from the acquired Assurant Employee Benefits platform. And, of course, there were some losses that would be expected from those conversions but we're actually seeing those lapses lower or better than what we had modeled in the transaction.

So as we get through the conversions and get fully through our pricing actions, we would expect to see the employee benefits business continue to grow. And then combined with the stop-loss growth, which is 22% at this year, at this point year-over-year, we think the components will combine for a good growth trajectory.

Paul Holden
Analyst, CIBC World Markets, Inc.

Q

Great. Thanks for that. And then second question, this one's probably more for Dean. Given the excess capital you have, M&A is arguably the most important part of the story today. Given some, call it, dislocations or changes in valuations and emerging markets including Asia, with Trump trade policy and just given what we're seeing with some of the publicly traded names, are you seeing any improved opportunities for capital deployment in that part of the world?

Dean A. Connor
President, Chief Executive Officer & Director, Sun Life Financial, Inc.

A

Paul, first of all, obviously can't talk about any specific opportunities. I would say that, as we look around the world, assets are still at the higher end of valuation ranges. You see this in PE transactions; you see this in all kinds of – through all kinds of lenses. So, we haven't – as we look around the world, we haven't found any bargain basements. What we are looking at and talking about are good businesses where something's changed or might change in the eyes of the owner, the current owner in terms of the fit within their organization for that business, whether it continues to be a strategic fit, whether they have the capital to grow it appropriately, it's all kinds of reasons why somebody might want to sell a good business.

So, we're focused on strategic fit. We're focused on strong businesses, and we're focused on those conversations. And as I said earlier, the gestation period is measured in years, not months. Those kind of conversations where we can build up a relationship and be viewed as a really great home for those businesses, and I would say the transactions we've done over the last number of years fit that bill and that's the kind of thing we're looking for.

Paul Holden
Analyst, CIBC World Markets, Inc.

Q

Got it. Thank you for your answers.

Operator: Our next question comes from Tom MacKinnon from BMO Capital. Please go ahead.

Tom MacKinnon
Analyst, BMO Capital Markets (Canada)

Q

Yeah. Thanks. Good morning. Just a couple questions. One with respect to MFS margins; noticed some seasonality looking historically in this – in 2016 and in 2017, the margins in the second half are better than the first half. Is there any kind of seasonality with respect to – I know in the first quarter, you do some more incentive comp payments. Does that generally kind of move itself into the second quarter as well or is there any other reason why we would expect a bit of seasonality in terms of your margins?

Michael W. Roberge
Chief Executive Officer and President - MFS Investment Management, Sun Life Financial, Inc.

A

Yeah. That's true, Tom. It's just the seasonality on stock vesting. So, accelerate stock vesting that we see happen in both Q1 and Q2.

Tom MacKinnon
Analyst, BMO Capital Markets (Canada)

Q

Okay. So, is that...

Michael W. Roberge
Chief Executive Officer and President - MFS Investment Management, Sun Life Financial, Inc.

A

So you should expect – if you look over the last couple of years, you should expect all else being equal, you should expect margin to look similar year-on-year versus what we've seen in prior years.

Tom MacKinnon
Analyst, BMO Capital Markets (Canada)

Q

Okay, okay. That's helpful. And now, with respect to Canada, the earnings on the surplus in the quarter at CAD 29 million, looked a lot lower than the kind of average that's sort of been north of CAD 40 million over the last several – over the last eight or nine quarters. Was there anything that was driving that?

Randolph Brill Brown
Chief Investment Officer, Sun Life Financial, Inc.

A

Hi. It's Randy, Tom. So let me let me try and take that. No, there's no real key driver there. I would say there's some lumpiness in the numbers quarter-to-quarter, but I would say there's nothing that I would extrapolate from this particular quarter versus others.

Tom MacKinnon
Analyst, BMO Capital Markets (Canada)

Q

No AFS gains that were losses or anything like that or in that number?

Randolph Brill Brown
Chief Investment Officer, Sun Life Financial, Inc.

A

Just checking the – no. No, the numbers are really somewhat inline.

Tom MacKinnon
Analyst, BMO Capital Markets (Canada)

Q

Okay. And then finally, the strain in Asia was just negative 10 and better than you've sort of been running. And now, you've got increased scale in your Asian operation, so naturally, this should help probably improve product mix. But was there any particular noise in this quarter – you know, mainly in light of the International operations? And how should we be looking at that strain number going forward?

Claude A. Accum
President, Sun Life Financial Asia, Sun Life Financial, Inc.

A

Hey, Tom. It's Claude Accum. The strain last year was minus CAD 29 million. It's minus CAD 10 million this year, an improvement of CAD 19 million. Most of that's due to International. It comes from a small number of higher profit sales. So, that part – that gain; we don't expect that to repeat or continue. They can be up or down from International. So, yes, you're right, it is part of International. But you're right about the direction. Our goal is to take new business gains to a much more improved level in this direction, but that will take that pace more over a small number of years.

Tom MacKinnon
Analyst, BMO Capital Markets (Canada)

Q

Okay. So something in the line of the way it was last year, but possibly a little bit better than last year's but not – don't certainly continue at this kind of trend?

Claude A. Accum
President, Sun Life Financial Asia, Sun Life Financial, Inc.

A

Yeah. Our strategic goal is to take that line closer to zero over a four- or five-year pacing.

Tom MacKinnon
Analyst, BMO Capital Markets (Canada)

Q

Okay. Thanks for that.

Operator: Our next question comes from Doug Young from Desjardins. Please go ahead.

Doug Young
Analyst, Desjardins Capital Markets

Q

Good morning. Just maybe first, Dean or Kevin, I mean the underlying ROE 14%. Is this despite the excess capital, low debt to cap? I mean, if I remove the excess hold-co cash, I get closer to 16% and I guess those morbidity improvement that came through this quarter. But your debt-to-cap obviously is lower than the efficient area or region it would be in. So like the 15% to 16% seem like a reasonable range if you're able to deploy the excess capital or am I missing something in this whole thought process?

Kevin D. Strain
Chief Financial Officer & Executive Vice President, Sun Life Financial, Inc.

A

Hi, Doug. Why don't I start with that? And, of course, it's the ratio you're going to earn is going to depend on how we've deployed it and where we've deployed it and be quite specific. And a lot of the M&A activity can take time to come into income as you see integration costs and sort of buildup.

Our ROE is strong, and we do see all four businesses performing well from an ROE perspective this quarter. And something we're very focused on is the efficient deployment of capital and the returns of the ROE. So, I wouldn't want to speculate on what we're going to deploy that at. But we are going to play it in ways that is accretive to ROE over a long-term period. It's just kind of how quickly you can deploy it in a way that's effective and then how those earnings emerge over time.

Dean A. Connor
President, Chief Executive Officer & Director, Sun Life Financial, Inc.
A

And, Doug, it's Dean. I would just add that if you look at our mix of business and we've worked very hard on this over the past number of years, pretty substantial change in the mix of business away from capital heavy businesses to capital lighter businesses, which generally have higher ROEs. And I think so if you think about the mix of business as we move the balance sheet forward through time, you're going to end up with a different mix that fundamentally has higher ROEs built into it.

So and it's kind of behind your question but it's worth repeating that LICAT – the move to LICAT, which was it is a more risk-based capital system, has benefited Sun Life because of the significant changes we've made in the mix of business including the sale of the Variable Annuity business in 2013. So this is coming through and it's coming through in terms of – as an example, the ability to move capital up from Canada, which is why it's punching through 14% as the ROE.

So anyway, this is a great part of the Sun Life story, we're really pleased with this, and thank you for kind of pointing out the potential that's there.

Doug Young
Analyst, Desjardins Capital Markets
Q

And I guess it takes me to my second question, Dean. If I look at valuation, if I exclude MFS, if I exclude excess capital, I mean Sun Life is trading at what I would think is an interesting valuation multiple. I mean, M&A is slow to develop and you generate a nice amount of capital every year as well. Why wouldn't you be more aggressive on the buyback?

Dean A. Connor
President, Chief Executive Officer & Director, Sun Life Financial, Inc.
A

Well, I think by continuing the NCIB and in fact ramping it up to 14 million shares, we are indicating the fact that we intended to – we have the ability to and the intent to deploy more capital over the next 12 months towards buybacks. I think as you look back, we've bought back around CAD 380 million worth of shares in the year we've just finished. And that was less than the total that we had allocated towards that. But nonetheless, it was a significant deployment of capital towards that. And as I said, the 14 million NCIB shares – NCIB we announced last night is indicative of our intent to be somewhat more aggressive in allocating capital towards this.

Doug Young
Analyst, Desjardins Capital Markets
Q

Thank you.

Operator: And we have no further questions in queue. I'll turn the call back for closing remarks.

Gregory A. Dilworth

Vice President-Investor Relations, Sun Life Financial, Inc.

Thank you, Carol. And I would like to thank all of our participants today. If there are any additional questions, we will be available after the call. And should you wish to listen to the rebroadcast, it will also be available on our website later this afternoon.

Thank you and have a good day.

Operator: This concludes today's conference. You may now disconnect.