FINAL TRANSCRIPT

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MFC - Q4 2010 Manulife Financial Corporation Earnings Conference Call

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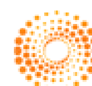

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CORPORATE PARTICIPANTS

Anthony Ostler
Manulife Financial Corporation - SVP Investor Relations

Donald Guloien
Manulife Financial Corporation - President and Chief Executive Officer

Michael Bell
Manulife Financial Corporation - SEVP and Chief Financial Officer

Jim Boyle
John Hancock Financial Services - SEVP, US Division and President, John Hancock Financial Services

Bev Margolian
Manulife Financial Corporation - EVP, Chief Risk Officer

Warren Thomson
Manulife Financial Corporation - Senior EVP, Chief Investment Officer

Scott Hartz
Manulife Financial Corporation - EVP General Account Investments

Cindy Forbes
Manulife Financial Corporation - EVP and Chief Actuary

Paul Rooney
Manulife Canada Ltd. - President and General Manager - Canada

CONFERENCE CALL PARTICIPANTS

Doug Young
TD Newcrest - Analyst

Tom MacKinnon
BMO Capital Markets - Analyst

Robert Sedran
CIBC World Markets - Analyst

Gabriel Dechaine
Credit Suisse - Analyst

Mario Mendonca
Canaccord Genuity - Analyst

John Aiken
Barclays Capital - Analyst

Darko Mihelic
Cormark Securities - Analyst

Steve Theriault
BofA Merrill Lynch - Analyst

Andre Hardy
RBC Capital Markets - Analyst

Michael Goldberg
Desjardins Securities - Analyst

Peter Routledge
National Bank Financial - Analyst

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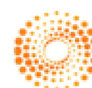

Joanne Smith
Scotia Capital - Analyst

Jan Willem Weidema
ABN AMRO - Analyst

PRESENTATION

Operator

Please be advised that this conference call is being recorded. Good afternoon, ladies and gentlemen, and welcome to the Manulife Financial Q4 2010 financial results conference call for February 10, 2011. Your host for today will be Mr. Anthony Ostler. Mr. Ostler, please go ahead.

Anthony Ostler - *Manulife Financial Corporation - SVP Investor Relations*

Thank you and good afternoon. Welcome to Manulife's conference call to discuss our fourth-quarter 2010 financial and operating results. Today's call will reference our earnings announcement, statistical package, and conference call slides, which are available in the Investor Relations section of our website at Manulife.com.

As in prior quarters our executives will be making some introductory comments. We will then follow with a question-and-answer session.

Today's speakers may make forward-looking statements within the meanings 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. For additional information about the material factors or assumptions applied and about the 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 slide entitled Caution Regarding Forward-looking Statements.

When we reach the question-and-answer portion of our conference call we would ask each participant to adhere to a limit of one or two questions. If you have additional questions please requeue, as 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?

Donald Guloien - *Manulife Financial Corporation - President and Chief Executive Officer*

Thank you, Anthony. Good afternoon, everyone, and thank you for joining us today.

Our fourth-quarter and full-year 2010 financial results were announced this morning. As you know, we made substantial progress delivering on our business strategy.

This is reflected in significant sales growth, reduced risk profile, and strong capital levels. We had record quarterly income of CAD1.794 billion.

I am joined on the call today by our CFO Michael Bell, as well as several members of our senior management including our General Manger of the United States, Jim Boyle; Canadian GM, Paul Rooney; our Asian GM, Bob Cook; Warren Thomson for Investments; and Bev Margolian, our Chief Risk Officer.

I am pleased to report that we are seeing solid progress on all fronts. Our fourth-quarter sales of insurance products targeted for growth were up 34%. Wealth products targeted for growth were up 28%.

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Insurance sales in Asia were up 56%, reflecting both the growing diversification of products and the expansion of our distribution channels. Sales in Canada reflected the value of our diversified franchise. Strong fourth-quarter momentum contributed to record sales in individual life and travel insurance, and a number of successes in the wealth management businesses.

Our U.S. Division continued its solid progress, repositioning their businesses. John Hancock Mutual Funds achieved record sales levels of $9.7 billion, 48% higher than the previous year. John Hancock Retirement Plan Services ended the year with full-year sales of an additional $5.1 billion, up 16% over the prior year. Total wealth funds under management in our US business reached a record level of $188 billion.

Across the Company, we saw our funds under management grow to CAD475 billion. These are strong operational results that highlight the strength of our franchises and the shift of our business mix.

Now turning to slide 6. We took advantage of rising equity markets and interest rates to increase our hedging of both equity and interest rate risk.

As you know, as at December 31, 2009, we had 35% of our variable annuity guarantee value hedged or reinsured. That number at the end of 2010 was 55%.

Beyond that, we have added CAD5 billion of macro hedges. As a result, through hedging of all types, we have now hedged 50% of our equity sensitivity, up from 25% at the end of third-quarter 2010.

Since the end of the quarter, we have witnessed improving equity markets and interest rates in 2011. We have taken further advantage of this opportunity to return to dynamic hedging.

In the last few weeks we have added approximately CAD8.5 billion towards our dynamic hedging program, and now have 63% of VA guarantee value hedged or reinsured. This amount, in combination with the macro hedges, means we now have approximately 55% of our equity market sensitivity hedged. And to be clear, this estimate includes an allowance, a substantial allowance, for hedge inefficiency.

Therefore, with the dynamic hedging actions we've taken in the first quarter of 2011, we continue to make substantial advances toward our goal to hedge 60% of our underlying earnings sensitivity to equity markets by the end of 2012, and 75% by the end of 2014.

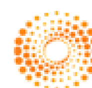
We also reduced our sensitivity to interest rates. At the end of the year our sensitivity to a 1% decrease in interest rates had declined to CAD1.8 billion from CAD2.2 billion at the end of the previous year. This is a solid movement towards our interest rate sensitivity goal of CAD1.65 billion and CAD1.1 billion by 2012 and 2014, respectively.

Manulife's capital remains strong. We increased our MCCSR ratio by 15 points to 249%. And this key ratio is now accompanied by a lower risk profile as a result of the aforementioned hedging actions.

This quarter we reported net earnings attributable to shareholders of CAD1.8 billion. As I said earlier, that was a record. This equates to fully diluted earnings per share of CAD1.00.

Fourth quarter net income excluding the direct impacts of equity markets and interest rates was CAD933 million.

With the CAD1 billion goodwill impairment and the CAD2 billion strengthening of reserves that we undertook in the third quarter, we recorded a full-year loss of CAD391 million. But for these items, we would have recorded a gain of CAD2.7 billion.



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In summary, we have made important progress on reducing our equity and interest rate sensitivities and we will continue to do so. Our capital is strong, our asset quality is superior, and we are seeing strong results from our strategy that will position Manulife for future earnings growth and ROE expansion.

With that I turn it over to Michael Bell, who will highlight our financial results and then open the call to your questions. Thank you. Michael?

Michael Bell - *Manulife Financial Corporation - SEVP and Chief Financial Officer*

Thank you, Donald. Hello, everybody.

Throughout 2010, we made significant progress relative to our strategic priorities. We have driven a change in our business mix towards targeted higher return businesses. As we discussed at our Investor Day, we expect this mix change to contribute to an increase in our ROE over the next several years.

We also strengthened our capital levels in 2010, and MLI's MCCSR at 249% at year-end is strong. When combined with the significant progress that we have made in reducing interest rate and equity market sensitivities, this capital level provides a substantial cushion to potentially adverse market conditions.

We also reported record quarterly earnings in the fourth quarter, aided by favorable equity markets and interest rates.

Slide 9 provides a breakdown of the notable items for the quarter. Please note that the net direct impact of the fourth quarter's higher equity markets and interest rates totaled nearly CAD900 million after-tax, despite the increased cost of the macro equity hedging program.

Other notable items totaled CAD241 million in the quarter, and included favorable investment and policyholder experience and net gains in our dynamic hedging program. These items were partially offset by an accounting change for our Hong Kong pension business and small refinements in our actuarial liabilities.

Excluding notable items, adjusted earnings from operations in the fourth quarter totaled CAD692 million. We view this as a particularly positive result, since it includes CAD34 million in expected after-tax hedging costs for the macro equity hedges added late in the fourth quarter.

Slide 10 provides another breakdown of our full-year 2010 results. In total, we reported a net loss of CAD391 million for the full year. Excluding the combined impact of approximately CAD3 billion of actuarial reserve strengthening and the Canadian GAAP goodwill impairment charge, our earnings totaled approximately CAD2.7 billion.

I would note those underlying earnings were relatively well balanced across our three major operating divisions, which we view as a strength.

As can be seen on slide 11, we have continued to reduce our exposures on variable annuity guarantees. At year-end, 55% of the gross guarantee value was dynamically hedged or reinsured. This compares to 35% at the end of 2009.

Subsequent to year-end 2010, we further expanded our dynamic VA hedging; and these actions have raised this to approximately 63%.

Slide 12 describes additional actions that we took in the last four months to further reduce earnings sensitivity to equity markets. During the fourth quarter, we took advantage of the equity market rally to initiate our macro hedging program. And in the last

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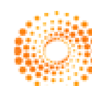

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six weeks of the quarter we shorted approximately CAD5 billion of equity futures contracts. As a result, the total amount of our short equity futures position more than doubled in the quarter, and our sensitivity to equity markets declined substantially.

The after-tax impact related to the macro equity hedges in the fourth quarter was CAD82 million, including the impact of the favorable markets. We expect the 2011 cost to be approximately CAD400 million after-tax for the full year, based upon our current macro hedge position and our long-term equity market assumptions. In addition, the recent increase in our dynamic hedging program is expected to reduce annual earnings by an additional amount of approximately CAD55 million after-tax in 2011.

Our high-level estimate, described at our Investor Day, of CAD400 million after-tax as the incremental cost of hedging in 2015 remains appropriate, as we expect future equity market appreciation will ultimately allow us to reduce our macro hedging position.

As you can see on slide 13, we've reduced our equity sensitivity. As of December 31, our earnings sensitivity to a 10% equity market decline was reduced by 43% to CAD740 million, as compared to the end of the third quarter.

As a result of the additional hedging implemented in the fourth quarter, 50% of our underlying equity sensitivity was hedged at year-end, up from 24% from the previous quarter. The progress we made in the last several months puts us ahead of our original timetable for risk reduction.

Relative to MLI's MCCSR of 249%, we feel that we have significant cushion in the event of potential adverse equity market conditions. This reduced sensitivity to capital has helped create a lower risk profile going forward.

Slide 14 details the beneficial impact of the equity market rally on our results in the fourth quarter. We estimate that the positive equity market performance resulted in a net positive benefit of nearly CAD450 million after-tax, which included the benefit from favorable experience on the dynamically hedged VA business.

The macro hedge cost more in the quarter due to strong equity markets. I would remind you that an additional CAD34 million is included in adjusted earnings from operations as the expected cost of macro hedging for the portion of the quarter it was in effect.

So in summary, the actions we have taken to reduce earnings sensitivity to equity market movements is expected to reduce the volatility of reported earnings in the future.

On slide 15, you will see that we've also made significant progress against interest rate sensitivity. In the fourth quarter the bond portfolio duration was lengthened in some of the most interest-sensitive liability segments. Since the third quarter, we've reduced our sensitivity by 18%, and we are now relatively close to our year-end 2012 target of a 25% reduction in sensitivity relative to the September 30, 2010, levels.

On slide 16, we provide updated sensitivities around the changes in corporate and swap spreads. Now, while there is no simple formula that will estimate the results accurately, an increase in corporate spreads would be expected to provide us with a benefit to net income, and an increase in swap spreads would result in a negative impact.

Currently, the predominant influence on our interest rate exposure relates to rates in the US, but other geographies impact our results as well. These estimated impacts on earnings are based on the year-end 2010 starting point and the business mix as of that date. Changes to various factors and management actions may change the sensitivities.

Now I'll move to slide 17, the interest rate impact on earnings in the fourth quarter. During the quarter, treasury rates and swap spreads increased, while corporate spreads tightened.

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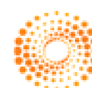

This combination of spread changes and management actions during the quarter reduced the beneficial tailwind of the uptick in treasury rates in the US. Overall we estimate that the net impact of interest rate changes was approximately CAD600 million, including the impact for the variable annuity business that is dynamically hedged.

I'll now turn to our source of earnings on slide 18. Expected profit on in-force was up across most of our businesses due to higher assets under management, which more than offset the increased cost of dynamic VA hedging.

New business strain increased primarily due to distribution investments in Asia and lower interest rates and updated valuation assumptions also contributed to this result.

Now this was partially offset by significant improvements in new business strain year-over-year in the US due to price increases and lower sales of no-lapse guarantee life insurance products. The net experience gain primarily reflected higher equity markets and interest rates.

Management actions and basis changes of CAD140 million pre-tax mainly relates to the expected impact of macro hedges and refinements to the actuarial methods and assumptions. Earnings on surplus improved over the prior year due to higher AFS equity gains and lower OTTI provisions.

Slide 19 summarizes our results by division, excluding the impact of the equity markets, interest rates, and investment results. The Asia Division results were lower due to the DAC adjustment in Hong Kong and higher new business strain.

In Canada, underlying earnings were in line with the prior year, as positive earnings growth in the wealth management businesses, including the Manulife Bank, was offset by higher new business strain from strong sales and lower interest rates.

Our U.S. Division demonstrated the most improvement in underlying earnings, as price increases and lower volumes in U.S. Insurance drove a substantial improvement in new business strain. Improved policyholder experience contributed as well.

So overall, we are pleased with the underlying trends in the divisional results and the continued balance of contribution by the major businesses.

Slide 20 summarizes our regulatory capital position for MLI. MLI reported an MCCSR ratio of 249% at year end, a sequential increase of 15 points. Combined with the actions we have taken to reduce our market exposures, our MCCSR represents an increased buffer relative to market performance risks.

On conversion to IFRS we face a modest decline in our MCCSR. In the first quarter 2011 we expect the impact to amount to approximately 4 points, growing to 8 points by the end of 2012 when the phase-in provision expires.

As illustrated on slide 21, we continue to offer our clients a diverse product portfolio. The products indicated in green represent the products we continue to strategically target for growth, since we expect them to have favorable long-term returns and lower risk profiles. We view this product breadth as a strength.

On slide 22 you can see the strong insurance sales results. For the full year, insurance sales of products targeted for growth grew by 20% over 2009, on a constant currency basis. We generated strong growth across a wide variety of our businesses.

Our Asia Division delivered strong sales growth, with full-year sales up 43%, while reaching a record CAD1 billion in 2010 and record sales in Indonesia, the Philippines, China, Vietnam, and Malaysia.

In Canada, individual insurance sales were up 4%.

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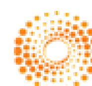

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In the US, good progress is being made on product repositioning efforts, as evidenced by the fact that life insurance sales excluding the no-lapse guarantee universal life product grew by 16% over the fourth quarter 2009. I would also note that we had number-one market share for most of the year in variable universal life sales in the US.

Turning to slide 23, our total wealth sales for the full year grew by 23% over 2009, excluding variable annuities and the book value fixed deferred annuity product. Asia Division experienced impressive growth of 27%, benefiting from new wealth products and the acquisition of Manulife TEDA in China.

Canada experienced excellent progress as part of our broader sales growth and diversification strategy, as evidenced by record mutual funds sales and strong growth in our Manulife Bank.

We are also very pleased with the results of our U.S. Wealth Management businesses. Sales of John Hancock Mutual Funds reached their highest level ever and Retirement Plan Services also ended the year with record asset levels. These results are very positive signs that our repositioning efforts in the US are working.

Slide 24 shows the growth in new business embedded value for our targeted growth products. New business embedded value for the insurance businesses we are targeting to grow increased by 17% in 2010, reflecting a more favorable product mix and strong growth in Asia and Canada.

New business embedded value on wealth products, excluding variable annuities and the US book value fixed deferred annuities, increased 10% over 2009. This reflects our successful repositioning efforts, as well as our strong franchise and the John Hancock brand.

Full-year new business embedded value for insurance and wealth on products we are not targeting for growth declined in 2010, due primarily to lower volumes, but increased in the fourth quarter as we took actions to improve their profitability.

Slide 25 provides a summary of our annual update for the in-force embedded value. This analysis will be detailed in our upcoming annual report.

In aggregate, our year-end 2010 embedded value declined modestly relative to year-end 2009. While there are a number of moving parts to the calculation, the main business factors that impacted the change in embedded value are the same ones that drove the third quarter 2010 actuarial basis change, particularly the higher morbidity assumption in Long-Term Care.

In addition, our substantial increase in variable annuity hedging decreased embedded value for year-end 2010. I would note that our year-end 2010 in-force embedded value continues to be higher than our current market cap. More detail will be included in our annual report.

As shown on slide 26, total funds under management at year-end 2010 was nearly CAD0.5 trillion, representing an increase of CAD35 billion over last year. We view this as strong growth.

Slide 27 demonstrates that our portfolio continues to be high quality and well diversified. 95% of our bonds are investment grade, and our invested assets are highly diversified by geography and sector, with limited exposure to the high-risk areas noted on the slide.

So by way of summary, we are pleased with our performance this past quarter and overall for the full year. We made substantial progress delivering upon our business strategy. We are ahead of our original timetable in reducing sensitivity to equity markets and interest rates.

Our capital levels are strong, with MLI's MCCSR 249%. When combined with the risk-reduction actions, we believe our capital levels offer a significant buffer against potential future market declines.

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We reported record quarterly net income in the fourth quarter, which was supported by favorable markets. Overall, our business operations are well positioned for future growth as we continue to execute on our business plan.

Similar to past quarters, I think it is important to address key questions that you are likely to have regarding these results. The first is -- what is the estimated impact of IFRS in 2011?

Next quarter, we will begin reporting IFRS with corresponding comparative IFRS financial information for 2010. As previously disclosed, with the exception of the additional goodwill impairment, we don't expect the initial adoption of IFRS to have a significant impact on our financial statements.

Our disclosures have provided a reconciliation of the January 1, 2010, opening shareholder equity and known events in 2010, such as the additional goodwill impairment under IFRS.

The capital impact from IFRS is expected to be approximately a 4 point decrement in MCCSR in the first quarter of 2011, and an 8 point decrement by year-end 2012.

The last comment that I will reinforce here is that there continues to be significant uncertainty around the future impact of IFRS Phase 2, since it is not clear what the final standard will ultimately be.

The second topic is -- what is the expected incremental cost of the recent expansion in our equity hedging in 2011?

I would remind you that our reserves and expected profit on in-force assume a long-term equity total return of approximately 10% per year. We initiated CAD5 billion in macro hedges in November and December of 2010. As a result we are trading the equity market performance for the short-term risk-free rate, which today is currently close to zero.

So when you multiply our macro hedge position by 10%, you get approximately CAD500 million of pre-tax expected hedging costs, or approximately CAD400 million of incremental after-tax impact per year. Now to repeat, this is based on our current macro hedge position and our long-term equity market assumptions, and actual results, of course, will vary.

In addition, the recent increase in our dynamic hedging program is expected to reduce annual earnings by an additional CAD55 million after-tax in 2011. Please also remember that these estimated incremental costs of the hedging will likely change in the future, as changes to various factors and additional management actions can have significant impact on reported results in the future.

The third topic is the status of the long-term care in-force rate increases.

Overall, although it is very early in the process, we feel positive about our progress so far with the states and their review and approval process of our in-force rate increases for long-term care. As of today, five states have approved substantial rate increases, including a handful of key states. We have also had constructive discussions with several additional insurance departments in other states.

We currently feel comfortable with our estimates and timetable that we developed as we calculated the reserve strengthening at the third quarter of 2010. Again, it is early in the process and we expect to provide additional updates in the future.

At this point, this now concludes our prepared remarks. Operator, we will now open the call to Q&A.

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QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Doug Young, TD Newcrest.

Doug Young - *TD Newcrest - Analyst*

Good afternoon. I guess my first question is related to the hedging costs, Michael. Obviously CAD400 million plus CAD55 million; what is the level at which you think that peaks out? And is that in a year's time and then starts to flow down into the CAD400 million that you are expecting by 2015?

Michael Bell - *Manulife Financial Corporation - SEVP and Chief Financial Officer*

Doug, the short answer is that it depends upon a number of factors, but I would expect that it will likely be higher in the near-term and then gradually decline to the CAD400 million. But it really depends upon a number of different factors including how equity markets perform.

The better equity markets perform in the near term, the faster we will get to our year-end 2014 target, and the faster that we can begin to unwind those macro equity hedge positions, which are costly. So at the end of the day, if we literally modeled out where the market is today, we assume precisely 10% equity market total returns per year from here over the next several years, the equity cost in 2015 would likely be lower than the CAD400 million placeholder that we have out there.

But again it is too early. There are still too many factors. And the point is that CAD400 million represents a reasonable placeholder for us, although again potentially conservative if the equity markets continue to perform well.

Doug Young - *TD Newcrest - Analyst*

Just a follow-up on that, within that model that you just described does it get to CAD500 million in 2012 before it starts to decline?

Michael Bell - *Manulife Financial Corporation - SEVP and Chief Financial Officer*

Doug, the short answer is it depends. It really depends, for example, on our own management actions. I mean, if we went out tomorrow -- I'm not suggesting we are going to do this. If we went out tomorrow and said, you know, by God, we are going to get to our year-end 2014 hedging targets right away, by the end of February, then the annual cost would be higher in the near term. Again -- so it's based on a number of different factors.

I think assuming a gradual implementation to get to those year-end 2014 targets, it is likely to be the pattern that I described earlier. But again, there are a lot of different factors; and I think the most relevant is that we're significantly reducing our equity market sensitivity for our reasonable cost to near-term earnings. And we are on a glide path to either meet or even potentially modestly exceed the earnings target in 2015 if everything works swimmingly according to plan.

But we will stick with our -- we will stick with the long-term targets that we gave at the Investor Day at this point.

Doug Young - *TD Newcrest - Analyst*

Okay, just my second question on lapse rates, obviously it looks like lapse experience is favorable in the US, but negative in Japan. Just wondering if you can give us a little more details around what products this relates to and what is driving it.

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Donald Guloien - *Manulife Financial Corporation - President and Chief Executive Officer*

Doug, Don Guloien jumping in. We'll let somebody answer that question on the relapse rate, probably Mike again, but I just want to add something to what Mike said. That is, he has perfectly described the question you asked, which is the decrement. But I think you also have to keep aware that if equity markets go up -- which was what would lead us to hedge more faster again -- that is going to have a salutary impact on many, many other parts of our operation.

You know when you've got CAD475 billion roughly under administration, fees are going to up, a whole bunch of other things are going to be incredibly positive. So the nice thing is, yes, there are scenarios that could cause the hedging costs to go up a bit more; but there will be a lot of other good news for our Company across the entire enterprise. Not the least of which is sales of some of those mutual fund, 401(k), and other type products. The question, Mike?

Michael Bell - *Manulife Financial Corporation - SEVP and Chief Financial Officer*

Yes, so Doug, on your question on the lapse rates, relative to a year ago, we have seen a pretty significant improvement in the lapse experience for the US life insurance business. Our speculation is that a fair amount of that may be economy-driven.

You may recall that a year ago we cited the weak economy as one of the reasons we were seeing early duration lapses in the US. As the economy has modestly strengthened, thankfully, that has proven to be a temporary phenomenon, not a more permanent one. So that's driven the year-over-year improvement in the US.

In terms of the lapse rates in Japan, there was one particular product which we updated the lapse rates on recently. It wasn't a huge impact, but it was enough to take a product that had new business gains at issue of a small magnitude to now some new business strain at issue. Again, not material, but we are serious about keeping on top of our valuation assumptions, obviously.

Doug Young - *TD Newcrest - Analyst*

In the US, is it variable annuities or is this like term life?

Michael Bell - *Manulife Financial Corporation - SEVP and Chief Financial Officer*

In the US, the primary -- and I will ask Jim Boyle if he wants to add -- the primary improvement that we are seeing is around the universal life product.

Jim Boyle - *John Hancock Financial Services - SEVP, US Division and President, John Hancock Financial Services*

Yes, Doug, Jim Boyle. In our insurance lines, both long-term care and life insurance, we saw favorable improvement in lapses. So on the wealth side the story is a bit different; obviously lapse is a bit of a different concept.

But we had positive net sales in both mutual funds and our 401(k) business. So our lapse experience generally across-the-board has been consistent with our pricing and our expectations, and our policyholders have been behaving effectively as we had assumed they would.

Doug Young - *TD Newcrest - Analyst*

Okay, thank you.

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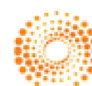

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Tom MacKinnon, BMO Capital Markets.

Tom MacKinnon - *BMO Capital Markets - Analyst*

Yes, thanks very much. Good afternoon. Just a follow-up on this hedging cost discussion here. When you had your Investor Day the way I understood it was from September 30, 2010, through the end of 2014 the aggregate spend would be CAD400 million in terms of equity market hedging costs. And that was sort of on a -- we will call it a dollar cost average formula throughout that time period; and assuming markets went up annually 8%, plus another 2% for dividends. That's correct, right?

Michael Bell - *Manulife Financial Corporation - SEVP and Chief Financial Officer*

Tom, the only piece I would adjust in what you said is we never talked about an aggregate cost of hedging. What we said was that by the time we got to 2015 we had a placeholder in there for calendar year 2015 of a CAD400 million aftertax hedging cost. We didn't explicitly try to give out a schedule.

I would also say we didn't explicitly say dollar cost averaging. What we said was we would expect to get to our targets by year-end 2014.

Tom MacKinnon - *BMO Capital Markets - Analyst*

Yes. Now if you had done -- if you did everything right at the very beginning of that projection, if you did all the hedging at the very beginning of the projection and you spent CAD400 million then, and the markets behaved exactly as you would have expected -- would we anticipate under that scenario that some of that would come back into earnings?

Donald Guloien - *Manulife Financial Corporation - President and Chief Executive Officer*

Tom, it's hard to speculate because at that time if you recall, the time we did Investor Day in November, the markets were lower. So if we had hedged at that point the actual cost would have been greater than what it would otherwise be, hedging when we did.

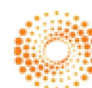
It is very hard to -- that is why Mike is -- he's not trying to be evasive; it just depends on when you do it. If we had hedged in the summer in August, you can only imagine what this might have cost us.

That is why our strategy was to have the very, very robust capital base to withstand the vagaries of the market and wait to hedge until markets rewarded us with higher levels, which is what we have done. And now we are being rewarded by higher equity market levels and higher interest rates, which enables us to go back to dynamic hedging.

So the costs will be much lower than they would otherwise have been.

Michael Bell - *Manulife Financial Corporation - SEVP and Chief Financial Officer*

Yes, Tom, Donald has got it exactly right. And I would add, if you are really asking the question -- do we expect our overall cost of hedging to decline over time? The answer is, yes, probably.



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And I say probably because as long as equity markets appreciate we would expect, once we have hit that long-term target on equity market sensitivities, to be able to begin to take off the macro hedge position. As we take off the macro hedge position the cost of hedging would decline.

I would also say just for completeness I would not expect short-term risk-free rates to be zero forever. So again I would also expect the macro hedging costs over time to shrink as short-term rates rise. But the first point is the primary point.

Tom MacKinnon - *BMO Capital Markets - Analyst*

So obviously it looks like the glide path towards that 2014, '15, projection you talked about is going to be hurt initially as a result of hedging faster; but then benefited more later as a result of hedging earlier.

Michael Bell - *Manulife Financial Corporation - SEVP and Chief Financial Officer*

I mean, directionally you --

Tom MacKinnon - *BMO Capital Markets - Analyst*

Assuming everything else works out as anticipated.

Michael Bell - *Manulife Financial Corporation - SEVP and Chief Financial Officer*

Yes, I was going to say there are a lot of assumptions obviously in your statement. I think that your point is a fair one, Tom. I would also add though a couple very important points.

Number one, let's keep in mind we took advantage of the markets rallying to put these hedges on. So that means that the all-in economic cost over time is lower to do it when the markets are high than when the markets are low.

Second, let's also remember, we have now significantly reduced our equity market sensitivity. To have more stable results quarter-to-quarter we view as a very good thing.

Tom MacKinnon - *BMO Capital Markets - Analyst*

Just one follow-up. What would you suggest, given that you have significantly de-risked the downside, any kind of view on what a target MCCSR might be?

Michael Bell - *Manulife Financial Corporation - SEVP and Chief Financial Officer*

Yes, Tom, that's an important question. So I'm not going to give you a specific number at this point because there are just too many different factors.

Obviously at this point we are a lot more comfortable with our capital position. In fact I think it is fair to say we are more comfortable with our capital position than any time in several years, certainly since the financial crisis. We are now several billion dollars over a 200% level; and several billions over that, over 150% kind of level.

But I still think at the end of the day the capital requirements are still uncertain and therefore I wouldn't try to put a number on the MCCSR at this point in time.

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Tom MacKinnon - *BMO Capital Markets - Analyst*

Okay. Thanks very much.

Operator

Robert Sedran, CIBC World Markets.

Robert Sedran - *CIBC World Markets - Analyst*

Good afternoon. I'm sorry, I don't mean to belabor this hedging issue. I guess I want one last point of clarification if I may.

But is it fair to assume here that until you get to the level at which you are satisfied that you are at your target level of hedging, that you are not going to be paying down or covering any of these macro hedges? In other words, future hedging from here will hopefully be dynamic; and until you get to the point where you can start replacing the macro with dynamic, you are not going to be doing it?

Michael Bell - *Manulife Financial Corporation - SEVP and Chief Financial Officer*

Robert, I will start and see if Bev wants to add. I would not make any absolute statements at this point in time. We're obviously very serious about our year-end 2012 and year-end 2014 targets, and barring a calamity we would certainly expect to meet those targets.

Having said that, we think that there is good balance between the dynamic VA hedging that locks in the long-term swap rate and is therefore built right into the reserve process, and the macro hedging, which is really a short-term vehicle not built into the reserve process because it is not tied to a specific product or a specific block of business and therefore is a floating short-term cost to reduce near-term sensitivity.

We think that balance makes a lot of sense. So the short answer is it will depend upon what market conditions are and what else is going on in the world. Let me see if Bev wants to add.

Bev Margolian - *Manulife Financial Corporation - EVP, Chief Risk Officer*

I think Mike nailed the question, you answered the question. I think that as we do add more dynamic hedging I think that there will be a point at which we take off some macro hedges, not necessarily one for one, but we are just looking at all of the market conditions and we will rebalance the positions between our macro and our dynamic.

Robert Sedran - *CIBC World Markets - Analyst*

Okay, thank you. Just a quick SOE-related question. I know the earnings on surplus tends to bounce around quite a little bit. If I was to look at the annual CAD430 million that you did in 2010, is that a number that would be considered normal on an annual basis, or would it be higher or lower than you would expect?

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Michael Bell - *Manulife Financial Corporation - SEVP and Chief Financial Officer*

Robert, as you said, there are so many different things that impact that. Again, a lot of it obviously will depend upon where interest rates go in the future and where we end up placing those dollars. We also, remember, harvested a significant amount of equity market gains, a significant amount of AFS equity gains here in 2010.

I mean if you really made me pick higher or lower I would probably say modestly lower. But again there are so many different factors I wouldn't probably be overly precise. Let me see if Warren, our Chief Investment Officer, wants to add.

Warren Thomson - *Manulife Financial Corporation - Senior EVP, Chief Investment Officer*

One point I think should be highlighted is the fact that in Q3 we did in fact lengthen the duration of our surplus significantly. And that was to take advantage of the steepness of the yield curve as well as provide a bit of a natural hedge to our interest-rate sensitivity in our liability segments.

So in fact because of that steepness of the yield curve we would expect to actually pick up some incremental run rate in our surplus earnings. But the second piece as well is it gives us the flexibility to realize AFS gains or losses to offset some of the sensitivity that we will see on the liability segments.

But we think overall our surplus asset mix is fairly stable with the exception of that lengthening of the duration that we did in Q3 -- and did a little bit more in Q4 as well.

Donald Guloien - *Manulife Financial Corporation - President and Chief Executive Officer*

I guess I would add to that one more thing. Over the last couple years we took some appraisal marks on our commercial real estate portfolios, and the real estate market is looking pretty robust. I attribute that to a couple of business publications asking whether it was the end of the commercial real estate market, and of course that is the best predictor of a raging bull.

Warren Thomson - *Manulife Financial Corporation - Senior EVP, Chief Investment Officer*

And the final one, actually, our AFS equity gains as well, those should be fairly stable. The levels we realized in 2010 we feel very comfortable could be repeated in 2011.

Robert Sedran - *CIBC World Markets - Analyst*

That's helpful. Thank you.

Operator

Gabriel Dechaine, Credit Suisse.

Gabriel Dechaine - *Credit Suisse - Analyst*

Good afternoon. Just to go back to the MCCSR, now I don't consider that you've got like real excess capital, but you are very comfortable. So what are the prospects of at some point within the next year or so, assuming things go well, you are able to move some of that back to the Holding Company and delever a little bit? Given that OSFI seems pretty intent on evaluating holding company capital regulation, Basel III type concepts on to insurers, etc.

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Donald Guloien - *Manulife Financial Corporation - President and Chief Executive Officer*

Well, I think, Gabriel, you have got it right. There is a lack of clarity around where the ultimate capital regulations are going here in Canada, and I think that is going to be uncertain for a while. Internationally you've got Solvency 2 out there and -- what do they call it -- regulatory modernization in the United States.

There is a lot of uncertainty about what levels of capital. So anybody who tells you that they know exactly with precision how much excess capital they have in the insurance industry is probably not aware of what is really going on.

Having said that we have a very robust level of capital, a fortress level of capital. A policyholder of Manulife has not a thing to be concerned about.

If you look at where Manulife bond spreads have come, they have come down 70 basis points in the last little while. We have made huge strides in hedging, as reflected in the decreased sensitivity to both equity markets and interest rates, plus have that very robust level indicated by the 249%.

I mean I can't think of another time when we have been more robustly positioned in terms of the amount of protection that we have at all levels. And the base reserves being stronger than they have been before and then in the level of capital we hold in addition to the reserves, and in terms of the risk profile of the Company going forward -- all three had moved in an incredibly positive direction. And I sleep very easy at night with the level of fortress capital that we now enjoy.

Michael Bell - *Manulife Financial Corporation - SEVP and Chief Financial Officer*

Now, it's Mike; I would add on your question on the leverage, we recognize that our leverage is higher than our long-term targets currently. With the IFRS pro forma adjustment, our financial leverage is approximately 33% companywide.

We do have approximately CAD950 million of debt maturing throughout 2011 including over half of that maturing here as a normal redemption later in February. So we would look at it as an opportunity to reduce our leverage over the course of the year.

Again it will take several years to get back to that 25% long-term target. But your question is right when you say -- will we look at this as an opportunity to start to bring that leverage ratio down? I do expect to do that.

Gabriel Dechaine - *Credit Suisse - Analyst*

Is that imminent, that repayment? I thought it was at the MLI, not MFC. Maybe I am mistaken.

Michael Bell - *Manulife Financial Corporation - SEVP and Chief Financial Officer*

I just meant in terms of our consolidated leverage companywide it obviously counts.

Gabriel Dechaine - *Credit Suisse - Analyst*

Fair enough. Then just on the asset, the investment side, and this duration extension. You increased your exposure to US government debt by about CAD11 billion over the past year. My understanding is your long-term goal is to rotate into more corporate to enjoy some higher yields.

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What is the -- when that takes place, if and when it does, how would that be expected to impact your earnings? I am trying to get a sense for if that is already implied in your five-year targets. Or is that something positive that could still take place?

Michael Bell - *Manulife Financial Corporation - SEVP and Chief Financial Officer*

It's Mike. I will start and see if Warren and Scott went to add. Yes, we are at this point, given our efforts to extend the duration of our assets backing the liabilities, we have significantly increased our holdings of 30-year U.S. Treasuries in particular. We do view that as an opportunity going forward over time to move out of treasuries and into long corporates.

That would in fact be an incremental increase. It would show up as a trading gain in our results as we swapped it out. Because again the 30-year Treasuries would be what is embedded in the valuation assumptions today.

The issue really is going to be managing our strong credit underwriting discipline and also looking at what supply is out there. We benefited significantly in 2009 and 2010 from the Build America bonds program. Obviously that was great while it lasted.

What the supply looks like going forward is an open question. We view it as an opportunity, but I certainly wouldn't try to put a number on it. Scott or Warren, anything you would add there?

Scott Hartz - *Manulife Financial Corporation - EVP General Account Investments*

I think that is just right. This is Scott. I would view it as an opportunity but not something we have planned on at all. As Mike mentioned, when you're making 30-year corporate loans you need to be very careful about your credit discipline. We clearly have done that through the cycle and will continue to do that. But I would just view it as an opportunity.

Gabriel Dechaine - *Credit Suisse - Analyst*

Okay. Just a nitty-gritty one here. The underlying VA sensitivity, if I look year-over-year I don't recall seeing that disclosure. It went up to CAD1.3 billion from CAD1.2 billion last year. Why did that number go up?

Is that because it is closer to ultimate withdrawal dates? And would that imply -- is that going to keep going up and we should -- bump up your hedging requirement to keep at that 50% to 60% hedge ratio?

Michael Bell - *Manulife Financial Corporation - SEVP and Chief Financial Officer*

Boy, that's a pretty detailed question.

Gabriel Dechaine - *Credit Suisse - Analyst*

We can take it off-line.

Michael Bell - *Manulife Financial Corporation - SEVP and Chief Financial Officer*

I was just going to say, why don't you let us take it off-line with you and we will go through that.

Gabriel Dechaine - *Credit Suisse - Analyst*

Sure.

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Operator

Mario Mendonca, Canaccord Genuity.

Mario Mendonca - *Canaccord Genuity - Analyst*

Good afternoon. Question perhaps for Michael and Donald. Heading into the quarter with rates moving the way they did, would have expected that higher interest rates would have some positive effects on this Company's longer-term sustainable earnings. Ignoring anything to do with the gains in any particular quarter from higher interest rates.

And Michael, you referred to it when you were discussing earnings on surplus, suggesting that higher interest rates would improve your earnings on surplus. Why is it that from Investor Day to today, with everything that has happened with markets and interest rates, that you would only characterize your 2015 objective as being attainable and appropriate? Why wouldn't they be essentially a gimme at this point?

Michael Bell - *Manulife Financial Corporation - SEVP and Chief Financial Officer*

Okay, Mario, it's Mike. I'll start and I'll let Donald add to it afterward. First, your point is -- I'm sorry, I don't mean to laugh. Your point is a fair one.

I would certainly agree that with interest rates now being higher and equity markets being higher, that overall helps the outlook for 2015, all things equal. I mean to call it a gimme, boy, there are a lot of things that are going to happen in the world over the next four years.

But you're absolutely right. If from this point forward interest rates stayed at the level, if equity markets appreciated from this point forward at a 10% total return per year, that would be very helpful in terms of the 2015 outlook. Again I still wouldn't get to the gimme stage, but it would be helpful.

I just think, Mario, as well, I don't know that updating the 2015 outlook on quarterly calls based on fluctuations is necessarily a productive exercise. That would probably be more false precision.

But I think it is fair to conclude that if we saw a material sea change in our outlook, positive or negative, we would talk about it. But your underlying point is a fair one, that as good as we felt at the Investor Day we feel better here 60, 90 days later.

Mario Mendonca - *Canaccord Genuity - Analyst*

From a more specific perspective now, how do higher interest rates manifest themselves in higher sustainable earnings on your sources of earnings? Is it fair to say that it results in lower earnings strain and higher earnings surplus, earnings on surplus, gradually over time as the bonds mature?

Michael Bell - *Manulife Financial Corporation - SEVP and Chief Financial Officer*

Yes, those are both fair points. I would also add that I think in general it would help our sales levels if interest rates were higher.

Again, long-term guaranteed life insurance products are very expensive to consumers when interest rates are low. When interest rates are more reasonable, those products are more reasonably priced and therefore we would tend to get more sales.

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I would also expect it to have longer-term positive impact on our ultimate reinvestment rate if that changed. Also I just think generally it would be a sign of a healthier economy.

So there are all sorts of reasons to feel bullish if interest rates were today's levels or 100 basis points higher levels for the next few years. But that is obviously not what we built into the Investor Day, but there are a lot of reasons to feel -- that we would feel better.

Mario Mendonca - *Canaccord Genuity - Analyst*

So finally with that said, taking into account the higher interest rates, what Don Guloien said a moment ago about real estate values improving, the very strong equity markets -- why would you suggest then that earnings on surplus in 2011 could be potentially lower than they were in 2010?

Michael Bell - *Manulife Financial Corporation - SEVP and Chief Financial Officer*

Well, I just think, Mario, that importantly there was a lot of bounciness in our results in IOS in 2010. As an example -- I appreciated Warren's comments that there should be more equity gains to be reaped in 2011. Again that depends upon the market performance.

We have also lowered our overall proportion in the surplus segment of public equities. So we have got -- you need more appreciation to get the same level of realized capital gains.

I look at the fourth-quarter number of CAD78 million pretax that is on the SOE on slide 18, and say -- if I multiplied that by 4 would I be far off?

So in answer to Robert's question, if I had to take higher or lower I would probably say modestly lower; but I am not trying to give you precision. I'm just trying to answer Robert's question.

Mario Mendonca - *Canaccord Genuity - Analyst*

Thank you.

Operator

John Aiken, Barclays Capital.

John Aiken - *Barclays Capital - Analyst*

Good afternoon. Taking the discussion of the MCCSR ratio the next logical step further, Donald, what would be your top preferences in terms of allocation of capital into various regions or products going forward as you become more comfortable and we get more information from the regulators?

Donald Guloien - *Manulife Financial Corporation - President and Chief Executive Officer*

Well, we're doing it right now. We're not being held back by capital. You know when we raised some equity it was very painful, just over a year ago. But it's enabled us to invest in all the things that we think are appropriate to invest in.

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We are not capital constrained in our growth in Asia. That is a very, very high margin, high ROE business as Mike has reminded you guys. If you look at the results that we have experienced, we are fulfilling our wildest dreams in terms of growth in those markets.

Same is true in Canada and the United States. So we are not being held back by lack of capital, that is the nice thing.

The shift is there. We have cut back in certain products where we think the long-term expectations aren't as good on behalf of shareholders, and allocated it to stuff that we think the returns and risk profile are best for our shareholders.

So we have got more than enough capital to sustain all the growth. If I could see an acquisition opportunity that is complementary to our businesses, that would obviously be highly attractive. But I think in this kind of market it is lifting a lot of boats, the tide; there is less likely to be the opportunities on sale that we experienced a couple years ago.

John Aiken - *Barclays Capital - Analyst*

Great. Thank you. You did answer my inference. I appreciate it.

Operator

Darko Mihelic, Cormark Securities.

Darko Mihelic - *Cormark Securities - Analyst*

Good afternoon. A question for Michael. I guess one of the things that would help me out in understanding the results a bit better is -- where would the macro cost of hedging show up in the source of earnings?

Michael Bell - *Manulife Financial Corporation - SEVP and Chief Financial Officer*

Sure, Darko. It is in -- we have included the expected cost of the macro hedging in management actions in the SOE, since it is a management decision each quarter whether we roll that, whether we increase it, whether we decrease it. So the expected cost is in management actions.

And the variance between the actual equity market performance and the long-term assumption of a total return of 10% a year would show up in experience gains and losses. So that if market perform -- if markets rallied like they did in Q4, there would be an experience loss just on the macro hedge program, relative to the 10% long-term assumption. Obviously, that would just be a partial hedge to other equity gains we would expect to have.

Darko Mihelic - *Cormark Securities - Analyst*

Okay, that's very helpful. Now, I guess the next question is -- where would the cost of the dynamic hedging show up in the SOE?

Michael Bell - *Manulife Financial Corporation - SEVP and Chief Financial Officer*

The cost of the dynamic hedging, the expected cost of the dynamic hedging primarily shows up in expected profit on in-force. The reason for that is that because the dynamic hedging has been designed to be a long-term program, we have built that rate into the reserve process based upon the long-term swap rate.

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So if you think about it, when we are hedging a certain block of VA business, we go out and we say -- okay, what is the equity market sensitivity on that VA block? We short an amount of futures to try to offset that sensitivity. That gives us the short-term risk-free rate.

We take that short-term risk-free rate and we swap it into a long-term swap rate. Then we say -- okay, let's say the long-term swap rate is 4%. We say -- okay, well, now the reserves can't look at a 10% annual total equity return; it needs to be based on this 4% that we expect to earn on the swap rate.

So we build it right into the reserves; and what that means then is a greater proportion of the variable annuity fees have to go to pay for the reserve changes rather than drop to the bottom line. So that is why it shows up as lower expected profit on in-force.

Then as we have talked about, a high-level rule of thumb of that is 50 basis points after-tax per year times the guarantee values. So with CAD58 billion now of guarantee value hedged through the dynamic VA program -- again, it's a crude estimate -- we would say that that 50 basis points on that, so 290 a year would be the cost relative to zero hedging. And that would be showing up as a headwind in the expected profit on in-force.

Darko Mihelic - *Cormark Securities - Analyst*

Where does the breakage show up in the SOE?

Michael Bell - *Manulife Financial Corporation - SEVP and Chief Financial Officer*

Let's see. We show the breakage in the experience gains and losses.

Darko Mihelic - *Cormark Securities - Analyst*

Okay. What was the reason for the massive amount of breakage this quarter?

Michael Bell - *Manulife Financial Corporation - SEVP and Chief Financial Officer*

Well, I don't know if I wouldn't necessarily call it massive. We were obviously pleased to see the benefit. There are a number of things that helped us out there. I will start and I will ask Bev if she wants to add.

First of all, remember that we don't hedge the PfADs in our dynamic hedging program. So in a quarter where you see equity markets do well and interest rates rise, we would expect to get a natural benefit because we would have a PfAD release that wasn't accounted for in the hedging program.

But again I would not get carried away -- this is going to bounce around quarter-to-quarter. It certainly bounced around quarter-to-quarter in 2010. But to answer your direct question, that was a big driver.

Bev, do you want to talk about some of the other pieces?

Bev Margolian - *Manulife Financial Corporation - EVP, Chief Risk Officer*

Yes, I think the other major (technical difficulty) that are underlying funds behaved or performed better than the hedge instruments. So we got some positive fund tracking if you will.

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Darko Mihelic - *Cormark Securities - Analyst*

I guess that is the crux of my question. I'm sorry, I'm just going to throw it out; this is a crazy, crazy question. But it seems to me that it is very far away from what you would have expected in terms of breakage. You could see it in fact in page 5 of your own press release; we can see what you expect in terms of breakage in an upward moving equity market.

So here's the crazy question. Is it possible that when equity markets are booming you can think of the hedge as a sort of a natural brake; and you can ease off on that brake when equity markets are moving up. And when equity markets are crashing you just sort of slam on that brake. Is that a crazy question, or it --?

Donald Guloien - *Manulife Financial Corporation - President and Chief Executive Officer*

Well, let's -- I would take it a different way. But you know it's not a crazy question. It is a good question.

First of all, we shouldn't be calling this breakage. As Mike explained, you want to hedge against what you think is most likely to happen. The accounting which gives rise to PfADs is basically a residual of Solvency accounting. It says forget your best estimates; now let's imagine that we torture the assumptions for conservatism in every dimension.

Higher mortality, right? Higher lapse rates. Higher everything that is negative and lower everything that is negative, and you come up with a different answer which is used for accounting. That is the notion of these PfADs.

I don't think many people if they really understood it would suggest that you should hedge to the padded result. You should hedge to your best estimate.

As a result there will be things that aren't hedged that will be great residual things. Now the good news is this actually works in a positive direction. As you have indicated, in rising markets, that will lead to higher than anticipated earnings. As Mike has indicated earlier, that will lead to more hedging on our part and higher hedging costs; but that is a really good news story.

The obvious -- the reverse is true in down markets. We don't hedge these pads. So if we have negative or positive results, that is not necessarily a failure of the hedging program. In fact it is more likely just as a result of the fact that -- let's all acknowledge that we are not hedging the PfADs. You wouldn't expect it.

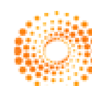
Bev talked also about the difference between fund tracking, between what the managers do. And as a general rule of thumb I find active managers tend to outperform in down markets and tend to underperform in up markets. That is not always true and that wasn't true in this quarter where you ended up with a more positive result than what the index is. But there is going to be movement there.

We, to be conservative, when we talk about 55% of our volatility is being hedged now, we already deduct an estimate, a very reasonable estimate and one that we think is conservative, for inefficiency or breakage. We also make the assumption that it will always go against us.

When markets are up, we sort of say -- okay, let's take it off the positive impact. When markets go down we take it off the other way and assume it is going to be worse than that.

That is not actually what is probably going to happen. Some elements of it, like fund tracking and so on, are going to be more of a random walk. I think the PfADs, the naught hedging of the PfADs, that is going to have a directionality to it.

But a big chunk of it is more random. It is more like a plus or minus concept rather than when markets are down it's always going to go against us, and when markets are up it is always going to go for us -- I mean -- or against us as well.



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Which is sort of what we assume in the calculation of reduction of earnings sensitivity. So a betting person would say that they would bet that the reduction in income sensitivity is actually going to be less than that that we are depicting. But we have put reasonable estimates in there because no one would want us to fairly assume that there will not be any inefficiency or breakage or tracking here of any type.

Michael Bell - *Manulife Financial Corporation - SEVP and Chief Financial Officer*

So, Darko, it's Mike. I will just add two other factoids here for you to consider. First, we have just very recently looked at our performance from the inception of the dynamic VA hedging program and found that an up markets, as Donald and Bev both alluded to, in up markets we have actually outperformed the inefficiency assumption that is built into the sensitivity.

So based on historical experience, that would be conservative. I thought that it made more sense to disaggregate our assumptions and then again track those over time before officially changing those assumptions going forward. But historically thus far that has proven to be a case, so your hypothesis would be a fair one, again for a lot of the reasons that Donald described as well.

I would add just to be balanced, while Manulife didn't have a significant VA hedging program in 2008, other insurance companies did. And you may recall that realized volatility was off the charts in 2008 at the same time that markets were down. So there are certainly examples where hedging ineffectiveness could be worse than what is described. All you'd have to do is look at that period.

So again to date we feel like our assumptions are reasonable based on our experience to date; they are conservative; but just want to be cautionary here in terms of predictive capacity.

Darko Mihelic - *Cormark Securities - Analyst*

Okay, thanks very much for taking my questions.

Operator

Steve Theriault, Bank of America Merrill Lynch.

Steve Theriault - *BofA Merrill Lynch - Analyst*

First question, I wanted to talk a bit about the dividend. With the MCCSR now hovering about 250% and your sensitivity is down significantly, are you starting to give any consideration to a dividend increase? I think I know the answer for the very near term, but further out what sort of criteria do you think needs to be met to consider an increase to the common share dividend?

Looks to me like within a few quarters you will be back to a payout ratio in the 30% range.

Donald Guloien - *Manulife Financial Corporation - President and Chief Executive Officer*

Well, it's a good question. What we would have to look to it a sustainable earnings, growth in sustainable earnings. You're absolutely right that everything is moving in the right direction for that.

The second thing is clarity around the capital rules, and again that is not just a Canadian concern; that is an international one, lack of clarity there.

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But that day will come. You phrased it exactly right, it is probably not a short-term consideration. Of course it is a matter for the Board, but that day will come and I look forward to that day.

We will probably be a little bit more conservative. It was so painful taking the dividend down, and as we all know in Canada financial institutions, people think it is a one-directional thing. So I think our Board will be very conservative in approaching that. But certainly I am comfortable that that day will come.

Steve Theriault - *BofA Merrill Lynch - Analyst*

Great. Then maybe another one for you, Don, if I might. We have talked a lot about equity hedging but wanted to talk a bit about rate hedging. Historically you have pushed back from the idea of crystallizing losses on some of the legacy non-cash interest rate charges. I appreciate fully it is a balancing act.

Can you talk a little bit about the process you went through to get comfortable to the point where in pretty short order you have gone most of the way to your 2012 sensitivity targets? Pretty much two years ahead of schedule, so why not be a little bit more measured?

Donald Guloien - *Manulife Financial Corporation - President and Chief Executive Officer*

Well, the big thing is we always had sort of an economic hedge and that is our surplus assets. For some very unusual reasons that have nothing to do with us, the accounting and regulatory posture is that the mark-to-market -- just about everything we have is mark-to-market except for the surplus interest rate gains, and those weren't taken into account.

Some of that is -- we have embarked on a philosophy that says if rates go down we will take gains in surplus and recognize them. Therefore through that process it gets recognized for capital purposes and is displayed in our interest sensitivity.

But we always had that flexibility. Those -- when people looked at our economic sensitivity, you could see that phenomenon demonstrated. So some of that is that.

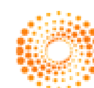
The other is the yield curve changed substantially its shape. Warren touched on it earlier. It got a lot steeper; and terming out reduced some of that sensitivity but also gave us a lift in the running yield. We thought that was a very sensible trade-off to make.

A lot of you guys were worried when we talked about doing that in the prior quarter, about how much we would give up. But because of the steepness of the yield curve, the give is not anywhere near what it might be and would have been at different points when the yield curve weren't so steep.

So you got that steepening yield curve that we are taking advantage of. I have an obligation to make sure that the downside is limited. When we did our reevaluation of the Long-Term Care business and the additional liabilities that emerge out of that, and also the VA business, that gave rise to a lot more interest sensitivity than we had before.

I can't let that run, regardless of what my view of interest rates are, I can't let that run beyond reasonable expectations. So we took all the appropriate action to bring it back on side.

Otherwise it would have grown. It would have grown a lot. So we basically tried to stem the growth and take it a little bit more than that.



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As a result, with the improvement in interest rates now, going through to the end of the year and where they have gone subsequent, the risk profile associated with interest rate exposure is significantly attenuated. A lot of it coming from just the market movement, frankly, not over actions that we have taken.

But we are in a good position now to lock some of that in through various instruments and we will look at it. We were very hesitant to do so before, not only because of the earnings give if markets went up; but also because collateral demands and so on that would be created by hedging too early from a risk management posture. It would not have been a good thing to do.

Now we are in a happy position of figuring out exactly how much we want to hedge at today's rates that look pretty good.

Steve Theriault - *BofA Merrill Lynch - Analyst*

Okay, that's fair. Maybe a last one, just more of a numbers question. You have put on CAD5 billion of macro hedges over the last several months. With the sharp rise in equity markets I would imagine the underlying futures positions have gotten fairly costly.

So if I think of it in these terms, what has been the cash outlay you have had to make on the marks on the futures? And how is that funded?

Michael Bell - *Manulife Financial Corporation - SEVP and Chief Financial Officer*

Steve, I will start and then Bev can add. I mean all you need to do there is take the CAD5 billion times the equity market appreciation, and that has been the net cash payout.

Again, the short -- we're exchanging the total equity return for the short-term risk-free rate which is approximately zero. So any equity market appreciation means cash out the door.

Now again, in the grand scheme of things that is rounding error in our liquidity position. But that has been the cash payout, and obviously that has been reflected in the first-quarter P&L.

Steve Theriault - *BofA Merrill Lynch - Analyst*

Just, sorry, one last one. You mentioned this earlier, but what is the size of the hedge inefficiency allowance?

Michael Bell - *Manulife Financial Corporation - SEVP and Chief Financial Officer*

It is detailed in the public disclosures, Steve. It grades; it assumes it gets worse as the markets are more volatile.

And as Bev and Don pointed out earlier, again has proven to be conservative because it assumes it is negative in both directions; and that has not been our history to date. Off-line, Anthony could certainly point you to the specific page if you're interested.

Steve Theriault - *BofA Merrill Lynch - Analyst*

That's great. Thanks for your time.

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Operator

Andre Hardy, RBC Capital Markets.

Andre Hardy - *RBC Capital Markets - Analyst*

I have two questions. First on slide 9, on the other notable items, there is always going to be positives and negatives, I realize that. But do you feel like you had a better than average quarter, an average quarter, or a below average quarter in terms of the positive contribution of other notable items?

The second thing is back to earnings on surplus. If we go back to the 2004 to 2008 period -- or sorry 2007 period, the Company generally had returns between 4% to 5% of equity. So if you take earnings on surplus over equity it tended to be between 4% and 5%. And this year it was 1.6%.

So can you talk about whether it is down as a result of a change in interest rates and mix? Or is it more the disappearance of gains or some gains that have turned into losses?

And how might that reverse in upcoming years? Is it a matter of rates rising or losses disappearing or gains reappearing?

Michael Bell - *Manulife Financial Corporation - SEVP and Chief Financial Officer*

Andre, it's Mike. First on your question on notable items, I would characterize the CAD241 million of favorable notable items as a better than average quarter.

On your question on the IOS, there are two main factors driving the stronger IOS that we had historically versus what we have had more recently. The first very importantly is the cost of the debt leverage that we have put on. Between the prefs and the literal debt that we have added over the last several years to boost our capital position, that has created in fact a significant negative drag that we didn't have before, and in fact a negative cost to carry on those particular proceeds.

The other would be the disappearance of the gains. We were harvesting significant gains during that period which weren't really a sustainable run rate. Now I wasn't at the Company; I believe that that was described at that period of time, that some of those gains were not run ratable. But those would be the main items.

Andre Hardy - *RBC Capital Markets - Analyst*

Thank you.

Operator

Michael Goldberg, Desjardins Securities.

Michael Goldberg - *Desjardins Securities - Analyst*

Thanks. I have a couple of number questions also. The first one relates to page 38 of the SIP.

Michael Bell - *Manulife Financial Corporation - SEVP and Chief Financial Officer*

We're getting there, Michael. Yes.

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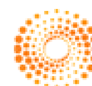

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Michael Goldberg - *Desjardins Securities - Analyst*

Okay, so what I would like to know is -- of the CAD45 billion of pad and excess margin on seg funds at the end of the year, what would be the announcement of tax item included in adjustments that would go against just that?

Michael Bell - *Manulife Financial Corporation - SEVP and Chief Financial Officer*

Cindy, do you have an estimate of that?

Cindy Forbes - *Manulife Financial Corporation - EVP and Chief Actuary*

If you tax-effect it, I actually think it is in the disclosures, if I understand your question correctly, Michael. We say that the taxes are CAD13 billion; and while there is an extra CAD4.9 billion of additional policy margins, you could pretty much pro rate the 13 by the sum of the 45 -- CAD4.9 billion.

Michael Goldberg - *Desjardins Securities - Analyst*

Okay, all right. My other question is -- of your total amount of CAD1.417 billion experience gains in the quarter, how much would the experience gains have been excluding equity and interest rate? In other words excluding investment experience on a pretax basis.

Michael Bell - *Manulife Financial Corporation - SEVP and Chief Financial Officer*

Michael, let us circle back to you on that off-line. I will give you the conceptual answer and then we could give you the specific number off-line.

If you take that pretax number and you convert on slide 9 the direct impact of the higher equity markets and interest rates number of CAD861 million, that is an after-tax number; you'd need to convert that to pretax. Do the same thing with the CAD184 million on the gains on the VA hedging program and the other investment experience. You could then back into the remainder.

I just don't -- again, we have got to after-tax and pretax, so it is kind of apples and oranges. But why don't you let us catch you off-line on the specifics?

Michael Goldberg - *Desjardins Securities - Analyst*

Okay, that's great. Thanks very much.

Operator

Peter Routledge, National Bank Financial.

Peter Routledge - *National Bank Financial - Analyst*

Thanks. Just a couple quick questions on the MCCSR. Total capital required dropped somewhat significantly. What were the drivers behind that?

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I know the equity market hedging doesn't do anything, but does the desensitizing actions for interest rates impact that? That's the first question.

Second question is, the adjustments to Tier 1 and Tier 2 capital, the other adjustments, improved significantly. What were some of the movements in that that caused that?

Last one is -- it looked like you put about CAD1 billion up from MLI to the HoldCo. Have I got that right, and is that enough for the whole year? And that will be it. Thanks.

Michael Bell - *Manulife Financial Corporation - SEVP and Chief Financial Officer*

Okay, Peter, I will start and then I'll ask Cindy if she wants to add. On the improvement in the required capital, a couple major factors there. Obviously we benefited from a required capital standpoint on the improvement in the interest rates and equity markets in the quarter; and that has a second-order impact on the required capital.

Currency has also helped us as the US dollar has continued to weaken. When that gets converted over to Canadian dollars for the required capital calculation that has helped us.

In the case of the MLI to MFC, that was really normal course of business. We see that essentially every year as MFC needs the funds for the fixed commitments that MFC has. So there was nothing interesting there. We don't have -- we continue to hold our excess capital at the MLI subsidiary level.

We do not have a material excess capital at the Holding Company level. We think again it makes a lot more sense to hold that at MLI.

Peter Routledge - *National Bank Financial - Analyst*

I ask just because last year I think it looked to me the dividend was a lot bigger. I just -- is that just your cash outflows at the HoldCo this year are lower?

Michael Bell - *Manulife Financial Corporation - SEVP and Chief Financial Officer*

I honestly don't remember the 2009 transaction. This transaction really was the full-year 2010 fixed commitments that MFC had and in effect moving the money up to cover those commitments in 2010.

So it was really a matter of course. It was not an idea of holding excess capital at HoldCo at all.

Peter Routledge - *National Bank Financial - Analyst*

And then just on the adjustments?

Michael Bell - *Manulife Financial Corporation - SEVP and Chief Financial Officer*

Yes; Cindy?

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Cindy Forbes - *Manulife Financial Corporation - EVP and Chief Actuary*

Well, looking at the page, while there was a change Q-over-Q, there was really nothing exceptional that happened in terms of the adjustments. So I think that it is something to do with foreign exchange and other small changes. So if you would like to take it off-line, I can.

Peter Routledge - *National Bank Financial - Analyst*

That sounds good.

Michael Bell - *Manulife Financial Corporation - SEVP and Chief Financial Officer*

Thanks, Peter.

Peter Routledge - *National Bank Financial - Analyst*

Thanks.

Operator

Joanne Smith, Scotia Capital.

Joanne Smith - *Scotia Capital - Analyst*

Good afternoon. I had a couple of questions. The first is given everything that has taken place with respect to the de-risking and the progress that you have made on your targets to get to those levels of equity market sensitivity and interest rate sensitivity, have you had any more favorable conversations with the rating agencies?

And when you are having discussions with the rating agencies, what are some of the conditions that they are setting? Is it a combination of operating fundamental improvement, say like in the US? Is it deleveraging, is it de-risking, is a combination of all? I am just trying to get the flavor of what we should be looking for going forward.

Michael Bell - *Manulife Financial Corporation - SEVP and Chief Financial Officer*

Okay, so Joanne, it's Mike. Yes, we have ongoing discussions with the rating agencies. As you can imagine after a quarter like this one, where we significantly reduced our equity market and interest rate sensitivities, we substantially strengthened our capital position, and again had progress really on each of the key operational areas -- that was a more positive set of discussions than we have had in a while.

In terms of the major items that would lead us to a stronger position and ideally would lead us to an upgrade at some point further down the line, probably not likely in the next couple quarters, but further down the line, I think it would be a combination of all the factors that you described. But mainly, number one, the rating agencies would like to see us have less volatility in our results. So less bouncing around quarter to quarter.

Second, less equity market sensitivity, interest rate sensitivity relative to our capital cushion. And obviously we made a big progress there in the last 90 days.

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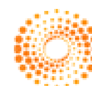

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Successful execution of our business strategy, particularly the repositioning in the US -- again that has really been a successful area for us over more than six months with record sales in 401(k) and also the mutual funds and the de-risking of the insurance and VA products.

And as you said, the reduction in the leverage. So really I feel reasonably positive on each of those areas; but it will take some time.

Joanne Smith - *Scotia Capital - Analyst*

Okay, that is a very good answer. Thank you, Mike. I would like to follow up on the surplus, on the earnings and surplus question.

Because the way that I am thinking of it, and putting this debt aside just for a minute; we can revisit that. But I am thinking about higher earnings, higher sustainable earnings. I'm thinking about lower new business strains with the exception of some temporary items that impacted the recent quarter in Asia and also in Canada. I am thinking about a lower risk profile, so therefore there is going to be less capital that needs to be backing the existing business and new business going forward.

I am thinking about rising equity markets. I am thinking about higher interest rates. Where am I going wrong with expecting that earnings on surplus is going to go up and not down?

Michael Bell - *Manulife Financial Corporation - SEVP and Chief Financial Officer*

Well first of all I think you have identified a number of very important positive trends for our Company and why we are bullish on the future. The only specific headwind to earnings that you didn't mention was the cost of hedging. The equity hedging is not a free lunch. The dynamic hedging program as well as the macro hedging program, both of those reduce our ongoing earnings run rate. So that is obviously a negative.

And the point on the interest on surplus is there are a number of different factors there that we have talked about throughout this call. So again I just wouldn't go gangbusters on those. We are not going to be reducing the debt by leaps and bounds any time real soon.

Again, we will get some AFS equity gains going forward; we'll see how that works out. So again we are bullish on all the factors, I just wouldn't go hogwild on the IOS.

Joanne Smith - *Scotia Capital - Analyst*

Okay, just as a follow-up to that, Mike, if I am thinking about the cost of hedging and I am thinking about the cost of carrying additional capital to support a riskier book of business, what is the economic difference there?

Michael Bell - *Manulife Financial Corporation - SEVP and Chief Financial Officer*

Well, net-net obviously we think that over time the economics are favorable to reduce our volatility. But again the long-term answer to that question will be dependent upon how much hedge credit we ultimately get in the capital requirements. And the capital requirements at this point are still uncertain -- not just for us but for other geographies as well.

Joanne Smith - *Scotia Capital - Analyst*

Sure, okay. Thanks very much.

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Donald Guloien - *Manulife Financial Corporation - President and Chief Executive Officer*

Joanne, I wanted to go back to your question about the credit rating agencies. We really don't know when they will get it, but the bond market certainly has. If you look at our spreads, they have come in from 236 basis points to 155. That is a reduction of approximately one-third in the last couple of months.

So they will get it. Give it six months or a year and maybe the rating agencies start to notice that Manulife is substantially de-risked from where it was before.

Joanne Smith - *Scotia Capital - Analyst*

Well, Don, I guess the issue that I am having right now is the progress that you have made. I understand the concern regarding the upfront costs associated with that. But the knowing that earnings are going to be less volatile in the future and the amount of progress that you have made towards your goal of achieving less market sensitivity and interest sensitivity, I would think that the rating agencies would start to come around.

Donald Guloien - *Manulife Financial Corporation - President and Chief Executive Officer*

You got it, Joanne, anyway.

Paul Rooney - *Manulife Canada Ltd. - President and General Manager - Canada*

Joanne, it's Paul Rooney here. I think what you have described might be considered an excellent thesis as to why our stock is undervalued.

Joanne Smith - *Scotia Capital - Analyst*

Okay. Thank you very much.

Anthony Ostler - *Manulife Financial Corporation - SVP Investor Relations*

So we are going to take, operator, our last question please. Last person in line.

Operator

Jan Willem Weidema, ABN AMRO.

Jan Willem Weidema - *ABN AMRO - Analyst*

Good afternoon. One last question, and my question is of a philosophical nature. Looking at the progress you have made with your hedging and the fact that you're ahead of your original timetable, do you prefer to accelerate your hedging level, if you would have the choice, or reduce the cost of hedging?

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Donald Guloien - *Manulife Financial Corporation - President and Chief Executive Officer*

Would we -- what we would -- I guess the ideal is we would like markets go up so we can hedge more at prices that will be advantageous. The higher the equity markets, in fact, the lower the cost of our hedging.

But as you correctly identified, the pace at which we hedge, higher equity markets enabled us to hedge more, so while the unit cost if you will is lower, the volume is greater.

We are enormously pleased by the direction of markets. I can't think of a more favorable scenario than what we have experienced in the last couple of months. It's enabled us to get way ahead of the hedging program.

Some people are trying to get their arms around the cost of hedging; but believe me, this is something the shareholders should be very, very please with, that we are able to stabilize our earnings at a fraction of the cost that it would have cost us at any other time in the cycle.

Jan Willem Weidema - *ABN AMRO - Analyst*

Okay. Thank you very much.

Operator

Thank you. There are no further questions. I would like to turn the meeting back over to Mr. Osler.

Anthony Ostler - *Manulife Financial Corporation - SVP Investor Relations*

Thank you, operator. We will be available after the call if there are any follow-up questions. Have a good afternoon, everyone.

Operator

Thank you. The conference has now ended. Please disconnect your lines at this time and thank you for your participation.

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