

FINAL TRANSCRIPT

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MFC - Q2 2009 Manulife Financial Corporation Earnings Conference Call

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PRESENTATION

Operator

Good afternoon and welcome to the Manulife Financial Q2 2009 financial results conference call for August 6, 2009. Your host for today will be Amir Gorgi. Please go ahead.

Amir Gorgi - *Manulife Financial Corp. - VP,IR*

Thank you and good afternoon. I would like to welcome everyone to Manulife Financial's earnings conference call to discuss our second-quarter 2009 financial and operating results. If anyone has not yet received our earnings announcement, statistical package and slides for this conference call and webcast, these are available in the Investor Relations section of our website at Manulife.com.

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As in prior quarters, our executives will be making some introductory comments. We will then follow with a question-and-answer session. The speakers who follow may make forward-looking statements within the meaning of securities legislation. Certain material factors or assumptions are applied in making forward-looking statements and actual results may differ materially from those expressed or implied in these statements. For additional information about material factors or assumptions (inaudible) and about material factors that may cause actual results to differ, please consult the slide presentation for this conference call and webcast available on our website, as well as the securities filings referred to in the slides entitled Caution Regarding Forward-Looking Statements.

When we reach the question-and-answer portion of the conference call, we would ask each participant to adhere to a limit of one or two questions. If you have additional questions, please requeue and we will do our best to respond to all questions. With that, I would like to turn the call over to Donald Guloien, our President and Chief Executive Officer.

Donald Guloien - *Manulife Financial Corp. - President & CEO*

Thank you, Amir and good afternoon, ladies and gentlemen. Thank you for joining us on this call. Overall, we were very pleased with our strong second quarter earnings, benefiting, as expected, from rallying equity markets.

We are also very pleased with our progress in business growth, growth in new business embedded value, rebalancing and derisking of our product mix, increasing our in-force hedging, our ongoing strong asset quality and our increased capital strength.

Across our businesses, our people are doing a good job of cost containment and we are benefiting as customers make the flight to strong, trustworthy and reliable brands like Manulife and John Hancock.

You've seen our key financial headlines, reporting earnings for the second quarter of C\$1.774 billion or C\$1.09 per share and this produces a very strong return on equity of 26.9%.

I do want to caution you that C\$1.7 billion and 26.9% are not run rates and later in our presentation, Michael Bell, our CFO, will address my promise of sharing our sense of normalized earnings and ROE going forward.

I want to address right off the top our decision to reduce the common dividend in order to retain more of our earnings. A few points on this. Number one, this decision followed a very thorough capital review with our Board. We were fully aware that reducing the dividend would not be popular in some quarters, but it is exactly what you would expect a financially disciplined company to do under these circumstances. It is in keeping with our decision to build fortress capital levels, which will provide more flexibility to respond to both risks and opportunities from a continued position of strength.

Reducing the dividend and retaining more of our earnings is the most economical means of preserving and building capital that will further cushion us from risk and support growth of all types.

While we recognize the importance of the dividend to shareholders and we did not take this change lightly, we believe our revised dividend continues to provide an attractive yield in line with the TSX 60, but more importantly that long-term shareholders will benefit as we deploy our capital to take advantage of both organic and strategic growth opportunities.

I will also point out that almost every one of our international competitors has already reduced their dividend, many by more than 50% and some on more than one occasion, which we don't intend to do. And some people have already commented Manulife is making this change from a position of strength in an environment where there is discernable flight to quality taking place.



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Later in today's call, John DesPrez will speak to our solid business results, but we also have the benefit of having Bob Cook, Jim Boyle and Paul Rooney with us to talk about Asia, the United States and the Canadian markets. So I hope you'll take advantage of their presence in the Q&A session that follows.

So before I turn the mic over to Mike Bell, I want to comment on how pleased I am with our recent management succession. First, I want to formally welcome Mike Bell as Chief Financial Officer. Mike is a seasoned international insurance executive with an outstanding track record as a public company CFO, a financial leader, a risk manager, investment manager, business head and team builder.

At the same time, I want to thank Peter Rubenovitch for his 14 years of distinguished service to Manulife. Peter played a key role in our demutualization, most of our acquisition and divestiture transactions and has also been instrumental in all of Manulife's capital markets activities.

Next, I want to acknowledge the appointment of Jim Boyle as President of John Hancock Financial Services, succeeding John DesPrez in leading our US business.

And Warren Thomson, who was appointed as Chief Investment Officer succeeding me and Scott Hartz is now Executive Vice President, General Account Investments, overseeing C\$180 billion in general account assets. All of these people are on the call with us today and prepared to take your questions. With that, I would like to ask Mike to take us through the financials in more detail. Mike?

Michael Bell - *Manulife Financial Corp. - SEVP & CFO*

Thanks, Donald. Hello, everyone. Today, we reported second-quarter earnings of C\$1.774 billion and earnings per share of C\$1.09. This quarter's earnings benefited from the significant increase in global equity markets, partially offset by the impact of lower corporate bond rates.

Now I would ask you to refer to slide 9, which provides a summary breakdown of the notable items that impacted this quarter's earnings. As noted on the slide, the strong global equity market performance in the quarter resulted in net gains of nearly C\$2.6 billion, the majority of which were driven by reserve releases for our guaranteed seg funds.

In addition, as noted in our June 19 press release, we experienced the negative impact of interest rate changes in the second quarter. This amounted to approximately C\$1.1 billion, which I will detail in a few minutes. We also continued to see emerging unfavorable experience for policyholder behavior related to seg fund guarantees. And in the second-quarter results, we recorded a C\$181 million after-tax charge for updated policyholder behavior, specifically for lower partial withdrawals in Japan.

In addition, we see emerging unfavorable experience in other areas of policyholder behavior. We expect to complete our annual review of all actuarial assumptions in the third quarter. And as it relates specifically to policyholder behavior on seg fund products, our preliminary analysis suggests that the third-quarter review could entail additional actuarial liability strengthening.

Now at this point, we expect that we could have an additional reserve strengthening not currently expected to exceed C\$500 million after-tax for this item. And we will obviously provide an update as we complete our analysis in the future.

Now in terms of the broader annual full review of all of our actuarial assumptions for our balance sheet, we also see other areas of emerging pressure, particularly related to economic and market-related investment assumptions and policyholder behavior in other lines. So as a result, all in, we expect that the third-quarter valuation basis change impact will be a net negative.

Now at this time, we choose not to speculate on the amount of this impact, but given that we have C\$144 billion of actuarial liabilities on our balance sheet, even a small change would likely result in a material charge to net income in the third quarter.



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Now I will finish the recap of second-quarter results. Provisions for credit impairments and reserve strengthening for downgrades totaled C\$215 million in the quarter. Also in the quarter, we increased our tax-related provisions on leveraged lease investments, which reduced after-tax income by C\$139 million. So collectively, these items totaled C\$998 million of favorable earnings impact and excluding these items, our adjusted earnings for the second quarter totaled C\$776 million after-tax.

Now on slide 10, this details the impact of equity markets on our results in the second quarter. As noted, equity markets returned over 15% for several key indices across the globe. Of the C\$2.6 billion of net gains related to equity markets, nearly C\$2.4 billion related to the after-tax impact of the release of reserves for seg fund guarantees. And these earnings were subject to lower average rates of taxation consistent with our recent past. And in fact, you can see the impact of this in our effective tax rate for our consolidated results in the quarter.

Now as shown on the slide, the remaining C\$190 million in net equity-related gains included the impacts of increases in the equity values supporting our liability segments, lower variable life reserves and higher fee income. And partially offsetting these items was C\$53 million of negative impact from other-than-temporary impairments accrued on equity positions in the corporate and other segment.

So turning now to slide of 11, the decline in corporate bond rates and the other investment-related items resulted in net charges of C\$1.13 billion in the quarter. This non-cash charge arose primarily as a result of the net lower interest rates assumed in the valuation of our policy liabilities. This impact was partially offset by interest rate gains that were based on fair value and incurred in favorable tax jurisdictions. Now the latter also impacted our consolidated effective tax rate in the quarter.

Now to provide background on the negative interest rate impact, I would note that our actuarial valuation methodology incorporates market-based interest rates on the reinvestment of net projected cash flows. These cash flows include the expected cash flows of current investment and derivative holdings, combined with the projected policyholder cash flows such as premiums and claims.

Now importantly, our derivative holdings reduce a portion of our open interest rate position associated with the net future cash flows. Said another way, our derivatives reduce the difference between the duration of our assets and our liabilities; however, they do not eliminate the difference nor do they reduce the risk of changes to credit spreads.

Our projected cash flows are impacted by both current market corporate bond rates and spreads between interest rate swaps and corporate bond rates. And as a result, decreases in corporate bond rates and decreases in spreads between the interest rate swaps and corporate bond rates both resulted in an increase in policy liabilities and therefore charged to earnings in the second quarter.

Now specifically during the quarter, long maturity corporate bond rates declined by approximately 80 basis points in both Canada and the US and corporate spreads narrowed significantly. So all in, these interest rate changes and other fixed income-related items resulted in non-cash charges of C\$1.1 billion.

In addition, we have updated our estimated earnings sensitivity to parallel changes in interest rates. And we now estimate that a 1% parallel decrease in interest rates would result in a charge of approximately C\$1.5 billion after-tax.

Turning now to slide 12, you can see that after-tax charges for credit impairments and credit downgrades totaled C\$215 million in the quarter. Net credit impairments were C\$109 million after-tax, nearly half of which related to our RMBS holdings, reflecting an increase in the anticipated losses on the underlying residential mortgages.

This quarter, a charge of C\$106 million was recorded for the reserve impact of credit downgrades and these downgrades largely related to corporate bonds and CMBS and CDO holdings.



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I would also note that included in the C\$215 million impact to second-quarter income is a C\$61 million total after-tax charge related to CIT debt.

Now in light of the challenging macroeconomic environment, we continue to be satisfied with the credit performance of our investment portfolio.

Turning to our source of earnings on slide 13. The impact of the investment markets on our second-quarter results mainly influences the experience gains component in this summary, which you can see improved significantly versus the first quarter this year.

Expected profit on in-force was up significantly over the second quarter of 2008, largely due to favorable currency movements and net growth in the book of business.

The impact of new business has improved over prior periods primarily as a result of higher priced products for new sales and favorable business mix shifts.

The significant net experience gain reported was primarily driven by the notable items discussed earlier with earnings due to very strong equity markets being partially offset by the negative impact of interest rates and credit charges.

Investment markets also impacted earnings on surplus where the OTTI charges on equities and credit impairments that I mentioned earlier led to a pre-tax loss of C\$21 million.

Management actions and changes in assumptions reflect reserve strengthening due to updated policyholder behavior assumptions that I described earlier, specifically those related to partial withdrawals in the Japan variable annuity business, largely offset by a net release from modeling refinements across a number of businesses.

Because a portion of the equity-related earnings, as well as some interest-related gains were incurred in jurisdictions with lower tax rates than those where the losses were incurred, we reported a net tax recovery in the quarter. Now excluding the notable items detailed on slide 9, the effective tax rate on our earnings this quarter was similar to that of the prior year.

Now on slide 14, we have provided summary metrics for our reserves and capital in relation to seg fund guarantees. With a significant rebound in global equity markets in the second quarter, the reported amount at risk has decreased from C\$30 billion in the prior quarter to C\$21 billion as of June 30.

As a result, balance sheet reserves decreased from C\$7.7 billion to C\$3.5 billion and as well the expected net cost of guarantees as measured by projected claims less projected revenue from guaranteed fees improved from an anticipated loss of C\$639 million in the prior quarter to a projected pre-tax profit of C\$980 million measured at June 30.

Now as outlined on the slide, since the expected profit is C\$980 million, the entire balance sheet reserve of C\$3.5 billion is a margin for adverse deviation. So this quarter, our balance sheet reserves plus 200% of required capital for these guarantees, now exceeds the expected result by over C\$10 billion.

At quarter end, our seg fund reserves were at the CTE70 level and approximately C\$14.5 billion of guaranteed value, which is approximately 14% of the total book net of reinsurance has been hedged.

Now on slide 15, we provided an updated estimate of capital and earnings sensitivities going forward. Specifically, MLI's reported in MCCR ratio was 242% at quarter end. A 10% equity market correction from quarter end levels is estimated to result in a decline of approximately 20 points in this ratio.



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From a consolidated earnings perspective, we estimate that a one-time equity market correction of 10%, followed by normal market growth at assumed levels, would reduce reported earnings by approximately C\$1.5 billion after-tax. And the observed decrease in sensitivity relative to first quarter is largely due to the lower in-the-moneyness of these exposures.

I will now take a moment to provide a brief update on our investment portfolio, which continues to perform well in light of the challenging economic environment.

As summarized on slide 16, our investment portfolio continues to be of high quality and well diversified. Our portfolio is well-positioned for the current downturn and we have limited exposure to noteworthy items. For example, we have no exposure to hedge funds.

We have also provided on slide 17 a detailed update on gross unrealized losses on our fixed income securities, as well as the progression over the last three quarters. Due to general spread narrowing, gross unrealized losses declined 45% sequentially to C\$5 billion and represent a relatively modest 5% of our total fixed income portfolio.

As previously indicated, we expect to have the ability to hold these securities until maturity and have provided for expected level of defaults in our actuarial reserves.

Now I would like to take a look at our relative divisional performance, as well as discuss our expectations for normalized earnings going forward. I am going to ask you to turn to slide 18. As we have done in the prior two quarters, we provide a year over year variance in earnings at the divisional level, adjusted to exclude market and investment-related variances bases changes and significant nonrecurring items.

Excluding these items in both periods, earnings in the second quarter were slightly higher than prior year levels. Specifically, favorable claim experience in Canada's Group Benefits business and additional income in Japan on higher seg fund reserves were partially offset by adverse lapse experience in the US and lower corporate results due to the absence of realized AFS gains, as well as higher debt costs.

Now given the continued volatility in capital markets and their impact on our reported results, both positive and negative, we believe that this type of analysis is a valuable way of assessing our underlying operational performance.

Slide 19 provides a summary of our expectations of normalized earnings for the remainder of 2009 and 2010. Very importantly, our expectations are based upon our book of business, 2% per quarter equity market appreciation, constant currency from June 30 and no unusual interest rate movements.

On this basis, we estimate normalized earnings of C\$750 million to C\$850 million after-tax per quarter. Now to be clear, we are not providing earnings guidance, particularly since no one can predict near-term market conditions with confidence.

I would also point out that our current estimated normalized earnings would imply a normalized ROE of approximately 12% with our longer-term objective being a higher ROE over time.

Turning to capital on slide 20, we are in the process of strengthening our capital position and building towards fortress levels of capital. Now we define fortress capital as providing the financial flexibility to weather many potential scenarios without being forced to raise common equity under adverse circumstances.

We also expect fortress capital to position our Company to take advantage of attractive organic growth and acquisition opportunities in the future. Now particularly during these turbulent times, we expect our long-term shareholders will benefit from maintaining strong financial strength ratings and strong capital ratios.



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Now to be clear, achieving fortress capital does not mean that we could weather any conceivable storm or that we intend to permanently accumulate significant excess capital as a potential contingency for acquisitions.

We expect to ultimately achieve fortress capital by delivering strong operating earnings through focused execution on the fundamentals and maintaining very prudent capital management.

Reducing common shareholder dividends also plays a key role in our path towards fortress capital as it enables us to accelerate the timetable to achieve fortress capital levels by retaining an additional C\$800 million per year at an implicit cost of capital that is lower than our other alternatives.

Now during the quarter, as summarized on slide 21, we successfully completed close to C\$2 billion of attractive financing transactions, which were primarily used to repay and refinance existing debt. The successful financings included C\$350 million through a new preferred share issue and C\$1.6 billion through two medium-term note offerings.

The newly issued preferred shares are non-cumulative five-year rate resets with initial yield of 5.6%. Of the newly issued medium-term debt, the five-year C\$1 billion note pays a fixed rate of just less than 4.9%, while the 10-year C\$600 million note pays a fixed rate of nearly 7.8%. Both notes constitute senior indebtedness pursuant to our medium-term debt program.

As shown on slide 22, subsequent to the end of the quarter, the Company raised an additional C\$1 billion through the issuance of innovative Tier 1 notes. The notes pay 7.4% per annum for the first 10 years.

And then finally on slide 23, you will note that our strong capital position continued to improve over prior levels. Specifically, MLI's second-quarter consolidated MCCR ratio was 242%, up from 228% in the first quarter of 2009. The increase in this quarter's MCCR primarily reflects the impact of strong reported earnings.

So overall, we had strong results in the quarter primarily reflecting strong equity markets. We strengthened our capital position, but expect to do more to ultimately achieve fortress capital levels. With that, I would like to pass it over to John who will provide an operational summary. John?

John DesPrez - *Manulife Financial Corp. - COO*

Thanks, Mike and good afternoon, everyone. Starting with slide 25, a few remarks on business operations. Insurance sales for the quarter were up 2% from prior year levels, but down 8% on a constant currency basis. Strong sales in Japan were offset by declines in the United States and Canada. Overall sales in the US improved significantly over the prior quarter, but were down from strong year ago levels. Life sales were down 29% and long-term care sales down 10%.

Life sales reflected the consumer trends to smaller policies and lower premium products. However, the sales environment has improved somewhat from the start of the year with the business experiencing strong new business applications and increasing sales.

During the quarter, John Hancock was named the sole carrier for the Federal Long Term Care Insurance Program, the largest employer-sponsored long term care insurance program in the United States.

In Canada, overall sales were in line with prior year levels with Group Benefits sales increased by 8% partially offsetting the 13% decline in individual life sales. While individual sales were down primarily due to strong whole life sales in the prior year, Group Benefit sales were up on growth in mid- and large case accounts and distribution expansion.

In Asia, overall insurance sales exceed prior year levels by 24%. Japan sales almost doubled prior year volumes driven by continued success of its new insurance offerings. All sales in Hong Kong improved considerably over the first quarter of 2009.



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Turning to Wealth sales on slide 26. Sales for the quarter were down 11% or 19% on a constant currency basis as continued strong growth in fixed products in the United States and Canada were more than offset by declines in sales of variable annuities across all geographies.

Variable annuity sales declined by 30% compared to the second quarter of 2008 as a result of risk management initiatives and weaker economic conditions. Excluding variable annuity sales, total Wealth sales were up 5% over prior year levels, but down 5% on a constant currency basis.

In the United States, Wealth sales, excluding variable annuity products, increased by 16% over the first quarter of 2009, but decreased 17% from prior year levels. Sales of fixed products nearly doubled prior year levels as equity market volatility and credit concerns prompted investors to seek fixed return products from top-rated firms. This increase was more than offset by decreased volumes from the sale of other Wealth Management products due to weak economic conditions.

In Canada, Wealth sales, excluding variable annuity products, increased by 16% over prior year levels as a result of volumes more than doubling in both individual fixed products and Group Savings with the latter driven by success in large case defined contribution sales. This growth was partially offset by declines in mutual funds sales.

In Asia, Wealth Management sales, excluding variable annuity products, increased as a result of the acquisition of an asset management company in Taiwan in 2008.

Turning to slide 27, you will see that premiums and deposits increased by 3% from prior year levels. This, however, represented a decline of 7% on a constant currency basis. Increased premiums arising from higher sales of fixed Wealth products and in-force insurance business growth were more than offset by the decline in variable annuity deposits as previously discussed.

I would also point out that higher sales of fixed Wealth products have resulted in very strong cash flow from operations versus prior year levels.

On slide 28, new business embedded value totaled C\$644 million in the second quarter, up 19% from the first quarter of 2009, but down from prior-year levels. Insurance new business embedded value was 8% higher than prior year levels driven by growth in Japan and US long term care, while wealth new business embedded value was down 45% reflecting lower variable annuity sales and new business hedging costs.

As shown on slide 29, total funds under management as at June 30, 2009 were C\$421 billion, an increase of 5% over the prior year. Net policyholder cash flows of some C\$20 billion and favorable currency movements more than offset the market value declines over the last 12 months.

Finally, turning to slide 30, as I discussed last quarter, managing equity risk exposure continues to be a priority of the Company. With the rally in global equity markets in the quarter, we opportunistically hedged an additional C\$3 billion of in-force veritable annuity business. All told, approximately C\$14.5 billion of guaranteed value is currently being hedged, approaching 15% of our exposure net of reinsurance.

Substantially all new business in the United States and Canada continues to be hedged on an ongoing basis. We also continued to implement changes to our product offerings further rebalancing and derisking our product mix. Most notably, in the United States, we introduced a new variable annuity product called AnnuityNote, which offers a more simplified design and has a more conservative risk profile. In addition, certain products in Canada and Japan were discontinued. With that, I will turn it back to Donald who has some closing remarks.



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Donald Guloien - *Manulife Financial Corp. - President & CEO*

Thank you, John. So in conclusion, I would like to emphasize that we are very pleased with the strong earnings, our quarter-over-quarter business growth and our capital levels. We reported solid performance in most areas of our business, rebalanced our product mix, derisked products and positions, maintained strong asset quality and executed a number of successful capital raises during the quarter. Operator, that concludes our prepared remarks and we are prepared to take questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Tom Mackinnon, Scotia Capital.

Tom Mackinnon - *Scotia Capital - Analyst*

Thanks very much. Two quick questions here. First question, Donald, with respect to the dividend cut. Is there anyway we can measure the effectiveness or measure how we can see any increase in value as a result of this dividend cut? Should we see stronger ratings, stronger sales, possible acquisitions down the road? How are we -- how can we measure effectively the increase in value as a result of the dividend cut? Or how would you say that we should be able -- we should measure that? And I have a follow-up.

Donald Guloien - *Manulife Financial Corp. - President & CEO*

Tom, I think you will be able to measure it after a period of time, not on a prospective basis because it depends what happens. If equity markets or the economy takes a nosedive, we will provide a cushion of safety for our policyholders and for our shareholders that makes it unnecessary to raise diluted equity in very adverse circumstances. Hopefully, it depends on when it occurred and how soon and so on and the depth of it. But that would be the protective element, defensive development.

On the positive side, it gives us the fuel to fund our growth both on an organic basis and a strategic basis. If opportunities were to come to market that we were to find attractive, we would intend to pursue those.

Your comment on rating agencies, the rating agencies have a fair degree of concern about the insurance industry. And we obviously believe that retaining capital and the firm is going to be positively regarded by the rating agencies.

So I think in summary, Tom, it depends on what happens, but I think, at the worst case, if Manulife ends up 24 months from now, 36 months from now with a very nice cushion of capital that enables us to do strategic endeavors, worse things could happen.

Tom Mackinnon - *Scotia Capital - Analyst*

Is there anyway we would know when this fortress would be built? Can you give us any sort of a -- is it a MCCR percentage or any other benchmark we might be able to determine when the fortress building is complete?

Donald Guloien - *Manulife Financial Corp. - President & CEO*

Tom, I am going to let Mike Bell answer that question.

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Michael Bell - Manulife Financial Corp. - SEVP & CFO

Hi, Tom. Tom, at this point, I wouldn't pin it on a specific number. Again, the idea here is to strengthen it further from where we were certainly at June 30 levels. But remember here, the goal is to have enough financial flexibility to deal with a bunch of potentially negative scenarios out there. Again, not every single conceivable scenario, but a bunch of negative scenarios out there without being forced in a corner and needing to raise common equity under adverse circumstances. So I would characterize it as being more cushion than what we had at second quarter, but I would not pin it on a specific number.

And just to reinforce Donald's point, we expect this will be very good for long term shareholder value, both avoiding the negative, as well as having the flexibility to take advantage of opportunities out there in the market, both organic growth as well as acquisition, that those will all be good things.

Tom Mackinnon - Scotia Capital - Analyst

Okay. And secondly, with respect to the C\$750 million to C\$850 million guidance that was discussed, as I understand that, that does not include the impact of any changes in seg fund guarantees, is that correct?

Michael Bell - Manulife Financial Corp. - SEVP & CFO

What it assumes, Tom, is that equity markets march up steadily at a 2% per quarter rate. And it also explicitly does not include any potential basis changes either positive or negative in the future.

Tom Mackinnon - Scotia Capital - Analyst

I mean just -- so if the market -- the 2% a quarter kind of suggested in terms of the S&P 500 at 2010 year-end somewhere around 1040. If it was 1100, we would have to expect that this number would have to be higher than the guidance -- I am not going to say guidance, but in the C\$750 million to C\$850 million provided. Presumably then there would have to be some additional items that would be incorporated as a result of any seg fund stuff or anything else, is that correct?

Michael Bell - Manulife Financial Corp. - SEVP & CFO

Tom, that's good reasoning and --

Tom Mackinnon - Scotia Capital - Analyst

(multiple speakers) 10% that you talk about with equity markets. If equity markets are up 10%, it is C\$1.5 billion based on June 30 figures, so it has got to be something in addition to that if the markets were higher than 1040 at the end of 2010. Am I reading that correctly?

Michael Bell - Manulife Financial Corp. - SEVP & CFO

Well, again -- so two things. Generally, number one, your logic is on the money. Second, remember you need to measure that 10% relative to an expectation of 2% per quarter. But again, with those points in mind and all things equal, you are thinking in the right ballpark in terms of how to think about earnings for the remainder of the year.

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Tom Mackinnon - Scotia Capital - Analyst

Okay, thanks very much.

Operator

Jim Bantis, Credit Suisse.

Jim Bantis - Credit Suisse - Analyst

Hi, good afternoon. Just to follow up on this fortress capital level and the reason I am following it up -- I guess when I think about the responses before, they just seem a little unsatisfactory because when you look at the capital ratios that you highlight in terms of 240% and you look at your comments with respect to that level being at a satisfactory level, you talk about not being near your fortress capital levels, I think you're going to have to provide more guidance in terms of -- outside of the capital ratio, when can we feel comfortable that you have achieved your financial flexibility? And if you feel that you are not nearly close to that level, perhaps it would have been necessary to actually do the equity issuance as well this quarter.

Donald Guloien - Manulife Financial Corp. - President & CEO

Well, Jim, we are entirely satisfied with the capital levels that we have. What we are talking about is when we do our capital planning, we look at far more pessimistic scenarios than what we are currently experiencing. And frankly what my best judgment would be and that of the management team, we have to be prepared for a broader range of eventualities. What is a highly satisfactory level of capital today in a down market or with more trouble on the horizon with respect to the economy or credit or a whole range of factors could turn into a less satisfactory capital level. And we want to take a very, very prudent approach to capital levels and that is what that term fortress implies.

Jim Bantis - Credit Suisse - Analyst

Thanks, Donald. I appreciate that, but I guess when we have looked at some of the quivers that you could have used, you have got the preferred issue completed, the sub debt completed, innovative capital, the dividend cut. I mean could you revisit some of these drivers of capital again in the future?

Donald Guloien - Manulife Financial Corp. - President & CEO

Yes, we could. We don't want to strain our leverage ratios and coverage ratios and so on, things that rating agencies look to. Obviously that would put pressure on our ratings. And as I said earlier in the call, the rating agencies have a somewhat negative view of the insurance industry and we are very proud of the ratings that we have. And I think on a ratings basis, we are amongst the strongest financial service companies in the world.

We want to stay in that zone and yes, we could do those things. It is very clear that the market has reacted very positively to our offerings of all types of capital, but we think that retaining dividends, the cash dividend as capital is the most cost-effective means of building towards fortress capital available to us at this time.

Jim Bantis - Credit Suisse - Analyst

Thanks. With respect to slide 11, we have seen a significant impact with respect to interest rates. And I guess we are trying to understand here the volatility that this could be going forward in terms of earnings, particularly when you have seen the spreads



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already narrow dramatically. Maybe you could talk a little bit about this in layman's terms of how we should be measuring this going forward?

Michael Bell - *Manulife Financial Corp. - SEVP & CFO*

Jim, it's Mike. Well, first off, there is not a single metric here. There are a number of different measures, so it is not as easy as pointing you to a single number. But as we have talked about many times, as certainly as was detailed significantly in our year-end annual report, in general, a drop in interest rates tends to hurt our net income. And again, there is a lot of interplay here with Canadian GAAP rules, so there are various pluses and minuses. So it depends on specific durations, it depends upon specific asset quality credit ratings that we are looking at, it depends upon various geographies.

But conceptually, the most important point here is that, today, our assets are shorter than our liabilities. That is number one. And number two, to reduce that duration gap, we have used swaps to lengthen the duration of our assets. Now they are still even with the swaps shorter than our liabilities. And importantly with those swaps, we are not able to achieve the traditional corporate spreads on the underlying assets. So we are susceptible as well to spreads narrowing.

So I think the way to think about it, we just updated for you in our prepared remarks that a 100 basis point drop in interest rates on a parallel basis would be worth approximately C\$1.5 billion after-tax. I think it is fair to say that corporate A rates, long corporate A rates are the single most important number. So if you look at corporate A rates, for example, since June 30, they've obviously moved to a further tightening to the tune of 45 to 50 basis points since June 30 and you can get a sense if that has worked against us.

Now the good news is equity markets since June 30 have moved in the other direction. But it is not as simple -- other than the parallel shift that I just mentioned, it is not as simple as that. But the two most important factors are overall interest rates, particularly long corporates and also the spreads. Those are the two most important sensitivity factors.

Jim Bantis - *Credit Suisse - Analyst*

Got it. Thanks very much, Michael. I will follow up.

Operator

John Reucassel, BMO Capital Markets.

John Reucassel - *BMO Capital Markets - Analyst*

Thank you and just, Mike or Donald, I guess I will ask about fortress capital in a slightly different direction. Assuming the world doesn't change much from today or gets a little better, taking your normalized earnings assumptions, how long would it take you to get to your fortress capital levels? Are we talking about rebuilding still through the course of 2010 or as opposed to a number we are all looking for, internally, is this an 18-month program you are still on or how long should this last?

Donald Guloien - *Manulife Financial Corp. - President & CEO*

John, I would love to be able to respond to that and give you a specific answer, but I can't. The definition of fortress capital to start is one that would be highly dependent on our outlook on market circumstances at that time and also our sensitivity to those market circumstances.



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So for instance, the more of the business we hedge, the less reserves we require and the less capital we require. The more we derisk the products, as John DesPrez talked about, same thing. So it is a whole bunch of things combined. Yes, obviously earnings and earnings retention help enormously. We will continue to pursue, as we said earlier, other forms of capital initiatives and so on at various times when the opportunity presents itself in the marketplace. And we will continue to sort of derisk our product profile, as well as build earnings from other areas. So it will be a combination of things.

I mean, again, I think we are in very good shape right now, but what you have got is a highly financially disciplined management team that wants to make sure that we have got what it takes to withstand the most difficult circumstances. Not with absolute guarantees, as Mike pointed out. There are scenarios you can always paint that would threaten us, but we want to be in a very, very robust position.

John Reucassel - *BMO Capital Markets - Analyst*

Okay, I will move on to another topic. John DesPrez, I would have characterized Manulife on the sales front, particularly in the US, as the leader -- the leadership products would have been the US individual life and variable annuity products. Given the repricing on VAs and maybe more competition in individual life, is that leadership position going to change? Should we be looking at other products or we are just having a shift here? This is just a temporary blip in sales?

John DesPrez - *Manulife Financial Corp. - COO*

I think you have to separate the two. In the variable annuity business, we have clearly led the industry in repricing the product, derisking the product, which we think is appropriate. We have introduced a new product, really trying to redefine in many ways the annuity space in a way that is much more financially attractive to the issuers [inaudible] AnnuityNote product. So there is a secular shift going on there that will last for some time.

In the life insurance business, I think you are seeing just a blip. In point of fact, our sales have been stronger every month this year, month over month. July continued to be much stronger than June. Simply what happened in the life insurance space is that we, as you know, John, focus very much on the high-end estate planning type end of that business where the premiums can be very, very substantial. And during this financial crisis, consumers were very hesitant to write those huge checks. But in fact, we are starting to see that business now start to clear. Our inventories have never been higher. The sales activity as measured by a whole lot of things is very, very strong. So I think that you will see our position in life insurance will not be compromised over any medium term cycle here.

In terms of the broader question of will we put some more emphasis on other product categories, the answer to that is yes. We have a lot of distribution that we can leverage in a lot of different ways and we have a variety of plans underway to do just exactly that.

John Reucassel - *BMO Capital Markets - Analyst*

And John, just a follow-up. So the VA, you are leading the industry here in redefining the variable annuity product. I guess you take the risk that the rest of the industry may or may not follow.

John DesPrez - *Manulife Financial Corp. - COO*

That's true.



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John Reucassel - BMO Capital Markets - Analyst

Does that impact your ability to -- your relationships with the large wealth management houses or not so much? Do you think you can weather this?

John DesPrez - Manulife Financial Corp. - COO

Well, I think that our relationships are broad enough with the major distributors. There are very few distributors anymore that we only sell one thing through. And in point of fact, we are adding -- one of the greatest strength that we have here is that we are adding major distributors during this crisis who are looking for additional quality players. I will just give you one example.

In our long term care business, we recently added Ameriprise as a distributor. Ameriprise will be, in all likelihood, our largest distributor of long term care within 24 months. They took that action of adding us to their shelf frankly out of concern with perhaps the financial strength of some of their other -- or their current product vendor. It is that type of thing that we seek to capitalize on and you will see some more examples of that as we go along here over the next little while because we are in discussions with a number of people.

John Reucassel - BMO Capital Markets - Analyst

Okay, great. Thank you.

Operator

Michael Goldberg, Desjardins Securities.

Michael Goldberg - Desjardins Securities - Analyst

Thanks. First, I understand the dividend cut was a Board decision, but did management actually recommend the dividend cut?

Donald Guloien - Manulife Financial Corp. - President & CEO

Yes, Michael. The management was unanimous and thinks it's the right thing to do. Again, not because we have any particular problem, but because we think it is the right thing to do for a very strong and financially disciplined company that is desirous of having a profile of the strongest, safest company you can do business with in our space.

Michael Goldberg - Desjardins Securities - Analyst

Okay. So the decision to cut the dividend clearly banks, I would say, favorably on a favorable reaction from rating agencies due to the capital strengthening resulting from higher retained earnings. Can you tell us what gives you comfort that there won't instead be a negative reaction from rating agencies driven by, one, the damage to their reputations over the past year from being too aggressive and two, a possible reaction by them of questioning -- What don't we know that could have been so serious that Manulife would cut its dividend by 50%? Maybe we should reduce our rating or move to a more negative outlook. Could you give us some comfort that that negative reaction won't be the reaction that they take?

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Donald Guloien - *Manulife Financial Corp. - President & CEO*

Sure. And Michael, I am going to lunge right in here and then Mike Bell follow up. You shouldn't draw the conclusion this is done only for rating agencies. We are doing it because it is the right thing to do for our customers and for our shareholders. We have talked before about avoiding the risk of a dilutive equity offering. I thought it was very humbling to raise equity at C\$19.60 because I don't believe Manulife is a stock that should be valued at C\$19.60 back in December. It is the last thing we want to do. As you recall, in between there in March, our stock got down to C\$9 when the equity market went down. It was a very uncomfortable time, so we want to put as much distance between us and that possibility, albeit remote, as we possibly can.

So this isn't done for rating agencies. This is done for a whole host of reasons that allow us to say that we have an incredibly strong company, which is the benefit to our customers, the rating agencies like it, regulators obviously like it, our shareholders will like it in the long term. Although reducing a cash dividend is not a short-term way to popularity. Michael, do you want to --?

Michael Bell - *Manulife Financial Corp. - SEVP & CFO*

Yes, Michael, the only piece I would add -- I mean obviously the rating agencies need to -- they have their own opinions and speak for themselves, but based on conversations to date, I think they certainly applaud the direction that we are taking in terms of moving towards fortress capital.

I would point out that many people out there, even if it is not officially in their earnings coverage ratios, think about the shareholder dividend as a long-term commitment. So they recognize that this gives us additional financial flexibility, which obviously they view positively. And in terms of is there something out there that they are not aware of, I just want to be very clear. We are very transparent with the rating agencies and I think they know us very well. I would expect that to continue when they come in for their reviews in September. So again, of all the things you said, I think somehow the sense that we would somehow cover something up from the rating agencies I think is the one that is furthest off base.

Michael Goldberg - *Desjardins Securities - Analyst*

Okay, that is not the message I was trying to convey. It was simply just fear of the unknown let's say.

Donald Guloien - *Manulife Financial Corp. - President & CEO*

I know where you're going, Michael. Do we signal that we have some concern that they haven't yet latched onto and there is no sense of that.

Michael Goldberg - *Desjardins Securities - Analyst*

And my last question and then I will requeue if I have any others is your at-risk seg fund guarantees remain very high relative to your common equity. Can we look at further hedging equity sensitivity as another means to achieve fortress capital or do you want to have enough capital so that you can still tolerate a big unhedged position?

Donald Guloien - *Manulife Financial Corp. - President & CEO*

Well, Michael, you are right on the money. Yes, that is another means of achieving the same end. Absolutely. There is the pace at which you do it and a timing at which to do it and we don't believe the right thing to do right now is to hedge out all our risk for instance. But we have been pretty clear that we are proud of the fact that we have made progress at hedging in-force business, as well as the significant part, most of the new business. And we are making progress, pretty significant progress at

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reducing the exposure through hedging. But we are not planning to do it all in one fell swoop and we will keep you updated on how we are progressing on that. But I do want to properly condition you that our view on that will be market-based rather than time-based because we do not feel it is in our shareholders' interest to go and hedge the entire position at this point in time.

Michael Goldberg - *Desjardins Securities - Analyst*

Thanks.

Operator

Colin Devine, Citi.

Colin Devine - *Citi - Analyst*

Good afternoon, gentlemen. I would like to focus on three questions. First, Don, I don't think I will ever forget your predecessor, Dominic, closing the analyst meeting last October with the comment that quote; "we are the strong", and it is certainly evidence since then that Dominic at least was the misguided.

You have had time now to do a pretty thorough assessment of the risk management processes at Manulife or the lack of them in the VA case. And you have never been a shrinking violet about saying what you feel. So I would certainly appreciate hearing a critical review of what was avoidable and perhaps what wasn't and what you have done to change it. That is the first question.

The second was with respect to the reserve increases that are coming or changes. When I hear about adverse policy behavior, that just seems to me to be that you are aggressively writing lapse-supported products and I guess what I am most concerned about is the no lapse UL product in the US where I guess lapse rates look like they are going to be 1% to 2%. And I would like some assurance that we don't have another term to 100 problem on our hands here, which is going to require a significant strengthening.

And then lastly for John DesPrez, at the end of last year, John Hancock I should say, did a very large reinsurance transaction with its Barbados subsidiary. Could you walk us through what the benefits of that were and why you did it?

Donald Guloien - *Manulife Financial Corp. - President & CEO*

All right, Colin. I will take them in the order that you gave them. Looking with 20/20 hindsight, I think there are lots of things that you would do differently and it is easy to be a critic. I could rise to that occasion. I won't. I mean my old job of investing money, some portion of the loans we made went bad and it would be really easy to point to all the obvious reasons why that was reasonably foreseeable.

I will say a few things. I will say that Manulife has some legitimate concerns with hedging. The principal one being the Company was desirous of hedging the economic risk, not just the accounting risk. You know, I think those concerns were wellborn. People who told The Street that they had hedged away all the risk seemed to have suffered a great deal, maybe not as much as Manulife, but it hasn't all been good news from those companies who (technical difficulty) have explored hedging, particularly where they only were trying to hedge the accounting result, not the underlying economics.

Manulife tends to be a company that approaches things that are heavily quantitative, derivative-intensive in a very measured pace, and we were progressing along the path to hedging, you know, first by building all the models; secondly, by testing it



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with paper tests, back testing. Then running experiments with hypothetical money, then running experiments with small amounts of money, and then just starting with the new business.

You could argue that that was too slow a pace and I would not differ with you and certainly with the benefit of 20/20 hindsight, one might've said, throwing a bit of caution to the wind, might have gotten us to a better place sooner and Dominic has spoken to that. But again, that is with 2020 hindsight. I think another comment --.

Colin Devine - *Citi - Analyst*

Don, but don't you think building up a C\$100 billion exposure before you work that out might have been a little aggressive?

Donald Guloien - *Manulife Financial Corp. - President & CEO*

Well, you just anticipated my next part and let me finish. The second thing one could say is, okay, if you had legitimate concerns with hedging, should you have taken on as much business as you did on an unhedged basis and not constrained it? And I have said this with Dominic in the room, he is probably listening to the call, and he knows what my answer is and that is a thing that I think reasonably you could give pause to and say was that the right choice?

Clearly where the market has gone and all the chaos it has caused, we would certainly do it differently doing it again. But again, nobody anticipated, Colin. I certainly didn't running the investment portfolio. If I had seen this coming, we would've sold every on-balance sheet equity we had. We didn't do that and very few people did. But your point is did we expose the Company to too much risk and I think the fact that our stock price has suffered is an indication that we took a view and that view hasn't worked out as well as one would hope.

Colin Devine - *Citi - Analyst*

Thanks, Don.

Simon Curtis - *Manulife Financial Corp. - EVP & Chief Actuary*

It's Simon Curtis here. I will just take on your second question, Colin, about the lapse rates. When we are looking at policyholder behavior, we are very, very conscious of long duration lapse rates on products that are potentially lapse-subsidized. As a Canadian company where a lot of lapse-supported products were written many years ago, we have always been very cautious of the impact of those lapse rates.

Now when we are looking at policyholder behavior, frankly, the issues that we see are across all types of products. They are not specific to long duration contracts that are lapse-subsidized or any one form. We are just generally seeing that both early duration lapse, long duration lapse, lapse-subsidized products and products that are not lapse-subsidized, we are just seeing more efficient policyholder behavior. And that is a trend that we have seen for a number of periods and I think from my contacts in the industry is something that most companies are facing. So we are just not signaling any one particular issue, just a general policyholder behavior concern.

Donald Guloien - *Manulife Financial Corp. - President & CEO*

As I have said, Colin, to other audiences, there isn't a recipe book, a cookbook you can go to to see what policyholder will be after the markets go down 50% and after a huge number of people lose their jobs and we go into something that is the closest thing to the Great Depression that any of us have witnessed. And we are seeing different types of behavior. We have dynamic

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lapse assumptions that try and capture -- we expected people's behavior will change, but there is not a great body of experience to deal with that.

Colin Devine - *Citi - Analyst*

And Don, to be fair, I don't know that the market reduction has impacted lapse rates on no lapse UL coming in at 1% to 2%. It seems to me from talking with several of your competitors, it is just a mispriced product. And I bring it up because Manulife is the runaway leader in that product. Not just to clarify one other thing. When you were talking about the reserve added to seg fund guarantees, does that include US variable annuities or not?

Michael Bell - *Manulife Financial Corp. - SEVP & CFO*

Yes, Colin, it's Mike. Yes, it does.

Colin Devine - *Citi - Analyst*

Okay. And then if we could talk about the Barbados reinsurance transaction.

Donald Guloien - *Manulife Financial Corp. - President & CEO*

Just a second, Colin. You left something on the table there about the no lapse products that Simon wants to address.

Simon Curtis - *Manulife Financial Corp. - EVP & Chief Actuary*

Yes, when it comes to the no lapse products, I just repeat that we do not price with aggressive lapse assumptions. We may have competitive products in the market, but it is not driven by a competitive -- an overly aggressive lapse assumption.

Colin Devine - *Citi - Analyst*

Okay. What is your lapse assumption then, Simon?

Simon Curtis - *Manulife Financial Corp. - EVP & Chief Actuary*

Well, it would probably be around 1%.

Colin Devine - *Citi - Analyst*

Okay, thank you.

Donald Guloien - *Manulife Financial Corp. - President & CEO*

Now, Colin, we take a fair amount of strain on those products, which is something other people might want to do, which creates a capital implication. Again, remember, we talked about fortress capital enables us to sustain our organic growth. We take a lot of strain on those products because Simon uses conservative assumptions there and our valuation basis reflects that.

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Colin Devine - *Citi - Analyst*

But it hasn't slowed you down from selling them, Don, so it can't be too bad.

Donald Guloien - *Manulife Financial Corp. - President & CEO*

The third point was Barbados.

Colin Devine - *Citi - Analyst*

Barbados.

John DesPrez - *Manulife Financial Corp. - COO*

Colin, we will have to have IR get back to you. We did a whole series of reinsurance transactions at the end of 2008. I am not sure which one you're referring to. In any event, nobody here seems comfortable in responding to it. So why don't we get you together with the people who --.

Colin Devine - *Citi - Analyst*

I thought it was several billion dollars. That is what I wanted to be clear on. What was reinsured down there?

John DesPrez - *Manulife Financial Corp. - COO*

We will have someone call you.

Colin Devine - *Citi - Analyst*

All right.

Operator

Doug Young, TD Newcrest.

Doug Young - *TD Newcrest - Analyst*

Hi, good afternoon. Just I guess going back to page 19, Michael, you mention something that was interesting how the estimated ROE would be 12%, but the long term objective would be to get that ROE up. And if you'd like to quantify, I would love to hear a number, but I am sure you are not going to. But what I guess I am more interested in is how do you get that number up? Can you talk a bit about the levers that you guys have in terms of improving? And what I am trying to get at as well is it seems like a lot of your competitors are talking about expense cuts and we don't hear a lot around expense cuts from Manulife, so I am curious as to your thoughts on that.

And then the second part of my question revolves around that C\$750 million to C\$850 million per quarter, given what your expectations are, how much of that would be excess capital? I am trying to get back at the fortress level of capital question.

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And I'm also -- I guess a third part of the question is one of the reasons why you're trying to build fortress capital is organic growth, but the sales appeared fairly weak in quarter relative to a lot of your competitors and I think you addressed some of the issues, but I am curious if you can dig a little further on that. Thank you.

Michael Bell - *Manulife Financial Corp. - SEVP & CFO*

Yes, Doug, it's Mike. So I will start with a couple of your points. First, in terms of ROE, I would think about the improvement that we would expect in ROE over time really in two different buckets. The first bucket is really what we would get naturally. And what I mean by that is, remember that we have on our balance sheet, of our C\$26.1 billion of equity today at June 30, we have approximately C\$7.5 billion of goodwill.

So if you fast-forward, if you fast-forward over the next five to 10 years, assuming a certain level of book-of-business growth in the underlying business, the tangible equity would continue to grow while the goodwill would essentially be constant based on the goodwill that we have on the books today.

If you look at our return on tangible equity, it is in the high teens, again, brought down by the C\$7.5 billion of goodwill brought down to the approximately 12% level on a pro forma basis. So just by virtue of the fact that the book of business that, if you will, on a marginal tangible equity basis is returning at the C\$3 billion to C\$3.4 billion level, something in the high teens, you have got, again, kind of a weighted average of the high teens on the new stuff assuming we earn the C\$3 billion to C\$3.4 billion and assuming the book of business. You have got the high teens on that kind of melding in, if you will, with the 12% on the current books. So that is kind of one bucket that we just get naturally.

Now second, as we have talked about today and my understanding -- obviously I wasn't on the call since I have only been on the job six weeks -- but my understanding is, from prior calls, that we have talked about changes in the product portfolio, including looking at opportunities to grow the higher return products and in particular looking for opportunities to derisk our existing products, which would mean that of the products that we are growing, they would require less capital than what is embedded in the average 12% rate today.

And then the other piece in that second bucket is just exactly what you described. As a company, we are very focused on other opportunities to increase earnings. Reducing operating expenses is one lever and I would specifically highlight John DesPrez's organization as having made very good progress on that in the recent past. So other opportunities for earnings we would also expect to improve ROE over time.

So you're absolutely right. We are not ready to give a specific number. We would expect it to be higher than 12 at least near term. Unlikely to be back to the 16, but we will get back to you in the future in terms of longer term financial objectives.

On your question on the earnings that we would in effect retain over time and how much that would add to fortress capital and getting to our fortress capital objective, again, there are a number of different factors that go into play there. I think maybe the way I would suggest you think about it is, if we hit all of the assumptions that are based on our definition of normalized earnings, we would have annual earnings of C\$3 billion to C\$3.4 billion. We would pay out, round numbers, C\$800 million of shareholder dividends at the dividend level that the Board just approved. And then there would be a certain other level that would be needed just as retained earnings based on the book of business growth that we would have that, in some sense, isn't necessarily getting us closer to fortress capital levels, but is necessary just to support the growth in the book of business.

So again, at this point, I wouldn't give you a specific number. I understand your hunger for it and over time, I would expect to expand our disclosures there, but that would be the framework to think about it.



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Donald Guloien - *Manulife Financial Corp. - President & CEO*

Doug, there is one element there that you talked about in growth and saying -- I am going to rephrase the question -- but it was sort of like you guys talk about retaining fortress capital to fund organic growth and I don't see the growth there. And let me address that if I can.

We see very strong quarter-over-quarter growth. We wouldn't expect to see growth year-over-year given what has happened in the general economy. But if you look, for instance, at our Asian business, which is up I think 24%, Canada is in line with last year on the insurance side. The United States, it's, A, a more troubled market, but as John and I said before, a big portion of our business in the United States is upscale estate planning. Now I don't know about you, but after the stock market has dropped 50%, businesses are laying off people, orders are being canceled, banks are calling credit lines, I am not sure that I would feel very comfortable writing a check to what is known as an irrevocable life insurance policy for a couple million bucks in order to deal with my grandchildren's estate planning needs.

Now the neat thing about it is the needs don't go away. People still submit to underwriting. The backlog, John tells me, is as good as it has ever been. So we expect that once there is greater clarity in people's minds that those checks will be written and we will be the beneficiaries of that as one of the strongest, most reliable players out there with a great heritage in that field.

So it is a temporary disruption, but I suspect the growth will come. I can't promise it, but if I were a betting man, I would wager you on that, as well as what we talked about, which is basically where the economy has been disrupted -- Asia had disruption, but is chugging along very, very well and Canada, obviously impacted to a lesser degree than the United States.

Doug Young - *TD Newcrest - Analyst*

I'm sorry, Michael, just one quick follow-up. You said on the new stuff high teen ROEs. Did I get that right?

Michael Bell - *Manulife Financial Corp. - SEVP & CFO*

Well, what I was trying to point out, Doug, is if you look at our existing book of business, if you separate it out, if you separate it out, the goodwill piece, so if you just looked at the tangible equity and you assume that constant book of business growing going forward, the tangible equity is the piece that is going to grow. The goodwill is in fact fixed at that level. And when you couple that with the fact that we are looking in fact to grow the higher return on capital products and to derisk our products, which would lower our required capital, all of those things would suggest that the 12% should grow over time as a matter of course.

Doug Young - *TD Newcrest - Analyst*

Thank you.

Donald Guloien - *Manulife Financial Corp. - President & CEO*

Doug, we have never had the problem of sort of insufficient capital through most of Manulife's recent history. We have had more capital than we knew what to do with, which is one of the reasons the dividends were increased and the stock was bought back. So you probably wouldn't expect that we would be the most rigid and disciplined in making sure that everything met the highest hurdle rates because you can readily appreciate an intelligent use of capital even if it doesn't meet your hurdle rate is a good one.



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I think what Mike is talking about is a far more disciplined approach to making sure that things meet the hurdle rates and allocating capital very judiciously towards the things with the highest return, which is certainly going to have that salutary impact that he described.

Doug Young - TD Newcrest - Analyst

Thank you.

Operator

Mario Mendonca, Genuity Capital Markets.

Mario Mendonca - Genuity Capital Markets - Analyst

Good afternoon. Thanks for extending the call a little bit. Don, I hear you on the idea that there is nothing going on, nothing nefarious here that is causing you to want to have these fortress levels of capital. But it sounds to me like there are a lot of things that you are sort of hinting at. You're talking about policyholder behavior. That was something that Simon helped us with there. There is equity markets, there is these interest rates, the short duration -- assets being shorter duration than the liabilities.

I think what I'm trying to capture here is -- I know what you're saying about the 12% ROE. I am just not comfortable I know what book value that will be sort of earned on. And what I would like some help with and understanding is, to get all the ducks lined up here in terms of closing that gap between assets, the duration of assets and liabilities or strengthening reserves for interest rates, is that all going to happen next quarter and will it be like such a large number that it will have a material effect on the book value? Is there anything you can help us with there?

Donald Guloien - Manulife Financial Corp. - President & CEO

Yes, Mario and thanks for getting sort of the big elephant on the table, if you will and that is not a reference to me. One of the analysts said, in a review note that I saw, it is a guy who knew me a little longer, said you know gave me credit for being a straight-ahead guy, maybe because I have been on the other side of the street buying stocks and I like management teams that deal in a very forthright fashion with the issues that they are confronted with and that is the long-term posture. Manulife is in the trust business. We want to have the trust of the street, as well as our customers, as well as our distributors. So the posture that we are going to take is if we see storm clouds on the horizon, we are going to tell you we see the storm clouds. We may not be able to quantify how much rain is in those storm clouds, but we will tell you that we see them coming. And when we get better information, we will tell you exactly how much rain is there and then you will feel the rain some day and make a decision whether we did a good job of managing them, but we will talk about it ahead of time.

You saw that in our release in June, towards the end of June when we talked about some of the issues that we were being confronted with and we said policyholder behavior, particularly on the VA business, is not shaping up in a way that we feel happy about and could result. We have taken some hits this quarter, C\$181 million in respect of one unit's business. Other stuff we are still working on. But we have given you sort of a range of what that could be and it is not something that keeps me awake at night, certainly not when you are talking about changes relative, as Mike pointed out, a reserve basis that is C\$140 billion where 0.5% is C\$700 million.

So I am not lying awake at night worrying about Manulife. I think Manulife is in great shape. Our reserves are very conservatively provided for and they continue to be. But we have also been open with you about the fact that we have way more capital markets exposure than we used to as a result of what has happened. There is interest rate exposure and the equity exposure.

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The interest rate exposure, I should explain. It is nothing nefarious. Maybe the mechanism, because I have come to understand it more recently, so they sometimes say the dumbest guy is the best teacher. Things like long term care, for instance, we take in premiums for 30 years and then pay out a benefit of a fixed amount. The key determinant of how much we pay out is a function of lapse rates and utilization rates. But it is a fixed amount. But to be quite honest, we have no clue as to how much we are going to earn on the premiums that we receive in the 19th year. That's 18 years from now. So we don't have a clue what the investment rate is going to be, so our actuaries make some assumptions around that.

They also do things like they say, okay, well that means the liability, given that you going to get premiums in over a long duration, the nature of the liability is longer than the assets, so why don't you lengthen out a bit to match those and then lengthening swaps. Well, when they buy those lengthening swaps, those are mark to market. And they also make an assumption about the reinvestment rate. So think about what happened during the quarter. As basically interest rates went up, those swaps get mark to market on a negative basis, but as spreads came in, the assumption around reinvestment, right, the roll-out of the swaps into corporate A bonds, but they assumed that 19 years from now spreads are going to be lower because they are lower today.

Well, you and I both know that today's swap rates and today's corporate A rates have no bearing on what is going to happen 19 years from now. But that is the accounting methodology that we have and it is probably as good as any in the mark-to-market environment. But that creates this sensitivity to interest rates that bounces around.

Now the good news is on that one is I can say this one in a very definitive way. We have seen the spread between corporate A rates and swap rates come in 160 basis points in the quarter. I think that is an all-time record. And that creates that sensitivity. I am told that it is impossible for them to go to zero. Spreads can't go to zero. Equity markets can go up to infinity, but spreads cannot come in to zero. I think it is mathematically impossible. So the likelihood of repeat numbers like that on any sustained basis is not good. I am not telling you it is a one-time only thing, but I am telling you in an as open and honest way I can that we have more volatility in our reported quarterly results due to equity markets and interest rates, and that is a short term for swap spreads, corporate A rates, a whole vector of different interest rates, than we had before. And investors should factor that in when they take a look at us.

But the long-term expectation for the earnings is very, very robust. And I have said before, and I will say again, looking at quarterly earnings is not the best way to judge a life insurance company. I am happy to be saying that in a quarter when we are booking C\$1.7 billion of earnings. So it is not like I am trying to talk them up.

Mario Mendonca - *Genuity Capital Markets - Analyst*

Don, I totally appreciate what you are saying there about not adjusting earnings in a given quarter and that is why I am asking you specifically about what kind of book value effect these adjustments could have. And secondarily if once, Simon, you get through looking at everything next quarter, whether you are done and it will take a real adverse change in subsequent quarters to have you do it again. That is really what I am trying to get at.

Donald Guloien - *Manulife Financial Corp. - President & CEO*

Well, we do basis changes every year, Mario. The only difference is -- two differences that are very important. One is we are doing it in the third quarter when we usually do it in the fourth quarter. I don't think that will trouble you. But that was planned almost a year ago I think, a very long time ago. That it was better to do it that way so we get it out of the -- all the hubbub around year-end closing of the books.

The second one though is we tended to do basis changes and they tend to be either net neutral or slight positive. And what we are telling you is that there is a little directional sense to this that they are more likely to be negative than positive. But we are not conditioning you to expect some massive adjustment reflecting a massive --.



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Mario Mendonca - *Genuity Capital Markets - Analyst*

And Don, the reason I am asking questions like this is because the sort of commentary I have heard recently is that life insurance companies are becoming unanalyzable and therefore uninvestable because we have no idea how the changes in assumptions will affect earnings and the book value of the company. And the more investors start to think that these companies are not -- you cannot analyze them and therefore you can't invest in them, the sort of discounts these companies are going to get over the long term will be outrageous. So just a word of caution when you are talking about these big reserve adjustments, trying to put some numbers around them is pretty helpful because otherwise people look at your stock and say this is not something I can invest in, particularly in a quarter when you are cutting the dividend in half.

Donald Guloien - *Manulife Financial Corp. - President & CEO*

Mario, I agree with you 100%. That is why we are striving to be as transparent as we possibly can in the first instance that might be unnerving to people, but that is what we are trying to do because I agree precisely with you. More transparency is good on these matters.

The second thing is we would love to give you quantification and we obviously have numbers in the frontal lobe of our heads, but with all the securities lawyers in business these days, we are going to be very cautious about forward-looking statements and I would love to help you with, and Simon would, with more quantitative answers to some of your questions, but we can't do that.

Simon Curtis - *Manulife Financial Corp. - EVP & Chief Actuary*

I just want to add one comment, Mario, that I can assure you that this is not the first -- it will not be the first of a series of hits. When we do valuation reviews once a year, we do update all our assumptions to our current estimates and when we finish that review and book the net effect, we have brought our balance sheet up to speed. So this is not -- going to one of your earlier concerns -- this is not going to be one of a sequential series. It is our annual review where we will bring all of our assumptions up to date.

I will also mention that one of the reasons that it takes time to come up with final numbers and why we talk generalities more than specific numbers is we have to go through a fairly extensive review process on this where these will be reviewed by both our auditors and external peer reviewers so that by the time we publish these, they will be very firm reliable numbers.

Mario Mendonca - *Genuity Capital Markets - Analyst*

One final thing, the commentary is pretty clear that because insurance companies are this complex and it is impossible to understand earnings, the default that people use is the dividend and as long as the dividend stays healthy, they can say -- I may not understand earnings, but at least this company pays me C\$0.52 a year and when the company is cutting the dividend then that default you go back to isn't even there. So you have got a double whammy here.

Donald Guloien - *Manulife Financial Corp. - President & CEO*

Mario, I totally understand your analysis and people who draw that conclusion because they are so frustrated by the accounting model. I can't tell them that that is a silly posture. All I can say is that that would be irrelevant in the analysis of Manulife. Manulife has quite the capabilities. You have seen it with our capital raising. We could raise all kinds of capital and fund it through the back door paying dividends, but we don't believe that is an intelligent thing to do with the risks that are still inherent in this market.

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I mean people who would think the economy has totally healed itself and we are off to the races are kidding themselves. The risk is still very, very substantial in terms of the economy, in terms of the stock market and in terms of our sensitivity to both of those things. So we are not doing it because we think our business is weaker, we are doing it because we think it is the right thing to do to build capital levels that will again minimize the risk for our shareholder of dilutive equity raises at adverse times and allow us to capitalize on organic and strategic growth opportunities. End of story. That is it.

If people want to say that our earnings power has gone down, the discussion we have had around normalizing earnings, that number is less than our historical run rate if you look over the past four years. If you want to look at that as an indication, I think that is something that someone could draw a conclusion from. But it wouldn't be an analysis of quarterly earnings and again, I am saying that in the quarter when we have C\$1.7 billion of earnings and I would hate to think that a shareholder would take that number and multiply it by four.

Mario Mendonca - *Genuity Capital Markets - Analyst*

Got it. Thank you.

Operator

Darko Mihelic, CIBC.

Darko Mihelic - *CIBC World Markets - Analyst*

Hi, good afternoon. Thanks for taking my call. I will just ask one question. Maybe as a follow-on to Mario's question just now, I appreciate the decision to cut the dividend was a difficult one. Presumably it would be the same on the way up. So perhaps you can talk about what it would take -- maybe you could talk about payout ratio expectations and what it would take for Manulife to get into a position where it would once again be raising the dividend. And I ask this -- I have numerous clients who do use a dividend discount model, so any help on these measures would be appreciated. Thanks.

Donald Guloien - *Manulife Financial Corp. - President & CEO*

Well, one thing we and our Board referenced in determining the level of the dividend adjustment was this normalized earnings that Mike spoke to, C\$750 million to C\$850 million a quarter. And it has been our historical practice to consider dividends in the range of 25% to 35% of net income. I think more appropriately recognizing that we can have investment gains, we can have movements in markets and interest rates having either a positive or negative impact, it would be more appropriate to discuss that payout ratio relative to the normalized earnings expectations.

So 25% of say the midpoint of C\$800 million would produce the dividend level that our Board has adopted. I am not -- when I say that, I am not committing our Board at all times to maintaining either that payout ratio or the reference to normalized earnings, but I can tell you that that is one of the ways we looked at it. And you are going to see I think a tendency until we get to sort of fortress levels of capital for us to pay out in the lower end of that range. So I would not want people to bank on quick increases in the dividend level. Although I really look forward to the day when we can do that and it would be preconditioned on an analysis of how much risk is out there in the economy, how exposed we are to that risk and how much capital we have to cushion for that risk.

Darko Mihelic - *CIBC World Markets - Analyst*

Great. Thanks very much for your comments.



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Operator

There are no further questions at this time. So I will return the meeting back to Mr. Gorgi.

Amir Gorgi - *Manulife Financial Corp. - VP,IR*

Thank you, operator. We will be available after the call if you have any further follow-up questions. Thanks and good afternoon.

Operator

Thank you. The conference call has concluded. You may disconnect your telephone lines at this time. We thank you very much for your participation.

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