S&P Capital IQ

CONTENTS

The Hartford Financial Services Group, Inc. NYSE:HIG

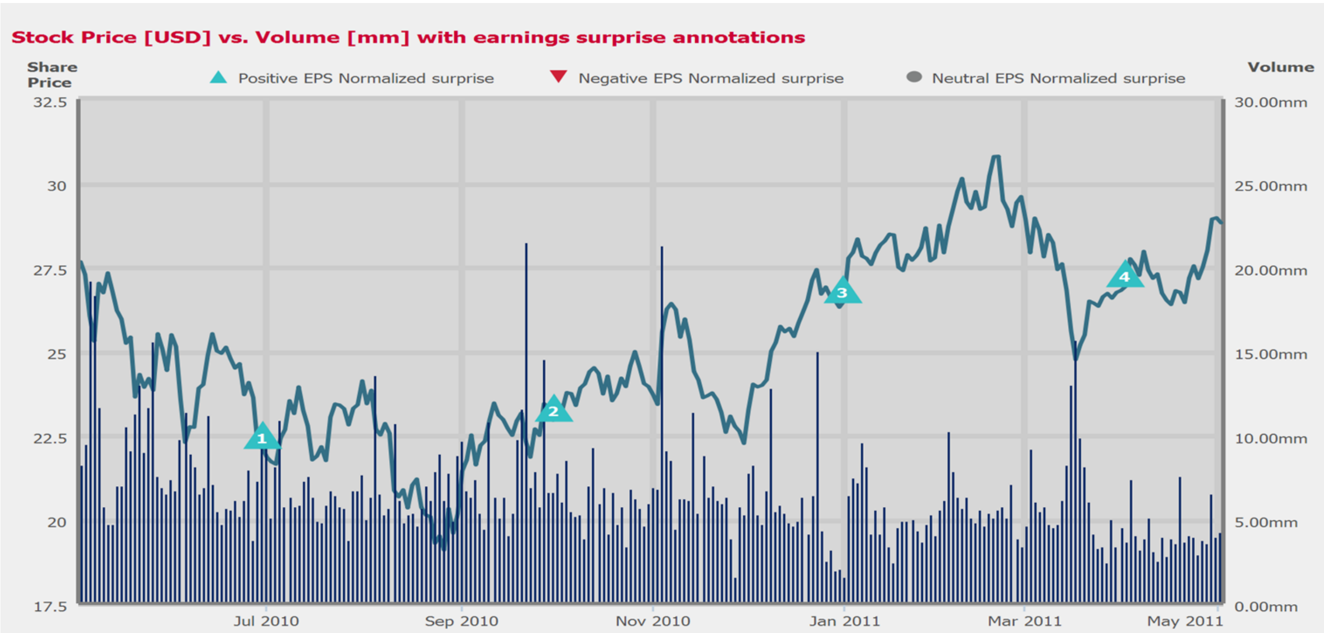
FQ2 2011 Earnings Call Transcripts

Thursday, August 04, 2011 1:00 PM GMT

S&P Capital IQ Estimates

	-FQ2 2011-			-FQ3 2011-	-FY 2011-	-FY 2012-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.01	0.00	▼(100.00 %)	0.90	3.07	4.03
Revenue (mm)	6046.25	5401.00	▼(10.67 %)	6015.81	24390.06	24753.52

Currency: USD
Consensus as of Aug-04-2011 10:41 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ2 2010	0.77	0.92	▲1 19.48 %
FQ3 2010	0.93	1.43	▲2 53.76 %
FQ4 2010	0.95	1.06	▲3 11.58 %

FQ1 2011	0.95	1.16	▲22.11 %

Call Participants

EXECUTIVES

Christopher John Swift
Chairman & CEO

David N. Levenson
Former Executive Vice President and President of Wealth Management

Douglas G. Elliot
President

Liam E. McGee
Former Chairman

Lizabeth H. Zlatkus
Former Chief Risk Officer and Executive Vice President

Sabra R. Purtill
Senior Vice President of Investor Relations

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Presentation

Operator

Good morning. My name is Roshira, and I will be your conference operator today. At this time, I would like to welcome everyone to the Hartford Financial Group Second Quarter 2011 Earnings Conference Call. [Operator Instructions] And now I would like to turn the call over to Sabra Purtill. You may begin.

Sabra R. Purtill
Senior Vice President of Investor Relations

Thank you, Roshira. Good morning, and thank you for joining us for The Hartford's Second Quarter 2011 Conference Call. The press release, supplement and today's slide presentation are on our website as is our second quarter 10-Q, which was filed last night. Chief Executive Officer, Liam McGee; and Chief Financial Officer, Chris Swift will discuss our results and accomplishments. After which, we will have time for Q&A. In addition to Liam and Chris, several other members of our senior management team are also here today including Doug Elliott, Alan Kreczko, Dave Levenson, Greg Mcgreevey, Andy Napoli and Liz Zlatkus.

Please note, as discussed on Page 2 of the presentation that any statements made today concerning The Hartford's future results or actions should be considered forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995. These forward-looking statements are not guarantees of future performance, and actual results may differ materially. We assume no obligation to update these statements. You should also consider the important risks and uncertainties that may cause actual results to differ, including those discussed in our press release, our second quarter 10-Q, 2010 Annual Report on Form 10-K and other filings we make with the SEC. In our presentation, we will use some financial measures that are not derived from Generally Accepted Accounting Principles or GAAP. Definitions and reconciliations of these measures to the most directly comparable GAAP measures are in the investor financial supplement, press release and 10-Q.

I'll now turn the phone over to Liam.

Liam E. McGee
Former Chairman

Thank you, Sabra. Good morning, everyone. Thanks for joining us. The Hartford's business demonstrated solid fundamental performance in the second quarter and the results were consistent with the preliminary financials we announced in July. But before I get into details, I want to formally welcome Sabra Purtill to The Hartford as Senior Vice President of Investor Relations. As you know, she joined us in June from Assured Guaranty where she was Managing Director of Investor Relations and Sabra has more than 20 years of insurance experience. Many of you have met her and know she has a deep knowledge of the industry and a commitment to clear and effective investor communications. We really are excited to have her as part of our team, and I look forward to working with her. Sabra, welcome.

Now as we announced last night, the operating businesses had solid fundamental performance. But on a core earnings basis, it was essentially a breakeven quarter for The Hartford. Record catastrophe losses as well as asbestos and other items described in our July preannouncement affected the bottom line. But I do want to take a moment and thank our claims teammates for their hard work and dedication in what has been a very, very busy period for them and for many, many of our customers. The Hartford's customers always come first to this team, and they have been recognized for the outstanding service that they provide. The Hartford, along with others in the insurance industry, provides confidence and peace of mind to customers during very difficult periods in their lives.

Last evening, as you know, we also announced a significant capital action, a $500 million share repurchase program that we expect to complete by early 2012. We are confident that this next capital management action, following others outlined on Slide 4, is prudent and appropriate. We've strengthened the balance sheet, improved the investment portfolio and made significant progress implementing the Japan hedging program. These actions have positioned the company to return capital to shareholders, an important action toward increasing return on equity and generating earnings per share growth.

At our April 2010 Investor Day, we targeted an 11% ROE run rate for the company by the end of 2012. We remain committed to increasing ROE, but given the impact of the macroeconomic environment on some of our original assumptions, we now expect it will take longer to reach the 11% goal. Since Spring 2010, the economy has grown more slowly than we anticipated then, and interest rates have remained at historically low levels. Also, losses in our investment portfolio were less than expected, resulting in a higher level of GAAP equity.

We are on track on our other 2012 objectives. We targeted a 200 basis point improvement in the company's efficiency ratio by the end of 2012, and our expense initiatives are on schedule, as Chris will show you. In addition, we remain on track for high-single digit adjusted core earnings growth by the end of 2012, but we will likely have to navigate some economic headwinds in the coming quarters to do so.

At The Hartford, we are committed, over time, to generating ROEs in excess of our cost of capital. And we do know that you want more details on our balance sheet, and so, we have scheduled an October event to do so. Chris will give you more specifics on this event. We will also host an Investor Day on December 8 to provide you with a detailed update on the company's business and go-forward strategy.

Moving to segment results. In Commercial Markets, P&C Commercial written premiums were up 8%, another quarter of significant top line growth. These results were achieved despite challenges in the economy and sustained competition in the middle market and financial product sectors in particular. Small Commercial and Middle Market written premiums were both up more than 9%, reflecting disciplined rate action, exposure growth and strong retention levels. In Group Benefits, the pricing changes we are making are beginning to have a positive effect. The loss ratio showed initial signs of improvement this quarter, but we believe it is too early to call it a trend. Competition in this business remains fierce, yet we are being cautious and disciplined on new business and renewals with a primary focus on profitability.

As you know, at the beginning of the second quarter, Doug Elliott joined us to lead Commercial Markets. Since then, he has been deeply engaged in evaluating the business, developing specific strategies for improving returns and driving growth. Doug also joined us at this year's VIP Summit where we brought together about 130 principals and leaders of The Hartford's top producing P&C agents and benefits brokers. Upon joining the company about 2 years ago as you recall, I was impressed by the strong long-term partnerships between The Hartford and its agents. To sum, it was another reminder for me of the special collaborative relationships that we have. This year, in addition to our traditional P&C-focused content, we held a number of business sessions that cover The Hartford's Life Insurance, Retirement Plans and benefit offerings, which were met by our P&C distribution partners with a very positive response.

Because in this economy, agents are looking for ways to increase revenues. Selling more product lines to existing customers offers them a highly effective way to grow their business, and many were vocal in their support of our strategy. The proof, of course, will be in the production over time, but we are seeing some positive signs that this distribution strategy is gaining momentum. The Hartford's Retirement Plans and Life Insurance sales through P&C agents were both up more than 30% in the second quarter over the prior year. And we're seeing promising results from the integration of the Group Benefits and P&C Commercial sales teams. Through June, their joint sales efforts have generated more than $70 million in incremental premium this year.

In Consumer Markets, we continue to make progress on repositioning our agency book of business to a more profitable customer segment, as well as on building out AARP and other affinity relationships. Consumer Markets is delivering profitable results in line with our plan. The combined ratio, excluding catastrophes and prior year development, was 91.6%, a 1.6 point improvement over the prior year.

Consumers remain very price sensitive, and the industry is highly competitive. So in this environment, the rate actions we are taking affected both retention and new business, driving written premiums down 6%, about what we anticipated. We believe that we will still achieve our targeted written premiums in this segment for the year although it will require us to increase the growth rate in the second half. As a leading indicator within AARP, we're beginning to see progress in response and conversion rates with our marketing initiatives, which should drive future premium growth.

In Affinity, efforts are on track, and the team is executing programs targeted to members and new partners. But driving sales through new partners in this channel takes time, and we view this as an investment to generate future premium and profitability. Including Sierra Club, which we signed in June, we now have added the ability to market to more than 6 million new Affinity member households.

Wealth Management's focus on product innovation and multi-channel distribution is generating results. We're excited about the second quarter launch of the new variable annuity product solutions, and have been pleased with the initial reception by our distribution partners, who are very interested in learning about the product's features and benefits. But fourth quarter sales should be a good leading indicator of the potential of these product solutions and their contribution to our proportionate goal of $5 billion in annual total annuity sales.

Individual life insurance sales were up 14% over the prior year, with good success in distribution channels beyond the traditional wirehouse focus. Customers are selecting The Hartford's Life Access rider on 1/3 of new policies where it is available. Life Access provides policyholders access to their death benefit for any purpose after they are diagnosed with a chronic illness. At The Hartford, we now have life insurance solutions to help customers protect against the financial risks associated with living longer than they thought possible, getting sick along the way or premature death.

Reflecting an industry-wide preference for fixed-income, mutual fund deposits were lower this quarter. We continued building out the fund portfolio in the second quarter, launching a world bond fund, as well as 2 funds focused on emerging markets. Retirement plan assets under management rose 27% over the prior year to $55.5 billion, a record for the company.

Before I pass the call to Chris, I want to comment briefly on recent events in Washington. We are pleased that Congress and the President have reached a bipartisan agreement to raise the debt ceiling and reduce spending. The legislative in process in Washington can very much be difficult to watch, but the outcome is what matters. However, it is vital that the government continue to reduce the deficit and bring spending as a percentage of GDP to more normal historical levels. And in addition, The Hartford does business with more than 1 million businesses, most of which are small businesses, and we believe incentives to small businesses for new job creation and investment in plant and equipment, along with the moderation of new and existing regulations are important to help stimulate our economy and create jobs.

We were pleased to take a next capital management step with the $500 million share repurchase program. We are focused on improving our return on equity, and reducing the cost of capital. Over time, our goal is to generate ROEs in excess of our cost of capital. The Hartford operates today with a solid foundation that includes a stronger balance sheet, an improved investment portfolio and risk profile, improving efficiency and businesses that are well positioned in a challenging market.

I'll now turn the call over to Chris.

Christopher John Swift
Chairman & CEO

Thank you, Liam. Good morning, everyone. I'll begin on Slide 6. Our results are consistent with what we preannounced on July 13. Second quarter 2011 core earnings were $12 million before preferred dividends and $0.00 on a per diluted share basis. Catastrophe losses of $447 million pretax, were the highest second quarter catastrophe losses in the company's history. These losses were roughly in line with our market share. Catastrophe losses have been at higher than historical levels for some time and consequently, we have been increasing CAT loads in our pricing models. Our losses this quarter did not exceed our reinsurance retention. Our CAT reinsurance program is designed to reduce our net loss to major single events such as hurricanes. We included a slide in this program in the appendix.

This quarter, we also completed our comprehensive annual asbestos review. As previously disclosed, we increased our asbestos reserves by $290 million pretax. The vast majority of our claim liabilities are developing as we expected since last year's study. The deterioration we experienced this quarter arose from continued litigation pressure in preferral insureds, particularly from measles [ph] claims. We believe this is consistent with industry trends.

In addition to these 2 items, we had a software write-off and a DRD tax benefit from finalizing federal returns. Looking through all these items, we view this quarter's run rate earnings as roughly on par with first quarter of 2011 and the quarterly run rate of 2010.

Slide 7 shows summary results for Commercial Markets, which includes our P&C Commercial and Group Benefits division. P&C Commercial posted 8% written premium growth, continuing strong growth trend from the first quarter of 2011. We are pleased with this growth as well as the results we're seeing, particularly in Small Commercial. We are taking price actions to improve profitability in middle market and specialty. Overall, P&C Commercial is performing well. The group benefit market remains competitive, and we are focused on profitability. This quarter, we saw some signs of progress. The loss ratio improved slightly to 78%, largely due to disability incidence and termination rates. While still above historic norms, this is a 30 basis percent improvement from last year. Like Liam said, it is too early to call this a trend, but we are pleased to see this stabilize.

The results for Consumer Markets are summarized on Slide 8. The combined ratio x cats and prior year development improved, largely due to auto. The pricing increases we've taken over the past year are now earning in and outpacing loss cost trends.

Turning to Slide 9, Wealth Management core earnings were $333 million, excluding a slightly unfavorable DAC unlock. There was also a $52 million tax benefit associated with DRD, most of which is in Global Annuity. U.S. annuity net flows were negative $3.6 billion in the quarter, consistent with the expectations of our full year 2011 guidance. Individual life insurance sales were up 14% over prior year period. As you can see, Retirement Plans, excluding the DAC unlock and the DRD benefit and Mutual Funds, core earnings improved 23% and 17%, respectively.

Turning to Slide 10. We remain on schedule to achieve a 200 basis point improvement in our efficiency ratio by year end 2012. Our efficiency ratio is down about 90 basis points from 2009, after recalibration for the sale of SRS and Federal Trust. The appendix gives you the recalibrated 2009 starting point.

In order to achieve our ultimate goal, we are targeting $200 million of reductions. On this Slide, you can see the breakdown of targeted expense improvement categories that will get us there. We have broad efficiency initiatives underway in many areas including finance, information technology and enterprise operations. We are reexamining processes and systems from the bottom up, with an eye towards simplifying and streamlining operations in order to improve both quality and speed. We continue to be pleased with the performance of our investment portfolio. Net unrealized gains and losses improved again in the quarter as shown on Slide 11. At the end of the quarter, we had a net unrealized gain of $819 million, an improvement of $2.4 billion over the past 12 months. This reflects price recovery and spread tightening in CMBS, CDOs and financials. It also reflects the impact of our disciplined portfolio management process over the past 2 years, which has reduced our investment portfolio risk.

This quarter, we recorded our lowest level of impairments on securities since 2007. Impairments totaled $23 million, but were more than offset by a release of $26 million in our mortgage loan portfolio.

European sovereign debt issues are weighing on capital markets. We do not have a material allocation to European credits in our general account. Our European exposure is largely invested in high-quality corporate bonds and utilities. To be clear, we have no exposure to the governments of Greece, Portugal, Spain, Italy or Ireland in our general account, and only $20 million of exposure to a financial institution in Spain.

Turning to Slide 12. Our book value per diluted share, an important measure for evaluating our company, rose to $43.11, an increase of 13% over the last 12 months. About 1/2 of this is due to net income after dividends, and the rest from improvements in net unrealized capital gains and losses. Our book value per diluted share, excluding AOCI, has risen by 6% to $43.26.

Our U.S. statutory surplus position is summarized on Slide 13. U.S. statutory surplus was $15.6 billion at the end of the quarter. P&C catastrophe losses and dividends through the holding company were the principal reductions to our surplus. On the Life side, earnings and the change in the DTA more than offset the impact of variable annuities. Our RBC ratios remain strong. At the holding company, we had $2.3 billion of cash and liquid investments at the end of the quarter. This is more than sufficient to fund the share repurchase program and our near-term commitments, including the October debt maturity.

I wanted to touch briefly on the solid progress we have made in our Japan tail hedge program. As you know, our goal is to have a robust, dynamic hedging program for Japan in place by the end of the year. At the end of the quarter, as we calculated, we are roughly 75% complete. We remain at that level today.

We are close to our hedge targets for yen and equity markets, while we still have coverage to place on Japan interest rates. In retrospect, our decision to prioritize yen hedging was on the mark. We added substantial protection over the past year at attractive price points relative to today's levels.

As you know, our hedge is designed with a focus on economics, while providing statutory protection in severe scenarios. In fact, if the yen had been 20% lower at the end of the second quarter, there would be no other -- and no other changes in the capital markets, the impact to statutory capital would not be significant. When our program is fully in place, we intend to manage our Japanese hedges dynamically, just as we do with our U.S. GMWB program. We will actively rebalance positions based on potential liabilities, market conditions and instrument's maturities and the like.

Several investors have asked me about the ultimate cost of this program. The cost and the benefits of the Japan hedging are highly dependent on market scenarios. In markets that are benign or rising, we will incur a hedging cost, but our risk profile should improve. In an adverse market scenario, Japan hedging will provide significant benefit to shareholders. We are confident that under a severe stress scenario, we will be able to limit our overall risk to an acceptable level, and one that is well within our capital resources.

We are continuing to refine and build our Japan hedging program. At our October event, we will provide you with greater clarity and benefits on the cost of our Japan hedging program over a number of market scenarios. Then, in our third quarter results, we will incorporate an estimate of the long-term cost of the program into our DAC models along with other DAC assumptions. Hedging Japan [indiscernible] is a prudent way to managing tail exposures. It provides significant downside protection, while maintaining some upside potential as markets improve.

We have accomplished a lot since the beginning of 2010. We have reduced the risk in our balance sheet. We have strengthened our capital position. And we have stabilized our earnings power. This quarter, we are increasing our guidance in P&C Commercial written premium growth and Global Annuity ROAs. This reflects first half of the year performance, and our expectations for the rest of the year. With respect to ROE, we remain focused on improving ROE with the ultimate goal of exceeding our cost of capital. To do this, we are focused on achieving high-single digit adjusted core earnings growth, combined with prudent capital management.

As you know, DAC accounting changes will affect DAC balances beginning January 1, 2012. This change will impact any ROE guidance we could give you today. At our Investor Day in December, when we have more certainty around this change, our 2012 earnings outlook and any other potential capital management actions, we will provide you with more visibility on our guide path towards ROE improvement.

As Liam mentioned, we are also planning to host an Investor Day on October 6 here in Hartford, to discuss our balance sheet. At the meeting, we will walk through a variety of items, including our investment portfolio, risk management, variable annuity hedging and capital. The October and December meetings will provide you with a much deeper, clearer understanding of The Hartford, our balance sheet, how we run our businesses, manage our risk and improve earnings growth and ROE. We look forward to seeing you then.

Turning briefly to the share repurchase program, I know some of you have liked to have seen this move sooner, but we have always said we would be prudent in our capital management actions. We expect to complete the $500 million share repurchase program by early 2012, subject to legal considerations and market conditions.

In conclusion, we feel good about our accomplishments to date, especially when you consider the industry and the economic environment. Our balance sheet is strong, and our investments performed well this quarter. Our risk management is significantly enhanced from where it was 2 years ago and well positioned to manage emerging risk. Our business fundamentals are good, and we are effectively balancing top line growth with bottom line returns. We are on track to become a more efficient organization. The share repurchase authorization is a tangible acknowledgement that The Hartford's financial position and stability have greatly improved.

With that, I'll turn the call over to Sabra.

Sabra R. Purtill
Senior Vice President of Investor Relations

Thank you, Chris. I just wanted for make one point of clarification with respect to the Japanese hedge program. At the end of the quarter, as we calculated, we are roughly 3/4 or 75% complete. As mentioned, we are happy to announce that we will be holding a balance sheet meeting on Thursday, October 6 at 10 a.m. at our home office in Hartford. Our presentation and Q&A session will be webcast, but we certainly hope you can join us in person. We will e-mail the full details and RSVP information shortly, along with a "save the date" notice for our December investor meeting. As mentioned, we will hold an Investor Day this December. It will be in New York City on December 8, and will include presentations by Liam, Chris and our Business Presidents. We will send you full details after Labor Day.
We'll now start the Q&A session. We know there are a lot of people on the call, so we'd like to request that you use this time efficiently, so that everyone has a chance to ask their questions. Any detailed financial or accounting reconciliations, we'd be happy to cover after the call. Roshira, we're now ready for you to give the instructions for asking a question.

Question and Answer

Operator

[Operator Instructions] Your first question comes from Randy Binner with FBR Capital Markets.

Randolph Binner
FBR Capital Markets & Co., Research Division

I have a question on the Japan run-off and didn't that amount of risk to the NAR changed this quarter, moved from about $5 billion to $5.4 billion. And I guess the question is, Chris, your comments said that the yen was very well hedged. So should we think about that change in the NAR this quarter as being mostly market-driven since the hedge is so effective against the yen?

Christopher John Swift
Chairman & CEO

It's Chris. That calculation really does not include any of the, I'll call it, balance sheet hedging we do. So it's more of a gross net amount at risk. So I wouldn't view it that way.

Randolph Binner
FBR Capital Markets & Co., Research Division

So how should we think about what drove the NAR change then from last quarter to this quarter?

Christopher John Swift
Chairman & CEO

Generally, market levels. I mean, we disclosed the yen equity markets in general so again, it's the combination of all the inputs that calculate the net amount at risk.

Randolph Binner
FBR Capital Markets & Co., Research Division

All right. And then just one more on the hedge. I guess with the notional value not changing that much for the disclosure in the Q, can you explain the mechanics, kind of a high level of how the notional did not change even though the hedge program appears to be making progress, now that it's 75% complete?

Christopher John Swift
Chairman & CEO

Sure, and Liz's here too and she can add additional color. But I think, simply, I don't think you can look at the notionals and then draw any necessary conclusion on positions, risk levels, things that we've added during the quarter. I mean, we've rotated certain positions from futures to options and the like, but I don't think that table should give you a good -- it does not give you a good picture of our risk positions. Liz?

Lizabeth H. Zlatkus
Former Chief Risk Officer and Executive Vice President

Yes, Randy. So I would agree, it's not a good indicator of the coverage increase. I'll just give you one example. If you extend cover on options, you just dwell it out for a longer period of time. You would have more coverage the way we think about it, but the notional wouldn't change. And it depends on how all of the money strike the options, et cetera. So it's just not a good indicator. I would turn your attention more to the Q where you can see the sensitivities in the Q, and you can see both currency and equity increased. So from any market level, that's the amount of protection that as the markets go down 1% or currency strengthened 1%, you can see that the amount of coverage we have has increased.

Operator

Your next question comes from Nigel Dally with Morgan Stanley.

Nigel Phillip Dally
Morgan Stanley, Research Division

The first question is just on the year-end 2012 ROA target. I understand that the 11% now looks unlikely which probably isn't really a surprise to most investors but, and I know that you're planning on providing additional detail at your upcoming Investor Day. But any color as to how much lower your expectations are now relative to what previously you're expecting would be helpful. Why don't we start there, then I have a follow up on capital.

Christopher John Swift
Chairman & CEO

Well, Nigel, let me be clear, first of all. We're saying the timing of the 11% will be pushed out, not that we're not as committed to achieving it. As I said in my remarks, when we went to go back to April of 2010, first of all, Chris and I and the management team really want to run the company against targets. And we kind of have a philosophy, if you don't really have a destination, you don't know when you get there. And as I noted in my remarks, clearly, the economy has not recovered at the pace that we expected, and interest rates just have remained at levels we would not have anticipated at that point in time. And we haven't consumed as much capital, unfortunately, in our investment portfolio, because of the good work of our teammates there. We are committed, as Chris and I have said a couple of times this morning, to increasing our ROE and over time, we want to get our ROE at minimum, initially, to be on top of our cost of capital and then over time to exceed it. What I can tell you, Nigel, is that the management team, as well as the management team with the board, is really managing our company, not just at an aggregate level from an ROE perspective but business by business. So each of our businesses, those that are above their cost of capital now have a plan for improving it, and those that are below it have very specific communicated plans that we're monitoring closely to get those businesses at and then ultimately over the cost of capital and monitor if that's not possible. And I'd emphasize, that's not just the management team. That's in conjunction with our board as well. Finally, as Chris said, I think because of the economic uncertainty and the market uncertainty, number one. Number two, there's a lot of unknowables at this moment. We're working through the DAC methodological change and the impact of the Japan hedge on DAC. I think it's more appropriate for us to give you the glide path towards improvement in the December timeframe at our Investor Day, and that'll be one of the things we'd spend a lot of time on.

Nigel Phillip Dally
Morgan Stanley, Research Division

Second question is just on the capital. Chris, I think you've said in the past that warrant extinguishment will be probably a higher priority than regular common stock repurchases. Is that still the case today or should we expect more of a combination or warrant to common stock buybacks in tandem as you execute your capital management initiatives? Also, the second quarter was clearly challenging and market conditions remain tough this quarter. So as we think about the buybacks, are you likely to go ahead regardless of market conditions or should we think about these repurchases as being contingent on some sort of stabilization?

Christopher John Swift
Chairman & CEO

I think on your last point, we're ready to go. We talked about the cash at the holding company, our outlooks, our views. So again, I wouldn't view that we're not prepared to execute at this point in time, subject again to the legal and market conditions. I think on your question on warrants versus common share, all I would say is that at today's market levels, where our common stock is trading, common stock looks pretty compelling to purchase. But we'll go through our analysis that we'll do and in making conclusion on what's best and/or any combinations.

Liam E. McGee
Former Chairman

This is Liam. I'll just add a little more color on top of what Chris said very well. We've been pretty consistent, Chris, myself and the management team, that we were going to be prudent and consult with all of our constituencies as we looked at potential actions that impacted capital. We said we went through that process when it regarded repaying TARP in our capital raise, certainly in doubling our dividend, and of course, this capital management action as well. To your point about market conditions, I would reiterate what Chris said, "We're ready to go". There are no real contingencies that we have to get through to do it, but we have both internally in conjunction with our constituents including rating agencies, really stress test the firm against a number of scenarios, including severe stress scenarios and also take in rating agency models to do the same. So we feel quite confident that -- and we expect to complete the share repurchase program in early 2012. Chris, you might want to share since you've personally kind of led the discussions and deliberations with the rating agencies, kind of how that process went.

Christopher John Swift
Chairman & CEO

Sure. We, Robert Michael Arena [ph] , our Treasurer, we did it together over the course of July, met with all the agencies. It really was designed to give them a business update broadly through the second quarter, talk about various components of the results that we just released. We went through our views on capital. We went through our views of our capital margins under different scenarios. We also modeled obviously all the agencies' perspectives from their own model perspective. Brought him this, I call it six-month, short-term capital management action, and the results speak for themselves. And we announced it today and communicated clearly with all our key constituents.

Operator

Your next question comes from Andrew Kligerman with UBS.

Andrew Kligerman
UBS Investment Bank, Research Division

Two question topics. I guess the first one. So if you're pushing out the ROE target, but you're mentioning that you want to at least achieve your cost of capital, what I'd like to know is what is The Hartford's cost of capital and how do you measure it? And then I have a quick follow up.

Liam E. McGee
Former Chairman

Chris, why don't you take that?

Christopher John Swift
Chairman & CEO

Sure. Obviously, our cost of capital is dependent on market conditions and the market will ultimately determine that. What we're focused on, like we've said consistently, is growing our earnings base and producing more stable, predictable results. And again, we think that the cost of capital will come down over time. If you look at it today, we would measure sort of our aggregate weighted cost of capital maybe in the 12.5% range and our equity cost of capital at 14.5%.

Andrew Kligerman
UBS Investment Bank, Research Division

That's great. So your objectives are much higher than 11% over the long-term?

Liam E. McGee
Former Chairman

Well, Andrew, let's be clear. We have 2 objectives here. One is to increase our ROE, and what we said this morning is to get it to that 11% point will just take us a little longer because of the factors I described. If not, those factors clearly are different than we anticipated in April of 2010. And secondly, we want to drive our cost of capital down. We think, not the exclusive factors, but the 2 factors that are most important are, I think, the dramatic improvement in our investment portfolio. I do think the market will appreciate that and drive our beta and our cost of capital down. Of course, we have great conviction about the effectiveness of our Japan tail hedge, and we'll give you more detail on that in October. Now those are not the only 2 sources of why our cost of capital may be higher, but I think most would agree, there are probably but 2 most primary reasons. So we want to get our ROE up, we will get our ROE up, but we also are managing the firm to drive our cost of capital down. And so, we think over time, as Chris and I said at least a couple of times each, we want to be clear with investors. We believe it's paramount for us to run this firm over time to get our return on equity to exceed our average cost of capital. I hope that gives a little more color to it.

Andrew Kligerman
UBS Investment Bank, Research Division

It does. Definitely, it does. And then, with regard to the mutual fund business, that's my other question. So you're still targeting $2 billion to $4 billion of net flows, yet in the quarter, you had a negative $1.2 billion inflow. So, a, can you still reach that target? And b, is the reason for this decline in net flows due to the recent media attention to potentially selling that business? And what's the outlook for that? Is it going to be part of The Hartford in 6 months or 12 months?

Liam E. McGee
Former Chairman

I think Dave Levenson will answer that question.

David N. Levenson
Former Executive Vice President and President of Wealth Management

Dave Levenson. So I guess where I'd start is just if you look at the industry flows, there was a sharp increase in fixed income flows and a sharp decrease in equity flows. Whenever that environment happens, that does not play well for our fund family, which you know is largely equity based. We do expect that will turn in the second half of the year, so we still remain confident about our guidance and our assumptions.

Andrew Kligerman
UBS Investment Bank, Research Division

And then, just with respect to the -- is it going to be part of The Hartford?

David N. Levenson
Former Executive Vice President and President of Wealth Management

You know our policy. We don't comment on market rumors.

Andrew Kligerman
UBS Investment Bank, Research Division

Okay. I mean, just strategically, do you think it's a good fit for the company? I mean, is it core?

David N. Levenson
Former Executive Vice President and President of Wealth Management

We love the business. It's performed well for The Hartford over time. We like our current suite of products, and we don't comment on market rumors.

Operator

The next question comes from Jimmy Bhullar with JPMorgan.

Jamminder Singh Bhullar
JP Morgan Chase & Co, Research Division

I had a question first on your, just your level of comfort with the Japan verbal annuity or Japan annuity DAC balance, I think it's around $1.7 billion-ish so. The flows are obviously negative. They're going to remain negative to blow [ph] off shrinking. So why should we not expect a DAC write-off in that business? And then secondly, maybe talk about just capital deployment. You have the $500 million buyback that you plan to complete by the beginning of next year, should we expect capital management to be an ongoing part of your -- or capital deployment to be an ongoing part of how you operate? So beyond the first part of next year, should we expect additional buybacks just from your free cash flow?

Liam E. McGee
Former Chairman

I mean, why don't I take the second question first and then Chris will deal with the DAC issue as it relates to the Japan VA book. I just go back to what I said to an earlier question. You should expect this management team to be very prudent and thoughtful and rigorous and continuous in looking at the most efficient use of our capital. It's certainly consistent with the discussion I had just a few moments ago about improving our ROE and as well as simultaneously driving down our cost of capital. So we've just announced the $500 million last night, but we will again, in conjunction with our constituents and our board, the management team will look at most efficient use for our capital. We will evaluate other potential uses, investing in our businesses, obviously potential future dividend action, share warrant repurchases. We look at our investment portfolio as an example. Some of our highest risk assets, is there a way to de-risk some of that, economically. And finally, looking at our balance sheet, are there ways to restructure some of our debt at a lower carry cost, which I think would be good for shareholders, good for reducing the leverage of the firm as well and the cash flow of the firm. So we'll be disciplined and rigorous. I think, the reason we put that slide in there was to demonstrate since the last nearly 2 years, I think we've been very consistent in saying we're going to be prudent, we're going to be thoughtful. We're also very cognizant of the economy and the market uncertainties, but our highest priority is to increase shareholder return, and capital management actions will be always considered in that context and where we deem them appropriate taken and the appropriate ones taken as we believe we've done with this action. Chris, you want to talk about the DAC?

Christopher John Swift
Chairman & CEO

Sure. Jimmy, I think you know and that we've talked about, we've amortized that balance fairly quickly, right? It's through the amortization period, so as policies hit their amortization window, we should have DAC fully amortized. We still actually make good margins in Japan on a core basis so, I mean, our profit margins are very healthy there. We've talked about Japan contributing $200-plus million of core earnings on an annual basis to the firm. So it's still highly profitable. I think the last point that I alluded to in my comments is, we do our third quarter assumption update. We'll go through that completely, U.S. and Japan, and as we finalize the components of our Japan tail hedge program, we'll bake those long-term costs into our estimated EGP streams and take any appropriate adjustment required.

Jamminder Singh Bhullar
JP Morgan Chase & Co, Research Division

And could you also just talk about what your ongoing hedging costs are going to be once your fully done hedging the Japan book on an annual basis?

Christopher John Swift
Chairman & CEO

It's Chris. And then I could maybe add some color too. I think the way we think about it is it just depends on scenarios, right? It's sort of path dependent and call it rising or benign markets. It will look like we're having, I'll call it, higher costs than we do in down markets. There's also a definitional issue. What is a cost, right? I mean from a typical cost accounting perspective, cost is a little different terminology in the hedging world and in the capital markets world because sometimes, you don't have to expend any upfront dollars. And as you would think of it is in a traditional cost, but you have mark-to-markets that you have to reflect over a period of time. So definitionally, these are more of the things we want get into in our October meeting, but all I could tell you is like I said before, we will be transparent as possible. We will bake our long-term cost of estimates into our path-dependent scenario for Japan and take any necessary adjustments to our debt balance.

Operator

Your next question comes from Jay Gelb with Barclays Capital.

Jay H. Gelb
Barclays PLC, Research Division

And 2 questions. First, can you update us on your goal to generate $5 billion of annual new sales in the U.S. variable annuity product that was recently rolled out? And secondly, with Doug on the call, if we could hear from Doug Elliott in terms of what his initial perspectives are on the P&C business and what his focus will be for the future.

David N. Levenson
Former Executive Vice President and President of Wealth Management

This is Dave. Let me take the first question. So with respect to the $5 billion, as you know, that's a total annuity number, not just variable annuity. What we did do in the June timeframe, June 13, as we rolled out a series of additional product solutions that we're very excited about, there were really only 14 business days that that product was live in the quarter, but I will tell you that we received, have received great reception from our distributors. Our leading indicators are all up, meaning wholesaler activity and broker meetings, and we'll have a much better read on that as we get into the fourth quarter. We are not stopping there, though. I think as we get into the second half of the year, you will be seeing and hearing a lot more about additional things that we are taking on beyond just the variable annuity business. So we remain confident about the proportional goal of $5 billion.

Jay H. Gelb
Barclays PLC, Research Division

When do you think that could be achieved by on a run rate basis?

David N. Levenson
Former Executive Vice President and President of Wealth Management

So we've said 2012, and right now, there's no reason to deviate from that.

Douglas G. Elliot
President

This is Doug. As you know, it's been just over 100 days here for me at The Hartford, and I'm very excited to join this franchise. My early impressions continue to be very positive about the array of strong businesses we have in the commercial market. We have excellent positions in group benefit, small commercial, middle and some terrific complimentary specialties around those core. I'm excited about what I think we can do going forward. Obviously, with different ideas, we're looking at execution options, ways to speed up things we do here but built around a terrific group of distributors, agents and brokers, who I think feel strongly about our franchise. So as I look out, really just the beginning of great hope for what we can do going forward. I think we have some excellent teammates here within The Hartford that can execute with the best in the industry that we can see each and every day. So optimistic about where we head.

Operator

Your next question comes from Chris Giovanni with Goldman Sachs.

Christopher Giovanni
Goldman Sachs Group Inc., Research Division

I wanted to see if you guys can maybe provide us with an update for EPS sensitivity, the movements in the equity markets? And then also, sensitivity that capital RBC for maybe every 100-point change in equity markets. All else constant recognizing it is not linear.

Christopher John Swift
Chairman & CEO

It's Chris Swift. Again, I would go back to what we disclosed in the Q on the hedging sensitivities for equity rates, currencies. I think that's the best indicator. And again, our traditional guidance on EPS sensitivities for S&P movements and things like that are really unchanged at this point in time. But, I mean, if you got specifics, you're trying to update your model, maybe you and I and Sabra could just have a talk afterwards.

Christopher Giovanni
Goldman Sachs Group Inc., Research Division

Okay. That would be great. And then one just quickly for Dave Levenson. Just any signs of sort of early traction with the new VA product?

David N. Levenson
Former Executive Vice President and President of Wealth Management

Chris, as I mentioned, we did launch the new product on the 13th of June. So after 14 business days, all I can tell you is that the activity and the leading indicators are all up. People are embracing a lot of the new options, but we really won't have a very good read on that until we get to the fourth quarter.

Christopher Giovanni
Goldman Sachs Group Inc., Research Division

Okay. So no real view here through July?

David N. Levenson
Former Executive Vice President and President of Wealth Management

So as we look at July, again, there's been continuing additional activity, and that's probably what we would clearly expect after rolling out a new product, and we are seeing a lot more interest in our new solutions.

Christopher John Swift
Chairman & CEO

So Chris, net-net, the reception has been very positive. As Dave has said a couple of times this morning, appointments are way up, interactions with our distribution partners are way up. But we want to be clear, we're not going to declare anything until we start putting some points on the board. And so, probably the tail end of the third quarter and into the fourth quarter, as Dave has said, the proof will be in the sales numbers, but leading indicators are quite positive right now.

Operator

And your last question comes from John Nadel with Sterne Agee.

John Matthew Nadel
Sterne Agee & Leach Inc., Research Division

Two, if I can fit them in. What do you estimate your risk-based capital ratio was at the Life company at the end of the quarter?

Christopher John Swift
Chairman & CEO

It's Chris. I would say again, we don't do a precise calculation but our estimates are at 472 for the Life company.

John Matthew Nadel
Sterne Agee & Leach Inc., Research Division

And then just to go back to the ROE target and completely acknowledge that we'll get more information on this as we get toward the end of the year. And I recognize that DAC accounting changes can certainly get in the way. But if I removed the idea that there would be any DAC accounting change that would have an impact, if we thought more apples-to-apples versus the 11% target by the end of 2012, where do you see that end of 2012 as you look out today versus that 11% if I gave you apples-to-apples on DAC?

Christopher John Swift
Chairman & CEO

It's Chris. I understand your perspective and what you're trying to do. I would say, look, we think we're at a slightly below 9-ish core run rate right now that the guide path, the improvement, the activities that we're focused on primarily center around capital management and growing core earnings. You saw we took our first capital management, major capital management action with the share buyback. A lot of that is going to ultimately be dependent on how we can manage our equity base and capital base going forward in 2012. And as Liam said, we have a rigorous process. It's updated quarterly. We want to complete our share repurchase program in early 2012. Look at our risk positions. Look at the economic conditions. Look at how the businesses are performing. Our capital needs at that point in time, I think we'll have better insights into how we get to that improvement path. But thinking in terms of we're light of 9-ish right now, we want to grow and improve through 2012, which again, there is expansion and improvement potential, and we'll quantify it even more clearly for you in December.

John Matthew Nadel
Sterne Agee & Leach Inc., Research Division

And then if I could just follow up, because clearly credit in the investment portfolio has performed significantly better. I mean, that's certainly true for Hartford, it's probably true for the industry. So how much of a difference is there, as you think about how much more GAAP equity you have today versus what -- or you expect to have on average in 2012 versus what you might have thought was pressure from investment losses under the original plan? Because I suspect that's a pretty big driver, and maybe I'm wrong.

Christopher John Swift
Chairman & CEO

No, you're right. And I understand what you're trying to do and again I want to be helpful. But again, we're just not in the position to quantify that here right now. So we can talk more through it off-line if you really want try to update models. But again, I would say that we're still working our way through the credit cycle. I'm looking at Greg Mcgreevey a little bit.

John Matthew Nadel
Sterne Agee & Leach Inc., Research Division

Tough with today's environment, yes.

Christopher John Swift
Chairman & CEO

Yes. Well, so again but it is and has been a major driver and again in a positive way. We have consumed book value that we planned. But again, we're still through the vast majority of the credit cycle. But again, let us just get through December and we'll show you our views and the path towards that improvement path going forward.

Sabra R. Purtill
Senior Vice President of Investor Relations

Thank you, all for joining us today for The Hartford Second Quarter Conference Call. I wanted to note I know there's a few people in the queue but we do have some time locked out on Chris' schedule for the afternoon. So if you'll just give us a call, we will be happy to follow up with your questions off-line. Thank you, all for joining us, and we look forward to seeing you and talking to you again soon. Bye.

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