29-Oct-2015

Horace Mann Educators Corp. (HMN)

Q3 2015 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Greetings and welcome to the Horace Mann Third Quarter 2015 Earnings Conference Call. At this time, all participants are in a listen-only mode. A brief question-and-answer session will follow the formal presentation. [Operator Instructions] As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Ryan Greenier, Vice President, Investor Relations. Thank you sir, you may begin.

Ryan E. Greenier
Vice President-Investor Relations

Thank you, Christine and good morning, everyone. Welcome to Horace Mann's discussion of our third quarter results. Yesterday, we issued our earnings release and investor financial supplement and copies are available on the Investor page of our website. Our speakers today are Marita Zuraitis, President and Chief Executive Officer; and Dwayne Hallman, Executive Vice President and Chief Financial Officer. Bill Caldwell, Executive Vice President of Property and Casualty; and Matt Sharpe, the Executive Vice President of Annuity and Life are also available for the question-and-answer session that follows our prepared comments.

Before turning it over to Marita, I'd like to note that our presentation today includes forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995. The company cautions investors that any forward-looking statements include risks and uncertainties and are not guarantees of future performance. These forward-looking statements are based on management's current expectations, and we assume no obligation to update them. Actual results may differ materially, due to a variety of factors, which are described in our press release and SEC filings.

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In our prepared remarks, we may use some non-GAAP financial measures. Reconciliations of these measures to the most comparable GAAP measure are available in the supplemental sections of our press release.

And with that, I'll turn the call over to Marita Zuraitis.

Marita Zuraitis

President, Chief Executive Officer & Director

Thanks, Ryan and good morning, everyone, and welcome to our call. After yesterday's market close, Horace Mann reported third quarter operating income of $0.50 per share. This was a solid result, considering challenging external trends, including industry-wide increases in auto loss trends, equity market volatility, lower returns on alternative investments and impacts of continued low interest rates. Looking at the trends that were within our control, we like what we're seeing, the third quarter reported P&C combined ratio improved by almost 1 point to 95.4% and, on an underlying basis, we saw 1.4 points of improvement to 93.9%. On a year-to-date basis, the reported combined ratio improved by 1 point to 96.5%, which moves us closer to our goal of a mid-90s combined ratio.

Top line metrics in P&C are strong, with auto sales up 7% in the quarter. Importantly, we like the type and mix of business we're attracting and we see an increase in educator PIF count. Equity market declines result the in $0.03 of negative DAC unlocking in the annuity segment this quarter. Ex-DAC earnings reflected some pressure on returns from alternative investments.

We also generated modestly lower fee income on the variable annuity book, as a result of a lower average account value. In the life segment, we were pleased to see a more normalized level of mortality in the quarter. Reoccurring premium sales were similar to the prior year, but we did see a modest increase in single premium whole life sales.

On year-to-date basis, operating income was $1.58 per share. As we typically do in the third quarter, we revised our annual earnings per share guidance, and now expect full year 2015 operating income to be $2.10 to $2.20 per share. From a capital management perspective, we returned over $25 million to shareholders in the quarter. In addition to our quarterly dividend, equity market volatility provided an opportunity to deploy $15 million of share repurchases. Dwayne will provide more detail on both of these items later in the call.

Looking more closely at the P&C business, catastrophe losses in the quarter were relatively benign at 3.4 points. The fairly mild weather quarter contributed to the strong results in our property line. Rate actions, underwriting refinements and lower reinsurance costs continue to drive improvement in property and, on a year-to-date basis, underlying results have improved by more than 7 points.

The strong performance in property more than offset the current impact of the increases in auto severity that we noted last quarter. We, like much of the industry, are seeing higher physical damage and lost costs in new vehicles, but also in older vehicles, where relatively minor collision is more likely to result in a total loss.

In addition to physical damage severity, we are also experiencing a modest increase in BI severity. While we are helped by a more predictable group of customers, our educators are not totally immune from broader industry trends. We did see a non-material increase in auto frequency during the summer months, likely correlated with trends of lower gas prices and increases in miles driven. We are watching all of our auto loss trends carefully. And as we have said, auto profitability is a game of inches. We remain focused on improvement opportunities and are increasing our efforts, given those overall macro trends.

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Beginning last quarter, we accelerated our rate actions for certain segments and geographies and expect the fourth quarter to reflect the largest increase of the year. We will end the year at the high-end of our original auto rate plan of mid-single digits, which will help margins as these rate increases earn-in over the next 12 months.

But improving profitability isn't just about rate. As I've mentioned over the past few quarters, we've improved our defense by improving our analytics, gathering more data, and enhancing our pricing segmentation.

All of these efforts result in a more refined price for the risk we underwrite, and we are having a positive impact on profitability. And we continue to advance various loss containment initiatives in our claim organization, which is designed to provide incremental improvements in our overall loss ratio. That said, these positive impacts are currently being overshadowed by macro trends. As a result, we will continue to drive underwriting appropriate rate actions and continue our claims evolution to ensure we stay ahead of loss cost trends.

Looking at annuity. Assets under management grew by 5% and ended the quarter at nearly $6 billion. Annuity sales remained healthy and, in the quarter, agents sold over $100 million of new business. On a year-to-date basis, sales were up 9% and totaled nearly $280 million. One of our strategic priorities is to increase the amount of reoccurring sales, which are typically 403(b) payroll contributions.

These deposits are an integral component of an educator's retirement planning and, in our role as a trusted advisor, getting teachers started in retirement savings early in their career is critical. Our agents have responded, and sales of re-incurring products were up 10% in both the quarter and on a year-to-date basis. Late last week, we launched our new Indexed Universal Life product. The IUL product provides simple death benefit protection, combined with the potential of long-term contract value accumulation. And the product is designed to offer premium and face amount flexibility throughout the stages of an educator's life. The product is our first Universal Life offering and will replace a third-party product we currently market.

The introduction of our new IUL product fills out our product suite of Horace Mann manufactured life insurance products. We can now meet a variety of educators' needs from basic protection products to those designed to provide long-term protection with premium flexibility and cash accumulation features. This allows us to extend our reach into our educator households and their extended families.

In addition to the IUL launch, we also enhanced our term offerings with expanded underwriting segmentation and a more streamlined application process.

When I think about distribution, association relationships are a critical component in building brand awareness and deepening relationships in the education community. We have longstanding relationships with many national, state and local associations and are pleased to announce that we have strengthened our partnership with the AASA, a School Superintendents Association. This important association relationship will improve awareness and strengthen our relationships with nearly 10,000 key decision makers in the K-12 marketplace, and I'm excited about the opportunities that this new partnership will generate.

From a people standpoint, I'm pleased to announce that Allan Robinson recently joined Horace Mann as the Senior Vice President of Claims. I've worked with Allan closely in the past, and I'm confident in his ability to continue to enhance our claims capability and related claims experience. Before turning the call over to Dwayne, I wanted to note that this quarter marks my two-year anniversary as CEO. I'm very pleased with the advancements we've made to profitably grow all three segments of our business.

We've made good progress in P&C. The combined ratio was improved by nearly 3 points over the past two years. More refined pricing segmentation has contributed to the growth in auto policies. This is a substantial

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achievement. Our auto book is growing for the first time since 2007, and we've completed our property risk management exercises in Florida, essentially eliminating all homeowners' exposure in that state.

The introduction of the Fixed Indexed Annuity product exceeded our expectations. And for all of our annuity products, we are seeing strong sales, good reoccurring deposits and stable persistency, all of which contributed to the $700 million increase in assets under management over the past two years. And we have life back in our life business, with more agents integrating life insurance coverages as part of their overall plan to help customers achieve their financial goals.

The actions we've taken over the past two years have strengthened the foundational elements of our business and created a solid base to accelerate our growth. With last week's introduction of the new Indexed Universal Life product, our product set is largely complete.

We now have the ability to provide a comprehensive solution that protects what educators have today, while helping them prepare for their future. This full suite of products will help us further improve our cross-sell metrics and solidify our agents as trusted advisors in the education marketplace.

The advancements we've made in infrastructure over the past two years have also been significant. We've overhauled the life administration systems and are making progress on annuity. Our Customer Contact Center response times have improved and we've expanded service hours and added online capabilities.

These initiatives enabled us to launch new products, improve the agent and customer experience and, importantly, will efficiently support significant growth over time.

In 2016, we will begin the multi-year effort to modernize the P&C administration, claim and billing systems. These efforts are focused on ensuring we have modern efficient systems that provide ease of doing business to our customers and allow them to interact with us on their terms. And we've made progress in distribution. The core of the Horace Mann experience is a knowledgeable trusted advisor. Because of our focus on the niche market of educators, we know the issues educators and school districts face better than anyone else.

And we can build comprehensive solutions to help both districts and individual educators. We will continue to engrain this solutions orientation across our entire agency force. Our experience has shown that agents who help customer's design a holistic goal based financial plan that includes appropriate insurance risk protection are more successful. They have higher retention and cross-sell rates, attract more customers and have a deeper relationship with educators and school districts in their territories.

Our focus on the quality and expertise of our distribution has translated to increased productivity and an improved customer experience. I'm excited about the opportunities in front of us. We are clearly on the right path to becoming the preferred financial services and insurance provider of our nation's educators. And with that I'll turn the call over to Dwayne.

Dwayne D. Hallman

Chief Financial Officer & Executive Vice President

Thanks, Marita, and good morning everyone. Third quarter operating income was $0.50 per diluted share, $0.05 lower than the prior year, largely due to higher auto loss severities, lower investment income and negative DAC unlocking in annuity. P&C after tax income of $11.2 million was $0.6 million lower than the prior year quarter, largely due to a higher auto loss ratio, a reduced level of favorable prior-year reserve development and lowered net investment income.

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Included in this quarter's results was $5 million pre-tax or 3.4 points of catastrophe losses. Weather in the quarter was favorable, and both cat and non-cat property losses were lower than the prior year. The auto results for the quarter included one point of unfavorable current accident year development, marginally related to the second quarter. The development was mainly in physical damage, resulting from the emerging severity patterns. If you adjusted the quarterly results for such, you'd see that the second quarter and third quarter underlying auto loss ratios were very similar on an accident year basis.

On a year-to-date basis, the underlying auto combined ratio is up about 1.5 points, largely due to the macro trends and auto frequency and severities. As Marita said, we're accelerating our rate actions and looking closely at underwriting opportunities to ensure we remain on track to improve profitability. In the property line, we continue to see the benefit of rate actions, lower reinsurance cost, and the impact of our underwriting actions.

As I mentioned last quarter, our initial loss pick for more recent accident years continue to develop favorably and, obviously, influences the initial picks for the current accident year. All of these factors are contributing to the significant improvement in the underlying property combined ratio. On a year-to-date basis, it has improved by more than seven points and is the key driver of the 1-point improvement in the overall P&C combined ratio.

Third quarter catastrophe losses were relatively benign at $5 million and were mainly related to California wildfires and conductive storms in the Midwest. The level of third quarter catastrophe losses were quite favorable, marking the second year in a row for both us and the industry, where third quarter catastrophe losses were somewhat positive contributor compared to expectations.

Looking at the quarter's prior-year reserve development, we have $1.5 million of favorable development in auto, primarily within BI. Property contributed $1.3 million, marginally due to 2014 and 2013 accident years. On a year-to-date basis, favorable prior year reserve development totaled 2.3 points, a level very similar to the prior year.

The expense ratio this quarter was 26.6%, slightly below our previous run rate, largely due to the timing of various expense initiatives. P&C net investment income was impacted by negative returns within the alternative investment portfolio and, as a result, was about $2 million lower than the more typical quarterly results.

P&C written premiums increased 5% to $162 million in the quarter, largely on rate actions. Written premium for auto was up 5% and property increased 3%. Retention remained relatively stable in nearly 85% in auto and over 88% in property.

In the annuity segment, operating income excluding DAC unlocking was $9.9 million, $1.2 million lower than the prior-year quarter. Assets under management grew 5% to just under $6 billion, driven by persistency remaining closed to 95% and continued strong sales. The annualized net interest spread of 185 basis points declined 5 basis points over the quarter, consistent with our expected trend for 2015.

We continue to be disciplined in crediting rate management and are finding opportunities to put money to work at attractive risk-adjusted returns despite the challenging market environment. That said, this quarter's results also included lower returns on our alternative investments.

In the life segment, operating earnings, excluding DAC unlocking, declined $0.4 million to $3.6 million on higher mortality cost and lower investment income compared to the prior year. Mortality losses were in line with expectations for the quarter. We're seeing modest increases in premiums and contract deposits, reflecting the emerging signs of growth in this line.

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Consolidated net investment income was $81 million in the quarter, a decline of $1.6 million despite higher asset balances. Our limited partnership and alternative investments declined in value by $0.6 million in the quarter. While we typically see quarterly returns of $1 million to $2 million from this portfolio, it will experience more volatility returns than our core portfolio. But overall the performance remains solid. We have very few investments that are booked on the quarter lag. And given some early insight, we don't expect any negative income impacts in the fourth quarter.

The core fixed maturity portfolio performed well in the quarter, with new money yields exceeding our target reinvestment rate of 3.75%. Assuming a continued low interest rate environment, we expect yields to remain pressured in 2016, which will negatively impact the net interest spread.

As I mentioned last quarter, we utilized our credit facility to repay $75 million of senior notes. The interest rate on the credit facility is lower than the senior notes and, as a result, interest expense declined by about $1 million in the quarter. Our planned use of the credit facility was an integral part of our refinancing strategy. Based on our view over the last couple of years, the interest rates would continue to be low. We have an additional $125 million of senior debt maturing in April of 2016.

As you would expect, we are monitoring the capital markets for an appropriate window to refinance our total debt structure. Should we repay the remaining senior debt prior to year-end, we would expect to incur a make-whole premium of approximately $3 million, or roughly $0.05 per share. Overall, on a reported basis, book value per share was $32.09, which includes the net unrealized gain position of $143.2 million (sic) [$403.2 million] at the end of the quarter. Excluding net unrealized gains on investments, book value ended the quarter at $26.52, a 6.5% increase compared to last September.

Looking at this measure, over a longer period of time, the five-year compounded annual growth rate in Horace Mann's adjusted book value per share plus dividends was 11% through the third quarter. As Marita indicated, we repurchased 453,000 shares in the quarter at an average price of $33.22 compared to a VWAP of $34.58. The pullback in the equity markets resulted in an opportunity, in our view, to repurchase shares.

Factoring in this quarter's activity, we have approximately $7 million remaining on our current $50 million share repurchase authorization. As a result, the board authorized another $50 million at the September board meeting, and we expect to continue to be active in the market, should the opportunity present itself.

As we typically do in the third quarter, we are narrowing our full year guidance to reflect year-to-date results and our expectations for the fourth quarter. On a full-year basis, we expect operating earnings of $2.10 to $2.20 per diluted share. Within P&C, accelerated rate actions in emerging auto offense have increased our net written premium growth estimate to 4% to 5%. Retention remains stable, and auto sales growth has been better than anticipated. We are on track to produce 1 point to 2 points of total underlying P&C loss ratio improvement, which will result in a reported combined ratio in the mid-90s range.

As far as auto and property are concerned, we're expecting the current trends in auto severities to continue into the fourth quarter. In addition, our historical seasonal loss patterns for the final quarter of the year can be volatile and tends to produce the highest loss ratio quarter of the year, irrespective of the increased loss severity trend.

As a result, for the full year, we'd expect the auto underlying loss ratio to be a point or two higher than last year. Within property, we continue to see favorable loss trends, but we now expect to achieve 5 points to 7 points of full year underlying loss ratio improvement, given the strong results so far this year.

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In early October, we experienced an elevated level of losses as a result of the historical magnitude of rainfall in South Carolina. While many losses may contain uncovered flood claims, the significant rainfall did result in vehicle damage, roof leaks, sewer backup and damage to structures from fallen trees. As a result, we expect fourth quarter cats to be higher than last year, and we expect a full year cat load in the 7-point range.

Looking more closely at expenses, we have a number of infrastructure expenses forecasted for the fourth quarter, as well as a number of additional customer experience initiatives. These are included in our full year P&C expense ratio estimate of approximately 27 points. In addition, there is also modest expense increases expected in both annuity and life.

Turning to annuity. We expect net investment income to remain pressured due to the lower interest rate environment. As a result, we expect fourth quarter ex-DAC earnings to be similar to third quarter results. Our spread outlook hasn't changed, and we still expect to be in the mid-180s for the full year.

Spreads will continue to decline until we see a meaningful higher interest rate environment, given our current portfolio yields. Assuming model mortality, our life segment produces between $15 million and $17 million of earnings on an annual basis. In the first half of this year, mortality ran $2 million to $3 million ahead of our expectations. As a result, we are adjusting our annual estimate for the life segment downward to $13 million to $15 million to reflect year-to-date results.

Life sales should be modestly favorable to the prior year in the fourth quarter, as the new Indexed Universal Life product was launched last week. That said, we expect a 12 to 18 month ramp up, similar to what we experienced with the Fixed Indexed Annuity. As I mentioned earlier, should we refinance our April 2016 senior debt maturity before year-end, the make-whole premium would be approximately $0.05 per share. We have not included this in our guidance estimate.

We're on track to create a strong growth in both earnings and book value per share. Our focus is to produce solid results by growing profitably, having a full product suite, an ongoing focus on boosting agent productivity and continued execution on our technology improvements will accelerate our efforts to become the company of choice for educators.

Now I'll turn the call over to Ryan to start Q&A.

Ryan E. Greenier

Vice President-Investor Relations

Thanks, Dwayne. Christine, please open up the line to begin the Q&A portion of the call.

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QUESTION AND ANSWER SECTION

Operator: Thank you. We will now be conducting a question-and-answer session. [Operator Instructions] Thank you. Our first question comes from the line of Bob Glasspiegel, with Janney Montgomery Scott. Please proceed with your question.

Robert R. Glasspiegel
Janney Montgomery Scott LLC
Q

Good morning Horace Mann and congratulations, Marita, on your two-year anniversary.

Marita Zuraitis
President, Chief Executive Officer & Director
A

Thanks, Bob, and good morning.

Robert R. Glasspiegel
Janney Montgomery Scott LLC
Q

On your modernization plan for 2016 that you were referring to, maybe a little bit of color on what are the highlights and how much an expense ratio it might cost?

Marita Zuraitis
President, Chief Executive Officer & Director
A

Yeah. Before I pull it – turn it over to Bill, to see if Bill wants to comment, you saw what we did in the life and annuity space, very thoughtful approach to infrastructure improvement over a multi-year, and we still have yet to complete the annuity portions of that. As that rolls off, we're rolling into modernizing our P&C systems. And as we've said before, we elevated our expense ratio projections and still expect to see some of these expenses come through in the fourth quarter and what we believe we can do over time is update our P&C infrastructure, the way we have life and annuity, at that new run rate that we talked about.

So, I feel good that we took a thoughtful approach to a multi-year effort to improve our infrastructure. And I often talk internally about premium being fueled and by having momentum in all of our businesses, it's worked out the way we had hoped where our increase in momentum can fund some of these infrastructure projects that we've talked about, but it is fundamentally a modernization of our administration and billing and claims platform over a multiple of years.

Dwayne D. Hallman
Chief Financial Officer & Executive Vice President
A

Hey, Bob. This is Dwayne. If I can just add one point. Several years ago, we made some pretty significant investments on P&C, implementing new software for both on the front-end, the rating end, et cetera. And about the time that comes to an end from a depreciation standpoint, if we time this right would be the time that new expense would begin to roll for new claims admin, et cetera, systems. So, you won't see a big jump in the expense ratio given the timing of the projects.

Marita Zuraitis
President, Chief Executive Officer & Director
A

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And that's a great point, Dwayne. I mean, we made a conscious effort that we would do a full infrastructure upgrade in ALG life and annuity right out of the box, but we haven't done anything from a P&C perspective. From a technology perspective, things like Property Portal, Auto IQ – and these are internal names for us, but think about it as friendly front-ends to make it easier for our customers and agents to use our systems. So, we're not waiting for full modernization. We're pulling forward those things that help our customers and our agents work with us but we will then turn that over as ALG rolls-off using those funds for full P&C modernization.

Robert R. Glasspiegel
Janney Montgomery Scott LLC

Q

Okay. Thank you. Great to see the property results improving. Of course my questions are going to be on auto. You've been pushing mid-single-digit rate increases through and results are deteriorating. And this is something we're seeing with a lot of competitors, the trends that you're highlighting, actually, more on the frequency side than the severity side, which you're highlighting. But there seems to be a bifurcation of – some companies are holding in and reporting stable results and the others are struggling. Is there something more significant going on? It's just an industry thing? Is there – you need intelligent devices in cars. Is it something about your book of business? Is there adverse selection going on? As you would think mid-single-digit rate increases for year would be enough to be able to stabilize margins?

William J. Caldwell
Executive Vice President-Property & Casualty

A

Hey Bob, its Bill Caldwell.

Robert R. Glasspiegel
Janney Montgomery Scott LLC

Q

Hey, Bill.

William J. Caldwell
Executive Vice President-Property & Casualty

A

Hey, how are you? Obviously we're...

Robert R. Glasspiegel
Janney Montgomery Scott LLC

Q

Hanging in there.

William J. Caldwell
Executive Vice President-Property & Casualty

A

Obviously, we're closely monitoring the trends for auto, both for Horace Mann and for the industry. I'll take a shot at unpacking some of this for you. There was a lot in that question and, hopefully, I could hit most of it.

So, when we break it down by frequency, we do think there is benefit of our book. When you consider all these macro trends around annual mileage and gas prices, we're certainly not completely insulated from them. And as Marita said in the script, we did see a modest increase in property damage over the summer. Fortunately, that was a decreasing trend, so July was high, August was lower and then September was at a more normalized rate. So, obviously we'll continue to watch that going into October.

On the severity side, this was the majority of our deviation from prior Q3 loss ratio. As we mentioned in the last quarter, the dual effect of more newer cars with expensive technologies, as you mentioned, combined with older

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cars on the road, they're just totaled more easily, because their values are so low. A small rear-end in the parking lot with the technology even in a eight or nine-year-old car could cause that car to be totaled because of the estimate to repair that technology compared to the relative value of the car.

Average vehicle age on the road is increasing. We're seeing the oldest fleet that we've ever seen was about 11.5 years old, I believe, now for the industry. Our age is increasing as well. We do have a slightly younger book, but that does impact the severities on the growing segments of our book, which would be newer and older cars.

Also, bodily injury and severity was up modestly. Medical costs are outpacing CPI and more serious accidents caused by – some of those miles are the city and some of those miles are on highways, and those accidents on highways tend to be more severe.

Then we placed it by geography. We look at this by state, by quarter. We have our drill in place. When you cut it by the major coverages [ph] the IPG collision (33:07), nothing really jumps off the page. Of course we have states that are worse than average and we have rate drills and we have underwriting drills and we have claims drills. And we'll intensify those actions as we see a state that needs more action. Conversely, if we have states better than average, too, where we'll invest in marketing programs and our agents and try to bring in more business on those states.

You take California, for example, it's a state with a lot of educators and a lot of miles, so there's a lot of places to drive in California. We'd note that the miles driven are up significantly. And you think about the industry versus Horace Mann, we don't write a lot in Los Angeles or San Francisco, which you think would be higher frequency areas, you know the bumper-to-bumper traffic, smaller accidents. Our book of business is mostly rural and suburban, so some of those additional miles maybe on the highway, where we could see again those more severe accidents, which impact both frequency – impact both liability and physical damage.

But at the end of the day, it's a profitable book of business. We consistently beat the industry loss ratios year-over-year, and it's important to remember that we manage the household. So, this auto book is heavily cross-sold, so those cross-sold units tend to be property and tend to be annuities, which increases the margin in the educator household.

Marita Zuraitis
President, Chief Executive Officer & Director

A

And Bob, you mentioned in your question, you used the word struggle, I think you can tell from Bill's comments that it's really not a struggle for us, but it is a game of interest. And when we think about auto, it's just a series of dials, and this is a time where you've got to tighten some of those dials. But I do know that we've got good data and good analytics, and we'll be tightening some of those dials. You also mentioned the rate plan 2016 will obviously have more rate in it than we had in 2015, because that's one of the dials that you can tighten.

I'd also remind you, and Bill brought it up at the end there, that our educator niche segment is unique, and this is a time when our total accounts sale really pays-off for us. We don't think about ourselves as an auto carrier exclusively; we think about ourselves as a total account provider. We've got home and auto and, in this quarter, home helped. We've got annuity and life. And in many quarters, annuity and life helped.

So, that total accounts sale not only brings value to our customer, and also increases our retention – and you see that in our retention numbers being better than industry averages. It also helps us from a mix perspective in our finances that we have all those lines working in our favor. So, I'm not overly concerned about the auto line. We'll tighten up our dials and, as you know, auto tends to be relatively short and price certainly will help, but we have other dials to tighten as well.

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William J. Caldwell
Executive Vice President-Property & Casualty
A

And Bob, just a little bit more on the rate. We obviously did recognize this in the second quarter. We're a pretty nimble company. When we say our highest effective rates will be in the fourth quarter, that really isn't a small feat when you consider the analysis recognizing and analyzing it, filing and that becoming effective. So, we did recognize it last quarter, and we're able to react within the calendar year, which is pretty unusual.

Robert R. Glasspiegel
Janney Montgomery Scott LLC
Q

Well, that's encouraging and thoughtful answer. It sounds like you're not worried about adverse selection at all being an issue.

William J. Caldwell
Executive Vice President-Property & Casualty
A

No, I think that would be a frequency problem, Bob. And again, we look at our new business coming in. We're excited about the trajectory. We understand there is a new business penalty associated, but we look at the lifetime value of the customer. So, I would be concerned if I started to see a frequency problem. We're just not seeing it yet.

Marita Zuraitis
President, Chief Executive Officer & Director
A

Our educator niche...

Robert R. Glasspiegel
Janney Montgomery Scott LLC
Q

Thank you.

Marita Zuraitis
President, Chief Executive Officer & Director
A

Our educator niche also helps us from an anti-adverse selection, if you will. We are dealing with homogeneous set of customers here. We're not in the broad populous.

Robert R. Glasspiegel
Janney Montgomery Scott LLC
Q

Fair point. Thank you.

Marita Zuraitis
President, Chief Executive Officer & Director
A

You're welcome.

William J. Caldwell
Executive Vice President-Property & Casualty
A

Thanks, Bob.

Operator: Our next question comes from the line of Meyer Shields with KBW. Please proceed with your question.

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Meyer Shields
Keefe, Bruyette & Woods, Inc.

Q

Thanks. I'm going to focus on auto also, if that's okay. When you look at the most relevant competitors, are you seeing a change in their pricing dynamics? In other words, as you push more rate, does that impede your competitive position?

William J. Caldwell
Executive Vice President-Property & Casualty

A

Thanks, Meyer. We obviously follow our competitors closely. Rates are filed. So, it's public information. We have an internal tracking system. So, we are watching rates. We feel the increase that we're taking rate matches for industry. We also know the elasticity of our customers, which again tend to be more cross-sold. So, we understand where that inflection point is when we tend to impact retention, and we try to stay outside of those bounds. But considering that we're moving in line with the industry at about the same rate, at about the same time, I don't expect material impacts to retention or even new business sales.

Meyer Shields
Keefe, Bruyette & Woods, Inc.

Q

Okay, that's helpful. Also you mentioned that one of the drivers of severity are older cars that are more easily totaled. Do you have a sense, when you talk about older cars, I guess as a sort of a rule of thumb that it's not worth buying physical damage for cars more than seven years old, because the premiums outweigh any payments you would get. Does that hold for your book or is there a greater propensity for older vehicles to carry physical damage coverage?

William J. Caldwell
Executive Vice President-Property & Casualty

A

Yeah. Keep in mind we have a very conservative base. We tend to see more physical damage, sometimes we tend to see lower deductibles than I've seen in my past. Of course we price for that. But there's also the issue of these cars are – they're running longer because they weren't used during the recession, so they do have more perceived value to the customer. So, a lot of customers are carrying physical damage. And sometimes that's just the momentum they've had, or inertia as the case may be, they just haven't taken it off. But we are considerate of that and we reflect that in our pricing.

Meyer Shields
Keefe, Bruyette & Woods, Inc.

Q

Okay. And then final question, I guess, on the property side, I think, Dwayne mentioned that there was a little bit of a true-up of second quarter losses in the auto side. Was there any of the sort of opposite impact in property?

Dwayne D. Hallman
Chief Financial Officer & Executive Vice President

A

This is Dwayne. No, in property, there wasn't an impact between the second quarter and third quarter.

Meyer Shields
Keefe, Bruyette & Woods, Inc.

Q

Okay, perfect. Thanks so much, guys.

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Operator: Our next question comes from the line of Sean Dargan with Macquarie. Please proceed with your question.

Sean Dargan
Macquarie Capital (USA), Inc.

Q

Thanks, and good morning. I'll leave auto aside.

William J. Caldwell
Executive Vice President-Property & Casualty

A

Thank you.

Sean Dargan
Macquarie Capital (USA), Inc.

Q

I'm just wondering, as you re-visit your actuarial assumptions, has anything changed in your long-term interest rate view. With some other life companies, we've seen some DAC charges related to the interest rate piece on their life and annuity books. Just wondering, if anything has changed in your assumptions as regards to interest rates?

Matthew P. Sharpe
Executive Vice President-Annuity & Life Division

A

Sean, it's Matt, how are you? No, there hasn't been a change in the assumptions. The DAC experience you're seeing this quarter is driven by the equity market performance. Other than that, we haven't changed any assumptions.

Sean Dargan
Macquarie Capital (USA), Inc.

Q

Okay.

William J. Caldwell
Executive Vice President-Property & Casualty

A

As far as our total review of our DAC, as you mentioned some companies perform that review during the third quarter and begin to book some adjustment to that, depending on what their underlying book is. As you can guess with Horace Mann, as we consistently are, conservative in our estimates. Our actuaries in the midst of doing the same exercise, we do it as of the end of 9/30, going into the fourth quarter. But at this point, we would not anticipate any sizable DAC adjustment like you're beginning to see with some other carriers.

Sean Dargan
Macquarie Capital (USA), Inc.

Q

Okay. So, that DAC amortization or annuities was related to variable annuities then?

Dwayne D. Hallman
Chief Financial Officer & Executive Vice President

A

Yeah, it's the performance of the market that drove the [indiscernible] (41:36) in the third quarter.

Sean Dargan
Macquarie Capital (USA), Inc.

Q

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Okay. And then, you mentioned that mortality experience returned to a normalized range. But it's still unfavorable compared to the experience of the past several years. I'm just wondering what's going on in that book? Is it that the average policyholder is now older and is dying more frequently and you don't have enough premiums to, I guess, offset the pressure on the benefit ratio?

Dwayne D. Hallman
Chief Financial Officer & Executive Vice President

A

Yeah, the mortality was in line with expectations for this quarter, moderated a little bit from the prior couple of quarters, but it was in line with our expectations. Our book is a relatively mature book and, over time, the mortality is going to track with the aging of that book. We're not seeing any early duration mortality issues. It's all coming in the late durations – in the later durations in the book. So, that's, to us, it's just normal mortality.

Sean Dargan
Macquarie Capital (USA), Inc.

Q

Okay. I guess, the concern is, are you putting enough new premiums on the books to moderate the trend towards older age mortality?

Dwayne D. Hallman
Chief Financial Officer & Executive Vice President

A

Yeah. So, let me add a little bit more color there. So, we've been emphasizing the growth in the Horace Mann life insurance sales for the last four years or so. Overtime, we moved away from proprietary products and went towards third-party products. Over the last four years, we've been pulling all those third-party products back on to our own paper and trying to re-grow the life insurance book. Marita refers to it as putting life back into the life insurance business. That's what she is getting at. As we want to continue to grow that book at a double-digit growth rate to try and offset the older book, as well as the fact that we went away from selling our own product, selling third-party products in the past.

Sean Dargan
Macquarie Capital (USA), Inc.

Q

Okay, got it. Thanks.

Operator: Our next question comes from the line of Tim Hasara with Kennedy Capital. Please proceed with your question.

Timothy Paul Hasara
Kennedy Capital Management, Inc.

Q

What percent of your portfolio is in alternatives exactly?

Dwayne D. Hallman
Chief Financial Officer & Executive Vice President

A

Tim, this is Dwayne Hallman, just to give you an idea, we have about $165 million in alternatives, and that's made up of real estate private equities and structured corporate credit and some infrastructure. So, the portfolio as a whole, I would put it in the immaterial bucket, but when you have a poor performance, like we did experience, it does tend to pop its head out every once in a while.

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Timothy Paul Hasara
Kennedy Capital Management, Inc.

Q

Can you explain exactly what occurred in the poor performance there? Do you have – and do you have hedge funds in that allocation?

Dwayne D. Hallman
Chief Financial Officer & Executive Vice President

A

Yeah. We have a hedge fund – a couple of hedge funds in the allocation. One was – it still performed positive during the quarter, but substantially less than our run rate. And as I mentioned in our opening comments on the P&C side, there was one that actually experienced some negative returns during the quarter. But if I recall correctly, it's been positive performance for every quarter probably over a two-and-half year period. This is really the first quarter we've seen. I mean you're familiar with the markets and it was a tough quarter, and these are arenas where that would certainly show-up outside of just the pure equity market.

Timothy Paul Hasara
Kennedy Capital Management, Inc.

Q

Perfect and one of the – are you anticipating any investment allocation changes in that particular sector, or any other material changes?

Marita Zuraitis
President, Chief Executive Officer & Director

A

Tim, not at this time.

Timothy Paul Hasara
Kennedy Capital Management, Inc.

Q

Okay, thank you.

Operator: Mr. Greenier, we have no further questions at this time. I would now like to turn the floor back over to you for closing comments.

Ryan E. Greenier
Vice President-Investor Relations

Thank you for joining us this morning on Horace Mann's third quarter earnings call. If there any further questions, please don't hesitate to reach out to me or Kristi Niles. Thanks.

Operator: Ladies and gentlemen, this does conclude today's teleconference. You may disconnect your lines at this time. Thank you for your participation, and have a wonderful day.

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