

06-Dec-2022

Prudential Financial, Inc. (PRU)

Goldman Sachs US Financial Services Conference - Fireside Chat

CORPORATE PARTICIPANTS

Robert Michael Falzon
Vice Chairman, Prudential Financial, Inc.

OTHER PARTICIPANTS

Alex Scott
Analyst, Goldman Sachs & Co. LLC

MANAGEMENT DISCUSSION SECTION

Alex Scott
Analyst, Goldman Sachs & Co. LLC

All right. So we'll get started with the next session. Rob Falzon here, Vice Chairman of Prudential Financial. So thank you for being with us.

Robert Michael Falzon
Vice Chairman, Prudential Financial, Inc.

Yeah. Happy to be here.

Alex Scott
Analyst, Goldman Sachs & Co. LLC

It's pleasure to have you.

Robert Michael Falzon
Vice Chairman, Prudential Financial, Inc.

Yeah. Good to be here.

Alex Scott
Analyst, Goldman Sachs & Co. LLC

The format will be fireside chats. I've got a series of questions that I'm going to run through.

QUESTION AND ANSWER SECTION

Alex Scott

Analyst, Goldman Sachs & Co. LLC

Q

The first one is a little bit more high level and I just thought I'd ask as part of your strategy to transform Prudential Financial, you've already taken a good amount of action. So I thought maybe we could discuss what you've done so far, and where you see it going over the next couple of years?

Robert Michael Falzon

Vice Chairman, Prudential Financial, Inc.

A

Yeah. Thanks for that Alex. Give me a chance to sort of do a broad tee up. So let me just sort of talk about that strategy first and then I'll speak with what we've done and are doing. So what we've said very publicly is that we want to become higher growth less market sensitive and more capital light as business system while meeting customer needs and creating a better customer experience focused on customers that are in three business areas; investments, life protection and retirement protection; those three areas.

In order to do that, what we recognized is that we would have to significantly change the mix of our businesses, the mix of the products that we're selling within those businesses and invest in capabilities, capabilities that would result in both greater efficiencies for the company and better customer experiences as well. So sort of going through that priority, from a product mix standpoint, we've been very successful at pivoting into – away from products that are more capital intensive, market sensitive both in our annuities and our life business and introducing new products which have customer protections but without the level of guarantees. And therefore it's less market sensitive and less capital intensive as well.

From a business mix standpoint what we've done is some pretty significant dispositions got out of Korea, got out of Taiwan in the US are two businesses that we exited, we're closing the sale of those two businesses in the middle of this year and from a sort of investment standpoint, then that's generated like in excess of \$7 billion worth of proceeds. From an investment standpoint we've been very disciplined. We have been investing primarily in PGIM and in our emerging markets. Those are the two areas that we've identified from an inorganic standpoint we want to grow and we've been successful with doing programmatic acquisitions in both of those. So we feel good about what we've done from a product mix standpoint, feel good about what we've accomplished, so far from the shift in business mix.

We also announced during the third quarter that we hit our target goal of \$750 million of expenses being taken out of the business system. We did that a year ahead of when we expected to do so and importantly in doing that, we've created better customer experiences and be happy to talk about what those sort of things look like. So that's – that sort of job done from an expense and customer experience standpoint. The expectation going forward sort of the outlook as we think about what we want to accomplish on a go-forward basis is frankly think about it as kind of being more of the same. So continuing to introduce products across our business lines, we're going to continue to look at the business mix and opportunities to de-risk on a go-forward basis. There's no must do's there, but there're some nice-to-dos and if the market conditions are right, we would execute against that. And we're going to continue to look at how we create that our customer experiences and investing in capabilities from a – both from investing from PGIM in emerging markets, PGIM particularly and expanding out to set of capabilities that we have there and then investing in capabilities, which are transforming that customer experience for us.

We're quite excited about the outlook for the company on a go-forward basis, particularly excited because the sort of investments we're making, particularly the things that we're doing in the investment management world are creating this sort of self-reinforcing business system. And that's key to our strategy on a go forward basis. As we build capabilities in PGIM, it's not just to the benefit of third-party assets that we can then manage, it's also to the benefit of the competitive positioning of our businesses in insurance and retirement. The better we are at investing, the more capital we can attract into those businesses, the more successful we can be from a competitive standpoint in those businesses. When we're successful there, it generates a high level of the AUM, which in turn then builds the investment management platform and then that cycle continues to work its way through. So quite excited about that and feels that we've already begun to do that. The pension risk transfer transaction that we completed, \$8 billion, that was not just a good transaction from a retirement standpoint, but it also took all that AUM and steered it over to our investment management platform.

Alex Scott*Analyst, Goldman Sachs & Co. LLC*

Q

Got it. And over the last year, the transformation has really been sped up by some of this transactional activity you've done with PALAC and so forth. I'd be interested in just your views on the private market and risk transfers and broad category. Is that still a tool that you'll look to utilize to further de-risk?

Robert Michael Falzon*Vice Chairman, Prudential Financial, Inc.*

A

Yeah. So as I mentioned, it's sort of a – it would be nice to do, not a have to do. So we accomplished two very large transactions, one of which was a de-risking in the annuities book and we've stated an objective with regards to how we're trying to bring that book down to a more proportional size. Now, when we talk about that, it's really – it's focused very much on traditional variable annuities with living benefit guarantees. We like the annuities business. We just want to have products like we've introduced with FlexGuard that are less capital intensive, less market sensitive, but still needing a customer need. And the success we've had with FlexGuard, we've sold \$12 billion of it since we introduced it in 2020, I think is evidence of the fact that we are in fact meeting customer demand.

So we want to continue to be in that business, but we want to continue to look at opportunities to de-risk both the back book on annuities, we're looking at our life business as well. If we did something there we would likely be in sort of the [ph] SGUL (06:13) space. We have dedicated teams within the companies that we stood up that are focused just on managing the back book and looking at opportunities to de-risk.

Now, I want to repeat also what I said, which is that it is a nice to do, not a have to do. We can get to the kind of business mix we're looking to get to organically if we need to. The ability to do things inorganically both on the disposition and the acquisition side is an accelerant to that.

Alex Scott*Analyst, Goldman Sachs & Co. LLC*

Q

And then in terms of growth areas of the business, I think you touched on a little bit, but what are the areas of the business that are you're looking for more organic growth and what should we be looking for in 2023 as we look to sort of track the progress on that?

Robert Michael Falzon*Vice Chairman, Prudential Financial, Inc.*

A

Yeah. So a couple of things, one is we actually have begun to benefit from a growth standpoint in that change in the economic environment. We've talked about low interest rates being a headwind for such a long period of time, we're actually seeing now with higher interest rates. Our core earnings sequentially in the third quarter went up sort of nicely and that's primarily driven by that higher interest rate environment. We expect growth from all of our businesses. If we did not think that there was an organic growth opportunity in any of our businesses, we would look to exit them just as we did with the Retirement Full Service Business where we thought – we were going to be challenged to grow that business on a go-forward basis.

And so highlights of that would be obviously in our higher growth businesses PGIM. In emerging markets, PGIM is, we've talked about it, as being sort of mid-to-high single-digit organic growth through the cycle. We've been – we've demonstrated that primarily through flows that we've been able to attract into that business. Emerging markets by definition are higher growth. But outside of those concentrated areas, we feel actually quite good about the Institutional Retirement Business, so pension risk transfer, longevity risk transfer. Pension risk transfer marketplace is a \$3 trillion market in the US, outside the US, it's a \$4 trillion market. Each of those markets has sort of penetrated in around 10%-ish or so. There's a lot more to go. This year in the US, you'll probably see a \$50 billion a year in terms of the level of volume of PRT, pension risk transfers in the US and a similarly record level outside the US as well. We think going forward that this year will be \$50 billion and next year, probably would be \$40 billion plus as well. So we see that as that trend is gaining more and more momentum and shows no sign of slowing, if anything continuing to accelerate. So we feel quite good about what that opportunity looks like in the Institutional Retirement market.

I also would mention Japan and I mentioned it because most people have this perception of Japan demographics, slow growth market. From our standpoint, that is true. However, we continue to grow there organically, because year-in and year-out, we capture market share and in the traditional life business, which is sort of flat growth, we're able to grow in that market environment. But also importantly, there are growth sectors in both health and retirement. They're growing at 5% to 10% each and they're pretty material profit pools as well. So we see opportunities there. Across the rest of our businesses, I would say that we see organic growth occurring by virtue of being able to continue to expand out products there, and group its voluntary products. In individual life we just rolled out FlexGuard Life as a IVUL product. And in annuities, again, continue the growth and FlexGuard as well as FlexGuard income and other products like fixed annuities that will be looking to position ourselves more competitively.

Alex Scott

Analyst, Goldman Sachs & Co. LLC

Q

Maybe we could drill into the Japan comments you made on growth. I mean, does the current environment and interest rates giving a little bit of relief over there? Does that help in terms of the products you can sell? I mean, does it open up the array of products you can sell in Japan at all?

Robert Michael Falzon

Vice Chairman, Prudential Financial, Inc.

A

Well, interestingly – so, first, if you look at that Japan business, I know I alluded this before, it's a crown jewel for the company. It's one of the – I was just over there two weeks ago, actually, we're celebrating our 35th anniversary as a company in Japan. And over those 35 years we've become one of the three largest. It's [ph] AISE, GIAJ (10:27), and ourselves. And [indiscernible] (10:28) two or three depending on the kind of metric that you look at. So we have got a very significant competitive presence there. We're differentiated from the other players as a result – because of the distribution model that we have. That distribution model has allowed us to capture market share and actually to continue to sell really profitable products into that marketplace despite the

competition that exists there. As we think about the environment, I guess, Alex, what I would say is interest rates are a tailwind from a return on the portfolio standpoint, but you almost have to look at that market with two lenses.

The first is a very short-term lens, which is what the COVID experience has been. And for us that's had two impacts. The first is the entire industry was in coordination with our regulators. We were paying out hospitalization benefits when individuals were not hospitalized, right. We had an accelerated payout on that. That policy has changed as of just this last quarter, and there's a higher standard that's associated with that. So we've had some adverse claims experience as a result of that policy adjustment. The industry has now changed as regulator – basically reverted and the regulator has embraced that.

The second is from our model standpoint, the differentiation of our model is that it's a high touch model. We have life planners and life planner consultants and our ability to recruit and their ability to be productive in an environment where you can't be face to face as a result of the COVID restrictions that were in place in Japan meant that we had reduced productivity and we were not adding to our head count as rapidly as we'd like to. Again, as COVID is becoming more endemic, that should be mitigated. And we feel good about the opportunity there.

From a longer term standpoint the demographic trend probably is the thing to pay most attention to, as opposed to where interest rates are at any point in time. Life demand will be about flat. As I just mentioned before, we'll capture market share. So we'll continue to grow that as a result of the distribution system we have. But what's happening is there are growth segments as a result of the ageing population in health and in retirement. Those segments are growing 5% to 10% each. Together, the profit pool there is a – I'd want to say it's a \$6 billion-ish kind of a profit pool. That revenues are profit pool associated with those product areas. So it's an area where we think shifting our product mix to include or expanding our product mix to include not just the life protection that we've been known for in that marketplace, but more in the health and retirement protection as well. We'll tap into the growth areas, and that probably overwhelms anything that's otherwise happening from an interest rate standpoint, although that is a tailwind.

Alex Scott

Analyst, Goldman Sachs & Co. LLC

Q

Got it. All right. I'm going to shift gears a little bit and I'll probably come back to some of the growth questions. But I wanted to make sure we got to some of the capital questions that we've been getting from investors.

Robert Michael Falzon

Vice Chairman, Prudential Financial, Inc.

A

Yeah.

Alex Scott

Analyst, Goldman Sachs & Co. LLC

Q

In your 10-Q disclosure, there were some comments about capital having some negative impact from asymmetrical non-economic accounting treatment and potentially the year-end actuarial review. Could you just unpack for us what those impacts are and the likelihood that it could actually lead to something like a share repurchase suspension?

Robert Michael Falzon

Vice Chairman, Prudential Financial, Inc.

A

Sure. So let me start with an observation and I'll tell you why I started the observation. First, we're in a higher interest rate environment and that's a really good thing for business fundamentals, right, because we've got roll over in the portfolio. We're rolling it over at positive spreads now to where the portfolio is rolling down. We're rolling it over to the new money rates are higher than our disposition rates. So that's a positive impact. We have lots of product that has recurring premium particularly in Japan, investing at a higher rates is a good thing for us as well. And then the nature of our business is that we have the duration of our liabilities by definition is always going to be longer than the duration of our assets. You can only go out in the US 30 years from an investment standpoint. We sell products that where the life of that liability is going to be beyond 30 years. And so by definition as good a job as we can do from an ALM standpoint, you're always going to be longer duration. In a higher rate environment, that means that your assets have gone down in value but less than your liabilities have gone down in value. And so that's an economic benefit to us in a higher rate environment. I say all that Alex because none of that shows up in GAAP and a lot of that also does not show up in stat.

Okay. So you have an environment where fundamentally, there's a really good economic thing happening to the business but the manifestation of that and reported results isn't always obvious at least not initially. So one, from an economic standpoint, we did have the assumption update in the second quarter and while we were able to absorb that reserve strengthening within the subsidiary operations that we have, there is an impact on then the flexibility that they have from a free cash flow standpoint. So we would expect in the very near term, that as a result of absorbing that which we have the capability to do and to be very clear, we needed to do nothing with regard to assets in the holding company. We're fully able to absorb that down at the subsidiaries. But it means that free cash flow coming out of those subsidiaries in the near term is likely to be a little bit reduced and that has an impact on the capital – to some level of capital flexibility.

Secondly, the rate at which rates have risen has resulted in significant realized and unrealized gains within the portfolio. There's a non-economic manifestation of that in stat but I'd be happy to get into if anyone wants to talk about things like IMR, but let's just leave it at what happens is when rates are going up and asset values go down, there's this asymmetric treatment within stat where those losses are run through the income statement and affect your statutory capital. Whereas when interest rates are going down and you're getting gains on those, they don't run into your stats. They're hung up and they're amortized [indiscernible] (16:30) time. That's a better construct. But that asymmetry is sort of manifesting itself. Now it's non-economic. It's an industry issue. [ph] ACOI (16:37) is talking to the NAIC about it, and the NAIC is open to visiting on what they should be doing about it. We're talking with our regulators. We're very comfortable that we've got a very strong financial profile.

We have financial flexibility and in terms of the implications of that, from a buyback standpoint to the latter part of your question, our board – first, I think we committed that we're going to finish out the program that we've done this year and announced the buyback through the end of this year. And then with respect to next year, we said the board's going to be visiting that – on that early in the year. I don't want to get ahead of my board on that, but I would say that a primary – not exclusive, a primary consideration by the board is really going to be around what the economic outlook is. How likely is it that we're going to have a very significant recession that could translate into a pretty severe credit cycle. And I think our concerns around financial flexibility that we want to retain and how much we want to do in the way of buybacks is going to be influenced by that view more than anything else.

Alex Scott*Analyst, Goldman Sachs & Co. LLC*

So, I want to ask about the credit. I'll get to that one in the next one. Before we leave the capital, though, I did want to ask you about this Lotus Re reinsurance company setup.

Robert Michael Falzon*Vice Chairman, Prudential Financial, Inc.*

Yeah. Yeah.

A

Alex Scott*Analyst, Goldman Sachs & Co. LLC*

I think a lot of people have kind of talked about it more in the context of it consuming some capital this year as you funded it.

Q

Robert Michael Falzon*Vice Chairman, Prudential Financial, Inc.*

Yes.

A

Alex Scott*Analyst, Goldman Sachs & Co. LLC*

But certainly you're not doing it because it's going to be inefficient, it's supposed to improve efficiency. So I'd just be interested in understanding that structure a little bit more.

Q

Robert Michael Falzon*Vice Chairman, Prudential Financial, Inc.*

Yeah. And let me, again, broaden that conversation. What we seek to do is actually, outside of emerging markets, we want to be active in three principal regulatory jurisdictions, Japan, US and Bermuda. And what we want to do is essentially regardless of where we're selling product is to have that product financed in a regulatory regime where the economics of the product best line up with the economics of the regulatory regime. Now, that answer changes for all product, for every product. There's no one answer that says Bermuda's better than the US, the US is better than Japan, Japan's better than – there's – what we find is that individual products, the regulatory regimes get things right and they get things wrong. And we work, from an advocacy standpoint, to try to – where we think there is a deviation from prudent reserving and that's driven by economics and where the statutory regime is, we work with our regulators to try to advocate for changes.

A

But in the interim, we look to sort of to house products where they're best aligned with the regimes as they exist today. And what we did in standing up Lotus Re, it gives us the flexibility to do that. That's a long-term strategy. We're in active conversations with our regulators as we move books of business around between those entities and where we write business from. So, again, I wouldn't want to speak to anything in the very near-term, Alex, and get ahead of my regulators on that. But it is very clearly designed in order to allow us to optimize the return on capital that we're getting, while providing a prudent level of reserves and capital to back our liabilities and ultimately produce a higher ROE and level of free cash flow.

Alex Scott*Analyst, Goldman Sachs & Co. LLC*

Got it. And then maybe circling back on credit, when we think about your investment portfolio and how you've positioned it for weathering the storm if we do have that with the recession, how do you think through that? Is there any kind of information you can help us with on stress scenarios and where you stand right now?

Q

Robert Michael Falzon*Vice Chairman, Prudential Financial, Inc.*

A

Yeah. So, portfolio management is a core strength of ours. We've always been quite proud of it and we have a great track record. You can sort of see what losses have actually been through cycles. Even with the subprime cycle that everyone went through, our actual realized losses on our portfolio has been well under what we underwrite from a pricing standpoint. So we feel quite good about our track record there. It's a large, well-diversified, high-quality portfolio. And in particular what we benefit from is our investment management business future, both from the standpoint of the security selection when we go to investing and picking specific bonds out, but also from the capabilities that they have in private asset classes, private placements and in commercial mortgages. They're each sort of 12% to 14% of the portfolio, so a significant weighting of the portfolio in those. And what we've seen is that the performance of those assets through cycles is incredibly stronger. So a BBB private placement performs like a A public security. And we've seen that and done research on it and published that research, so we've shared that with regulators et cetera.

So we have substantiated that it's a better performing asset class for us. And we get that because PGIM directly originates that. They're number one in that marketplace and probably number one or the top in the commercial mortgage origination as well from an insurance company standpoint. And so those capabilities, along with security selection, allow us to have, we think, is a very resilient portfolio. You've seen that. I would expect that if we have a credit cycle that our history of performance will continue into the future, that we'll do relatively speaking quite well there. But having said that, we are seeing no distress whatsoever in the portfolio today. In fact, if I look at credit migration, it's been positive in the last quarter, not negative, right. And so, no signs of any of that distress yet.

Alex Scott*Analyst, Goldman Sachs & Co. LLC*

Q

Understood. Okay. Maybe before we leave the investment portfolio on interest rates, you mentioned earlier in the conversation the economic benefit that you're getting from higher interest rates, higher new money yields. Could you remind us some of the sensitivities there and how we should think about how that rolls into your net investment income yield?

Robert Michael Falzon*Vice Chairman, Prudential Financial, Inc.*

A

Yeah. So if you look at the spread in the third quarter to new money rates against the portfolio, that would be between 70 and 90 basis points. So think about it between 75 to 100 basis points, so round numbers, of positive spread that we're getting on portfolio rollover. It's a similar order of maybe 20 basis points or so less when you look at disposition yields against new money rates, but same kind of positive spread. That's a relatively new phenomenon for us.

So if you recall that we were having up until a year or so ago, there was a \$0.03 per quarter compounding drag associated with low interest rates that got knocked down to around \$0.02 a share up until earlier this year. And then, as a result of the rise in interest rates, we no longer have a drag, we're having a positive impact on it. So, and that manifested itself in the third quarter core earnings. So we had noise around returns from alternatives and then the COVID experience in Japan that I alluded to before. But if you strip those things out and you look at core earnings, you're operating earnings increased by about 4.5% and core earnings per share increased by about 6.5% in the sequential quarters. So it is manifesting itself in higher returns from that higher rate environment. And so, I think we're sort of well positioned to continue to benefit.

Alex Scott*Analyst, Goldman Sachs & Co. LLC*

Q

Got it. Maybe moving over to PGIM, can you discuss the outlook for flows? And just in the context of the macro environment that we're in, higher interest rates, et cetera, had do all those things funnel into what you're seeing in your pipeline?

Robert Michael Falzon*Vice Chairman, Prudential Financial, Inc.***A**

Yeah. So, to describe PGIM, important to understand, really large and fixed, we have multi-asset class, we've got fixed income equities, private real estate, real estate debt and equity. So it's a multi-asset class manager. In each of those areas, we're an active manager. And we're particularly large in fixed income. And I say that because with the rise in interest rates, that's obviously had a negative impact on PGIM's flows and actually assets under management, so just the mark to market on the fixed income portfolio down as a result of rising interest rates towards what's just happening from a flow standpoint. So we always focus on flows, because it's a good indicator of the health of the system. But from an AUM standpoint, the flows really haven't had a material impact. It's been really the mark to market that's had the impact on core earnings out of that business.

From a flows standpoint, as rates have risen, what you've seen is that from a retail standpoint, there have been negative flows out of fixed income and in particular out of active fixed income, which is our area. There have been at least in the most recent quarter, there was actually positive flows going into passive fixed income on shorter duration. We're not a player in passives. And what we're looking is, making sure that we can create some product line that could absorb that flow on a go-forward basis. If you're going to be in passive, you really need to be [indiscernible] (25:42). And that's, you know, we've chosen to be on the active end. And so, we haven't benefited by any of the repositioning into the short passive. And that's been, as I said, particularly a retail phenomenon.

So, we had \$8.5 billion worth of negative flows in the third quarter, but we had \$9 billion of positive institutional flows in that quarter. So, the negative was entirely driven by retail. And we're not unique, and you could see that across industry statistics, that's what happened and we were just affected as everyone else was affected, and that longer-term, as we're at a higher level of interest rates, it's a very healthy thing for the fixed income franchise, right. You're getting higher returns from fixed income, which is going to mean that once the perception of the rate rise cycle is done, flows should be coming back into there and we'll benefit from that, and the flows should be disproportionate because you're now at a higher level of earnings, more attractive to have your money in fixed income than it was before, particularly for retail investors. I actually happen to personally believe we're at the very front end of that right now. It's beginning. You'll hear more and more pundits talking about this is the time to beginning to get back into fixed income. And so we could see the benefits of that.

While that's the case, I would say in the short-term we continue to see negative industry flows on a retail basis for fixed income. And our institutional business, we've had 18 of the last 19 years we've had positive flows, \$55 billion on average of the prior 5 years, so \$11 billion per year, very strong positive flows. They're driven in large part by our institutional franchise. But in any given quarter that could be choppy.

We have 1,600 institutional clients and we've got some really big institutional clients. And when they move, you could see \$1 billion movements from a single client. Now, net over time that's been a big positive for us. But in any given quarter you could see a move out or a move in. So there could be noise from an institutional standpoint in any quarter going forward, but I think the trends on institutional is very healthy indicator and the trend from a retail standpoint is it hasn't turned it quite yet. So long as our performance holds up, and we took a little bit of a dip in first part of this year because we were long on rates, but that's since rebounded. Our track record, our 3-, 5- and 10-year track records are very competitive. So, as long as performance holds up, which it has been and has done over a long period of time, and so long as we continue to broaden out the product line that we've got, we feel very comfortable that we'll continue to be a net beneficiary of flows over time.

Alex Scott

Analyst, Goldman Sachs & Co. LLC

So next topic I have for you is in Japan, the yen exposure.

Q

Robert Michael Falzon

Vice Chairman, Prudential Financial, Inc.

Yeah.

A

Alex Scott

Analyst, Goldman Sachs & Co. LLC

So you have this big Japan business. Could you help us think through the sensitivity economically to movements in the yen and help us out a little bit with the ways you hedge that? And I'm particularly interested in the capital hedge you guys have...

Q

Robert Michael Falzon

Vice Chairman, Prudential Financial, Inc.

Sure.

A

Alex Scott

Analyst, Goldman Sachs & Co. LLC

...I know there's some ways to facilitate the...

Q

Robert Michael Falzon

Vice Chairman, Prudential Financial, Inc.

I actually designed that capital hedge when I was the treasurer of the company, so I know about that I guess...

A

Alex Scott

Analyst, Goldman Sachs & Co. LLC

So I'm interested about how that cash makes its way to the holdco as well as part of your answer?

Q

Robert Michael Falzon

Vice Chairman, Prudential Financial, Inc.

Sure. Sure. First, let me just talk about the business aspect of it, Alex, because that's important. And that's actually primarily where we see the impact of volatility in the yen. What's happened is, we sell a lot of US dollar product in Japan. We innovated that, we've been doing it for decades. There's a lot of demand for it. The Japanese retail investor does not take a lot of equity risk, but they're very comfortable taking FX risk. And it's been a good bet for them over the long-term from a yen depreciation standpoint.

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But what happens is when you have this level of depreciation of the yen, there are two manifestations of it. One is some of the policies they have are weighing the money and they cash out on that. So we've had an elevated level of surrenders in our Japan business of our US shorter-duration US dollar denominated products. We have surrender charges and things which sort of make us whole from that standpoint, but that's profitable business where those future profits are now going away. So it's not a good event for us when we get those kind of surrenders, even if in the short term there's some positive – instances where we have a positive short-term impact, it's not long-term healthy for the business.

The other is, as they're looking to fill their needs on a go forward basis, you need a lot less US dollar product to beat your yen expenses on a go forward basis. And so our sales are also impacted by the depreciation of the yen. When we think about the yen, we think about sort of product sales and product mix as the primary implication of it. From a purely financial standpoint, we have an income hedge and we have an equity hedge. Income hedge is rolling 36 month hedge where we're always at a point where the next four quarters are 100% hedged. And then it scales down to when you're in the 36 month, in the last set of quarters, you're like a third hedged or something like that. That just smooths out the volatility. So in any given year, we can tell you for the upcoming year, this is our exposure. This is our yen exchange rate. It's locked in. And therefore it doesn't create any noise on a year to year basis. But to the extent the yen is depreciating over that three-year period of time, you will eventually see it there.

Now, having said that, we have very little yen earnings, because if you think about the book of business that we're writing and have written is US dollar, generating dollar profits, so premiums are in dollars, 100% of our expenses are in yen. And so, if you take the sort of the yen book generating revenues and you allocate 100% of the expenses against that, there's a lower level of profit coming out on the inside and then all the dollars are flowing through. So, people think about us having this big Japanese business and a lot of yen exposure. No, we actually don't have from earnings standpoint, we have very little yen exposure and it's hedged.

From a capital hedge standpoint, we look at that business as being, again, we want to protect the dollar economic value that we've got embedded in that business. So what we constructed a number of years ago is that we would hold US dollar assets against the economic equity that we have, the value of the equity that we have embedded within that business.

The challenge with that is if we did that without any hedging, we would have very bad statutory outcomes in Japan, because holding those US dollar assets under SMR, you get penalized for doing that, and so we'd have bad SMR ratios. So what we devised was an internal hedge where from the US holding company to our Japan business, we've entered into an FX swap. And so for Japan purposes, those dollar assets get translated into yen assets and yen income, and then from a US standpoint, to the extent that the yen depreciates the settlements in those hedges mean that cash comes out of Japan and up to the holding company, obviously the reverse happens when the yen appreciates. But at the end of the day, what we've done is we've protected the dollar value of that business given that we're a dollar traded company. And that's sort of how we wanted the economics to line up. So it's a really good hedging program that basically means that when you think about the yen, you can kind of ignore it in terms of how it works, how it affects us from a financial standpoint, and think about how it affects us from the product mix and sales that we've got.

Alex Scott

Analyst, Goldman Sachs & Co. LLC

Q

One part of the transformation strategy I want to circle back on is the M&A, the inorganic aspect of it that you guys have talked about.

Robert Michael Falzon

Vice Chairman, Prudential Financial, Inc.

A

Yeah.

Alex Scott

Analyst, Goldman Sachs & Co. LLC

Q

And I think as you were doing some of these de-risking transactions, there was a certain amount of money that was sort of set aside for M&A. So I just wanted to get the update on what that M&A budget sort of looks like, and what are the opportunities you see out there?

Robert Michael Falzon*Vice Chairman, Prudential Financial, Inc.***A**

Sure. So first, from a focus standpoint on M&A, as we've articulated, is going to be around asset management, so PGIM and around emerging markets. In the case of asset management, very much focused on capabilities there. And within that, I'd probably highlight three things. One, continuing to build out, we've got about almost \$0.25 trillion of assets under management in private alternatives. We want to continue to grow that. Two, we've got about \$300 billion of retail assets under management. Of course, with things changing, that may be a slightly stale number somewhere around that order of magnitude. We want to continue to grow our retail on a global basis. And then third, we want to continue to expand our international investing capabilities, which will then give us more access to international investors, where we've got, I want to say, three quarters or so of US pension funds are clients of ours. But then if you go on a global basis, that number would drop down to maybe 60% or something like that, because we have less of a presence with international investors, and that has to do with having international investment. We need broader international investment capabilities to attract more of that capital. And so we think we're at about 30% or so of our AUM comes from non-US institutions. We think we can push that to 40% to 50%. So there's a lot of growth opportunity there if we can build the capabilities. So it's focused on that emerging markets. We're not looking to plant new flags. We're looking to create scale in the markets we're already in by expanding those platforms.

We have \$5 billion worth of holding company liquidity. So what we'd call our highly liquid assets as of the end of the third quarter. Now, that number has been negatively impacted by the assumption update that we did earlier in the year, as I mentioned, and then we get to the market impacts in terms of what that's done to our AUM and our earnings. So, obviously, those were short-term impacts that would have meant that that number could have been even higher potentially as opposed to we didn't fund anything out of it, but does have an impact on how much cash came out of the system or could come out of the system.

Having said that, \$5 billion is at the upper end of our targeted range of \$3 billion to \$5 billion, and we have – therefore we believe all the financial flexibility we have both on-balance sheet and off-balance sheet and through additional transactions that we can do, that if we find something interesting to do from an M&A standpoint, we'll be able to execute against that. We're very confident in that. Having said that, we have been incredibly disciplined about acquisitions and we're going to continue to be so. We want to make sure that it fits well what I just described from a capabilities or scale standpoint and we're very sensitive to making sure the valuation works recognizing you have this war against balancing buybacks and M&A.

Alex Scott*Analyst, Goldman Sachs & Co. LLC*

All right, I think we're out of time. So, thank you very much for being with us.

Robert Michael Falzon*Vice Chairman, Prudential Financial, Inc.*

Yeah. Thanks, Alex.

Alex Scott

Analyst, Goldman Sachs & Co. LLC

Thank you, everyone.

Robert Michael Falzon

Vice Chairman, Prudential Financial, Inc.

Okay.

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