Q2 2013 Earnings Call

Company Participants

- Alan Schnitzer, Vice Chairman
- Bill Heyman, Vice Chairman and CIO
- Brian MacLean, President and COO
- Gabriella Nawi, SVP of IR
- Jay Benet, Vice Chairman and CFO
- Jay Fishman, Chairman and CEO

Other Participants

- Amit Kumar, Analyst
- Brian Meredith, Analyst
- Clifford Gallant, Analyst
- Greg Locraft, Analyst
- Jay Cohen, Analyst
- Josh Stirling, Analyst
- Michael Nannizzi, Analyst
- Mike Zaremski, Analyst

Presentation

Operator

Good morning, ladies and gentlemen. Welcome to the Second Quarter Results teleconference for Travelers. We ask that you hold all questions until the completion of formal remarks, at which time you will be given instructions for the question-and-answer session. As a reminder, this conference is being recorded on Tuesday, July 23, 2013.

At this time, I would like to turn the conference over to Ms. Gabriella Nawi, Senior Vice President of Investor Relations. Ms. Nawi, you may begin.

Gabriella Nawi {BIO 2211991 <GO>}

Good morning. Welcome to Travelers' discussion of our Second Quarter 2013 results. Hopefully all of you have seen our press release, financial supplement, and webcast presentation released earlier this morning. All of these materials can be found on our website at www.Travelers.com, under the investors section.

Speaking today will be Jay Fishman, Chairman and CEO; Jay Benet, Vice Chairman and Chief Financial Officer; and Brian MacLean, President and Chief Operating Officer. Other members of senior management are also available for the question-and-answer period. They will discuss the financial results of our business and the current market environment. They will refer to the webcast presentation as they go through prepared remarks and then we will open it up for questions.

Before I turn it over to Jay, I would like to draw your attention to the explanatory note included at the end of the webcast. Our presentation today includes forward-looking statements. The Company cautions investors that any forward-looking statement involves risks and uncertainties and is not a guarantee of future performance. Actual results may differ materially from those projected in the forward-looking statements due to a variety of factors. These factors are described in our earnings press release and in our most recent 10-Q and 10-K filed with the SEC.

We do not undertake any obligation to update forward-looking statements. Also in our remarks or responses to questions, we may mention some non-GAAP financial measures. Reconciliations are included in our recent earnings press release, financial supplement, and other materials that are available in the investors section on our website.

Now, Jay Fishman.

Jay Fishman {BIO 14011069 <GO>}

Thank you, Gabby. Good morning, everyone, and thank you for joining us today. We are very pleased with our results this quarter posting record net income per share of $2.41. We are particularly gratified that this is another quarter which demonstrates the very successful execution of the pricing strategy in Commercial Lines which we embarked on nearly three years ago.

Our granular, active approach to improving profitability has been very successful. The aggregate rate and retention data that we show you for our Commercial businesses demonstrate the success, but the data underneath tells an even more powerful story of improvement in profitability. This is important and Brian will take you through that in more detail.

But let me share with you that underlying margin improvement in our Commercial businesses since 2011, which we achieved primarily through earned rate on renewal business exceeding loss trend, has as of now generated an increase in after-tax operating income of $650 million on an annualized basis. If we include Personal insurance, and more to say on Personal Lines in a minute, the increase is more than $1 billion. Importantly we have done so without disruption to our agents or customers.

The relevant question now is where do we go from here? Since 2005, we have maintained a financial goal of producing a midteens operating return on equity over time. The overtime aspect of the goal allows us to maintain the objective even when conditions are such that returns at that level are not immediately achievable on an accident year basis, such as now.

If you adjust our year-to-date operating return on equity of 15% to more of an accident year look by excluding the impact of net favorable prior-year development as well as the impacts of the favorable tax and legal resolutions, the adjusted ROE is approximately 8.5%. Also to achieve a midteens operating ROE over time, there will be years where we must exceed the target because there will be other years when, due to any number of factors, we will fall below.

So it is clear that we have more work to do to achieve our objective and as a consequence, our strategy remains intact. We will continue to execute for improved returns just as we have been doing.

In Personal insurance, we have also had a strategy of improving profitability through higher pricing. What has become apparent to us in the Auto insurance line is that the combination of the rapid adoption of the comparative rater technology in independent agents' offices, which now is the source of a substantial amount of the quotes that we issue and changing consumer expectations for this product have impacted our new business volume meaningfully.

Consequently, we have concluded that to improve profitability and to create long-term value, we must have a more competitively priced product. By leveraging technology and taking other actions, we will make substantive changes to our business processes that we expect will allow us to meaningfully reduce costs without impacting service or quality. Brian will take you through the details but through these actions we expect to be able to more competitively price our product and improve our profitability.

Before I hand it over to Jay, I would like to comment on our announcement in June that we agreed to acquire the Dominion of Canada. This was a strategic move, providing us with meaningful scale and market position in Canada. We are enthusiastic about the opportunity and are looking forward to welcoming the Dominion employees to Travelers.

With that, let me turn it over to Jay.

Jay Benet {BIO 2456473 <GO>}

Thanks very much, Jay. Let me start by saying how pleased we all are with the Second Quarter and year-to-date results. I do want to correct one thing Jay said. On page 21 of the webcast, we do have a reconciliation of the operating return on equity year-to-date as reported of 15% and when you do adjust for the net favorable prior year development and the favorable tax and legal settlements, it is actually 11.5% would be what we would consider to be the accident year kind of run rate of that.

But with that, our liquidity and capital positions remain very strong and we continue to generate capital in excess of what we need to support our businesses. Operating cash flows of approximately $722 million for the quarter and $1.3 billion year to date are also very strong, notwithstanding the cat losses that remain very high relative to historical standards, although significantly below the corresponding prior year periods.

We maintained our strong cash position, ending the quarter with holding company liquidity of just over $2 billion, after returning $491 million of excess capital to our shareholders with dividends of $191 million and common share repurchases of $300 million.

Our strategy of returning excess capital to our shareholders remains unchanged. As we've stated in the past, the combination of dividends to common shareholders and common share repurchases will likely not exceed operating income over time and in any given period, the difference between operating income and the level of dividends and share repurchases will also be a matter of timing.

I'd remind you also that the amount of common share repurchases will also depend on a variety of additional factors including corporate and regulatory requirements, maintaining capital levels commensurate with the Company's ratings, our share price, pension funding needs, strategic initiatives, and other market conditions.

We have included an overview of our cat reinsurance coverage on page 20 of the webcast, which has been structured in a way that is generally consistent with the prior year. Effective May 16, we entered into another three-year reinsurance agreement with Long Point Re III in which they issued $300 million of cat bonds providing us with Northeast hurricane coverage on specified lines of business subject to a $1.25 billion retention after which we can recover up to $300 million on a proportional basis until covered losses reach $1.8 billion.

Effective July 1, we renewed our Gen Cat Treaty with terms that were similar to last year, an attachment point of $1.5 billion and recovered losses of up to $400 million within the 1.5 billion to $2.25 billion level -- layer.

Also effective July 1, we renewed our $600 million Northeast Gen Cat Treaty with the same $2.25 billion attachment point as in the prior year. Given the current reinsurance pricing environment, all of this was accomplished at a cost that was lower than the prior year. A more complete description of our cat reinsurance coverage, which also includes a description of our Gen Cat aggregate excess of loss treaty that covers an accumulation of certain property losses arising from multiple occurrences, is included in our Second Quarter 10-Q, which we filed earlier today, as well as in our 10-K.

All of our capital ratios remain at or better than our target levels and we ended the quarter with a debt to total capital ratio of 20.1%. Due to the recent rise in interest rates, net unrealized investment gains decreased by $1.2 billion after-tax in the quarter, driving a 2% reduction in book value per share in the quarter or 1% year to date.

This impact of higher interest rates more than offset the very positive impact on book value per share of our strong earnings, which was the major driver of the change in adjusted book value per share. Adjusted book value per share, which excludes unrealized investment gains and losses, increased 3% during the quarter and 5% year to date.

I would note that the rise in interest rate does have a positive side. Going forward, if interest rates stay at their current levels, we will be able to reinvest proceeds from maturing bonds at higher yields than we were previously assuming. I would point out, though, that at current interest rate levels this will still result in a reduction in future net investment income, just not as much.

The rise in interest rates also led to an $87 million after-tax realized investment gain this quarter due to our use of U.S. Treasury futures to shorten the duration of the investment portfolio. At the beginning of the year, given the interest rate environment and the economic outlook, we decided to increase our short position from a then-nominal amount of $800 million. The position was increased to $2 billion by the end of the First Quarter and further increased to as much as $2.7 billion before the position was closed by the end of the Second Quarter, due to our outlook for interest rates versus the carrying cost of this strategy.

Lastly, I would also like to point out that the rise in interest rates has not been significant enough to impact our pricing strategy in any meaningful way.

So Brian is now going to provide some further comments on operating results.

Jay Fishman {BIO 14011069 <GO>}

Jay, just let me interrupt one second, if I may. I understand I misspoke and I know you corrected it, but because it is so important, please just let me reiterate that the adjusted ROE on what I described as the more of an accident look is 11.5%. If I said 8.5%, it was indeed just simply an error on my part. It is 11.5%. Thank you. Brian, I apologize.

Brian MacLean {BIO 4679150 <GO>}

No problem. Thanks, Jay. I will go right to the segment results, beginning with Business Insurance, where we continue to be extremely pleased with the fundamentals of the business.

The combined ratio for the quarter of 96.2% improved nearly 7 points versus the prior year while the underlying combined ratio which excludes the impact of cats in prior year development improved over 3 points.

Looking at the production results for the segment on page 9, retention and renewal premium change were both strong and in line with recent periods at 80% and nearly 9% respectively, while new business volume was down slightly from the First Quarter. Over the last six quarters, the production trends have been remarkably stable with retention running consistently around 80, renewal price change between 8 and 10 points, and rate around 7% to 8%.

Slides 10 through 12 show a basically similar story of consistency for each of the businesses within the segment and in each case the compounding effect of rate increases is driving a meaningful improvement in our combined ratios.

So the aggregate production results remain strong but as we mentioned many times, the aggregate numbers alone don't tell the entire story. In fact, the detail of where we are getting the rate and what accounts we are retaining is key to evaluating the success of our pricing strategy.

On slide 13, we show our commercial accounts rate change and retention data for the Second Quarter of 2013 as compared to the Second Quarter of 2012. The data is segmented by the individual accounts long-term loss ratios with the bars on the left representing our best-performing accounts and the bars on the right representing our worst-performing accounts.

We have shown this data before and I want to emphasize that it is a summarized version and the analytics we actually use to manage the business are at a much more granular level. The results show that for our better accounts, retention was very strong and rate change was solid and consistent with a year ago. For our poor performing business, rate increases were up significantly year-over-year while retention was down meaningfully.

Additionally as you evaluate our results, keep in mind that our rate actions over the past three years have improved the returns in each of these loss ratio bands. So in fact, although the aggregate pricing improvements are very consistent over the past six quarters, an analysis of the underlying data reveals that our execution has in fact improved over time and is contributing to higher levels of profitability.

So overall in Business Insurance, a very encouraging picture. The earned impact of these rate gains along with loss trends across the segment that continues to run at about 4% drove meaningful margin expansion. Going forward, our emphasis is to continue to improve returns through maximizing the rate and retention trade-off at a very granular level.

In Financial, Professional & International Insurance, operating income for the quarter was down 15% year-over-year due to higher catastrophe losses and less favorable prior year development. The cat losses in the quarter were primarily due to the unprecedented flooding in Alberta, Canada.

Excluding cats in prior year development, the underlying combined ratio of 89.9 for the segment was strong and improved more than 2 points year-over-year. This improvement was driven largely by expanding margins in our management liability business along with the impact of recent underwriting initiatives across the segments.

Written premium was up slightly compared to the prior year quarter, driven by strong security results, continued favorable rate and management liability, and new business from international, especially offset by higher levels of ceded premiums.

In June, we were pleased to announce our agreement to acquire the Dominion of Canada. The combined business will benefit from Travelers' sophistication in the use of data and analytics as well as claim and risk control capability. The Dominion's extensive distribution network provides us with an exceptional platform for expanding our

Commercial lines of business in Canada. In combining Travelers of Canada's surety, management liability, and commercial middle-market products with the Dominion's Commercial and Personal portfolios, will create an organization with significant product breadth and a balanced mix of business.

The transaction is expected to close in the Fourth Quarter of 2013 subject to regulatory approvals and other customary closing conditions.

In Personal insurance, operating income was up significantly versus the Second Quarter of 2012 due to lower levels of catastrophe losses and higher underlying underwriting margins. The underlying combined ratio for the quarter showed a 3 point improvement year-over-year with about 2 points driven by earned rate increases that exceeded loss cost trends.

Looking specifically at auto production trends, retention of 80% and renewal premium change of over 8% were both in line with recent periods. Net written premium in new business volumes were down year-over-year as a result of our pricing actions.

Turning to Auto profitability, the underlying combined ratio of 96.4 was an improvement of over 1 point versus the prior year quarter primarily reflecting the earned impact of the written rate gains we have achieved over the past several quarters.

Loss cost trends for Auto remained consistent with recent quarters, with mix adjusted frequency continuing to be benign and severity stable at a slightly elevated level. Specifically, bodily injury severity this quarter remained in line with what we have seen in the previous three quarters.

In Homeowners, pricing was also very strong with renewal premium change coming in at over 11%. Retention was consistent at 83%, while new [ph] business volume was down slightly from the prior year quarter. The underlying combined ratio for Home was 81.5% in the quarter, an improvement of over 3 points year-over-year. The improvement was driven by a lower level of non-cat weather losses along with earned rate increases that exceeded loss cost trends.

So a very strong underwriting result and we are beginning to see the positive impact of our underwriting and pricing actions.

So overall, a very good quarter, but as Jay mentioned in his opening comments, the Personal Auto marketplace is changing. We remain committed to offering a product that is both competitively priced and delivers an appropriate return for our shareholders and accordingly, we are taking expense reduction actions that will allow us to improve both pricing competitiveness and product returns.

Specifically, we expect to reduce our claims and other insurance expenses such that we realize a savings of $140 million pretax when fully implemented. This represents about a

10% reduction in our unallocated claim and other insurance expense base in Personal insurance.

We will begin realizing some of these savings immediately and they will be fully realized in 2015. The savings will be achieved through the consolidation of certain operations along with other efficiency gains throughout the business.

The majority of the savings will be driven by staff reductions, primarily through attrition. But we will also be giving notice to approximately 450 employees this week. We expect to take a restructuring charge of about $16 million, $10 million of which is expected to be incurred in the Third Quarter of 2013.

While some of these savings will be realized in our Homeowners business, the majority of the impact will be in Auto and these actions are clearly aimed at improving our strategic position in that line.

We are pleased with the progress we've made in the Personal Lines business and we believe these actions will allow us to offer an even more competitive product in a challenging marketplace.

I will now turn it over to Gabby.

Gabriella Nawi {BIO 2211991 <GO>}

Thank you, Brian. Before we open it for questions, I would like to note that the management team is participating from several different locations this morning, so please bear with us as we coordinate our responses.

With that, Andre, can we open it up for questions, please?

Questions And Answers

Operator

(Operator Instructions) Amit Kumar, Macquarie.

Q - Amit Kumar {BIO 15025799 <GO>}

Thanks and good morning. Two quick questions. First related to pricing, in terms of the business insurance pricing trends, I am looking at the renewal rate change. Do you think based on where we are and what rates we have achieved in the past, does the RRC in Business insurance, does it stay somewhat flattish from here or does it change meaningfully from here?

A - Brian MacLean {BIO 4679150 <GO>}

Let me start. This is Brian MacLean. Let me start with an answer and then Jay or Jay can chime in.

The first observation I would make is when we look at the actual results, so we're not going to go far out in the crystal ball world, but if we look at the actual results over the last six quarters, from page 10, it's incredibly stable. The red line there of renewal rate change is basically rounding off of 7.5% for all of those quarters.

So what we saw in the quarter was very consistent with where we have been. Our view about it, I would want to emphasize what we said in the presentation, that we don't have targets and it's not necessarily about attaining a specific level of rate gain. It's about achieving returns.

So we're looking very granularly and obviously trying to retain the best business and drive the price increases on the weaker stuff. There can be a next quarter, a rate change number identical to the one we just had which might be generating much better returns or much worse depending on where you get it. So we are very focused on the segmentation.

As far out as we are going to go is what we saw in the quarter was very consistent. June was a pretty strong month. July looks like it's trending pretty consistently. But where the market is going to be in three, four, five months, we will all see. But we haven't seen anything in our results that would say the market is about to shift dramatically and the fundamental situation with interest rates and weather volatility continues.

A - Jay Fishman {BIO 14011069 <GO>}

Brian, would you agree that over the last three years as more of the Commercial business has moved from the right side to the left side and as a consequence, more is in the higher-margin rather than the lower-margin business, that achieving a flat rate in that same environment is actually net underneath an actual improvement?

A - Brian MacLean {BIO 4679150 <GO>}

Yes, and what you mean by flat rate is 7.5% round number rate increase.

A - Jay Fishman {BIO 14011069 <GO>}

Correct. It's really the rate applied to the mix that is the important factor here.

A - Brian MacLean {BIO 4679150 <GO>}

Right. When we look at our granular execution and the impact of now a couple of years of rate increases on the portfolio, we feel the round numbers 80 retention, 7.5% rate we are getting today is producing a much better result than the 80% and 7.5% renewal rate change we were getting a year and a half ago. So we feel very good about it.

Q - Amit Kumar {BIO 15025799 <GO>}

Got it, that's helpful. I'm sorry, go ahead.

A - Brian MacLean {BIO 4679150 <GO>}

I was just going to say, but don't see any major shifts in what's going on in the market.

Q - Amit Kumar {BIO 15025799 <GO>}

Yes, you know one quarter does not make a trend, but we will see. The only other question I had is --

A - Jay Fishman {BIO 14011069 <GO>}

I would just make an observation, it's not one quarter. It has been a lot of quarters. Just an observation as to the data, that's all.

Q - Amit Kumar {BIO 15025799 <GO>}

The other question was on Dominion. Dominion's business makes a combined ratio and I know it's a bit too early. Just looking at their business mix and their combined ratios, could you just sort of broadly talk about what your strategy might be and how it might differ versus the current strategy? Thanks.

A - Alan Schnitzer {BIO 3529437 <GO>}

Sure. Good morning. It's Alan Schnitzer. When you are talking about the current strategy, I'm not sure exactly which one you are asking about.

Q - Amit Kumar {BIO 15025799 <GO>}

I'm talking about the combined ratios, 106.1 for 2012 and their topline is $1.2 billion. Just sort of broader thoughts on that going forward, how does that change? Does it change near-term or does it take somewhat longer to turn that around? Thanks.

A - Alan Schnitzer {BIO 3529437 <GO>}

Let me take a stab at that. So stepping back, the transaction really is a strategic transaction for us. It gives us important scale and competitive position in a big market that currently we are -- we don't have either in, so from a strategic perspective, we think it's important.

In terms of what's driving that combined ratio, a lot of that is their Personal Lines Auto business and we think that when we bring our data and analytics and claim expertise to that marketplace, we can -- and it will take some time -- but we think we can substantially improve that result.

Also they've got a small commercial platform that we like a lot. We think we can bring our expertise and analytics from that business into that marketplace. And one of the real benefits for us in this transaction is that they've got a terrific distribution platform in Canada. And we like the opportunity to expand our commercial middle market products through their distribution. So we think that there is good premium growth in the platform from that.

So in looking overall in International, we have been certainly over the last couple of years focused on investing in that business and managing the loss side, which we've done very effectively over the last couple of years. So we are very confident that when we apply that same expertise to the Dominion, we will be able to have positive effects on that.

One of the impacts of what we've been doing for a couple of years is expense ratio has ticked up both from investing in people and data and analytics and also from over the years having shed some premium that didn't meet the risk of reward calculation for us. So the additional volume that comes on from Dominion really helps us from the expense side as well.

So that's really sort of the outlook and the strategic positioning of the transaction.

Q - Amit Kumar {BIO 15025799 <GO>}

Got it. Okay, thanks. Thanks for the answers.

Operator

Mike Zaremski, Credit Suisse.

Q - Mike Zaremski {BIO 20606248 <GO>}

Good morning, thanks. In regards to margins, in the press release I noticed that low levels of large losses were cited within the International segment and I also noticed that lower levels of non-catastrophe weather-related losses were cited in Personal Lines. So I guess does that mean we should build some margin cushion into our forward estimates, given non-cat level large losses have been running below historical averages? Or am I thinking about that the wrong way?

A - Jay Benet {BIO 2456473 <GO>}

This is Jay Benet. As we've said in previous quarters, any individual quarter is going to be impacted by things that go well beyond the general flow of earned rate versus what you would consider to be the underlying loss trend. We spike out at least verbally because that's probably as good as it's going to get.

We have things like large loss activity and some view as to with the non-cat weather favorable or unfavorable relative to the prior year and we try to give you that perspective. What we always suggest you do is look at the longer-term view as to what the combined ratio looks like ex cat and PYD and with those words around it and what others say, try to get a view as to what the weather looks like and build that into your models.

I hope that's helpful. That's probably as granular as we can get with it.

Q - Mike Zaremski {BIO 20606248 <GO>}

Okay, it just stood out because I know in 2Q of last year you also cited lower levels of large losses.

A - Jay Benet {BIO 2456473 <GO>}

The other thing you can do is -- we wrestle with this as well, so we try to put some words into the outlook within the 10-Q that might also be helpful.

Q - Mike Zaremski {BIO 20606248 <GO>}

Okay. Great. Last question in regards to investment income levels, I noticed the portfolio's average pretax yield actually rose a bit sequentially to 3.9 and I think you cited duration increasing. Can you comment on how we should prospectively think about those dynamics given the recent increases in new money rates?

A - Bill Heyman {BIO 3429455 <GO>}

It's Bill Heyman. I would go first to what Jay said earlier and that is the recent increase in market rates obviously permits us to put new money out at better rate than we were before but still at rates below the book yields on maturing securities.

So I think I would simply take the projections that Jay has made in the past of net investment income going out two, three, four years and tweak them for this increase in rates. Frankly I wouldn't tweak them much. If this is -- if what we have seen in June is all we are going to see in 2013 and some would think that may be the case, I wouldn't make major changes in projections.

A - Jay Benet {BIO 2456473 <GO>}

If I could add a couple of things. We talked about the short position in treasury futures and by eliminating that at the end of the quarter, that had an impact of slightly expanding the duration of the portfolio. Having said that, too, the rise in interest rates also expands the duration of the portfolio, given the expected impact on bonds that would be called or not called under that circumstance.

So the change in duration is really not a structural change at all in the portfolio and as Bill just said, the rise in interest rates would have a fairly moderate impact on the reinvestment yields so given how much is rolling over versus what's in force.

And in our 10-Q, in the outlook section, we talk about all of this having an impact, that would suggest about $25 million less in after-tax net investment income off of the fixed income portfolio per quarter going forward if interest rates stay where they are. I think before we said that number was about $30 million. So it's a relatively modest impact.

A - Jay Fishman {BIO 14011069 <GO>}

Jay, I would just make one observation. You just mentioned in passing that the gain was attributable to closing the position. That's actually not completely correct because it's a mark-to-market position, so whether we had closed it or not closed it, the gain would have been there. We closed it because of our expectations of interest rates and the relative cost of carrying the position. But the position is a daily mark-to-market position.

A - Jay Benet {BIO 2456473 <GO>}

That's entirely right. Thanks for correcting that, Jay.

Operator

Josh Stirling, Sanford Bernstein.

Q - Josh Stirling {BIO 17463087 <GO>}

Good morning. Thank you for taking our call. So obviously we've all been very impressed for the past couple of years with your pricing leadership, pricing approaching I guess 20% at this point. You've helpfully done the math for us in 11% to 12% accident year ROE and there's obviously still some pricing yet to earn in and rates are moving higher.

So I think we're all sort of sitting out here scratching our heads trying to figure out how much longer pricing will continue. You've given us some guidance, which is helpful in your Q, and I'm wondering if you can just expand on that a bit and give us a sense when you've actually worked with your actuaries, you meet with your insurance regulators and you share them with your indications, how much more rate in some of your major segments do you actually need to take at these levels? Thank you.

A - Brian MacLean {BIO 4679150 <GO>}

Jay, do you want to start or --?

A - Jay Fishman {BIO 14011069 <GO>}

Yes, I was just thinking about how to do that. First, I would -- we have always said that one of the things we can't do is to in any way is to project or speculate competitive reactions, so just because we articulate pretty clearly what we intend to do, it certainly doesn't mean that it's going to happen or that we approach it with that certainty. But nonetheless, we continue to have space to go.

We've been saying for the longest time and I take some pride in the fact that the objective, the financial objective that we articulated now some eight years ago is one that we've stayed with consistently. It's not been remanufactured to be convenient to the environment. It is what we think long-term returns in our business should be and hopefully can be again.

But our goal is to get back to the midteens return on equity over time. And at 11.5% now, on an accident year basis, round numbers, we still have a ways to go. Not all products are the same and very important, not all businesses are the same. As a consequence, not all pricing strategies are the same.

We talk all the time about the analytic grid that demonstrates high to low returns and our emphasis on pricing relative to that. But every time you take a step up, it changes, whether you are talking about an individual product line like workers comp or property or whether you are talking about a particular business like construction versus our surety business. So the strategies are all quite different and they are all return-driven.

But in the aggregate, we are going to continue to push as long as we can until such time as we bring ourselves back to the long-term objective. I think that is probably about as clear as we can be.

We have resisted even internally setting artificial goals or targets or budgets and rather always look at what we have always articulated as our long-term goals to be.

A - Brian MacLean {BIO 4679150 <GO>}

Two things I would add because, Josh, in your question you put in there rates moving. I would just point out that the rate movement that we just saw in interest rate has really had virtually no impact on our pricing. And to some degree because it was a relatively small move in rate, but even the 100 basis points at one point in time at the 10-year got a lot of play.

The duration of our liabilities is significantly shorter than that. So you have to look at the whole yield curve and see where rates are moving. So that has had minimal impact and we'd need quite a bit of movement interest rates before it started changing pricing significantly. The other -- (multiple speakers)

A - Jay Fishman {BIO 14011069 <GO>}

Actually, Brian, just in that regard, we asked -- and I do think these two comments are important -- most of our -- I will call it free cash, I don't mean to define that term, but most of our free cash is used in buying back shares. So if you look at our portfolio position over the last several years, it's actually been relatively flat. And most of our investing is reinvesting.

And so we are not -- it is not as if we are deploying significant amounts of new cash. We have been deploying it in buying back shares. We did ask our actuaries to make an estimate of what 100 basis point increase would be in the entire curve if there was a shift because of course every product is invested -- the underlying products have a duration philosophy that's tied to the asset. They are not directly matched but it's very much a philosophical match.

This is just an estimate and I perhaps even would call it a guesstimate, but in terms of returns, the equivalent of 100 basis point move in the yield curve would be about 2 to 3 points in pricing rate. So 2 to 3 points in price would be equivalent in returns to 100 basis point move in the entire yield curve. Brian, am I recalling that correctly?

A - Brian MacLean {BIO 4679150 <GO>}

Yes, that's correct. The other thing quick thing I would point out is that weather volatility is still there and although our Second Quarter cat number was dramatically less than what we have seen the last two years, it is dramatically higher than what three years ago we would have said was historical Second Quarter norms.

So that is still out there and the marketplace needs to deal with it. So that's kind of our view.

Q - Josh Stirling {BIO 17463087 <GO>}

That's very helpful, Jay, Brian. Thank you. Just one other question on strategy and distribution evolution. So your comments about the evolution of comparative raters -- agents starting to use them for renewal business as well, start to get -- you sort of raise a whole bunch of questions. It's not obvious that it's good for the agents and certainly more challenging for the companies.

I'm wondering if you could talk about how you think that your sort of broader sort of agency strategy evolves more -- if there's going to be changes in commissions or if you fundamentally try to change your position or approach to that market.

Then just more broadly related to that same point, is this something that sort of starts in Auto and then moves to Home and moves to Select and ultimately is sort of a Pandora's box once it's opened?

A - Brian MacLean {BIO 4679150 <GO>}

This is Brian. Let me start with a couple comments and then Jay. I will go to your last comment first, Josh, which is clearly we look at this and say it doesn't have to be just a personal auto dynamic, but complexity of product is really significant in being able to build an efficient rater technology and business process.

So even Homeowners is fairly more complicated than Auto and you get into the Commercial products and much more complicated than Auto, so we watch it closely but we don't think we are on the verge of comparative raters everywhere.

Then I would say the big backdrop to the question is we are not looking at a fundamental shift across the board of how we deal with independent agents. One of the great strengths of our franchise is the position that we have with agents and we have a lot of products and we have a lot of breadth. And we are going to continue to leverage that, working with them closely on what their business process is and how we continue to together bring a value proposition to the customers is important.

With that said, everything is on the table. We are constantly looking at all the dimensions of it, but we feel good about where we are with agents. Jay?

A - Jay Fishman {BIO 14011069 <GO>}

I would -- just an observation. I think we have a well-deserved and well-earned reputation for being a low-cost oriented company. We know from experience I think how to do that thoughtfully and in the best interest of the business. I think Brian's comment is right. We are determined to be successful in the business. We have an $8 billion premium combined Personal Lines business and in fact everything is on the table.

But we do know how to do this and the comparative rating technology I get asked all the time, is the product becoming a commodity? And I am always quick to answer no. A commodity is a product where the only thing that doesn't matter is the price, because all the price is the same. Every -- oil, the price is the same and that's not the case here. There are value differentiations and value perceptions and strength to agents and strength to customers and there are differentiations.

What the rater is doing though, clearly, is increasing price competitiveness at the point-of-sale. The technology has introduced the ability of agents to see greater multiples of prices much more easily. We do think that the onslaught of advertising over the last -- this is just an opinion, I can't prove it as a fact, but the onslaught of advertising in the space over the last 10 years has brought customers to the view that value is a more important component value dollars of the purchase than perhaps it was previously.

So it's going to force a greater level of price competition. And I think we are up to the task and that's what we are going to do.

Q - Josh Stirling {BIO 17463087 <GO>}

That's very helpful, Jay and Brian. Thank you.

Operator

Michael Nannizzi, Goldman Sachs.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Thank you, one question I had for you, I guess maybe for Brian first, is -- just looking -- I know we look at this on a year-over-year basis but sequentially the underlying combined in business was up a bit. And then even going back and looking at 1Q to 2Q, it's not clear that the Second Quarter is always higher than the first and even if we look at year-over-year, you were 400 basis points better in the First Quarter, 300 basis points-ish better here in the second.

I'm just trying to understand that was non-cat weather an element of that comparison or any color there on kind of the margin in Business Insurance? Thanks.

A - Brian MacLean {BIO 4679150 <GO>}

Mike, I think there's always -- as Jay Benet was saying before -- there's always volatility in the individual quarters. Nothing fundamental with the trend has changed over where we were with First Quarter and I know the deltas have shifted a little bit. If you look at our data on page 9, 3.1 points of underlying combined ratio better than last year and the First Quarter was better than that. That is the movement in those other things.

So we are going to have large losses go up or down and our non-cat weather go up or down relative to the previous quarter. I think that we are still in the same place we were in the First Quarter where we think the core underlying margins here in BI are improving somewhere between 2.5 and 3 points for the business and that is unchanged from where we were in First Quarter and everything has been, as I said before, pretty stable, both rate and loss trend there.

So we don't see any fundamental shift. I know the numbers do move around a little bit.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Yes, I'm just trying to understand because -- that's great, so the 2.5 to 3 points remained so you have some noise maybe in the Second Quarter. But is it possible to just give some parentheses around the rate-driven margin expansion that you saw in the First Quarter versus the Second Quarter? Just because again, I mean this is the first and we have had one, two, three, four, five, six, seven consecutive quarters of sequential improvement in that underlying combined.

A - Brian MacLean {BIO 4679150 <GO>}

I think what I was trying to say, Mike, is the rate-driven margin improvement is the 2.5 to 3. If -- when we try to back out the quarterly periodic volatility and look at what is the impact of the rate we are earning in versus the core loss trend, that continues to run at 2.5, 3 combined ratio points. Again you have to do the arithmetic to get -- just bring it through the combined ratio to get the math to work.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Got it, okay. Thanks. Then I guess one question on the actions in Personal Lines. Any thought around in this process the direct business and kind of cost rationalization or continued investment on that front?

A - Jay Fishman {BIO 14011069 <GO>}

The decision is certainly not being driven by the direct business, but the direct business will most certainly benefit from a lower-priced product. So it will certainly help in that regard.

I do want to reemphasize so that everyone understands clearly that the intention here is to lower cost and increase profitability, so the reduction in cost will in effect not be passed on entirely to the price of the product. Some of it will be retained in the form of improved profit. At least that's the plan. So it will help. It will certainly help the direct business.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Great, thank you very much.

Operator

Greg Locraft, Morgan Stanley.

Q - Greg Locraft {BIO 4221265 <GO>}

Thanks. Good morning. I just wanted to follow-up on the Personal Lines segment. The policy counts are -- you have admitted the policy count declines are pretty stunning and accelerating it seems at least this year. Homeowners back to 2006 levels, Personal Auto back to 2004 levels, the direct initiative seems to have stalled.

So you guys are losing a lot of share. You have admitted that. What I'm wondering is, is the cost plan enough? In other words, is there -- there's clearly a pricing problem in the marketplace with this segment. So is the cost plan enough such that you can cut your pricing or get more competitive to begin to stem the share losses?

Then second is what's the timing around when we will see the tangible actions in the P&L from a PIF perspective? I'm sort of wrestling with how long to take the share losses down in my model.

A - Brian MacLean {BIO 4679150 <GO>}

Let me start, Jay, and then throw it to you. So I will -- several comments there and maybe one of the things I would say right at the front is that the actions we are taking today are somewhat -- the expense actions are somewhat a reaction to what's going on in our top line but more focused on reacting longer-term to some changing dynamics in the marketplace. So it's not just because the PIF is down 12%. I would look -- so a couple things. Number one is --

A - Jay Fishman {BIO 14011069 <GO>}

Brian, can I also ask you to speak. Because Greg asked a question Home, Auto, Direct, and I think there's a distinction to be made there as well.

A - Brian MacLean {BIO 4679150 <GO>}

Let me start with Auto where we -- on the retail Auto business through our agent channel, for starters, retentions remain pretty solid and that has been a positive. So although it's down a couple of points, it's still running at a solid level and the shortfall has been in new business and as we've said and has maybe been obvious, that has clearly been impacted by our pricing actions.

We feel good that returns have improved, that -- and from six months are consistent with our expectations and our price change is independent of the expense actions we will be mitigating as you have seen the last couple of quarters with the Auto business. So hopefully that will bring us back in line.

The industry did post a 104.5 combined ratio last year, so it is a product that has needed rate and we feel good about the actions we take -- we have taken. We think the expense actions and as we said before anything else that we need to do in this business, everything is on the table, are really focused on improving that and helping us deal with the changing marketplace.

So the Homeowners business we view as fundamentally different there. We think there are some real capacity issues. That was I think much more of a focused weather exposure kind of actions and so it's not just the pricing we have been driving there, which has fundamentally been driven by the losses, the weather losses that have come through, but it's also other actions we have taken from underwriting, deductibles, terms and conditions that have really, really driven that.

So we feel very good about where our Homeowners business is right now and feel like we are in a position to move forward.

The tricky part of your question is where do we think the impact will -- what is the time horizon? We don't really forecast that out. We are looking at clearly a different PIF situation for 2014 but we will see what that is.

A - Jay Fishman {BIO 14011069 <GO>}

Just a closing comment on the direct, because, Brian, I think you got both of those just right. The dynamic in direct is very much what we have been intending to do. We have been doing a test, a test of pricing sensitivity and so our -- people have asked you your advertising is down. Yes, our advertising is down very intentionally because we've been focused on testing price elasticity in a very limited number of markets and gaining some insight into what that means.

So I would just observe that there isn't anything in our direct channel other than also seeing and observing of course that pricing really matters -- great shock -- pricing really matters. And so again what we are going to do in the Personal space here we hope, we believe will certainly help the direct channel as well.

Q - Greg Locraft {BIO 4221265 <GO>}

Okay, I guess just to follow up on this, because the answer is very thorough but what I'm wrestling with is -- I love that you are getting good price in the business and the retentions are holding in. So clearly the core client base is sticking with The Travelers once in the umbrella. Direct is so small it just seems like it's an experiment in a way in the P&L.

But really in the agency side of Homeowners and in Auto, it's the lack of the ability to attract new clients in and I am wondering if it's more than just the expense side. I'm wondering if it is actually you need to start to ramp advertising a lot more? You need to rearchitect the product which you mentioned. I don't know that costs money. I don't know if that's technology.

In other words, I'm just trying to wrestle with the cost to fix the new business acquisition engine in the Auto segment.

A - Jay Fishman {BIO 14011069 <GO>}

The analytics that we have indicate maybe even more than indicate that pricing sensitivity for new business through comparative raters is just significantly different than it was in the past. And we have all sorts of data that shows when you are lowest in the comparative rater space, when you are second lowest and when you are third lowest, so we know what it takes to be successful.

And so we don't believe that there's anything with respect to our product that needs to be reengineered or -- we are always filing changes. We are always filing changes in pricing. We are always filing changes in underwriting and claiming. So there's always changes going on, but we believe this is the issue in the new business front and you're right, the renewal business has been quite stable and that is very encouraging. So we think we are on the right path here.

Q - Greg Locraft {BIO 4221265 <GO>}

Okay, excellent. Thanks a lot.

Operator

Brian Meredith, UBS.

Q - Brian Meredith {BIO 3108204 <GO>}

Good morning, I have two questions here for you. First, Jay, I'm just curious, the acquisition of Dominion, nice opportunistic acquisition. But given where your stock price now is trading on a price-to-book multiple, does it change at all your thought process with respect to capital allocation? Are acquisitions here potentially more attractive than share buyback?

A - Jay Fishman {BIO 14011069 <GO>}

No, I don't believe so. This was -- there were a couple of things about the dominion transaction that were really appealing to us. One is, it gave us some real size and scale in a market where we just were lacking badly.

Two, there is some scarcely value up there. There are precious few companies to be acquired. They are either mutuals or subsidiaries of larger companies or very large companies themselves. So there is a scarcity value and it provided a first-rate management team we think and terrific systems and technology and a platform to do business.

So it had several compelling reasons that really just had us think about it as a special opportunity but not thinking about it differently in the context of capital management, no.

Q - Brian Meredith {BIO 3108204 <GO>}

Great, thank you. Then the second question, I wonder if you could chat a little bit about the small commercial business. It seems it's continued to be a little sluggish there. Is that because of the economic environment) Is it because that there's maybe more competitive down there? Why is it tending to be a little bit slower from a growth standpoint actually declining this quarter on a written premium basis than some of the other lines?

A - Brian MacLean {BIO 4679150 <GO>}

This is Brian MacLean. I'll start. There's several things going on there. You know we talked a while back about what was going on in the larger end plus we talked a little bit about auto trends that we were seeing in commercial and specifically in the Select world. So there was some targeted underwriting actions that we were taking, which we have now pretty much worked through.

And it was a business if you think of -- it's almost a great example of the segmentation concept that I was talking about in commercial accounts. If you looked across our spectrum of businesses in Business Insurance a couple years ago, Select would have been one that from a return perspective we were struggling with more than others, so it would have been on the righter side of the graph of our businesses.

If you look at the pricing that we've gotten there and in that business, RPC is really driving to the bottom line, we have gotten to the point where we feel pretty good. We've worked through some underwriting actions and that is one that we would be hopeful, expecting that as the returns picture has improved, we're going to be retaining more of that business going forward.

So it is -- we feel good about how we have executed but we think the trajectory there should be changing in the future.

Q - Brian Meredith {BIO 3108204 <GO>}

Great, thank you.

Operator

Jay Cohen, Bank of America Merrill Lynch.

Q - Jay Cohen {BIO 1498813 <GO>}

Yes. Thank you. I guess a couple things. First, I guess two questions on pricing. The first is the good news on pricing was on the International side, it looks like there was an inflection point to the positive side. Can you talk about what's happening there?

A - Alan Schnitzer {BIO 3529437 <GO>}

Jay, it's Alan Schnitzer. Certainly it did tick up a little bit. I wouldn't call it inflection point. I would say that the pricing dynamics outside of the United States continue to be very different than what we see in the United States. I think what you are seeing in our results in particular have come from our efforts recently to increase our use of data and analytics and manage the portfolio and profitability. I would not say there's an overall shift in the market though.

Q - Jay Cohen {BIO 1498813 <GO>}

Got it and I guess getting back to Business insurance, you described the pricing environment over the past several years as quite stable and clearly that shows up in the graph. This deceleration that you've seen modest as it is in the Second Quarter, investors are very sensitive to this. And I am wondering -- I think, Brian, you had mentioned July being reasonably good. If you could give us some indication of where July stood relative to June or relative to the 2Q, that would be helpful because again, people are very sensitive to this issue. Your stock is up 2.3%. Any color would definitely be helpful.

A - Brian MacLean {BIO 4679150 <GO>}

I think -- I completely get it. I will on one hand admit that we obsess over fractional movements in these things. But I think we and the marketplace are obsessing a little too much and I know we've got a better window into the detail than you do.

So if you look at -- we ticked down a little bit from last quarter literally rounding off of 7.5%, which had ticked up a little bit from the Fourth Quarter, so the numbers have really been about in the aggregate 7.5%.

Within Business insurance, June was the strongest of the three months in the quarters but again I'm talking about fractions of a point here, the difference between a 7.2 and a 7.4 in total rate.

And July looks like right now, our look of July looks like it might be a little bit better than June, but again I'm talking about rounding a couple tenths of a point. So I don't mean to overemphasize it.

We get the sensitivity. I think we are all watching the market closely but it has been about where it has been for a while.

And then the last point I would make is we are really actively managing the business. We are trying to make sure we are getting it in the right places and --.

A - Jay Fishman {BIO 14011069 <GO>}

Brian, I was actually just going to interrupt because I do think that is so important. These conversations there's almost a backdrop as if somehow pricing is magically obtained from a third party source from somewhere. What we are getting is what we are trying to get. I ask the question all the time, are we trying to get 12 and we are getting 7? And the answer is no. We are managing this process very thoughtfully, always with a focus to not having disruption to agents or customers.

We are in the business for the long term. We look at returns over time and we will continue to march in improving returns. As long as we're moving that way, we feel pretty good. By the way, the retention remains as solid as it has and you can see from the more detailed graph how strong that really is.

Q - Jay Cohen {BIO 1498813 <GO>}

So I guess really the main point based on this conversation is that the monthly data trend does not suggest any sort of slip off, any notable slip off and what you are saying is the market to you does not feel like it is softening at this point despite this modest deceleration in the 2Q?

A - Jay Fishman {BIO 14011069 <GO>}

First, it's only July 23, I think, so it's a little -- always a little reluctant to declare anything when we are only three quarters of the way through the month. So what we are getting is to some extent anecdotal with some data around it. So it's early. It's early.

But if you -- on a more anecdotal basis, if you speak to people in the field, you don't get the comment back that there is any substantive change or receptiveness to our strategy. Brian, would you agree with that?

A - Brian MacLean {BIO 4679150 <GO>}

No, I completely agree. Jay, basically I think the way you asked the question, yes, we would agree with that, that what we have seen in our results and what we see and what we are out in the marketplace quoting on, the market looks the same to us as it has been for a number of quarters now.

We hear the same rhetoric but what we see and what we hear from our people is that it is continuing to move at about the same pace.

Q - Jay Cohen {BIO 1498813 <GO>}

That's helpful, Brian and Jay. Thank you.

A - Gabriella Nawi {BIO 2211991 <GO>}

This will be our last question. Thank you.

Operator

Clifford Gallant, Nomura.

Q - Clifford Gallant {BIO 1854853 <GO>}

Thank you. There has been talk in the reinsurance marketplace that some of the new capacity that has come in has perhaps structurally changed the business, maybe made reinsurance permanently cheaper or at least more stable. I'm curious, how do you -- how will that affect your business over time and how you manage things?

A - Jay Benet {BIO 2456473 <GO>}

This is Jay Benet. First of all as we said in the past, we operate the business as a gross lines underwriter. We don't rely on reinsurance to be in any particular marketplace and where we do have reinsurance, it's generally in the larger risk or certainly in the cat area.

As it relates to our view of the market and I'm sure there are others who have a more intense view if they are utilizing the market a lot more than we are, but given our view of the market, it seemed like there's a lot of capacity that has come in on the upper level cat kind of coverages and that has helped drive prices down. And as I mentioned, the costs that we had this July of renewing our coverages were favorable so it cost us less.

How that is going to translate or if it will translate into a working layer type benefits to companies that rely on that, we don't have any great insight, but it would seem to us at least unlikely that that's going to be where this capacity would want to play.

So not a big impact on our business for sure and we will see what happens going forward in the marketplace. But it seems like most of this capacity would be for higher level cat coverage where the expectation of actual losses taking place would be very, very low.

Q - Clifford Gallant {BIO 1854853 <GO>}

Okay, thank you.

A - Jay Benet {BIO 2456473 <GO>}

I hope that's helpful.

Operator

This does conclude our Q&A session for today. I would now like to turn the conference back over to Ms. Nawi.

A - Gabriella Nawi {BIO 2211991 <GO>}

Very good. Thank you for joining us today. Always in Investor Relations we are available for questions and answers. Have a great day.

Operator

Ladies and gentlemen, this does conclude the conference for today. We thank you for your participation and ask that you please disconnect your lines.