ATHENE HOLDING LTD.
Q3 2019 Earnings Call
Moderator: Noah Gunn
November 5, 2019
10:00 a.m. ET

Operator:
Good morning. My name is Thea, and I will be your conference operator today. At this time, I would like to welcome everyone to Athene's Third Quarter 2019 Earnings Conference Call and Webcast. Thank you. I will now turn the call over to Noah Gunn, Head of Investor Relations. Please go ahead.

Noah Gunn, Head of Investor Relations:
Good morning. Welcome to our third quarter 2019 earnings call. Joining me this morning are Jim Belardi, Chairman and CEO; Bill Wheeler, President; and Marty Klein, our Chief Financial Officer.

As a reminder, this call may include forward-looking statements and projections which do not guarantee future events or performance. We do not revise or update such statements to reflect new information, subsequent events or changes in strategy. Please refer to our most recent quarterly and annual reports and other SEC filings for a discussion of the factors that could cause actual results to differ materially from those expressed or implied.

We'll be discussing certain non-GAAP measures on this call, which we believe are relevant in assessing the financial performance of the business. Reconciliations of these non-GAAP measures can be found in our earnings presentation and financial supplement, which are available at ir.athene.com.

I will now turn the call over to Jim Belardi.

Jim Belardi, Chairman, CEO and Chief Investment Officer:
Thanks, Noah, and good morning, everyone. We are incredibly proud of the strategic progress we've made at Athene and are encouraged that our solid fundamentals will continue to drive meaningful earnings growth, sustainable mid-teens ROE and attractive book value growth. We achieved record organic volumes at record average pricing returns in the third quarter, and while our results were below our expectations, we are confident in our strategy and underlying earnings power going forward.

This quarter, I'm now going to turn the call over to Marty to provide some additional context around the results, and I will come back to discuss investment trends and how we're delivering shareholder value. Marty?

Marty Klein, Chief Financial Officer:
Thanks, Jim. And good morning, everybody. For the third quarter, we reported GAAP net income of $276 million or $1.50 per diluted share. Our adjusted operating income available to common shareholders for the quarter was $243 million or $1.34 per share. Notable items totaled $62 million in the quarter, including $48 million from our annual unlocking process and other liability costs. Excluding notable items, total adjusted operating income was $305 million or $1.67 per share. Retirement Services adjusted operating income, excluding notables, was $318 million, resulting in an adjusted operating ROE excluding notables of 16.7% for the segment.

Our consolidated net investment earned rate, or NIER, was 4.35% in the third quarter which moderated from the elevated rate of 4.67% in the second quarter, primarily due to normalizing investment income from alternatives as we expected.

Within the overall NIER, our fixed income earned rate was impacted by two primary drivers: first, declining interest rate weighing on floating rate investment income, particularly the short end of the curve, which fell approximately 25 to 40 basis points during the third quarter and approximately 50 basis points over the past 6 months; and second, lower-than-expected prepay income in our RMBS portfolio, which can fluctuate depending on underlying borrower behavior. Importantly, none of the deviation was caused by credit deterioration but rather cash flow timing expectations. Lower prepayments in the period served to slow the amount of discount recognized within income, pushing more into future quarters and extending the average life of the portfolio.

As we look forward over the near to medium term, in fixed income, based on our interest rate movements through the end of October, we expect our NIER in the fourth quarter to be relatively stable around the third quarter rate within a couple of basis points above or below.

This will provide a baseline heading into next year, which could ultimately be higher or lower depending on a variety factors, including interest rate movement and yields on new purchased assets. In addition, we will continue to adjust crediting rates upon renewal, down, as appropriate, and we would also expect to see a modest decline in our cost of hedging.

For alternatives, while these investments are certainly subject to quarterly variability, under

certain conditions, we expect baseline annualized returns of approximately 8% to 9% in the fourth quarter, normalizing to approximately 10% heading into next year.

Moving to the cost side of our spread model. Our total cost of funds for the second quarter was $934 million or 3.18% of average invested assets in Retirement Services. This reflects a 23 basis point increase from the prior quarter, primarily driven by unfavorable unlocking in the third quarter, resulting from our typical annual review of actuarial assumptions.

Turning to cost of crediting. The rate increased 4 basis points quarter-over-quarter driven by business mix from the continued growth within our institutional channel as a percentage of the overall business. It is important to note the underlying trend toward modestly lower crediting rates in each of our organic channels in this environment.

As a reminder, our institutional channel carries a higher crediting rate versus deferred annuities since essentially all the costs related to institutional are reflected in the crediting line, while deferred annuities also bear expenses within other liability costs from acquisition costs to amortization and rider reserve accretion. Given this dynamic, the quarterly variability in cost of crediting typically trends with the mix and timing of institutional deposits in the period.

In other liability costs, the rate increased 19 basis points quarter-over-quarter, primarily due to the impact of our annual unlocking process I mentioned previously. As you know, we strive to keep our assumptions updated in line with the interest rate environment and as experience emerges. In response to the lower interest rate environment, we prudently adjusted our long-term rate assumption, which drove an unfavorable impact that was partially offset by favorable experience in certain legacy blocks of business.

The net effect of these items increased other liability costs by $48 million during the third quarter. Our revised long-term interest rate assumption now anticipates the 10-year U.S. Treasury yield to grade up to approximately 2.75% in 8 years, a rate well below the levels generally assumed in the life insurance industry and consistent with our disciplined approach to underwriting and balance sheet management. Excluding notable items, other liability cost was $292 million or 100 basis points of average invested assets, in line with our normal range of expectations.

Moving to operating expenses, we continue to benefit from our highly scalable operating platform. For the third quarter, the operating expense ratio was 27 basis points, a 4 basis point or

13% decline year-over-year, which translates to roughly $12 million of savings in the quarter.

Lastly, our tax rate in the quarter was lower as a result of the favorable statutory reserve unlocking related to similar actuarial dynamics that impacted our GAAP reporting as well as a more favorable mix of business. In the near term, we expect the rate to rise, moving to an estimated rate of 8.5% to 9.5% in 2020 with variability depending on the mix of onshore versus offshore income.

Putting this all together, the third quarter net investment spread in Retirement Services was $330 million or 113 basis points of average invested assets. Excluding notable items, the net investment spread in Retirement Services was 135 basis points. After reflecting our platform costs, including G&A, which I just discussed, debt service and taxes as well as our corporate segment, our adjusted operating return on assets, excluding notable items, was 103 basis points for the third quarter.

Turning to capital. We successfully completed our second preferred stock offering in the quarter, raising $345 million of gross proceeds. With this additional capital, offset by capital deployed for organic growth and share repurchases at attractive returns, we ended the quarter with $1.8 billion of excess capital and approximately $2.5 billion of untapped debt capacity.

As a reminder, on October 1, we closed the sale of 67% of ACRA to the ADIP fund, resulting in $575 million of capital being transferred to Athene in exchange for economics and $6.6 billion of invested assets. This is primarily composed of two-thirds of the Lincoln block reinsurance deal and the Bristol-Myers PRT transaction, as previously communicated. Our capital ratios remained strong at the end of the third quarter with an ALRe estimated RBC ratio of 420% and U.S. estimated RBC ratio of 421%.

Our strong balance sheet should further be supported by nearly $1 billion of additional excess capital expected to be added from the announced strategic transaction with Apollo as well as on-demand capital from ACRA, providing us even more flexibility to deploy capital across economic cycles.

In summary, while our third quarter results were impacted by the low interest rate environment and certain notable items, we expect our multi-year double-digit earnings growth momentum to continue next year as our business generates significant and profitable growth.

With that, I'll turn the call over to Bill to provide comments around our liability origination activities.

Bill Wheeler, President:
Thanks, Marty. In terms of liability origination, the third quarter results demonstrated the strength of our multi-channel model as we generated record organic deposits of $5.6 billion, up 72% year-over-year. While you might be thinking that we lowered the bar on returns to achieve that result, in fact, the opposite is true as the blended underwritten return on the third quarter volumes exceeded 20%.

The largest driver of the quarter's activity was our pension closeout business, where we closed the previously announced deal with Bristol-Myers Squibb totaling $2.6 billion of deposits. So far this year, we have closed on more than $5 billion of PRT transactions at attractive returns, which is nearly twice the volume we closed on in all of 2018. While the fourth quarter is typically seasonally strong for PRT and we're continuing to be active in bidding for new business, we expect activity will normalize in the near term coming off a third quarter high.

Lastly, on PRT, it's worth noting that we've made early progress in evaluating the business prospects within the U.K. pension market as the reinsurance partner to domestic insurers. While it's early days, we anticipate the U.K. PRT market could very well be an attractive long-term growth opportunity for Athene.

Our retail channel generated $1.9 billion of deposits during the third quarter. This activity was relatively consistent with levels we saw in the prior quarter. The impact of pricing measures in response to the lower interest rates was felt in new policy application, while policies that were already in process ultimately closed during the quarter.

Looking ahead to the fourth quarter, we expect retail sales activity to soften as a result of the decline in new policy applications we saw on the back half of the third quarter. That said, despite the challenging environment, we continue to be an industry leader in the fixed indexed annuity market, and we expect to remain very competitive next year.

One of the ways we're doing this is by continuing to expand our product distribution footprint. On our last call, I mentioned our new relationship with PNC Bank that launched in July, and we are having ongoing discussions with a couple of other large platforms that we hope will provide new distribution opportunities later this year or early next year.

In our third-party flow reinsurance channel, we generated roughly $600 million of deposits in the third quarter, which moderated from particularly strong quarterly volumes of approximately $1 billion in the first half of the year, as expected.

The decline was primarily driven by the adjustment of quota share levels in a declining interest rate environment as we remain disciplined on preserving profitability. While it's hard to predict the level of industry annuity volumes and quota share levels can fluctuate, we believe our go-forward flow reinsurance volumes have the potential to regain momentum.

Lastly, we closed on just over $500 million of funding agreements in the quarter, including one funding agreement backed note as well as FHLB business, each of favorable returns. While these deals tend to be more episodic and are subject to the spread environment, we are optimistic on the issuance pipeline.

So in summary, the third quarter demonstrated the strength of our multichannel model while also maintaining our disciplined underwriting new business at high levels of profitability. Notably, for the first nine months of the year, we have already exceeded our full year total from 2018, which means 2019 volumes are likely to be substantially higher, a strong result for our platform.

In our inorganic channel, we are seeing numerous opportunities to deploy capital at attractive returns. In a mixed macro environment, Athene differentiates itself as a top solutions provider, reflecting the depth of our expertise, execution capabilities and solid capital position.

The industry is still going through a significant restructuring. Companies continue to seek to reduce exposure to complex liabilities, shed noncore businesses or exit whole businesses in hopes of redeploying capital in a more accretive fashion. We believe our excess capital serves as strategic differentiator for Athene and further cements our position as the preferred industry consolidator.

Our strategic capital solution, ACRA, will meaningfully supplement our stand-alone capacity. As Marty mentioned, it became effective on October 1. And to date, we have closed on $3 billion of third-party commitments for investment into ACRA, making solid progress towards the $4 billion targeted amount.

We continue to expect that we'll reach the target sometime around year-end. When combining Athene's stand-alone excess capital and debt capacity with a third-party capital in ACRA as well

as the incremental excess capital we've generated from the strategic transaction with Apollo, we estimate that total deployable capital could support approximately $90 billion of acquired liabilities.

Now I'd like to turn the call back over to Jim to discuss investment trends, capital and our strategic progress.

Jim Belardi, Chairman, CEO and Chief Investment Officer:
Thanks, Bill. While our third quarter results were impacted by the lower interest rate environment and seasonal items from annual unlocking, we saw strong underlying trends in the business, including the record organic growth at very attractive returns that Bill discussed. This drove a remarkable 20% year-over-year growth in our total invested assets, which now exceed $120 billion.

In light of the current environment, I'd like to remind you of how declining rates impact our investment portfolio. First, 78% of our portfolio is in stable fixed-rate securities. As rates decline, the value of these securities increase, and we generate a significant unrealized gain. Declining rates do not impact the in-force yields of these securities.

Next, 17% of our portfolio is in floating rate securities, which were generally bought at a discount to par. As a reminder, one of the primary ways we generate alpha in our portfolio is through differentiated asset allocation. We have these floaters in our portfolio by design, which is mostly comprised of our CLO and RMBS assets.

In the case of RMBS, our investment expertise and dynamic asset allocation capabilities allowed us to identify and purchase the bulk of these securities several years ago at approximately 75 to 85 cents on the dollar, which represented tremendous value and continues to benefit our portfolio today.

To give you a sense of the magnitude, our floating rate portfolio has generated more than $800 million or 23% of our investment income year-to-date through a combination of interest income and accretion. So overall, the earnings from these securities are a meaningfully accretive component of our investment spread.

We invested $7 billion of flows during the quarter. And based on our current pipeline, we think we will invest more than $30 billion for the full year, a record. Consistent with our philosophy as active asset managers, the yield on our fixed income purchases this quarter was approximately

45 basis points higher, net of fees, than the BBB Corporate Index. In an environment where interest rates have grinded lower, investment yields are even more challenging to deliver. Despite these headwinds, we are working hard to identify attractive risk-return opportunities in a variety of asset classes.

We are highly focused on sourcing better-yielding non-CUSIP investments to generate attractive net investment spreads without assuming disproportionate credit risk. We are doing this by working with our partners at Apollo to build out senior secured direct origination capabilities in a variety of asset classes that allow us to access a consistent flow of opportunities with much more attractive spreads than we could otherwise capture in value-starved, CUSIP-based corporate credit.

In aggregate, we expect to invest more than $3.5 billion in directly originated private credit this year, not including our private corporate portfolio. These assets were sourced across a variety of asset classes, including aircraft leasing, private credit, U.S. residential and commercial mortgage loans, non-U.S. residential loans and franchisee loans.

As an example of continued progress in improving our sourcing capabilities, during the third quarter, Athene announced an agreement to acquire a large aircraft lease portfolio from PK AirFinance, a leading aviation lending platform acquired by Apollo from GE Capital. We expect to add approximately $1.7 billion of aircraft structured securities when the transaction closes later this year. And going forward, we expect this platform to provide us more than $1 billion of new investments per year.

Turning to our alternatives portfolio within our Retirement Services segment, we generated an annualized return of nearly 9%, in line with our expectations for the third quarter. In terms of specific highlights, MidCap and AmeriHome, our two largest alternatives position, returned 14.9% and 14.0%, respectively. Strength in both investments was driven by increasing fee income from heavier loan origination volumes.

Elsewhere in the portfolio, our investment and sister company, Athora, a European reinsurer, appreciated as a result of its continued growth, including the pending acquisition of VIVAT, the second-largest life insurer in the Netherlands. Athene's real asset investments as well as Catalina, a runoff P&C reinsurer, also contributed to the quarter's return. Our alternatives strategy remains differentiated in its makeup. And while quarterly returns can vary, this has helped us generate double-digit Alt returns historically.

Before I open the call to your questions, I wanted to take a step back to highlight the many ways we are creating long-term, sustainable shareholder value. We have been increasingly transparent with all of you in discussing our business trends as well as seeking feedback about potential areas where we can improve, and we look forward to maintaining an open dialogue.

Ultimately, we believe the primary driver of long-term shareholder value is effective capital allocation. We remain focused on deploying capital into the highest returning areas across organic growth, acquisitions, share buybacks and strengthening our balance sheet to drive additional ratings upgrades.

Our execution to date demonstrates meaningful progress. First, we've exceeded our growth plans while achieving attractive mid-teens or higher targeted returns across our organic and inorganic channels. The result is that we've added approximately $50 billion of attractively priced liabilities in less than 3 years since we went public, representing a 70% increase in our total invested assets.

Second, we've demonstrated the strength of our capital position and taken the steps to improve our ratings, achieving A ratings across the board from S&P, Fitch and A.M. Best with expectations to achieve A+ ratings. These rating upgrades help us grow more quickly and more profitably as illustrated by a return to the funding agreement backed note market this year.

Third, we've demonstrated our willingness to control the factors we can to help close the gap between our exemplary operating performance and our undervalued stock. Opportunistically repurchasing shares in size has been a tool in our capital management strategy since late last year, and we've been very active capturing high-teens returns through this deployment. Our Board has provided 5 authorization increases in less than 12 months, totaling $1.6 billion of capacity. Through October, we have repurchased more than $900 million of our shares to date, amounting to approximately 12% of our current market cap, a significantly greater pace than most companies.

Finally, another key example of our proactive strategy to unlock shareholder value is the transaction we announced last week to eliminate Athene's multi-class share structure. Importantly, this transaction serves to broaden our appeal to a range of active and passive investors and significantly enhances our index inclusion eligibility with a key provider like S&P Dow Jones.

Once the transaction closes, which we expect to happen during the first quarter of next year, we believe Athene will be fully eligible for inclusion in a major S&P index such as the S&P 500 or S&P MidCap 400. While inclusion could take time and is subject to the discretion of the S&P Index Committee, Athene would otherwise not be considered without taking this important step.

In addition, the transaction deepens the strategic and economic alignment of our long-term partnership with Apollo, offers an attractive financial investment in their business and augments Athene's capital base for future growth. We remain confident that the transaction will generate significant value for our shareholders over time and are tremendously excited about our prospects ahead.

With that, we will now turn the call back to the operator and open the lines for any of your questions.

Operator:
The first question will come from John Nadel with UBS.

John Nadel, UBS:
If I adjust your third quarter results for the notable items and I take into account sort of current market conditions, I know it's getting late in the year, but do you still expect to exceed $7 per share in operating EPS in 2019? And then my follow-up to that is, Marty, I think in your prepared remarks, if I heard you correctly, you've indicated that you expect EPS growth to continue to run at double-digit pace. Is that something we should be expecting for 2020?

Marty Klein, Chief Financial Officer:
John, I'll field both of those questions. When we talked about the $7 EPS number, that was really before a couple of things. One was, here in the third quarter, was a significant amount of notable items, $62 million after tax, including unlocking, obviously, which was not in the mix at that time.

We did not have any prediction on it at that time and did not factor that in. And then obviously, with lower rates since then, that's impacted us. I think if not for those 2 things, we would have expected to continue to be just over $7. But those 2 things together, that kicked us to what will be, frankly, below $7 for the year.

The RMBS stuff I referenced in my remarks is not just the coupon income but also prepayments, particularly on our non-agency RMBS slowed down a lot. So the accretion of the discounts slowed down a ton in the third quarter. To give you an example, it was like $9 million of benefit in income for the quarter versus a total of about $70 million in the first half of the year, so a big slow-down, which is not to say we're not going to get that income, it's just to say it's been delayed as the business – as that RMBS portfolio, at least at the moment, is running off more slowly that we would have predicted. So talking about $70 million from that in the first half versus $9 million the quarter, so very stark decline, which – hard to predict when that's going to recover, but we do expect to get that accretion and discount back, which is like $400 million over the next 3.9 or 4 years of the average life of that portfolio.

On 2020, yes, we do expect double-digit growth. We'd expect a rebound. Listen, I think the fixed income NIER at 4.11%, as I said in my remarks, it's kind of a baseline heading into next year. And it's going to be then impacted by what happens with rates and new money stuff.

It's going to be, to some extent, impacted by – does accretion of discount pick up on RMBS or not. But I think even assuming that doesn't pick up, we'd expect double-digit earnings growth, and we'd expect a return on assets of anywhere from 110 to 120 basis points.

John Nadel, UBS:
Got you. And just one point of clarification, Marty, real quick. That double-digit pace of EPS growth in 2020, is it fair for us to assume that that's off of 2019, excluding the notable items in 3Q?

Marty Klein, Chief Financial Officer:
Yes. I think that's right.

Operator:
The next question will come from Andrew Kligerman with Credit Suisse.

Andrew Kligerman, Credit Suisse:
Great. With regard to the comment that you generated unlevered returns in excess of 20% and I'm assuming that's on the deals as well, how are you able to do that? And maybe what kind of competition are you facing moving forward? And what's the likelihood of continuing to see good volumes?

Bill Wheeler, President:

Well, you've put your finger right on the issue, Andrew. It's hard in a competitive environment to exceed 20%. And what we sort of did this quarter is because of the low interest rate environment, we've tightened pricing a lot, and honestly, looking back, we probably overdid it.

Now the good news is returns in the quarter are great, but volumes are slowing. And so we're going to move the pendulum back a little bit in terms of – we've already done that, frankly, in both the reinsurance and the retail business. So we're not going to sustain 20% returns and volumes are going to pick momentum back up, but we clearly slow a little bit in the end of the third quarter. So that's a little color on what happens.

So it tells you the margins that are out there. I mean our 20% margins, we obviously have certain competitive advantage of almost nobody else enjoys. And that allows us to earn superior returns and still be competitive, but I do think we maybe overdid it a little bit in the third quarter.

Jim Belardi, Chairman, CEO and Chief Investment Officer:
Andrew, It's Jim. I would just add to that, our target returns for organic business remains mid-teens, so we're not changing that. We just did better than that in the third quarter.

Andrew Kligerman, Credit Suisse:
Got it. And with regard to the $62 million of notable items in Retirement Services, could you talk about where your discount rate is right now? And how much it was lowered if...

Marty Klein, Chief Financial Officer:
Sure. As I mentioned in my remarks, we moved it down. It was in the low – our assumption for the 10-year treasury, 8 years out, was in the low 3's. And we've now, in this unlocking, moved it down to 2.75%, which is a whole lot lower than at this, I think, elsewhere in the industry. I think, as a reminder, Athene started out after the crisis through all the business we've underwritten and originated since then was in a low-rate environment.

So we never really had liabilities on at higher rates, but we've also tried to be very prudent and take that rate down. It's very important to us to have a very prudent balance sheet that's well capitalized with no legacy liability risks and very well underwritten liabilities. And part of it is putting those liabilities on our books at what we think are pretty reasonable assumptions. And so 2.75% treasury in this environment feels like, to us, just about the right number for a longer-term view.

Andrew Kligerman, Credit Suisse:
Yes. That sounds right. And just in terms of the funding for ACRA, are you close to getting the $4 billion of capital commitments?

Bill Wheeler, President:
Yes, we are. There's, I think, another one large investor that's just about ready to sign – we're dragging them across the line, and then we're chasing the last $500 million.

Operator:
The next question will come from Tom Gallagher with Evercore ISI.

Tom Gallagher, Evercore ISI:
First, Marty, just a follow-up on the near expectation. You said you thought it would be stable in 4Q. Is that – do you have visibility that you have lowered crediting rates enough to offset the negative impacts that you expect from floating rate in 4Q? Or is that because you're expecting some of this RMBS prepayment negative to reverse itself?

Marty Klein, Chief Financial Officer:
I really – I think that – my commentary was really on the fixed income NIERs. That's staying about the same. And we're not really calling for a big rebound in that in this next quarter. I think there will be some of it because it's unusually low, maybe for a variety of factors. But my commentary was really reflecting not really any kind of real come back in that. I would expect fourth quarter the return on assets to be kind of in the ballpark of where it was this quarter, excluding the notables.

On the cost of crediting, I think it's important to remember that while – when interest rates, particularly LIBOR moves down, the floaters move down very quickly. 1 and 3-month LIBOR is a great preponderance of our portfolio. But on the crediting rate side, it's a bit of a lag effect, right? We can't just take all the in-force down right away.

And I think what we'd expect in this current environment, Tom, is that over the next few quarters heading through next year, the overall crediting rate is probably going to drop, say, a couple of basis points or so a quarter or it could be 1 or 2 basis points, 2 or 3 depending on the quarter. But that will slowly tick down as we do take the opportunity as business comes up for renewal, to reset it at lower rates. And also, in this environment, expect a little bit lower cost of hedging.

It's interesting in the deferred annuity book for the legacy business, the cost of crediting, actually in deferred annuities, did tick down 2 basis points in the third quarter. It was offset by 2 basis points of increase from new business we put on, particularly MYGA business in the second quarter. MYGA is almost all – a lot of that return is in crediting rate. There's not really any rider reserves on it, obviously. And so the decline in the in-force of a couple bps was offset by a couple of bps on new business in the second quarter when rates were higher, but we wouldn't expect that dynamic to continue. We just expect a couple of bps or so decline over the next few quarters, so it's sort of a lagged effect on the crediting rate side.

Tom Gallagher, Evercore ISI:
Just to follow up on that. Do you have more flexibility to lower crediting rates? It's – sounds like pretty marginal impacts here. And obviously, this is – there's been a decent near-term negative earnings impact here. Just curious why you wouldn't be taking more aggressive actions on the crediting rate side.

Marty Klein, Chief Financial Officer:
Well, it's not like it's a really bad quarter without doing that. I mean I think we're trying to be prudent and manage our business well for the longer term. It's a business that we've sold over the last 2 or 3 years. First of all, some of that's been product that doesn't really have the opportunity to renew because it has multiyear guarantees, might be 3 years or something like that. They can't renew it.

But stuff we just sold a year or 2 ago, we don't try to ratchet those rates down a whole lot. We want the business to sit there and be relatively stable. But we do take opportunity in older stuff, and we're getting some decent margins. I think if not for the notables this quarter and a slowdown in RMBS prepayments, it was not a bad quarter, not a great quarter certainly, but not something that we'd want to hurt our long-term reputation in the marketplace.

Bill Wheeler, President:
Tom, we do have the ability to lower rates faster. And we choose not to, mainly – as Marty talked about, because what we – if you go really fast, they're not going to – might be perceived as a capricious way. The market will punish you, right? And we've seen that with other carriers who have, for whatever reason, tried to move rates down 1 or 2 years after selling the business. And producers don't like it, so we're – it's a judgment call in terms of how fast we adjust them. It is fair to say rates are quite a bit lower. And our feeling sort of is if they get meaningfully lower, then we'll probably have to start acting more aggressively. But we're trying to strike a balance.

Jim Belardi, Chairman, CEO and Chief Investment Officer:
Tom, this is Jim. One more thing. I agree with everything Bill and Marty said. But essentially, one-twelfth of our book, we have the opportunity to reprice every month, ballpark, just a generalization, etc. And you're right. We do have a fair amount of leeway until we would hit minimum.

So we're going to look at that very carefully and I suppose to strike the right balance. But that's a subject of a lot of discussion here, especially as we head into 2020 and keep in mind our profitability every day on that. So we'll communicate more as we go along, but we do have flexibility to take those down, and we're going to look at it carefully.

Marty Klein, Chief Financial Officer:
One last point, and as I mentioned in our remarks, but just that you don't lose sight of it, Tom, is that we are writing more institutional business, and that does have higher crediting rates because with many of the other liability costs. So to the extent that mix increases, the overall crediting rate may not shrink. So you have to look at the underlying trends in the businesses, the PRT and the funding agreement rates declines in institutional quarter-over-quarter. But obviously, the mix of that business was higher, so we saw the overall credit rate increase. But the underlying trends and all the organic channels are on the way down.

Operator:
The next question is from Ryan Krueger with KBW.

Ryan Krueger, KBW:
I had a question on the fixed income yield. So 4.11% good run rate ending the year going into 2020, is this in light of the current interest rate environment? And assuming no changes to the interest rate environment, can you give us some sense of the trajectory that, that may have in 2020? I mean would we – would you expect some further declines based on where you're investing new money?

Marty Klein, Chief Financial Officer:
In the current environment, right, and there's some moving parts, it's very hard to predict exactly. I'd expect it to be around the same ballpark, give or take a couple of basis points. RMBS speeds are one factor. How we invest and what goes off the books is another, but that's kind of, I think, a decent baseline in the current environment.

Jim Belardi, Chairman, CEO and Chief Investment Officer:
Ryan, one of the things we're counting on and I've mentioned in my script that we're having a lot of success in sourcing non-CUSIP assets. The $3.5 billion, the way we define it this year, we would expect it to be more next year. Those assets without sacrificing credit quality are higher yielding, and we're looking for those type of assets to be become a bigger part of our portfolio and will either increase yields or at least offset any other declines from our floater portfolio.

But our biggest – on the floating portfolio, our 2 biggest components are CLOs and RMBS. And the CLOs are actually high-quality CLOs for the most part, a bigger portfolio than RMBS, and they performed very well. We expect them to perform very well next year as well. But the non-CUSIP origination is a key part of our strategy to offset any declines in yields.

Ryan Krueger, KBW:
And then in regards to inorganic opportunities, do you think counterparties would be potentially willing to transact in the current interest rate environment? Or is that – do you view that as a meaningful headwind to getting deals done?

Bill Wheeler, President:
Well, it clearly has a negative influence, but I don't think it stops people from transacting. A lot of it has to do with your attitudes about where you think interest rates are going and what's the psychology around that. And I think people who really feel they want to transact for strategic reasons, they want to exit a block or something like that or free up capital, it all depends about – do you think it's going to get better in a year or not? And I would say the reality is, is most people probably don't think interest rates are going to get a lot better in the next year. And so in our discussions with various management teams, they still seem very interested in transacting. And they obviously want to see where pricing comes out, but I would say it's an impediment but maybe not a major one.

Operator:
The next question is from Erik Bass with Autonomous Research.

Erik Bass, Autonomous Research:
Can you talk about the sales environment in retail and whether competitors have been responding rationally to the decline in interest rates in terms of their price adjustments? And also, have you seen any change in consumer appetite for annuities?

Bill Wheeler, President:
There's 2 parts to that question. One is, in the MYGA market, people clearly have pulled back, and MYGA sales, traditional fixed annuity sales are – seem to be off quite a bit. And obviously, the base interest rates are much lower. And so I think that competitors have repriced some, but they're probably not as much as they should have. So that's kind of what I would say.

With regard to indexed annuities, it's not clear how much indexed annuities have slowed. I don't have a great feel for that at the moment until I see the third quarter numbers. What's interesting for us is our indexed annuity sales are going to be up year-over-year.

It's still a – it's a product class which has got a lot of secular growth in it, never mind what's going on with interest rates. So I would expect it to grow, but maybe the growth rate will slow. Competitors, too, they've repriced a little, probably not as much as they should have. And so I think that's kind of what's going on in the market.

Erik Bass, Autonomous Research:
And then your comments on PRT and interest in the European market, would that be as a reinsurance counterparty? Or would you be able to directly source deals and do fully funded deals in Europe?

Bill Wheeler, President:
No. We aren't licensed on the ground there, so we have to act as a reinsurer. And I think that's the right way. I think, strategically, we've kind of concluded that that's the right way to go.

Erik Bass, Autonomous Research:
Got it. So would you just be taking the longevity risk? Or would you be able to get assets as well?

Bill Wheeler, President:
No, no, no. Assets as well. We're not interested in just isolating longevity rates, that's not – not like others have. We're interested in taking a percentage of the whole liability.

Operator:
The next question will come from Humphrey Lee with Dowling & Partners.

Humphrey Lee, Dowling & Partners:
Just related to the assumption review, should we expect any impact on other liability costs going forward?

Marty Klein, Chief Financial Officer:
Humphrey, it's Marty. No. I'd expect them to be kind of be in that – bounce around between 95, 97, 100, 102 basis points quarter-to-quarter. We feel like taking our long-term interest rate assumptions of 2.75% from low 3%, that should hold us for quite some time. It's a very prudent number, we think, and we think we took another – we've been updating our actuarial assumptions every quarter as we seek experience and looking for. That ended up being a slight good guy this quarter. But no, I don't expect a material difference in the other liability costs rate from what it had been.

Humphrey Lee, Dowling & Partners:
Got it. And then just to follow up on the cost of funds, in general. I think in your earlier kind of response to the other question, you expect the cost of crediting could see maybe a couple of points – sorry, a couple of bases point decline in the future quarters as you kind of reprice some of the book. And then – but then in general, should we expect cost of funds to be kind of – remain at kind of close to kind of 3% level going forward given the mix shift? Or is there any trajectory that could kind of more – coming back down to like 2.8% to – like 2.7% to 8-ish?

Marty Klein, Chief Financial Officer:
Yes. I would say that, again, it's going to very much depend on business mix. But as we kind of look forward on business mix, and again, we pivot across our channels where we see the best opportunities. So that could certainly move around. But I think that other liability costs, as I said, should be kind of at normalized levels I spoke about a minute ago. And I think we'll reprice some deferreds.

And institutional, it will drop in rate, just given the low-rate environment if it stays there. So we'd expect a couple of bps in aggregate roughly quarter-by-quarter across the whole liability book. Again, I would urge you and others to kind of look more deeper within that, look at the deferred annuity business and the institutional business.

But in aggregate, with the business mix, we'd anticipate – we'd expect the overall cost occurring to go down a basis point or 2, maybe 3, depending on the quarter over the next 4, 5 quarters.

Operator:
The next question is from Alex Scott with Goldman Sachs.

Alex Scott, Goldman Sachs:
So the first one I had was sort of back on the pipeline, and I know there's a lot of focus on interest rates and what that may be doing to the pipeline. But could you talk about like your ability to source assets and how that may be impacting your pipeline and what you're willing to do?

I mean it sounds like more direct origination, you're doing that. I think that probably helps a lot with supporting the retail flows. But do you have enough direct origination opportunities to still go out and do big deals and be able to generate the kind of alpha that you want to be able to in the current credit environment?

Jim Belardi, Chairman, CEO and Chief Investment Officer:
Alex, the answer is absolutely. We talked about what we've done so far in "senior secured" directly originated credit this year, it will be more next year. We have an ongoing allocation to that asset class in our weekly net investment earned rates that we provide to our liability pricing people so that we're in sync on that.

That shows our confidence that we're going to continue this momentum. I mean Apollo and we are in contact with a lot of different counterparties. They want to do business with counterparties that have a lot of capital and counterparties that you wouldn't even think we'd be dealing with that want to partner on various origination platforms, initiatives etc. from Silicon Valley or across the board.

So a lot of conversations. PK is the best example so far, but we expect more to come in this arena. And you're right. That drives our earned rate and our ability to be competitive in all aspects of our liability platform.

Bill Wheeler, President:
Alex, I'd say one other thing. We're very careful to make sure that asset allocation doesn't vary significantly between different channels and markets and product categories. It will vary a little bit just because liabilities are a little different, but if you give the juicy assets to one particular market or product, you're effectively subsidizing that channel versus others. So we try to be very careful about how we manage asset portfolio targets.

Jim Belardi, Chairman, CEO and Chief Investment Officer:
No. That's right. Look, we're very disciplined on this. And unless we are confident that this

percentage of every asset allocation story is sustainable, we don't put it in there. It's not like we change this allocation every week. So we're confident enough, very confident in this directly originated category private credit that we have an allocation there, and we expect it to be in there permanently.

Alex Scott, Goldman Sachs:
Got it. That's helpful. A follow-up I had is on the lifetime income benefit reserves. And just thinking through the review that you did and bringing down the ultimate assumed interest rates, I mean, should I expect any difference in the way that those liabilities are accruing? Will that affect your go-forward earnings power? I think it sort of works as a K-factor the way that, that accrues. So will that K-factor sort of increase is, I guess, the question.

Marty Klein, Chief Financial Officer:
I think it will increase very modestly. It's Marty. But I don't – again, I think the other liability costs overall rate we talked about, which includes amortization of DAC as well as rider reserve accretion and a couple other things, I think that's going to probably be in that – anywhere from 95 to 105 but kind of hover around 100, maybe just under 100 basis points in aggregate, including that.

Operator:
The next question is from John Barnidge with Sandler O'Neill.

John Barnidge, Sandler O'Neill:
The withdrawal rate as a percent of beginning period assets was the lowest in the year. How should we be thinking of that going forward, please?

Marty Klein, Chief Financial Officer:
Yes. It is a bit lower, which is a good thing. I think we're still looking at how to do the financial planning for next year. I would still think at this point that we'd expect the DAC rate in aggregate around 10%, give or take. We'll fine-tune that as we go here. And it's been higher the last year or two than it had been before, and we expect the year to come back down.

But I think it's impacted by a couple of things this year. One is just the old Aviva business did a lot of business 9 and 10 years out, and so that business is coming up out of its surrender charge period. But then 7 years out and so far, they didn't do that much, so you're seeing kind of a lump of stuff coming from the Aviva stuff, and so that raises the decrement.

And then with the addition last year of the Voya transaction and Lincoln transaction, which were older, more seasoned blocks, those also, overall, sort of increased the decrement rate, which again is priced into the business as we look at those blocks.

Those blocks are more seasoned but also have more stuff coming out of its surrender charge, so there's probably a little bit more variability quarter-to-quarter with those. But I would think that for the near term, looking at roughly a 10% decrement rate, it could be a point above or below that is probably about right.

John Barnidge, Sandler O'Neill:
Okay. And my follow-up, given you got increasing scale being achieved, how should we be thinking about operating expenses as a percent of total assets? I mean does it seem reasonable that it may tick down a basis point or 2 each year?

Marty Klein, Chief Financial Officer:
Yes, it could. Obviously, it's a function of how much we grow. And when we do inorganic stuff, that kind of jump-starts our growth even more because we're growing pretty decently organically. But obviously, when you do organic stuff – inorganic deals, which is our strategy, it goes up a lot. It could go down a basis point or so next year just with organic growth. We'll have to see.

I think – and also, I would note that there's a lot of GAAP accounting changes happening: CECL, which we basically are done with, but we're still putting in place; and then LDTI, which is a massive undertaking. Those are things that we and others in the industry have to do, and there's a lot of money we have to spend on changes to our processes, working with advisers, a lot of IT changes that kind of elevated on a onetime basis.

So I would think and hope it could go down, certainly longer term. But next year, it's certainly going to be impacted by a couple of those GAAP things, so the decline may not be as much in terms of basis points. I mean it could be just relatively stable, depending on corporate growth, could come down a bp. If we do something inorganically, it should come down a lot.

Operator:
The next question is from Elyse Greenspan with Wells Fargo.

Elyse Greenspan, Wells Fargo:
My first question. Now that you guys are close to fundraising for ACRA, I'm just trying to get a sense of how you guys have – have you spoken with investors about putting that capital to use? I know you have the legacy Athene deals, so the Bristol and Lincoln going in there. But how do we just think about additional deals and pipelines? And what time frame have you communicated to investors putting that capital to use? And there been any change over the past few months?

Bill Wheeler, President:
Elyse, it's Bill. No. There hasn't been a change. Our – we have a 4-year window from the initial closing to invest that money, and so – and that's consistent, right? So we haven't given them any new messaging about, oh, looks like it will be later or looks like it will to be faster. Our expectation is that we'll be pretty active, and so I wouldn't say our outlook there has really changed.

Elyse Greenspan, Wells Fargo:
Okay. And then in terms of modeling, as we think about the PK AirFinance assets, how should we think about the return that you expect on those assets? Can you give us just some kind of guidance there?

Jim Belardi, Chairman, CEO and Chief Investment Officer:
Yes. I won't be specific, Elyse. But I think what you'll see, and this could be what you see in future of these types of transactions, is essentially there will be a securitization where most all of what we're getting is going to be investment-grade rated, most likely asset-backed securities. That's the case here in this PK AirFinance.

And the yields on those will be significantly wider than what we could do in investment-grade corporate space, even wider than what we could do in other more generic asset-backed securities. And then there's a piece that will be of the equity piece that will be in alternative on our books that will be in the range of what our normal alternative criteria is.

And I think for alternatives, going forward, you'll see more of that business, which we view as strategic alternatives. That's a key component in this structure in order to for us to get, in this case, close to $1.5 billion of attractively priced asset-backed investment-grade rated. So that's the way.

There may be a small – another sliver in the no section, et cetera, but more or less immaterial to the total transaction. But that's the way we view it on a relative value basis and a sizing basis, and I think that's the model going forward.

Operator:
The next question is from Suneet Kamath with Citi.

Suneet Kamath, Citi:
Just 2 quick ones. First, on the ROA on a consolidated basis or maybe just Retirement Services, Marty, I think you'd said 110 to 120 for the fourth quarter. But did you give a sense of how you expect that to trend in 2020?

Marty Klein, Chief Financial Officer:
Actually, I'm glad you asked. So maybe I misspoke or maybe you I misheard or may be both. But no, I think the 110 to 120, Sunnet, is for 2020 kind of overall expectation for next year. I do think that for the fourth quarter, as we mentioned, I would think Alts will be in the 8% or 9% range.

And we don't expect any real recovery in the fixed income NIER. So I think with those dynamics, we'll have a return on assets that's a little over 100 basis points as best we can predict and pretty close to where it was, excluding notables, this quarter.

We'll have more opportunity to take down credit rates over the course of next year and some other things. That's why I think we'll get an improvement next year. But no, in the fourth quarter, I'm not going to expect that kind of number. It's going to be probably around 100 or just over 100 like it was here in the third quarter, ex notables.

Suneet Kamath, Citi:
Okay. Yes. I might have wrote that down wrong, so apologies. And then secondly, I just want to go back to one question from last week's transaction. And I asked it last week, but I just – maybe I should have followed up. But as we think about the consideration mix that you got as part of that deal, it seems very heavily weighted in favor of Apollo stock. And obviously, we talked about last week that being somewhat capital inefficient from your perspective. But just why is such a heavy tilt towards Apollo stock? Why not more of a blend of cash and stock?

Marty Klein, Chief Financial Officer:
Well, Suneet, it's Marty, it was as negotiated deal. I think part of it was definitely – obviously, it

was driven really by Athene going to a single class of stock and how can we best achieve that with our partner, Apollo, but we also wanted to increase alignment, certainly with Apollo going to 35%.

We're able to not only get rid of the dual class but creates more alignment. But also as part of the increasing alignment, we thought it would – we all thought it would be good for Athene to own some Apollo stock. The way that came down, though, ultimately was to get it funded. And where Apollo was with its ability to fund the balance sheet and kind of where we were, the mix we took down was – or are going to take down, I should say, is that $350 million cash and $1.2 billion of Apollo shares.

Yes, it is capital inefficient in some ways, obviously, the cash is cash, and that's very capital efficient. But we still think that it should be a good returning asset, and it's good to increase alignment and so given that was where we're able to get to with Apollo at that time, given what they had in cash and other things, we thought that was a reasonable place to land to get these much better, longer-term objectives.

Jim Belardi, Chairman, CEO and Chief Investment Officer:
Suneet, a couple of things. Apollo has a balance-sheet-light approach in general, so they don't fund many things with cash. And so this the way that made sense for them. Look, we think this is a terrific transaction. Both stocks have performed very well since that.

It's consistent with the stronger alignment that we attempt to have with Apollo. But look, the overriding single goal when we entered into discussions about this was both companies need to benefit. There's not going to be a winner and a loser. We think we accomplished that.

It's not perfect for either side, but it's good enough. And the market is reacting to that, I think.

So, yes, I hear you. And our investment in Apollo stock is, like anything else, going to be viewed as an Alt with Alt capital charges. But with their dividend yield of 6%, and so far, so good on the appreciation, we'll see. There'll be some more volatility, no doubt about it. That's the price we're paying for this strategic alliance and getting out of the dual class shares.

Operator:
At this time, I would like to turn the conference back over to Noah Gunn for any closing comments.

Noah Gunn, Head of Investor Relations:
Thanks, Operator. Thanks, everyone, for joining us this morning. If you have any follow-up questions regarding our results or anything discussed on today's call, please reach out to me or Sue Lee. We look forward to speaking with you again next quarter. Thank you.

Operator:
This does conclude today's Athene Holding's Third Quarter 2019 Earnings Conference Call and Webcast. Please disconnect your lines at this time. Have a wonderful day.