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AEL - Q4 2017 American Equity Investment Life Holding Co Earnings Call

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## CORPORATE PARTICIPANTS

**Jeffrey D. Lorenzen** *American Equity Investment Life Holding Company - Executive VP & CIO*

**John Michael Matovina** *American Equity Investment Life Holding Company - Chairman, CEO & President*

**Julie L. LaFollette** *American Equity Investment Life Holding Company - Director of IR*

**Renee Denise Montz** *American Equity Investment Life Holding Company - Executive VP, General Counsel & Corporate Secretary*

**Ronald J. Grensteiner** *American Equity Investment Life Holding Company - President of American Equity Investment Life Insurance Company*

**Ted M. Johnson** *American Equity Investment Life Holding Company - CFO & Treasurer*

## CONFERENCE CALL PARTICIPANTS

**Daniel Basch Bergman** *Citigroup Inc, Research Division - VP*

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

**John Bakewell Barnidge** *Sandler O'Neill + Partners, L.P., Research Division - Director of Equity Research*

**Kenneth S. Lee** *RBC Capital Markets, LLC, Research Division - Analyst*

**Mark Douglas Hughes** *SunTrust Robinson Humphrey, Inc., Research Division - MD*

**Pablo Augusto Serrano Singzon** *JP Morgan Chase & Co, Research Division - Analyst*

**Randolph Binner** *B. Riley FBR, Inc., Research Division - Analyst*

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

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

## PRESENTATION

**Operator**

Welcome to American Equity Investment Life Holding Company's fourth quarter 2017 conference call. At this time, for opening remarks and introduction, I would like to turn the call over to Julie LaFollette, Director of Investor Relations.

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**Julie L. LaFollette** - *American Equity Investment Life Holding Company - Director of IR*

Good morning, and welcome to American Equity Investment Life Holding Company's conference call to discuss fourth quarter 2017 earnings. Our earnings release and financial supplement can be found on our website at www.american-equity.com. Non-GAAP financial measures discussed on today's call and reconciliations of non-GAAP financial measures to the most comparable GAAP measures can be found in those documents. Presenting on today's call are John Matovina, Chief Executive Officer; Ted Johnson, Chief Financial Officer; and Ron Grensteiner, President of American Equity Life Insurance Company.

Some of the comments made during this call may contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act. There are number of risks and uncertainties that could cause actual results to differ materially from those expressed or implied. Factors that could cause the actual results to differ materially are discussed in detail in our most recent filings with the SEC.

An audio replay will be made available on our website shortly after today's call. It is now my pleasure to introduce John Matovina.

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**John Michael Matovina** - *American Equity Investment Life Holding Company - Chairman, CEO & President*

Thank you, Julie. Good morning, everyone, thank you for joining us this morning. We ended 2017 with strong fourth quarter results. Our non-GAAP operating income was $74.5 million or $0.82 per share. These amounts were the second best quarter in the company's history, surpassed only by the third quarter of 2017 results, which included a sizable benefit from unlocking of our actuarial assumptions.

As a reminder, the 3 key areas to drive our financial performance are: you know, growing our invested assets and policyholder funds under management, generating a high level of operating earnings on the growing asset base through investment spread and then minimizing impairment losses in the investment portfolio.

So for the fourth quarter of 2017, we delivered 1.6% sequential growth in policyholder funds under management. On a full year basis, we generated a 12.9% non-GAAP operating return on average equity and that excludes the impact of the actuarial assumption reviews and the losses on extinguishment of debt that we had in the third quarter. And our investment impairment losses after the effects of deferred acquisition costs and income taxes were just 0.04% of average equity.

The growth in policyholder funds under management for the quarter was driven by $1 billion of gross sales that represented a 10% sequential increase. As we noted in our third quarter call, we've captured higher new money yield since late June, allowing us to enhance our product offerings and competitive positioning. Sales momentum picked up in the quarter and you'll hear more about the sales environment and competition from Ron a bit later. We had a modest sequential increase in the investment spread in the fourth quarter, reflecting a larger benefit from bond transactions and prepayment income and a slight increase in the over-hedging benefit. And our low level of investment impairment losses, once again, reflects our continued commitment to a high-quality investment portfolio.

I'll be back at the end of the call for some closing remarks. But now I'd like to turn the call over to Ted Johnson, for additional comments on fourth quarter financial results.

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**Ted M. Johnson** - *American Equity Investment Life Holding Company - CFO & Treasurer*

Thank you, John. As we reported yesterday afternoon, we had non-GAAP operating income of $74.5 million or $0.82 per share for the fourth quarter of 2017 compared to non-GAAP operating income of $56 million or $0.63 per share for the fourth quarter of 2016.

Investment spread for the fourth quarter was 275 basis points, up 5 basis point from the third quarter of 2017 as a result of a 4 basis point increase in the average yield on invested assets and a 1 basis point decrease in the cost of money.

Average yield on invested assets was 4.47% in the fourth quarter compared to 4.43% in the third quarter. The increase in average yield in the quarter reflected a larger benefit from nontrendable investment income items which added 12 basis point to the fourth quarter average yield on invested assets compared to 5 basis points from such items in the third quarter of 2017. Nontrendable investment income in the fourth quarter of 2017 included 11 basis points from fees from bond transactions and prepayment income.

The average yield on fixed income securities purchased and commercial mortgage loans funded in the fourth quarter was 4.27%, compared to 4.39% in the third quarter of 2017 and 4.03% for the first 6 months of 2017. In January, we invested new money at 4.12%.

The aggregate cost of money for annuity liabilities was 172 basis points, down 1 basis point from the third quarter. The benefit from over hedging the obligations for index-linked interest was 8 basis points in the fourth quarter compared to 6 basis points in the third quarter of 2017.

We continue to have flexibility to reduce our crediting rates if necessary, and could decrease our cost of money by approximately 49 basis points if we reduce current rates to guaranteed minimums. This is up from 47 basis points at the end of the third quarter.

Interest expense on notes payable for the quarter was $6.4 million, down from $7.6 million in the third quarter. Third quarter interest expense included $1.2 million for our 6.625% notes due in 2021, which were redeemed on July 17.

Our effective income tax rate in the quarter was 33.1%. Income tax expense in the quarter was reduced by roughly $900,000 from the income tax benefit for share-based compensation. This benefit varies from quarter-to-quarter based on stock option exercise activity and vesting of restricted stock and restricted stock units. The effective income tax rate excluding this item was 34%.

Our risk-based capital ratio at December 31 was 378%, up from 375% at the end of this year's third quarter. The increase in the RBC ratio included 4 points from a decline in required capital for production, which we estimate for interim period using trailing 12 months sales, and 5 points from the excess of the increase in our adjusted capital and surplus over the increase in required capital from growth in assets and reserves. RBC was negatively affected by 6 points due to the reduction in adjusted statutory capital and surplus resulting from the revaluation of our statutory deferred tax assets due to tax reforms.

On the subject of tax reform, we expect our non-GAAP operating effective income tax rate to fall from 2017's level to a range of 20% to 22%. Our current analysis indicates that tax reform will have a relatively small benefit on new business pricing because the acceleration of cash payments resulting from changes in the tax reserve deduction and the capitalization and amortization of deferred policy acquisition cost will, on a present value basis, substantially offset the benefit of the lower statutory tax rate. We expect any benefit from tax reform on new sales will be competed away. However, we expect to capture much of the benefit on earnings generated by our in-force business. The economic benefit will not be as large as the drop in the statutory tax rate would suggest, as the change in the tax reserve deduction, which accelerates cash payments for income taxes, will be implemented for in-force over time.

Our expectations are based on our current understanding of the new law, and may be revised based upon regulatory direction and further analysis.

Now, I'll turn the call over to Ron to discuss sales, marketing and competition.

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**Ronald J. Grensteiner** - *American Equity Investment Life Holding Company - President of American Equity Investment Life Insurance Company*

Thank you, Ted. Good morning, everyone. As we reported yesterday, gross sales for the fourth quarter of 2017 were $1 billion, that's up 10.3% compared to the third quarter of 2017. This is the second time in the last 8 quarters that we reported higher sales sequentially. Our sales typically follow the larger market directionally, and early indications suggest that fixed index annuity sales were higher in the fourth quarter. While positive, we continue to face headwinds from the DOL fiduciary rule, low interest rates and the strong equity market. However, recent volatility in the equity market may provide a wake-up call regarding the value of safe-money products like fixed index annuities.

There's been a lot of emphasis placed on accumulation in the last couple of years, and it's times like these where the real benefit of fixed index annuities shine... principal protection, locked in interest and guaranteed income.

American Equity Life was in a strong competitive position for guaranteed income, caps and participation rates throughout the fourth quarter as a result of product changes we made in September and early October. In September, we increased income on our guaranteed income products, and in October, we introduced a new lifetime income benefit rider for our Foundation Gold fixed index annuity, which offers very attractive guaranteed income. We also reintroduced a popular no-free version of our rider.

Finally, we increased participation rates in caps on our accumulation offerings. Several of our competitors had rate reductions in September and October, but subsequently, reversed course, and raised caps and participation rates. Even so, we remain in a strong competitive position for guaranteed income, caps and participation rates.

Reflecting independent agents' emphasis on accumulation, we continue to focus more of our marketing efforts on our Choice Series at American Equity Life. The Choice Series accounted for 33% of American Equity Life sales in the fourth quarter versus 22% in the third quarter and 17% in the second quarter. Choice 10 was our best-selling product in the fourth quarter, supplanting Bonus Gold, which has been our best-selling product for several years.

When coupled with the optional market value adjustment rider, we introduced in early 2017, the Choice 10 offers some of the highest participation rates among annual reset fixed index annuities, and compares very well with the hybrid index/multiyear term products, which certain distributors have focused on. We're not fans of the hybrid index products that often have little or no trading history, add unnecessary complexity to the fixed indexed annuity products and lack the transparency which we believe is important in safe-money insurance products.

The changes we made in the fourth quarter helped us gain momentum. Pending business at American Equity Life averaged 2,249 applications during the fourth quarter, and was at 2,353 at the end of December, compared to 2,178 applications when we reported third quarter 2017 earnings. As of this morning, pending stands at 2,343 applications.

To augment our competitive position at American Equity Life, we plan to introduce a new guaranteed income product in March. We will have a premium bonus and non-bonus version of the product. Each version will have 2 fee-based options for lifetime income allowing the policyholder to decide at the time of purchase whether to activate lifetime income after a shorter or longer deferral period, and a no-fee option, which will have lower lifetime income than the fee-based options. This product incorporates significant input from our distribution partners, and we expect it to be well received in the market, as income levels are anticipated to be competitive.

Eagle Life sales in the fourth quarter increased by $77 million or 53% on a sequential basis. Increase our participation rates in October was the primary reason for increased sales. When our rates are competitive, the bank advisers and registered representatives prefer to sell our products due to our excellent service and simple product design.

Pending at Eagle Life stands at 205 applications to date compared to 213 when we reported third quarter earnings.

Our distribution footprint at Eagle Life continues to grow. In the fourth quarter, we added 1 new selling agreement and 314 representatives. In total, at year-end, we had 9 wholesaling distribution partners, 58 selling agreements and 5,897 representatives.

Our development efforts for Eagle Life have largely focused on third-party wholesalers with support from a small home office staff. We plan to increase the engagement and number of Eagle Life's home office personnel dedicated to distribution in 2018 with the expectation of cost-effectively increasing Eagle Life's sales.

Finally, I regularly receive comments, e-mails and letters confirming American Equity's excellent service culture is alive and well. In a recent e-mail, an exasperated agent exclaimed he called a competing company and was on hold for 26 minutes before reaching a live representative. The next day, his client called the company and was on hold for 45 minutes. At American Equity, our phones are answered by a live person in 60 seconds. It's the little things that make all the difference.

And with that, I'll turn the call back over to John.

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**John Michael Matovina** - *American Equity Investment Life Holding Company - Chairman, CEO & President*

Thank you, Ted and Ron. We are pleased with our fourth quarter results as spread remained relatively stable, and non-GAAP operating earnings increased despite continued headwinds from low interest rates. Although, our sales were down on a year-over-year basis, we are pleased with the sequential increase and the renewed momentum we are seeing at both American Equity Life and Eagle Life. Our current product offerings are competitive, and the new product we expect to roll out in March has us excited about the year to come. We believe the value proposition we've always offered to our agents, transparent products, attractive renewal crediting history and unparalleled service remains as attractive as ever.

Although, sales were soft, 2017 was a good year for American Equity. Policyholder funds under management increased by 7.1%, and we had record non-GAAP operating earnings of $285 million or $3.16 per share. And even if you exclude the impact of unlocking of our actuarial assumptions and that loss on extinguishment of debt, our operating earnings were $262 million or $2.89 per share, far surpassing our previous records of $205 million and $2.53 per share in 2015.

We welcome the Department of Labor's delay of the fiduciary rule to July 1, 2019, and are hopeful that the regulations unduly burdens -- unduly burdening distribution of annuities by independent agents will be substantially revised. While the eventual outcome of the fiduciary rule remains uncertain, we remain prepared to respond and grow our business.

Looking ahead to '18, tax reform should be a positive for our bottom line, while the acceleration of tax payments will likely offset much of the benefit of a lower statutory rate for new sales, we expect to benefit from a lower rate on our in-force business. And we will be sharing a portion of that benefit with our employees in higher payouts in our semi-annual employee bonus pool.

Our long-term outlook remains favorable due to the growing number of Americans who need attractive, fixed index annuity products, that offer principal protection with guaranteed lifetime income.

Since our founding in 1995, American Equity has created an unparalleled platform in the fixed index annuity industry. We're fully prepared to participate in the growth we see ahead for our market.

On behalf of the entire American Equity team, thank you for your time and attention this morning. I'll now turn the call back over to the operator for questions.

## QUESTIONS AND ANSWERS

**Operator**

(Operator Instructions) Our first question comes from the line of Kenneth Lee with RBC Capital Markets.

**Kenneth S. Lee** - *RBC Capital Markets, LLC, Research Division - Analyst*

Just had one on the competitive environment. You mentioned in the prepared remarks seeing some kind of rate increases from competitors. Do you think these rate increases are in reaction to the recent tax reform? Or do you see the potential for further rate increases coming up ahead?

**Ronald J. Grensteiner** - *American Equity Investment Life Holding Company - President of American Equity Investment Life Insurance Company*

Well, I'm not sure Ken that we can say that it was due to the tax increases or their investment portfolio. It was -- most of our primary competitors all made some type of change, whether it was increasing rates on their accumulation type products or adjusting income on their guaranteed products, but it's difficult to say what the rationale was.

**Kenneth S. Lee** - *RBC Capital Markets, LLC, Research Division - Analyst*

Got you. And I'll take one more question. In terms of the competition from the volatility managed indexes, those hybrid products, just wondering about how efforts are going to educate independent agents on the relative benefits to AEL's products? It's like what was mentioned in the past, and just wondering whether you've been seeing any -- either increased competition from these kind of products versus what you saw in the last few quarters?

**Ronald J. Grensteiner** - *American Equity Investment Life Holding Company - President of American Equity Investment Life Insurance Company*

Well, Ken, what we have been doing with our distribution is just showing the performance of the S&P 500 over a long period of time. It's got a track record that goes back, about 50, 60 years, something like that. We've seen some index credits as high as 16% in the fourth quarter and our average index credit in the fourth quarter was, I want to say, 5% or 6%. So pretty decent. So we talk about the performance of the S&P, the fact that it's transparent, the fact that it has a long history, and frankly, we think a lot of these hybrid type indexes when they talk about performance compared to the S&P 500. So the process is just educating on the transparency and the strength of the long-standing index.

**Operator**

Our next question comes from the line of Dan Bergman with Citi.

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**Daniel Basch Bergman** - *Citigroup Inc, Research Division - VP*

It looks like the core spread declined a few basis point from the third quarter level, and given that this has been holding in pretty steady -- if not actually increasing a little bit earlier in 2017, I just wanted to see if you have any thoughts on what you saw in the quarter and how we should expect core spread to trend ahead given all the moving pieces like the recent product investment changes and rising interest rate?

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**Ted M. Johnson** - *American Equity Investment Life Holding Company - CFO & Treasurer*

First of all, I mean, we still are -- while we were investing at a higher rate through in the latter half of last year, that still is a rate that's below our overall portfolio yield. So there is some pressure on the top line. When we look at cost of money, it gets a little bit harder to distinguish a little bit because we do now have products that have different spread targets, so different cost of money that's flowing through there. All of the renewal rates, adjustments, primarily, we have a small block that we implemented in renewal rate adjustment on in the fourth quarter. But predominantly, everything is already through. And so now, there is no more cost savings on the cost of money coming through for renewal rate. But we did see overall, when you looked at adjusted spread, it came down when we look at it up 4 basis point from last quarter. Last quarter probably had 1 to 1.5 point to 2 points related to some partnership income, nonrecurring income that we didn't call out, that's really related to that. But I think that the decrease we saw is more related to continuing investing at yields below our overall portfolio yield.

Now, we have seen, in regards to cost of money, we've gone through a period of -- went through in the fourth quarter really low volatility. Now we've seen volatility come back, but that low volatility causes the option that we purchase to hedge the monthly point-to-point strategy. That can cause that option to increase. And we certainly have seen, the cost for the monthly point-to-point option, increase over time here in this last year because of the real low volatility. Now we could see some of that reversed as we go through next year or through this year depending on what volatility happens in the marketplace. But that is another thing that's putting some pressure on our cost of money. And to highlight, the monthly point-to-point is a very popular strategy that a lot of money is allocated to by policy holders.

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**John Michael Matovina** - *American Equity Investment Life Holding Company - Chairman, CEO & President*

Just to emphasize, this is John. The target spread is probably directionally should be declining as we move forward given the change in the mix of business. Ron commented that the Choice is now our best-selling product, and non-bonus products have spread targets, and let's just say, 2% versus bonus products at 2.75% to 3%. If that mix of business holds up the target spread overall, it's going to go down as we move forward -- move into -- move to 2018.

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**Daniel Basch Bergman** - *Citigroup Inc, Research Division - VP*

That is very helpful. And then maybe one, it looks the lifetime income benefit rider fees and DAC amortization came in a little favorable though at least against what we've been expecting. Is there any sense you can provide on how much these items benefited from the assumption change last quarter? I guess I'm just trying to get a sense if there was anything unusual going on in the quarter? Or it's just a representation of how those items might look going forward?

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**Ted M. Johnson** - *American Equity Investment Life Holding Company - CFO & Treasurer*

In regards to DAC amortization, I think that's representative of what it should look like going forward. It's a fact new trend, it's related to the unlocking that we did last quarter. So I think that's nothing unusual, it's just the new pattern of amortization as we go forward post unlocking last quarter. On the LIBR fees, I think what we ended up there is that the net of LIBR fees less the reserve increase was a little bit higher or more positive to us than the quarter before. That probably and mostly is related to that LIBR fees were just higher related to higher growth in account values from index credits than what was expected. As Ron commented, we saw very strong index credits, we've seen very strong index credits throughout 2017, and that led to a higher account value growth and has led to higher fees.

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**Operator**

Our next question comes from the line of Randy Binner with B.Riley.

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**Randolph Binner** - *B. Riley FBR, Inc., Research Division - Analyst*

I guess my follow-up on the -- on the fees there, on the riders. Is that -- is it -- are we isolating, if I'm hearing you right, are you isolating the index credits as kind of the key incremental drive there? Because it can -- if the spread is lower going forward, higher fees can make up for a lot of that, but I'm just trying to kind of gauge in, kind of what level of sustainability you have at those higher fees?

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**Ted M. Johnson** - *American Equity Investment Life Holding Company - CFO & Treasurer*

Let me get, the fees don't necessarily drive our core spread. So...

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**Randolph Binner** - *B. Riley FBR, Inc., Research Division - Analyst*

No, no, I'm sorry, they're different, I'm sorry. I was just saying there are puts and takes in the model, is what I meant.

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**Ted M. Johnson** - *American Equity Investment Life Holding Company - CFO & Treasurer*

Correct. I mean, I think that -- I guess I don't know directly how to answer your question there, and whether or not that's going to affect core spreads. I mean, those fees, the way that rider is priced is to break neutral on it, not necessarily to add to the overall profitability. Now in any one quarter, there might be a little bit of a different pattern of what the net expenses to the company when you net out fees versus the increase in the reserve in the pattern. But it's not driving the core spread here.

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**Randolph Binner** - *B. Riley FBR, Inc., Research Division - Analyst*

Yes, no, I don't think they're related at all. I was just saying that it's an area of the model that would offset lower spreads, and so maybe ...

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**Ted M. Johnson** - *American Equity Investment Life Holding Company - CFO & Treasurer*

I mean, actual fees versus what have been modeled, yes, I mean, you can end up having a benefit from that if it's different than what's been assumed in the model.

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**Randolph Binner** - *B. Riley FBR, Inc., Research Division - Analyst*

But can we assume that there's going to be -- to the extent that your new products you're introducing this year are focused on providing income riders that we're going to -- there's going to be more fees on an absolute basis coming into the model?

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**Ted M. Johnson** - *American Equity Investment Life Holding Company - CFO & Treasurer*

If the mix of sales goes towards guaranteed income, then yes, then there's going to be more account value subject to a fee. And so fees will go higher because of growth and products that have guaranteed income. On the other side of that, there is more reserves that will be set up because more products have guaranteed lifetime income on them.

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**Randolph Binner** - *B. Riley FBR, Inc., Research Division - Analyst*

Fair enough, but I mean, that would be -- if there's a singular thing in the new products that you think it's going to differentiate them, wouldn't the first bullet you go with would be the features that are in the guarantees in the riders?

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**Ted M. Johnson** - *American Equity Investment Life Holding Company - CFO & Treasurer*

Well, there ...

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**Randolph Binner** - *B. Riley FBR, Inc., Research Division - Analyst*

I mean, it's question for Ron, like what is the...

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**Ronald J. Grensteiner** - *American Equity Investment Life Holding Company - President of American Equity Investment Life Insurance Company*

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Well, you know when we look at the portfolio, we got the Choice Series which is really driven for accumulation, and what we find is the agents, who maybe do more holistic planning and have a securities license, are using them for accumulation and then may be using income with other tools. And then you have your independent agents who really want the FIAs with the guarantee lifetime income benefit feature. So when we look at our sales, yes, the Choice Series is significant as far as our sales, or has been. I think, our mix, it's still going to be heavy lifetime income benefit rider type products and accumulation. So it's kind of difficult to say if this new product we're talking about is actually going to take away from Choice Series type products and be more guarantee type products or what? I just think we have both types of products to appeal to registered reps and independent agents.

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**John Michael Matovina** - *American Equity Investment Life Holding Company - Chairman, CEO & President*

And we wouldn't expect it to take away from Choice sales. We would expect it to take away guaranteed income sales from competitors, it's the whole objective.

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**Randolph Binner** - *B. Riley FBR, Inc., Research Division - Analyst*

Yes, and I mean, I'm just trying to get to a point where -- I'm just trying to understand what the kind of the absolute level of those annuity product charges are going to be going forward, because I think it's going to be higher. But it was quite a bit higher in the last half of '17, so if it sustains at that level on an absolute basis, that is -- that's a change. So it's a lot more products charges come in. So all that's really helpful.

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**Operator**

Our next question comes from the line of Erik Bass with Autonomous Research.

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

I guess with your RBC ratio above 375% even after the DTA adjustment. How are you thinking about the potential to return capital to shareholders? I mean, is it too early to consider given the uncertainty around, I guess, potential NAIC changes and sales levels? Or is this a possibility that you are considering?

**Ted M. Johnson** - *American Equity Investment Life Holding Company - CFO & Treasurer*

The short answer is it's too early, but then let me give you the details behind that. As I've said, we've been very focused on ratings, we're very focused on Fitch and wanting to get investment grade with them. They did in their last report, while they do focus more and more on their Prism model, and I think that'll continue they did start to talk about an RBC ratio at 375% versus 350% for us to be investment grade. Now -- so that's part of our focus. Again, our focus also is on what is 2018 sales going to look like. I think, we feel optimistic about some of the new product features and new products that we're rolling out. And so we're in the middle of still doing our capital planning and looking at that, but at this point in time, it's too early to be discussing return of capital plan for the company to shareholders.

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

Got it. That's helpful. And then from an investment standpoint, Jeff, could you just provide an update on where you're seeing the best opportunities? And I think Ted mentioned that the new money rate was a bit lower in January than in the fourth quarter, despite higher interest rates. Was this a result of the shift in the type of securities you're buying or just tighter spreads?

**Jeffrey D. Lorenzen** - *American Equity Investment Life Holding Company - Executive VP & CIO*

I guess a little bit of both. We saw -- we're seeing a little bit softer market starting the year. Some of the sectors that we've been investing in take a couple of weeks to kind of get flowing again. There's a number of conferences that are in January for ABS, for CMBS, for mortgage loans, a lot of those are sectors that we've been allocating to and will continue to. Those markets just take a few weeks to kind of get going. And so, the first part in January seems like it's always a more challenging time of year for us to invest. As we go forward, we're going to be looking for sectors that we don't have to rely on the seasonality or the technicals in the market to deploy the money. And as we continue to do that, we're going to see -- we believe we'll see opportunistic spreads for us as we deploy our strategy.

**Operator**

Our next question comes from the line of Pablo Singzon with JP Morgan.

**Pablo Augusto Serrano Singzon** - *JP Morgan Chase & Co, Research Division - Analyst*

So first question is, I just wanted to get your thoughts on the best interest standards that are emerging from the States. So I think New York has one, Nevada has one. You know, how is your position against the standards as the stand now? And where do you think things will play out?

**John Michael Matovina** - *American Equity Investment Life Holding Company - Chairman, CEO & President*

Sure, Pablo. It's John Matovina. We're obviously monitoring those things. Nevada standard, I'm not aware that's applicable to insurance, it was a security standard. The New York standard is insurance and life insurance and annuities. The short easy answer on New York is we're not active in the State. So if reaching a final standard out of New York comes about, really wouldn't have any effect or have very, very little effect on us. Of course, the concern there is will the New York standard finds its way into a broader group of States, which people in our business, we've all talked about the fact that that's already happened fairly recently with the cyber regulation that -- the NAIC finalized, I think, last year. There's already been an active group on the NAIC side working on suitability that I don't think they have the same ideas as what New York has. So I wouldn't want to handicap how it might come down, but I think, there will be engagement from a broader group of people, and you may not see the same type of outcome that the New York standard gets adopted throughout the country by the individual States.

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**Ted M. Johnson** - *American Equity Investment Life Holding Company - CFO & Treasurer*

We're actively involved in working on the enhanced suitability standard and with the committee that's looking at this with insurance commissioners. So our hope would be is that states would wait and participate in that process, and that there is a cohesive enhanced suitability standard that's applied by all states.

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**Pablo Augusto Serrano Singzon** - *JP Morgan Chase & Co, Research Division - Analyst*

Right. Okay. So just based on your initial read of the New York standard, is it stricter than what agents have to comply with now under 84-24? Or is it more or less the same?

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**John Michael Matovina** - *American Equity Investment Life Holding Company - Chairman, CEO & President*

I haven't read it, but we have a person in the room that probably can answer that. Renee Montz, General Counsel.

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**Renee Denise Montz** - *American Equity Investment Life Holding Company - Executive VP, General Counsel & Corporate Secretary*

The New York standard is just different than 84-24. It adds some additional requirements. And I think one of the biggest concerns is that it adds life insurance. So a lot of companies are concerned about that, and how that would be applied. The critical thing is to get consistency across the states and the Federal regulator. So that's what we're pushing for, we're working with the NAIC, we're still working with DOL, trying to push them in that direction as well as they rethink their role.

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**Ted M. Johnson** - *American Equity Investment Life Holding Company - CFO & Treasurer*

And consistency is like consistency of definition of terms. You really need to make sure that the terms are similarly defined across these regulations. Otherwise it causes us additional cost in regards to compliance.

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**Pablo Augusto Serrano Singzon** - *JP Morgan Chase & Co, Research Division - Analyst*

Got it. So my second question is for Ron. So I appreciate the wholesaling portion of Eagle Life. But my question is, as you at look at your competitors in the bank and broker dealer channels, right? You know, the companies like Global Atlantic, for example, or Great American or AIG, they tend to lead in more than one product category. So usually it's indexed annuities, or MYGA, for example. Do you think AEL would have to do more of that to grow share in those channels?

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**Ronald J. Grensteiner** - *American Equity Investment Life Holding Company - President of American Equity Investment Life Insurance Company*

You mean other than fixed annuities? We have the multi-year guaranteed annuity, and we have the fixed indexed annuity. We have different surrender charge terms. So beyond that, we also have the advisory product too, I guess, but I don't know how much that'll show up in the bank channel.

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**Pablo Augusto Serrano Singzon** - *JP Morgan Chase & Co, Research Division - Analyst*

Right, my question is more of -- and maybe it's just a difference in terms of what they're offering, but they tend to be leaders in more than one product category, right? So I'm wondering if that sort of a precondition to be significant in those channels, right, to the same extent as them? Or do you think you can grow just by focusing on index annuities?

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**Ronald J. Grensteiner** - *American Equity Investment Life Holding Company - President of American Equity Investment Life Insurance Company*

Pablo, we're going to grow by using fixed index annuities. We've talked about being really, really good at one thing and that's what we're good at. I think, increasing our footprint and getting more boots on the ground is going to help us get into more financial institutions and try to get a bigger market share in the financial institutions that we're currently in. That's is -- in my prepared comments I talked about a bigger home office staff for distribution, so we can get out into those financial institutions and tell our story compared to what we have and the competitors.

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**John Michael Matovina** - *American Equity Investment Life Holding Company - Chairman, CEO & President*

This is John, I mean, we have MYGA products available. And there's been times where our rates have been quite competitive. I would acknowledge that probably Global Atlantic, in particular, comparing recently perhaps AIG has been -- has had higher rates than we have on that product. But we've had success in the past with using the MYGA product to get our foot in the door at a couple of financial institutions and would anticipate that will happen again sometime in the future.

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**Operator**

Our next question comes from the line of Alex Scott with Goldman Sachs.

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

First question, just on operating expenses. You mentioned putting more boots on the ground to Eagle Life distribution. I think, you also mentioned some of the bonus pool stuff with sharing some of the tax benefit. I mean, should we think about operating expenses for 2018 being higher by 2000 -- just relative to 2017? Can you kind of give us any kind of guidance around how to think about that?

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**Ted M. Johnson** - *American Equity Investment Life Holding Company - CFO & Treasurer*

I don't believe what the cost that we're talking here in regards to adding some additional staffing, for Eagle for marketing purposes, is really going to be that incremental to our bottom line, that's really going to show up. And in regards to the comment about tax reform and part of that being shared with employees, we have -- if that's just saying if our profit goes up, we already have a kind of profit sharing type of bonus program with our employees. It's based upon the amount of sales and also some of the same metrics in regards to operating income growth, et cetera that we would be sharing with employees purely because our earnings would go up because of a lower tax rate. So that's not -- that's not necessarily incremental operating expenses that are really going to show up in any significant way.

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**John Michael Matovina** - *American Equity Investment Life Holding Company - Chairman, CEO & President*

And on the Eagle side, I mean, that those direct expenses would be in lieu of what we might have otherwise paid in commissions to third parties, third parties representing us. Now the accounting treatment might turn out to be different because those third-party commissions would be capitalizable, because they vary with production versus a fixed cost. We got to go through analysis to figure out what you can capitalize, and I'm far enough removed from that, that I better stop there and not get into the accounting. But I know enough to know that there might be different treatment for in-house costs versus variable cost outside. But on an economic basis, if marketing efforts, sales efforts are successful, it will be cost-effective relative to what we might have otherwise spent for variable cost.

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

Okay. And then back on the cash taxes. I mean, could you kind of give us a way to feel -- a way to think about how much higher the cash taxes would be relative to GAAP taxes? And how worse that tax is for that matter? And how it sort of impact your view of, I guess, through a capital generation and maybe the mix between how it show up in terms of like DTA versus other assets?

**Ted M. Johnson** - *American Equity Investment Life Holding Company - CFO & Treasurer*

Well, with the cash tax piece what you're going to have to do for modeling purposes is look at the deductibility of reserves. And there's 2 pieces, there is 1 we kind of already talked about new business, but it's really the question is on in-force, and how that's going to play out. So that deductibility, so it's 92.81% -- say 93%. You look at that in regards to the in-force block there, and there is going to be a transition adjustment that happens over an 8-year period of time that's brought in. And so what you'll have to do is taking that calculation as calculate out what you believe that transition adjustment is going to be and flowing that in over the 8 quarters, but -- I'm sorry -- 8 years, 34 quarters. And you have to take into consideration how much less cash flow that's going to result and us to be able to invest.

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

Understood. Okay. And then for risk-based capital, I'm just thinking about the way that agencies are viewing it, the potential denominator impact, et cetera. You know, is there a level you would be comfortable at operating -- you'd be comfortable operating at? Or is RBC not the right way to think about it as there are other capital metrics that we should be considering as well?

**Ted M. Johnson** - *American Equity Investment Life Holding Company - CFO & Treasurer*

I think we've been saying this for a while and the rating agencies are saying this too. I mean, RBC really isn't the capital thing to focus on. RBC is a calculation purely for the regulators in regards to decide when they need to take some kind of action on a company that's having a capital issue. What's really when you look at the various rating agency models, and that's what we really have to model to, those are on a pretax basis, the majority. And so tax reform isn't necessarily going to affect that. And yes, we realize that some of the rating agencies still reference an RBC ratio. However, I think that's becoming less and less important. So really what we're managing to is the capital levels that we need for our ratings at the various rating agencies. So, you know, certainly, the NAIC is looking at the RBC calculation. They haven't come out with how they're going to adjust them. I think, there are some thoughts that there's going to be some other adjustments within the calculation as they go through implementing tax reform in that calculation and it's not going to be just inputting the 20% tax rate across-the-board. But what those are yet we don't know, but even post that and looking at our RBC ratio, we're going to be in excess of 300%, which is way above any kind of regulatory action level. What's more important to us and others, I believe, is how the rating agencies -A. M. Best, S&P, Fitch- are looking at, how this effects to our capital models, which I said before, those capital models are being calculated on a pretax basis.

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

And is there a crude way for us to just think about maybe even just like GAAP equity, the reserves and something like that where we can sort of think about where you'd target?

**Ted M. Johnson** - *American Equity Investment Life Holding Company - CFO & Treasurer*

I don't think that would be the right measurement to talk -- to look at. I think what's going to have to happen is once the RBC -- once the NAIC recalculates how they want RBC calculated, all companies will be calculating your RBC, and you'll be able to back -- then reverse engineer that into the level of RBC you need for the capital, you need for S&P and A.M. Best and Fitch and others for the actual debt ratings or ratings -- financial strength ratings that you want at the company. I think, it's little hard at this point in time to say, you know, okay, RBC ratio should be 325% going forward until the RBC -- until the NAIC comes out with the new calculation on how they're adjusting it. There's just -- there's not a way to reference what that number will be going forward.

**Operator**

Our next question comes from line of John Barnidge with Sandler O'Neill.

**John Bakewell Barnidge** - *Sandler O'Neill + Partners, L.P., Research Division - Director of Equity Research*

With your stated interest in the ratings upgrade, do you have any interest in participating in a pension risk transfer transaction, institutional annuities, flow reinsurance or even block transaction, should they come available?

**John Michael Matovina** - *American Equity Investment Life Holding Company - Chairman, CEO & President*

Very, very, very unlikely. I don't think we have the rating to participate some of that stuff, or the -- it's not in our DNA.

**John Bakewell Barnidge** - *Sandler O'Neill + Partners, L.P., Research Division - Director of Equity Research*

You talked a lot in there, you talked about flow reinsurance and those type of things. And so, I mean, are you talking that as an assuming company? Or as a seeding company in regards to the reinsurance?

**John Michael Matovina** - *American Equity Investment Life Holding Company - Chairman, CEO & President*

As an assuming company.

**Ronald J. Grensteiner** - *American Equity Investment Life Holding Company - President of American Equity Investment Life Insurance Company*

Yes, I'm with John on that, that's not necessarily in our playbook.

**John Bakewell Barnidge** - *Sandler O'Neill + Partners, L.P., Research Division - Director of Equity Research*

No, that's fair. Now that you're 1 year up on the election, many organizations going 1/1/17 DOL compliant along with tax reform. Does there seem to be a general sigh of relief and optimism in the IMOs that you've already started to really see come through year-to-date?

**John Michael Matovina** - *American Equity Investment Life Holding Company - Chairman, CEO & President*

Well, there is certainly a relief that they don't have to be financial institutions and sign on behalf of their independent agents. There hasn't been a lot of talk about it recently. I think there is a sigh of relief though. There is some work that needs to still be done, because the full implementation is in 2019. So we can't let our guard down completely, but I -- as you put it and used a good term, a sigh of relief for now.

**John Bakewell Barnidge** - *Sandler O'Neill + Partners, L.P., Research Division - Director of Equity Research*

And then my last question. There seems to be some conflicting views in the market on impact from tax reform. Some think, savings are going to be competed away into the product like you, while others think it will be retained to build up RBC. To the extent you can talk about yourselves, why do you believe it will be competed away? And have you already seen signs in January to suggest as much?

**Ted M. Johnson** - *American Equity Investment Life Holding Company - CFO & Treasurer*

We have not seen signs so far that people have raised rates because of tax reform. When we look at new business and look at our pricing and take in to consider -- consideration tax reform, the benefit of the rate dropping to 21%, a majority of that is wiped away when you take into consideration DAC tax increase and the reserve deductibility. There's a little bit of benefit that you have, but it's not a great deal. Now, in regards to building up RBC, I would look at that as part of the in-force and the earnings that we would expect to capture and others expect to capture over time because of the lower tax rate on that.

**John Michael Matovina** - *American Equity Investment Life Holding Company - Chairman, CEO & President*

Some of those other comments about new business, are they coming all from annuity carriers? Or are they coming from life carriers? We know what it looks like on a fixed index annuity. We don't know necessarily, know what it looks like kind of life insurance product.

**Operator**

Our next question comes from the line of Ryan Krueger with KBW.

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

Can you help us think a little bit about the potential impacts of increased volatility. I think, you actually mentioned that, that would actually be a positive for some of your products, but presumably that would increase the cost of money on others. So I'm just trying to think through that, and if you feel like you can -- and if there is an increase that you can offset it through renewal pricing?

**Ted M. Johnson** - *American Equity Investment Life Holding Company - CFO & Treasurer*

So, the reference to volatility and option cost. So on our monthly point-to-point, the options that we buy to hedge the monthly point-to-point, with higher volatility those become a little bit cheaper or become cheaper over time versus, right now prior to this activity that we saw in the last week, low volatility has caused those option costs to go higher. We have a substantial amount of money or policyholder funds that are sitting in the monthly point-to-point, because that strategy gives them the highest opportunity in regards to return. But also, if there is a higher risk that they could get 0, too. But it is a very, very popular option. So a lot of our option cost and overall option cost can be driven by the cost of that option. But yes, higher volatility would cause other options to potentially go up, but maybe not as high as, you know, not as proportionally higher compared to the decrease that you might see in the cost for the monthly point-to-point options.

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

Okay. So higher ...

**Ted M. Johnson** - *American Equity Investment Life Holding Company - CFO & Treasurer*

It's all driven around what strategy, not necessarily product or product design.

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

Okay. So net-net, higher volatility is not a bad thing, even potentially could be...?

**Ted M. Johnson** - *American Equity Investment Life Holding Company - CFO & Treasurer*

I mean, I caution that, I mean, depending on the level of volatility, we certainly have gone through periods of time where volatility has spiked and stayed up for a longer period of time. That can put pressure on our cost of money, because the other options start to increase in cost. So it's just really -- that has a lot to do with the mix of business and the mix of what strategies people are in and where they move their money and what that level of volatility is.

**John Michael Matovina** - *American Equity Investment Life Holding Company - Chairman, CEO & President*

This goes back quite a few years now, but we had an experience as everybody did where volatility escalated for an extended period of time. And of course, our natural function is we kind of trail that. And so as cost escalated, we started adjusting caps from participation rates to get cost back in line. But that's a -- a trailing result, but then, you always have -- it's only 1 year to the next. You get to reset caps from participation rates every year. So it's not like it's going to be a permanent impact. And yes, a little bit increase in volatility is not going to have that big of an impact to cause overall cost to go up.

**Ted M. Johnson** - *American Equity Investment Life Holding Company - CFO & Treasurer*

But again, we do have the room to adjust renewal rates, caps, participation rates. And we've talked about that capacity is about 49 basis points. And that calculation includes what our ability is to adjust fix rates and also our ability to adjust caps and par rates.

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

Thanks, that's helpful. And then on -- do you have an updated view of the amount of sales in the year that would be roughly breakeven to your RBC ratio?

**Ted M. Johnson** - *American Equity Investment Life Holding Company - CFO & Treasurer*

You know, we're working on capital models right now. I think it's still probably around that $6 billion.

It's what we could produce and the capital ratio should stay fairly level from where they are at.

**Operator**

Our next question comes from the line of Mark Hughes with SunTrust.

**Mark Douglas Hughes** - *SunTrust Robinson Humphrey, Inc., Research Division - MD*

Ted, you've given some of the puts and takes on cash impact of the tax savings. Any way to kind of rough that out? Is it, are you generating half of the tax gain in terms of additional cash flow? Is that the right way to think about it?

**Ted M. Johnson** - *American Equity Investment Life Holding Company - CFO & Treasurer*

No, I don't think so. I'm trying to think of a way to -- I mean, as I said before you can have to calculate out. We don't publish tax reserves. So there's part, but you could look and say, okay, Stat reserves are how many billion? A worst case scenario is deductibility of 93%. You need to then calculate out that transition adjustment, and factor that in being brought in over that 8-year period of time. And you need to think about how much less cash flow that really means that you're going to have left to invest at your current assumed new money yield.

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**Mark Douglas Hughes** - *SunTrust Robinson Humphrey, Inc., Research Division - MD*

Right. And if you went to that exercise, do you have a sort of general sense where we might end up?

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**Ted M. Johnson** - *American Equity Investment Life Holding Company - CFO & Treasurer*

We don't have something that we're publicly saying at this point in time.

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**Mark Douglas Hughes** - *SunTrust Robinson Humphrey, Inc., Research Division - MD*

Okay. Fair enough. On the spread with the new products, your spread requirements targets are lower. If the old spread target was roughly 300 basis points, can you say kind of just again, roughly, where are we now in terms of what the spread would be needed to get a similar return? And if you do have the sort of evolving product suite that may lead to even more compression on that, again, getting into the same ROE?

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**Ted M. Johnson** - *American Equity Investment Life Holding Company - CFO & Treasurer*

Mark, we're working through the calculation on a weighted average basis, but we don't have a spread target number on a weighted average basis, to put out there right now. Before we know we used to say 300 basis points, and obviously, now it's not 300 basis points because the mix of the business is changing as more and more non-bonus product is put out there. In the coming quarter, we'll have something more on that.

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**Mark Douglas Hughes** - *SunTrust Robinson Humphrey, Inc., Research Division - MD*

Okay. Fair enough. And then Ron, it seems like the pending count is down just a few points year-over-year, if I look at the last year's, similar number at this time. You said you're going to be influenced, you think, by the industry outlook. Do you think sales are up in 2018? Is this we kind of turning the corner here In Q1?

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**Ronald J. Grensteiner** - *American Equity Investment Life Holding Company - President of American Equity Investment Life Insurance Company*

Well, we typically don't give too much guidance, Mark, on our upcoming year. But there are some positive indicators. One that we use is the number of incoming phone calls to our marketing department. Those numbers are up. The last few weeks we had calls that would match what we had last June and July. So that's certainly a positive. Optimistic with the new product that we're going to be introducing in March to our field. I said in my prepared comments that we've got a lot of input from our distributors. So if this is what they want and we're going to be able to deliver a good chunk of it, we're optimistic that they will sell it. So -- but I think, we'll have a little bounce in our step this year.

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**Operator**

We have a follow-up question from the line of Pablo Singzon with JP Morgan.

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**Pablo Augusto Serrano Singzon** - *JP Morgan Chase & Co, Research Division - Analyst*

My question is for Jeff. So just going through AEL's quarterly schedule you filed, there seems there have been an uptick in investments and CLOs and floating rate securities. I was wondering if that's AEL or maybe one of your reinsurers? And just given that that's a strategy that some of your peers have engaged in, just wanted to get your thoughts on investing in those types of assets?

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**Jeffrey D. Lorenzen** - *American Equity Investment Life Holding Company - Executive VP & CIO*

Yes, I think we mentioned in the past that asset backed securities were an area that we wanted to bring more light in our portfolio. We've traditionally been under-weighed, not only relative to the industry, but relative to our peers. CLOs was an area that created some opportunistic yield for us as well as positioning us for a rising short-term rate environment. It allows some resets in our rates as the Fed becomes more engaged in raising short-term rates. So we see it as an opportunity. It will continue to be an allocation as we go forward. I think what you'll see is the similar allocation to what we did in the third quarter, in the fourth quarter in terms of purchases. We will temper based on valuations. If spreads come in on that asset class, it's going to be an area that we'll reallocate to other areas that seem to be more opportunistic in terms of relative value versus risk. We do have some additional asset classes that we'll be engaged in, as we get into 2018 here, that we've engaged with some third parties on that we think will offer additional value to the portfolio on a risk-adjusted basis. So we did see a little bit of lower take-in in book yield in terms of purchases for the fourth quarter, but that's just come down to an asset mix and availability of securities at the time we're deploying cash. We'll see that through time. But overall, we remained focused on trying to continue to bring new purchases in line with current book yield of the portfolio, so we can help offset any depletion in potential spread that would be the result of new asset purchases.

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**Pablo Augusto Serrano Singzon** - *JP Morgan Chase & Co, Research Division - Analyst*

Great. Is there time for one last question, or?

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**John Michael Matovina** - *American Equity Investment Life Holding Company - Chairman, CEO & President*

Yes, you can have one more, Pablo.

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**Pablo Augusto Serrano Singzon** - *JP Morgan Chase & Co, Research Division - Analyst*

Okay. So I just wanted to get your thoughts on buffer annuities. So as you might be aware this is an emerging product (inaudible) broker, dealer and bank channels. I was wondering whether you see this as a threat in terms of getting share for the (inaudible) retirement dollar, a person might be willing to put with the broker or somewhere in the bank?

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**Jeffrey D. Lorenzen** - *American Equity Investment Life Holding Company - Executive VP & CIO*

Well it's a good question, Pablo. We look at the buffer annuity, and in our view it's actually a security. So you got to have a securities license to sell it. I imagine that it will have an impact, but with fixed indexed annuities and the age demographics that we're selling to, which is the low 60-ish as far as age. We think, that there is plenty of retirement money out there that is going to be interested in fixed indexed annuities and don't want to take anything less than 0. Well, they may be a distraction, we don't see it as a threat.

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**Operator**

And I'm not showing any further questions in queue at this time. I'd like to turn the call back to Julie LaFollette for any closing remarks.

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**Julie L. LaFollette** - *American Equity Investment Life Holding Company - Director of IR*

Thank you for your interest in American Equity and for participating in today's call. Should you have any follow-up questions, please feel free to contact us.

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**Operator**

Ladies and gentlemen, thank you for your participation in today's conference. This concludes the program, and you may now disconnect. Everyone, have a great day.

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