S&P Global
Market Intelligence

The Hartford Financial Services Group, Inc. NYSE:HIG

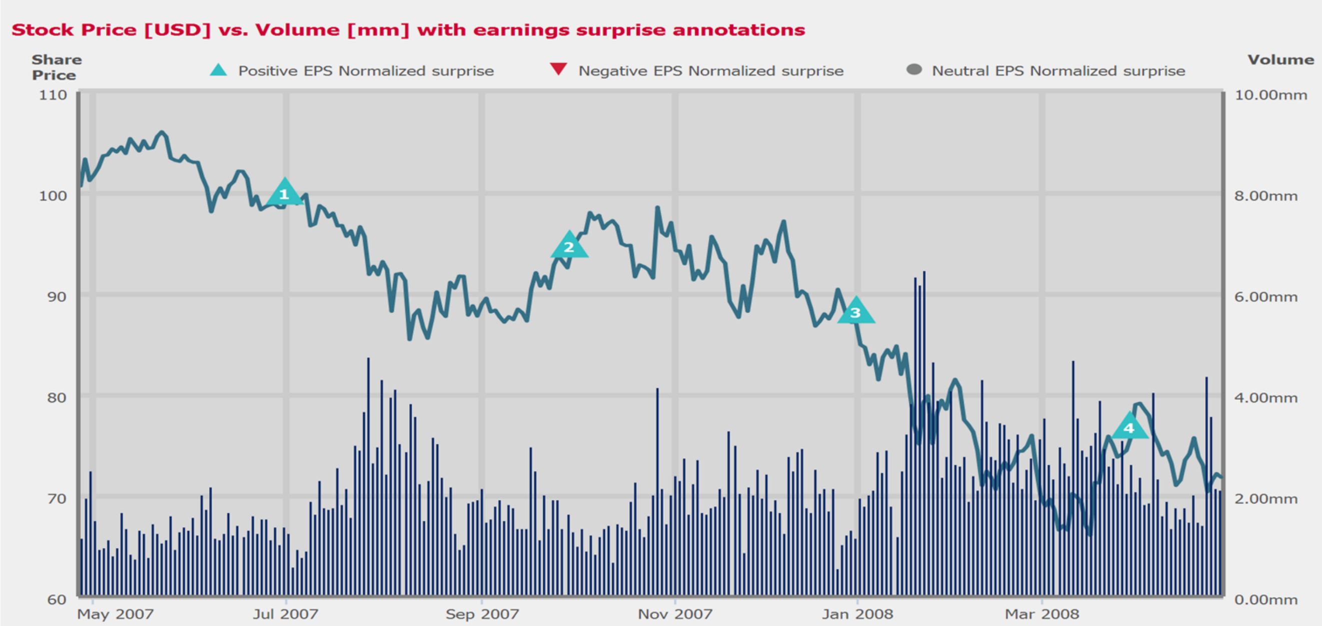
FQ2 2008 Earnings Call Transcripts

Tuesday, July 29, 2008 2:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ2 2008-			-FQ3 2008-	-FY 2008-	-FY 2009-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	2.10	2.22	▲5.71	2.01	8.95	10.04
Revenue	-	-	▲4.12	-	-	-
Revenue (mm)	7206.18	7503.00	-	6913.77	22310.48	28051.40

Currency: USD
Consensus as of Jul-29-2008 1:55 PM GMT



- EPS NORMALIZED -			
	CONSENSUS	ACTUAL	SURPRISE
FQ2 2007	2.28	2.39	▲1 4.82 %
FQ3 2007	2.46	3.33	▲2 35.37 %
FQ4 2007	2.49	2.66	▲3 6.83 %
FQ1 2008	2.46	2.51	▲4 2.03 %

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EXECUTIVES

Dave Znamierowski

John Walters

Kim Johnson

Liz Zlatkus

Neal Wolin

Ramani Ayer

Thomas Michael Marra
Executive Chairman of the Board

ANALYSTS

Al Copersino
Madoff Investments

Bob Glasspiegel
Langen McAlenney

Dan Johnson
Citadel Investment Group

Darin Arita
Deutsche Bank

Eric Berg
Lehman Brothers

Jimmy Bhullar
JPMorgan

Josh Shankar
Citi

Josh Smith
TIAA-CREF

Tom Gallagher
Credit Suisse

Presentation

Operator

Good morning. My name is Casey and I will be your conference operator today. At this time, I would like to welcome everyone to the Hartford's second quarter 2008 Earnings Call. (Operator Instructions). I would now like to turn today's call over to Ms. Kim Johnson, Senior Vice President Investor Relations, our host for today's call. Please go ahead, ma'am.

Kim Johnson

Thank you, Casey. Good morning and thank you for joining us for today's second quarter 2008 financial results conference call. As you know, our earnings press release was issued yesterday. To help you follow our discussion a financial supplement and a slide presentation are available on our website at www.thehartford.com.

Ramani Ayer, Chairman and CEO, will begin today's call with an overview of the quarter and key trends. Then Tom Marra, the Hartford's President and Chief Operating Officer, will provide more detail on our second quarter results and discuss business outlook. Liz Zlatkus, our CFO, will conclude with comments on our 2008 outlook, investment portfolio, and capital position. Following the prepared presentation, we will hold our usual question-and-answer session. Also participating on today's call will be Neal Wolin, President and Chief Operating Officer of our Property-Casualty company; John Walters, President and Chief Operating Officer of our Life company; Dave Znamierowski, Chief Investment Officer; and Alan Krezko, General Counsel.

Turning to the presentation on page two, please note that we will make certain statements during this call that should be considered forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995. These include statements about The Hartford's future results of operations. We caution investors that these forward-looking statements are not guarantees of future performance and actual results may differ materially. Investors should consider the important risks and uncertainties that may cause actual results to differ, including those discussed in our press release issued yesterday, our quarterly report on Form 10-Q for the quarter ended June 30, our 2007 annual report on Form 10-K, and other filings we make with the Securities and Exchange Commission. We assume no obligation to update this presentation, which speaks as of today's date. The discussion in this presentation of The Hartford's financial performance includes financial measures that are not derived from Generally Accepted Accounting Principles or GAAP. Information regarding these non-GAAP and other financial measures is provided in the investor financial supplement for the second quarter of 2008, in the press release we issued yesterday, and in the Investor Relations section of The Hartford's website at thehartford.com.

Now I would like to turn it over to The Hartford's Chairman and CEO, Ramani Ayer.

Ramani Ayer

Thank you, Kim. Good morning, everyone, and thank you for joining us today. Before I turn today's call over to Tom, I want to touch on a couple of topics that factored into the quarter. I will also highlight how we are investing for the future. So let's get started.

I am pleased with The Hartford's execution in the second quarter. We overcame tough market conditions to record nearly $700 million in core earnings or $2.22 per diluted share. Realized capital losses in the quarter were $156 million after-tax, down significantly from the levels seen in the first quarter. Our net income return on equity over the last four quarters is 12% and on a core earnings basis, our ROE is 17%.

The second-quarter saw more volatility in the capital markets. Liz will provide more detail later in the call, but I wanted to make several points about our investment performance. Our portfolio held up well during the quarter and we remained confident in the creditworthiness of our investments. We saw the impact from rising interest rates on our net unrealized loss position. This contributed to a 2% sequential decline in book value per share. Also our CMBS and RMBS securities continue to perform well. While market pricing for these asset classes remains depressed, we are confident that the ultimate economic losses will be a fraction of the mark-to-market losses.

The Hartford has worked diligently over the past five years to fortify its balance sheet. One of the reasons we built our capital position was to address the challenges of market conditions like the ones we face today. Our balance sheet remains in great shape and even after weathering the effects of market volatility over the past year. I know our investors believe capital flexibility is precious. We do too. We have the capital necessary to meet our business needs and we have at least $1.5 billion of capital margin. Our liquidity is excellent and we have additional debt capacity should it be necessary. All said, I am very comfortable with the company's financial position.

Turning to our business results, I am pleased with how we are navigating some very challenging markets. Excess capacity in the property and casualty market is continuing to put pressure on pricing. On the Life side, the competition to secure retirement assets is intense. It is against this competitive backdrop that I give big marks to The Hartford's employees for their execution each and every day.

We recorded another quarter of strong performance in Property and Casualty. On an ex-cat accident year basis, our ongoing operations combined ratio was 90.7, just 1.5 point higher than last year. This is an outstanding result in a softening market. Our efforts to retain profitable customers and to selectively target new business are working.

In the Life company record deposits in our mutual funds and retirement plan businesses helped drive life assets under management to $363 billion at the end of June. As we look ahead, we expect competition for new customers to remain challenging. I want to assure you, though, that we will continue to make strategic investments while maintaining expense discipline. Markets will turn and we want to be ready.

In Property and Casualty, we are investing in our product set. In small commercial and middle market, we are enhancing our franchise with cutting edge pricing technology. This will enable us to more precisely identify new business opportunities as well as the most profitable renewal business. We are also innovating in personal lines, piloting new direct sales and marketing strategies that will complement our independent agency channel.

In the Life company, we are introducing product enhancements in numerous lines, including individual life insurance and U.S. and Japan variable annuities. We also are investing in the Retirement Plans business. As we work on integrating the retirement plan operations that we acquired last quarter, we are even more excited about the new capabilities they bring to the table. With that, let me turn it over to Tom to provide additional details about our second-quarter performance. Tom?

Thomas Michael Marra
Executive Chairman of the Board

Thanks, Ramani. As we did in the first quarter, I intend to cover the highlights of our Property-Casualty and Life results without commenting specifically on every business. Our press release and 10-Q have a lot of good information on each of our segments. We have also included a summary slide on each segment in the appendix to this presentation.

Now turn to slide 4. In Property-Casualty, we executed very well in challenging markets. Once again, we recorded very strong underwriting results, especially when you back out higher than average catastrophes. For the quarter, our Property-Casualty operations recorded core earnings of $283 million and our core earnings reflect $171 million pre-tax or 6.6 points of catastrophe losses. These losses related primarily to the severe tornadoes and thunderstorms that struck the Midwest and Southeast.

All of our businesses delivered excellent core underwriting performance. Our second quarter ongoing operations ex-cat, ex-prior-year combined ratio was relatively stable at 90.7 and we believe that to be a very good result. The factors driving our strong loss performance vary from line-to-line. In Personal lines, we are seeing favorable auto claims frequency and only modest increases in auto severity. We suspect part of the cause for the reduced claim frequency is fewer miles driven due to higher gas prices. We have reflected the favorable loss cost results by improving our full year Personal lines combined ratio outlook by 1.5 point.

In Small Commercial, our performance continues to be consistent. As a leading underwriter of this coverage, we are seeing the benefits of modest growth in loss severity combined with lower frequency. Based on the strong results for the first half of the year, we are improving our full year small commercial combined ratio outlook by 1 point.

Our net written premiums were $2.6 billion in the quarter, 3% below last year. New business growth has been the primary challenge to our written premium plans. The P&C markets we participate in are feeling the effects of the softening market competition to varying degrees. We continue to exercise underwriting and pricing discipline. Acknowledging the current state of the markets, we have lowered our written premium outlooks across all of our lines.

In the second quarter, we completed our annual asbestos review and added $50 million pre-tax to our reserves. Every year reserve estimates for individual cases change based upon the circumstances of each account. All of the changes we made this year were case specific and did not reflect any underlying change in the environment. In summary, our P&C operations had another very good quarter. As we look to the remainder of this year, we will remain disciplined. We intend to compete vigorously for new business but will not chase it for the sake of growing our top line.

Now, our Life results are highlighted on slide 5. Core earnings in our LIFE operations were very good at $450 million, up 3% over the prior year and up 15% from the first quarter of 2008. The quarter benefited from $32 million in tax benefits, $22 million of which relates to prior years for the first quarter of 2008.

I would like to take a moment now to look a little closer at a couple of our businesses. Our retail mutual fund business is performing extremely well. We were pleased to see deposits in the quarter exceed the top end of our guidance range coming in at a record $4 billion or 5% higher than a year ago. We are benefiting from excellent fund performance and strong wholesaling execution. Net sales hit a record at $1.9 billion, 9% better than last year. As we look forward, we have raised our full year guidance for mutual fund deposits based on this strong first half.

As Ramani mentioned earlier, we are determined to keep investing in growth opportunities. This may cause some are ROAs to decline in the short-term. You will see this in other retail, which includes retail mutual funds as well as several smaller operations. Here equity market declines have depressed the pace of asset growth. As a result, staying the course with our previously planned investments will have the effect of lowering ROAs for the balance of '08. This is reflected in our updated guidance.

Now, our Retirement Plans group also had a great second quarter. Deposits were $2.4 billion, up 72% over the prior year. This of course reflects the acquisitions we closed in the first quarter. However, even on an organic basis, deposits grew a healthy 17%. Integration of our acquisitions is on track and during the second quarter, we combined our sales force and moved about 300 people into Hartford offices. We have increased our 2008 full year ROA outlook for the Retirement Plans business to the range of 21 basis points to 23 basis points. This change reflects the tax benefits we recognized this quarter. Our view on the expected long-term ROA for this business remains unchanged in the low to mid 20s.

In our U.S. VA business, volatile equity markets lead to a challenging quarter. Deposits declined to $2.2 billion. Now we had expected deposits to be off, due to the restructuring of our wholesaling force in March and the timing of our new product launch on May 1. What we did not expect was such turbulent markets. Notwithstanding a tough second quarter, we continue to be excited about our new VA product. Feedback from our distributors has been positive and we saw a positive sales momentum through May and June. Plus we will introduce a product enhancement in August. It should position us as a competitive alternative to deferral bonus type guarantee products that are popular with some consumers and advisers. We have also seen improving fixed annuity sales as interest rates have moved up.

Forecasting sales in these equity markets is very difficult particularly in the middle of a new product launch, so we have changed our full year VA deposits outlook to a range of $9.25 billion to $10.25 billion. To the extent that equity markets remain volatile and depressed in the latter part of the year, we would expect deposits to come in towards the bottom of the range. If equity markets recover in the second half, we would expect to finish closer to the top of the range. We are also increasing ROA outlook for individual annuity segment primarily due to a lower expected tax rate.

In Japan, the markets remain tough. We believe second quarter industry-wide variable annuity sales will be down significantly year-over-year. We have seen the effects of volatile markets and intense competition over the first half of the year. We continue to invest in our VA product suite and we are expanding our distribution. Make no mistake; The Hartford is in Japan for the long run.

Finally, our group benefits business had an outstanding second quarter. Fully insured sales were up 13% from the prior year and fully insured premium grew to $1.1 billion, driven by an 8% increase in Life and Disability. These are great results in a very competitive market.

In summary, nice core earnings held up well in the second quarter. We are executing well in a tough environment with tremendous growth in our Mutual Funds and Retirement Plans businesses and we expect to launch new products in several lines to leverage our outstanding distribution capabilities. With that, I would like to turn it over to Liz Zlatkus. Liz?

Liz Zlatkus

Thank you, Tom, and good morning, everyone. Following on Tom's operating review I would like to walk you through our 2008 updated guidance. Please turn to slide 6. As you saw in our press release, we reaffirmed our guidance range of $9.20 to $9.50. This assumes an average of 308 million shares outstanding. At this point, our capital planning does not anticipate any additional share repurchases this year. Our outlook also assumes an annualized 4.5% return on our hedge fund and limited partnership investments for the rest of the year. While we did not quite see that yield in the second quarter, we are sticking with this assumption.

We are holding our assumed underwriting loss in Other Operations at $160 million. This figure includes the $50 million pre-tax asbestos charge we took in the second quarter. As you know, we will conduct our annual environmental study in the third quarter. The $160 million figure is merely an assumption. History has shown that actual underwriting results can move a lot year-to-year.

Importantly, our guidance does not include any estimate for the results of our third quarter DAC unlock. Based on the actual versus expected market performance, we do anticipate a DAC write down next quarter. We provide you with sensitivities to the unlock in the 10-Q on pages 39 and 40. Based on these sensitivities and separate account performance in the United States and Japan through June 30, our DAC unlock could result in an after-tax charge of $330 million to $640 million or $1.07 to $2.08 per share.

When actual separate account returns vary significantly from our assumptions, as they did this past year, the market impact of the DAC unlock tends to track more closely with the upper end of this range. Remember, the sensitivities we updated in the 10-Q only relate to separate account returns. We have not yet completed our assumption studies and those studies along with the account values at the time of the unlock will impact the charge.

Now, two final points about DAC. DAC can swing favorably and unfavorably. Last year as you may recall, our DAC unlock produced an after-taxes gain of $213 million. Finally but importantly, DAC is a GAAP concept only. Any charge we take for the DAC unlock will not affect our statutory capital position.

I would like to now move on to a discussion of our investment portfolio. The pie chart on slide 7 summarizes the make up of our $94.5 billion portfolio. Net unrealized losses on fixed maturities increased by $876 million this quarter, this is primarily due to rising interest rates, which were partially offset by a tightening of credit spreads across most asset classes. We believe current market dislocations and mark-to-market changes are substantially deeper than the economic losses we expect, even under severe recession scenarios. Even so, we recognize the change in fair value each quarter either through AOCI or net income.

Now we will keep a security with a price decline in unrealized losses only, if we believe the value will recover and we have the ability and intent to hold the asset until it does. Each quarter we stress test the cash flows on sub-prime and CMBS assets to determine if and when we expect them to recover. When we do these stress tests, our projections assume things get worse before they get better.

For example, our impairment process subjects our CMBS holdings to various recessionary scenarios. We assume negative GDP growth, rising unemployment, and declining property values. As a result, we impaired only one additional commercial mortgage backed security this quarter. The remaining CMBS impairments reflect price deterioration on securities previously impaired.

Moving onto slide 8, and the important issue of capital, our approach to capital management has not changed. We keep capital to provide flexibility to pursue business opportunities or acquisitions while mitigating the risks that we will have to come to you, to raise capital in a shock event. There are three parts to our capital plan. Number one, the capital needed to maintain our AA level ratings under the most constraining rating agency models; our capital margin of at least $1.5 billion above the rating agency requirements; and three, significant debt capacity.

As part of our capital management discipline, we regularly analyze, forecast, and stress test our capital under different scenarios. Now this is critically important, because many factors can and do change. For example, the rate at which we generate our consumed capital is affected by the growth and profitability of our business, statutory impairments, and changes in equity markets, credit markets, and interest rates.

In addition, changes in statutory accounting can impact our capital position. There is a proposal on the table now to change the statutory accounting for impairments related to structured securities. If adopted, as we anticipate, this change would reduce our year end 2008 capital position by up to $400 million. This change has been taken into account in our capital planning.

Finally, rating agencies can change their models at any time. Recent changes actually lowered our required capital for 2008. Some of you may recall that model changes consumed much of the capital we generated during the 2004 to 2006 period, so we are very pleased to see this change in direction. So as we look forward to year end 2008 and we assume more businesses perform as expected over the remainder of the year, the S&P ends the year at 1200 and credit spreads widen further, we project that we would still have at least $1.5 billion above our rating agency requirements at the end of the year.

Our comfort in The Hartford's capital position was one of the factors that led us to buyback stock during the second quarter. We repurchased $371 million of stock in the open market through the end of June. In July, we bought back another $129 million, bringing our total open market purchases year-to-date to $500 million. We also issued our first hybrid debt security in the second quarter. The $500 million we raised were used to fund an accelerated share repurchase program. We look at the pairing of the hybrid and the ASR as an efficient tuning of the company's capital structure. So all then, I feel very good about the capital actions we have taken this year and I am confident The Hartford is on a firm capital footing. Tom?

Thomas Michael Marra
Executive Chairman of the Board
Thanks Liz. Casey you can open us up to question. What I would like to ask each caller if you could as to limit yourself to one to two questions, so that we can get to everybody. Casey?

Question and Answer

Operator

(Operator Instructions). Your first question will come from the line of Dan Arita with Deutsche Bank.

Darin Arita
Deutsche Bank

Hi, good morning. I was hoping if we could talk first a little bit about variable annuity GMWB reinsurance capacity. It seems like Hartford was able to use some reassurance again. Can you talk about the reinsurance market's appetite for the GMWBs?

Thomas Michael Marra
Executive Chairman of the Board

Good morning, Darin. It is Tom. We are very pleased to be able to execute this reinsurance trade just recently. As you know, it is not been a wide open field and my guess is going forward it will be available although not abundant would be the way I would put it. I would maybe ask John or Liz if they want to add to that.

Liz Zlatkus

Yes, I would say the reinsurance market has not changed that much, Dan, but we are pleased that we executed both this reinsurance treaty as well as the other treaties that we have transacted over the years. So, as you can see in the Q, we have over 57% of the variable annuity GMWB book basically protected by either reinsurance or long dated customized derivatives. So, we feel really good about having that much of our book locked in and protected over the length and duration of the products. However, I would not say that the market has changed much, but we certainly take the opportunity to secure reinsurance when it makes sense.

Darin Arita
Deutsche Bank

Okay, that is helpful. Then just in terms of thinking about the capital margin, it sounds like it is still at $1.5 billion. Can you help me think about how the decline in the equity market has affected your capital position? I recall you had a slide in a previous Investor Day where a 15% drop in the equity market leads to a $500 million reduction in capital. Now the equity markets are off more than 15% within a 12-month period, and so is that the same, has that had the same effect on your capital position?

Liz Zlatkus

Dan, it is Liz again. First of all, yes, the markets obviously through June, S&P was down about 13%. As I spoke about, 1200 S&P level, that would be down about 18% from year-end. So, all of that impact that we talked about in terms of the impact on our statutory capital and markets go down is assumed in our capital planning and when we stress test, we are always looking at various market scenarios. So, that $1.5 billion capital margin we would expect at 1200 would include the impacts of the market decline.

Ramani Ayer

Darin, this is Ramani. I would just like to add one thing. It is very hard to give you a formulaic approach to determining capital margin, because we use the most constraining rating agencies for each company and rating agency models are not concretized and static. So, we do the best we can to give you a sense of our capital margin. However, it is very hard to give you precise definitions on it or precise way to model it.

Darin Arita
Deutsche Bank

That is helpful. I was just wondering if there is a difference, if there is a one day drop versus the same drop over an extended period?

Liz Zlatkus

Dan, what I would say is throughout the year if the market is dropping, you have impacts on your statutory capital like carbon compression. Again, that is in our modeling. Then at the end of the year, you look at the market levels at that point in time and you have to stress test it down under the statutory rules. So, I would say it is both, but again, that is included in our statements about our capital position.

Darin Arita
Deutsche Bank

Great, thank you.

Ramani Ayer

Thanks Darin.

Operator

Your next question will come from the line of Jimmy Bhullar with JPMorgan.

Jimmy Bhullar
JPMorgan

Thank you. I have a couple of questions. The first one is on your domestic VA business. Your sales were down 12%. I think you mentioned part of this was because of the market, but does not seem like industry sales are down as much at least on a sequential basis. So, if you could talk about what it is that pressured your sales beyond just the market, was it the new product launch or any other factors? Then secondly, if you could just give us a little bit more color on, you mentioned pricing in the P&C markets more aggressive than before. If you could talk about by your major business lines, you just talked about what you are seeing in the various business lines? That is it.

John Walters

Hey, Jimmy, this is John Walters. I will start off with the answer and then I will turn it over to Neal. On the US VA business, we did anticipate and it was reflected in our guidance that this was going to be a tough quarter for us. As we made two changes, we have made some changes to our wholesaling operation where we combined two different wholesaling forces at the end of the last quarter and in this quarter we came out with a brand new product that combined two existing products into one new product with some new features on it. So, we knew there was going to be some transition difficulties.

What we expected was a bit of a slowdown in April and May and then the beginnings of a resurgence as we went through the quarter and that is what we saw. I would say that the results were softer than we had anticipated, because what we did not anticipate was the weakness in the equity markets, which we think have affected variable annuity sales for the industry as well as us and so, that made the results a little below what our expectations had been.

Our sense is that on the industry that, the industry started stronger in April and then got a little slower in the second half of the quarter and that is just I think a result of the equity markets that we are operating in and brokers just having more difficulty putting client's money to work. I think that is going to continue to be an overhang until this market gets back on its feet and so that is reflected in our guidance for the rest of the year.

Jimmy Bhullar
JPMorgan

Just a follow up on that, your market share in VA has declined for the past five quarters, if I include the second quarter of '08. Do you believe that with the new leaders product you are positioned to grow at least in line with the market or with the overall industry?

John Walters

I do believe that we are…

Jimmy Bhullar
JPMorgan

For faster or slower?

John Walters

Yes, I do believe that we are positioned to grow at least in line with the industry and our sense is, there is no public information available yet, but our sense is that we probably picked up a little bit of market share in the second half of the quarter. So, our sales were improving while others were not is our expectation for the second half of the quarter. So, we feel good about our competitive position at this point and our ability to perform in line with the market or a little better.

Neal Wolin

Jimmy, on the P&C pricing I would take it by segment. In Personal Lines, as you see for us, pricing up a little bit in the quarter. I would say as we track the marketplace and competitors, we are seeing more and more of our competitors taking rate increases across the states. However, having said that of course still very competitive in the Personal Lines segment. In Small Commercial, our pricing for the quarter was off a bit and I would say that in that segment more and more of our competition, more carriers focused on that segment and some of them really being fairly aggressive on the pricing side and so, that is how we see the Small Commercial space.

In the middle market, pricing still off a fair amount for us, about 7 points in the quarter, but really very competitive marketplace in the middle market. I think for us a focus on renewals especially with respect to our highest categories of business and then seeking new business opportunities where you can but through all of that maintaining a constant focus on pricing discipline across all of those segments. We feel very good about that.

Jimmy Bhullar
JPMorgan

Thank you.

Operator

Your next question will come from the line of Josh Shankar with Citi.

Josh Shankar
Citi

Yes, good morning. I will just try and limit myself to one question for you. Asbestos, why should not we view this charge as a trend and can we dig a little bit into the components of these cases so we can be assured that it is not a trend?

Neal Wolin

Josh, thanks for the question. It is Neal here. We look at every one of our accounts when we do our yearly asbestos study, so we are looking at over 1000 accounts and some of them move up, some of the move down, and across the whole thing if you net out all the ups and downs, we have taken, as you have seen, a $15 million charge. However, there is nothing secular underneath all that, meaning no trends that have contributed to the ups and downs. It is really just a big netting equation after we have examined in a very granular way each and every one of our accounts in our asbestos book. So, that is really what got us to the 50.

Ramani Ayer

Josh, this is Ramani. When we do these things, we call these things just in time. That is our anticipation in all of this. So, if there was a trend, we would tell you that. I do not see that as you look at this quarter's actions, I do not see that in the numbers.

Josh Shankar
Citi

How many cases were composed in this 50 uptick? Or is it an amalgamation of all 1000 cases that have come up 50 higher than you thought?

Neal Wolin

Josh, I think the way to think about it is there are puts and takes, so, some accounts improved from the prior year, some deteriorated. It is all of that in the mix that got us to the 50. It is not one or two.

Josh Shankar
Citi

I figured I would let someone else ask a question. Thank you.

Operator

Your next question will come from the line of Josh Smith with TIAA-CREF.

Josh Smith
TIAA-CREF

Hi, thanks for taking the question. Couple of quick ones. On your investment portfolio marks, it does not seem like you took much in the way of hits on the lower rated more recent vintage stuff. Specifically if I look at your Q on page 127, your 2007 vintage BB and below is only marked at $0.50 on the dollar and yet ABX would describe very little value to that stuff. Am I looking at that the right way? Is that amortized costs? Has that been reduced by any OTTIs or does that not impact amortized costs? That is the question.

Dave Znamierowski

Hey, Josh, it is Dave Znamierowski. Thanks for the question. That is a challenging table to read, so let me dissect your question. First, you cannot take the difference between, look at amortized costs as a percentage of fair value there and compare that value to the ABX indexes, for example. Couple of reasons for that, one is that table includes all the OTTI we have taken, which is approximately on that portfolio roughly in the range of $300 million or so, which disproportionately hit the '06 and '07 vintages. So, for example, we had a par security written down to, say, $0.50 on the dollar on that.

Josh Smith
TIAA-CREF

Okay, so that amortized cost is not original cost, original amortized cost? It is already been knocked down, so okay? That was my question.

Dave Znamierowski

There is one more important characteristic, which is, you cannot compare those columns to the respective ABX indices because the respective ABX indices refer to the original rating of the security at the time of issue. So, for example, an '07 issue BBB minus would be the reference point for and ABX index, not a AAA security that was issued in '07 that may have been downgraded to BBB minus. So, again, the index comparison is also a misleading comparison.

Josh Smith
TIAA-CREF

So, if I want to do that, I have to look up further up on the, have to look higher on the ABX rating then to get equivalent? Is that what you are saying?

Dave Znamierowski

You have got it, so if you look underneath all of these numbers, I am comfortable with the pricing that is in there. If you saw lower quality purchases, you will see that reflected in the underlying numbers. So, I have BBB minus securities at original purchase that are marked at 5 and 6 and 7 in that table.

Josh Smith
TIAA-CREF

Then just one of follow-up question on guidance. Given that you are assuming 9% annualized return for the back half of the year from June 30, I assume there is 2% dividend, 7% stock appreciation. Would you need basically, if the market went up in a straight line, would you need 15% appreciation from these levels? That is how the…

Dave Znamierowski

No, we assume from these levels, which is basically June 30, and an annualized return of 9, which is inclusive of dividends, as you mentioned.

Josh Smith
TIAA-CREF

Right, I will follow-up with Kim off-line but, whenever I ran the numbers, it looked like if it was a straight line appreciation of the market you would need 15% but, I will follow-up with Kim. Thanks.

Dave Znamierowski

Should not be. Thanks, Josh.

Operator

Your next question will come from the line of Eric Berg with Lehman Brothers.

Eric Berg
Lehman Brothers

Thanks very much and good morning to everyone. I have a question regarding the outlook for DAC and comments made by Liz. I think at one point in your prepared remarks, Liz, you were saying you provided a fairly large range of potential DAC charges, if I understood the range correctly. However, then you went on to say that DAC as we know can be both written down and written up. So, that left me a little bit confused. Are you saying that it is highly likely there is going to be a DAC charge and that is why you gave us the range? Or are you saying in fact there could be a DAC write up and a DAC benefit?

Liz Zlatkus

Eric, good morning. Thank you for the question. Now based on where we see market levels today, we clearly would expect a DAC charge. We cannot give you the exact amount, because we have not completed our full assumption update and all of the work we need to do, which will be completed in the third quarter. What I was trying to say with the range is, it is a wide range, but as you look at our actual performance of the markets as a separate account return and you compare that with what we would have expected in some of this is in the Q, on the US side, we are off about 16% and on the Japan side, we are off about 11% against our expectations. You are farther away from your expectations on market returns. You would tend to be higher in the range. Of course in this case, that would be a negative or a charge.

Ramani Ayer

Eric, its Ramani. If I could raise one point, Liz also went on to say that DACs can swing favorably or unfavorably and last year, if you recall, we had an after tax gain of $213 million. That was the point that you might have picked up as maybe signaling something about this quarter. That was related to last year.

Eric Berg
Lehman Brothers

Got it, thanks very much. Second and final question relates to the August product launch that I think Tom referenced. Tom, you were saying that this has to do with the deferred bonus. Can you elaborate?

Thomas Michael Marra
Executive Chairman of the Board

Yes, John is the expert, but, we are not coming out with a straight deferral bonus, but if folks defer for five years, they can move through the income bands. So in other words if they start at 6%, they can get 6.5% if they wait until the next stage band. John, do you want to give more detail on that?

John Walters

Essentially, Eric, what we have done is, for many of the deferral bonus products that are out there, once you start going on income, you no longer get any increase in your income. What we try to do is, be a little different than that with the way ours works and as long as you wait five years to take your first income amount, then as you go through either step-ups or age bands in the future, your income can still continue to rise. So, that is really the differentiating factor there. We think this will be a differentiating factor that will improve our competitiveness and will work well with the new suite of products that we launched in May.

Eric Berg
Lehman Brothers

Thank you, John.

Operator

Your next question will come from the line of Bob Glasspiegel with Langen McAlenney.

Bob Glasspiegel
Langen McAlenney

I appreciate the change in disclosure on your handout this morning. On DAC, you went through a very good discussion of how it affects the various issues. How does management think about DAC? Specifically does it affect compensation? I know it is a non-cash charge, but to what extent when you take a large DAC charge do you say we have to relook at pricing? I have a follow-up.

Ramani Ayer

Let me address the compensation issue, Bob. This is Ramani and I will have Tom or John address the pricing issue, etcetera. First and foremost on comp, we exclude the DAC charge principally because as you saw last year, we wrote it up and this year it goes the other way and its accumulative effect, if you will as you well know with DAC, it is a question of how you amortize the acquisition cost over the expected profits on a lifetime of a cohort of business. So, it is really moving this issue given the accounting regime from one year to another. So, we really exclude that. It is not reflective of operating performance. However, as far as pricing, I am going to turn it over to Tom and have him talk through.

Thomas Michael Marra
Executive Chairman of the Board

Well pricing, like DAC and like our outlook projections assume the 9% market return inclusive of dividends. Also we assume the weighting for the non-equity portion. So, in essence, Bob, we price for a long-term normal market and the vagaries that cause things like DAC write-offs or write-ups are not reflected in day-to-day pricing.

Bob Glasspiegel
Langen McAlenney

Okay. So, it sounds like you ignore it over the short-term.

Thomas Michael Marra
Executive Chairman of the Board

Well, we price for the long-term because these contracts are going to be. They are 20 plus year contracts and short-term GAAP swings positive or negative should not affect our view of long-term markets.

Ramani Ayer

One thing, Bob, I need to refine for you, though, is when I was thinking about the comp issue and thinking about the annual bonus or incentive comp, but when it comes to long-term, the long-term parts of our compensation system, that is all in with respect to book value per share. So, that was an adjustment we made, I cannot recall one or two years ago, maybe two years ago, where we basically moved to long-term compensation on book value per share plus dividends distributed. There the book value per share includes all charges, everything. It is a final book value per share.

Bob Glasspiegel
Langen McAlenney

Okay. Neal, my follow-up is for you. Now that you are factoring in down frequency in auto for guidance, have your underwriters started to factor it into pricing at all?

Neal Wolin

A little bit. We are saying for the full year that we expect frequency will be pretty flattish, and that is what is basically in our pricing.

Bob Glasspiegel
Langen McAlenney

I mean, driving mileage was down, I am sure you saw the numbers was down 3% or 4% in May, I believe, the last month we have seen the data. Flat seems like it might be a little bit on the high end. No?

Neal Wolin

I think that is probably right. The question, Bob, is whether the minus 3 or minus 4 in miles driven is on the high end?

Bob Glasspiegel
Langen McAlenney

No, just you are assuming flat frequency for pricing, you said, in the second half.

Neal Wolin

Yes, I think for us we want to see this over a couple of quarters at least, and so we are not going to adjust our frequency picks every quarter before we get a sense of the run rate and of the trend.

Bob Glasspiegel
Langen McAlenney

Okay. So, just analysts should factor it in, but not underwriters. Thanks.

Thomas Michael Marra
Executive Chairman of the Board

I surely would not tell you how to do your job, Bob.

Bob Glasspiegel
Langen McAlenney

Right, thank you.

Neal Wolin

We have got to think where energy prices are going and where they will stabilize, but there is some shift in driving patterns and people are making adjustments.

Bob Glasspiegel
Langen McAlenney

Thank you.

Thomas Michael Marra
Executive Chairman of the Board

Thanks Bob.

Operator

Your next question comes from the line of Dan Johnson with Citadel Investments Group.

Thomas Michael Marra
Executive Chairman of the Board

Good morning Dan. Hello.

Dan Johnson
Citadel Investment Group

I am sorry. Yes all right. So, the question is on stat capital. A couple quarters ago, David Johnson had mentioned that one of the unique characteristics of stat capital math is when the markets went down, the assets did not get impact on a mark-to-market basis, but the hedges did. Can you tell me how the down market, which we are clearly in, has added to your stat capital? If we were to return to something more like a normal market, what that would do as that impact unwound? Then I have got a DAC question.

Liz Zlatkus

So, Dan, it is Liz. Overall, I think what David was trying to explain is that it is not easy to compare GAAP capital and surplus with statutory. So, there are a variety of things that moved either consistent or inconsistent, whether it is interest rates or credit spreads or equity market levels. I will tell you that on average, stat capital does go down when markets go down. So, all in, they are negatively impacted. There are particular items, and again this is just one example like your hedged assets would go up when markets go down. So, conversely when markets go up, those hedged assets would reverse. On the other hand, there are other impacts like carbon compression and things that are negatively impacted by markets going down. I think what is important is, again, I go back to looking at how we plan for our capital and how we stress test it, and we feel good about our capital position in light of both the equity markets today and under some stress scenarios.

Dan Johnson
Citadel Investment Group

So, maybe it is fair to say that the down markets certainly do not help your stat capital position, but there is a bit of a smoothing effect on the way down. Similarly, there would be a little bit of a smoothing effect on the way up.

Liz Zlatkus

I do not know if I would call it smoothing, but I just think your conclusion is accurate. When markets are down, it negatively impacts stat capital, but it is lumpy, and I would not necessarily call it a smoothing impact.

Dan Johnson
Citadel Investment Group

Okay. The other question then pertains to DAC, and specifically I am looking at L5, the roll-forward schedule on a year-to-date basis. First, a point of clarification. The amortization from realized capital gains about $389 million, is that the DAC add back that comes from a capital loss, or is that actually coming from realized capital gains?

Liz Zlatkus

No, that is what you said at the beginning. It is the offset to realized capital loss.

Dan Johnson
Citadel Investment Group

Got it. Okay. So, if I add that together with the $649 million of also add backs due to the unrealized component, it is about $1 billion that is been added to DAC because of realized or unrealized movements in the investment portfolio. Well, I understand the accounting, but help me with the implications on go forward earnings as we eventually run this $1 billion back out of the balance sheet and into the income statement? If you can also add on how the impact from the DAC charge assuming it is let's say in the middle of your range, how will that impact go forward earnings as well? Thank you.

Liz Zlatkus

Hey, so, Dan, the first thing I am going to tell you is that I cannot give you specifics, but what I would say is when you are increasing your DAC balances you mentioned because of our investment losses, then over time you are going to have more amortization, obviously because, you still have to amortize the total amount over the life of the book. Conversely with the anticipated DAC charge in the third quarter again, we cannot tell you the number but it will be a charge, that would decrease DAC balance and so, therefore that would decrease amortization over the life of the contracts.

How those numbers interplay in terms of the impact on amortization in '08 and '09 we will not be able to tell you until we do our DAC unlock, because it depends on the pattern of estimated gross profits and how they impact the current years versus future years. However, suffice to say I think directionally as you were looking at it, one increases amortization, because we wrote-up DAC and one would decrease the amortization.

Dan Johnson
Citadel Investment Group

The $1 billion, that is going to get amortized over the life or the expected life of the products, not really over anything that would relate to the life of the assets that generated the capital or realized or unrealized loss?

Liz Zlatkus

That is correct.

Thomas Michael Marra
Executive Chairman of the Board

Yes, I would just say obviously that goes into the DAC and then you are going to have a DAC unlock event is what you said in the third quarter and then you will have amortization from there on. So, some of it presuming we are right and there is going to be a significant DAC unlock would be reflected in that process as well.

Dan Johnson
Citadel Investment Group

Okay. Thank you very much.

Thomas Michael Marra
Executive Chairman of the Board

Thanks Dan.

Operator

Your next question will come from the line of Tom Gallagher with Credit Suisse.

Tom Gallagher
Credit Suisse

Good morning. Just wanted to touch on the capital margin for a minute. When we step back and think what you are incorporating in that, are you factoring unrealized losses at all into that calculation or is it just impairment? That is the first part. The reason I ask that is, I would be curious how you all would look at let's say the pool of bonds that are now trading below 50% of par that are still in the unrealized category, it is $650 million or so. Is that something that you are actually factoring into capital planning in terms of those potentially getting impaired in the future? Thanks.

Liz Zlatkus

Tom, its Liz. First of all, the way that impairments would impact our statutory capital position, the rules for impairments under statutory are different than under GAAP. That is the first thing I would say. As I mentioned in my comments, while there is a proposal out there that would change the rules for statutory impairments and would actually increase them and we have talked about that, if the proposal was enacted, it would decrease our capital position by $400 million and that clearly is in our capital planning.

In addition to that, as we look out into the future and we stress our capital, we do look to how impairments that we have taken and how we look at our portfolios would run through the stat numbers because again there is a big difference between stat and GAAP. However, I would make a final comment and that is related to just how we think about impairments from the GAAP basis and your comment about the below 50%, and I can turn it over to Dave Z. However, as of June 30 when we looked at the securities, we do feel that everything that is in unrealized is recoverable. We have done a lot of stress tests over that and we have both the ability and the intent to hold those assets until recovery. So, I think we stand by what is unrealized and only when they cannot meet those tests, do we impair for GAAP.

Tom Gallagher
Credit Suisse

Liz, just a quick follow-up if I could. The proposal on the stat accounting, is that somehow going to factor in unrealized losses on structured securities or what exactly is going to occur there?

Liz Zlatkus

Sure, Tom, let me give you a little bit more color on that. So for structured securities under GAAP, we take a GAAP impairment to fair value of the discounted cash flows are less than book value. Under the current rules for statutory use undiscounted cash flow testing to determine if the security is impaired, and if it is impaired, just under an undiscounted method, you write it down just to the on discounted level. The change that is a proposal, again, it has not been enacted yet, but the change would make stat more comparable to GAAP. You would use discounted cash flows and if you failed the test, you would mark it to fair value.

Tom Gallagher
Credit Suisse

Okay. So, no change based on mark-to-market or anything along those lines? This just has to do with cash flow impairment.

Liz Zlatkus

I would say that the tests would be more similar, more statutory and GAAP under the new proposal for structured securities.

Tom Gallagher
Credit Suisse

Okay, thanks.

Liz Zlatkus

Sure.

Operator

Your last question will come from the line of Al Copersino with Madoff Investments.

Al Copersino
Madoff Investments

Thanks very much. I have two related questions for Liz, just quick ones. You have all given us the estimated average diluted shares for the full year. I am just wondering if you would not mind giving us your estimate, and I know it can only be an estimate for the diluted share count for the third quarter just because there is the ASR out there. That is my second and related question, are there any other changes to the share count or any other factor we should think about as a result of the ASR?

Liz Zlatkus

Good morning. So, how we looked at our guidance, we are using our guidance using a $308 million share count and that would really include what I would call the full billion dollar buyback both the $500 million ASR as well as the open market purchases both through the end of the quarter as well as the open market purchases in July. So, I think that is your question. As far as the ASR work, again, we got shares originally under the ASR program, but we would expect that if at prices today of our stock that we would get back an additional or we would buyback an additional $1 million shares when the ASR is completed. So, that is included in that $308 million share count.

Al Copersino
Madoff Investments

Okay. Thanks, Liz.

Liz Zlatkus

Sure.

Ramani Ayer

Operator, do we have any more questions?

Operator

We have no further questions.

Ramani Ayer

Well, then I am going to bring this call to a close. I would like to remind you that we are hosting an Investor Day in Japan this fall and that event is scheduled for September 10 and we look forward to sharing a deeper look at our international operations with you at that time. So, I want to really bring this call to a close by saying that the second quarter from our standpoint represents strong operating execution with very good underwriting profitability in Property-Casualty, good execution in Life. Our AUM really is up 3% year-on-year and we have also executed and completed our $1 billion share repurchase and in the face of volatile capital markets, our realized capital losses have moderated. So all in, we feel good about how the quarter turned out. I want to thank you for this call and we look forward to joining you again at the end of next quarter. Thank you again.

Operator
Ladies and gentlemen, this does conclude today's conference call. Thank you for your participation. You may now disconnect.