Q4 2018 Earnings Call

Company Participants

- Jay S. Bullock, Chief Financial Officer & Executive Vice President
- Mark E. Watson III, Chief Executive Officer & Director
- Mark H. Rose, Chief Investment Officer & Senior Vice President
- Susan Spivak Bernstein, Senior Vice President-Investor Relations

Other Participants

- Bijan Moazami, Analyst
- Bob Farnam, Analyst
- C. Gregory Peters, Analyst
- Christopher Campbell, Analyst
- Jeff Schmitt, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good day, and welcome to the Argo Group 2018 Fourth Quarter Earnings Conference Call. All participants will be in listen-only. After today's presentation, there will be an opportunity to ask questions. Please note this event is being recorded.

I would now like to turn the conference over to Susan Spivak with Investor Relations. Please go ahead.

Susan Spivak Bernstein {BIO 1514699 <GO>}

Thank you, and good morning. Welcome to our Argo Group's conference call for the fourth quarter and calendar 2018. Last night, we issued a press release on earnings, which is available in the investors section of our website at www.argolimited.com.

Presenting on the call today is Mark Watson, Chief Executive Officer; Mark Rose, Chief Investment Officer and Jay Bullock, Chief Financial Officer. As the operator mentioned, this call is being recorded.

As a result of this conference call, Argo Group management may make comments that reflect their intentions, beliefs, and expectations for the future. Such forward-looking statements are qualified by the inherent risks and uncertainties surrounding future expectations generally and may materially differ from actual future results involving any one or more of such statements. Argo Group undertakes no obligation to publicly update forward-looking statements as a result of events, or developments subsequent to this conference call. For a more detailed discussion of these risks and uncertainties, please see Argo Group's filings with the SEC.

With that, I'll turn the call over now to Mark Watson, Chief Executive Officer of Argo Group. Mark?

Mark E. Watson III {BIO 1463509 <GO>}

Good morning, and welcome to today's call to discuss our fourth quarter and year-end 2018 earnings. We achieved meaningful progress in 2018. We optimized our platform to reduce the exposure to catastrophe events by more effectively leveraging our risk management and capital structure. We made progress toward driving down our expense ratio. We grew top line by 10% and we focused our efforts on the businesses with the best loss ratios. We continued bringing technology into our U.S. business creating significant efficiencies, driving down costs and enhancing customer service. Importantly, ROE is headed in the right direction, excluding the recent accounting change to incorporate the change in fair value of equity securities. The ROE was 8.3% for 2018.

The current accident year excluding catastrophe losses in both the U.S. and International businesses improved in 2018. The expense ratio in both the U.S. and International business has also improved moving us towards our long-term ROE target of 700 basis points above the risk free rate, which currently approximates a 10% ROE. All of this was accomplished in a challenging environment for both insurance and financial markets underscoring the resilience and agility of our business. There's no doubt our business is performing solidly and shareholders have been rewarded as a result. However, we still have much work to do.

At the end of the day we're confident that we're continuing to build a unique and differentiated business, one that is best-in-class and delivers strong returns for shareholders. With that, let's dive into the details of our results. Last night we reported adjusted operating earnings at $0.55 per diluted share for the fourth quarter of 2018, up from $0.01 in the 2017 fourth quarter. For the full year of 2018 adjusted operating income was $3.22 per diluted share, up significantly from the $0.16 per share that we reported in 2017; again, a huge improvement.

Let's talk about how we got there. The improvement in results specifically reflects: first, strong risk management and the restructuring of the 2018 reinsurance and retro programs to reduce earnings volatility as I discussed on our last quarter's earnings call. The net loss impact to earnings in 2018 was less than half of what it was a year ago in 2017, thus notwithstanding the fact that the number of catastrophic events and the economic impact of them was not much less than it was a year ago.

Net catastrophe losses went from $145 million in 2017 to $62 million in 2018, or to say it a little bit differently when you think about the P&L, almost 9 loss ratio points from a year ago to just over 3 loss ratio points today. So, I think we can say again for the second quarter that the way that we managed our portfolios for CAT risk this year versus a year ago had a significant impact of volatility and in a very positive way.

The second thing that happened in the year is that our core loss ratios remained very strong. If you exclude the catastrophic events, then our loss ratios improved from 61.8% in 2017 to 58.9% in the fourth quarter of 2018. And equally important for the full year of 2018, the loss ratio excluding catastrophes was 57.8% from 58.6% in 2017.

Third, our targeted growth in selected markets in addition to improving our loss ratios, we were able to grow the top line by almost 16% in the fourth quarter of 2018 and almost 10% year-over-year to $3 billion for the year of 2018. We're growing the business at a very favorable pace and improving margins, and as you've heard me say before and I will talk about it in a little bit, this is while, we're readjusting portfolios and letting business go.

Fourth, we've had meaningful improvement in the expense ratio. The good news is not only were we able to improve our loss ratio and grow at a healthy rate, we also were able to lower our expense ratio by 260 basis points from 40.4% a year ago to 37.8% in 2018.

If you adjust for catastrophe related reinstatement premiums, the expense ratio for the fourth quarter was 36.7% compared to 39.5% a year ago or even a little bit more improvement, which reflects lower acquisition costs and the benefits of the scale associated with an overall increase in net earned premiums relative to expense.

More specifically, in regards to the expense ratio in the second half of 2018, we took further action design to keep our focus on expense management. Kevin Rehnberg is now the Chief Administrative Officer and will help lead the efforts to maximize the efficiency of our businesses group-wide. And also at the end of last year, we realigned the management structure of our International Operations appointing Matt Harris to service the new head of our international insurance business and I'm happy to say that Jose Hernandez is still in the Chair for International and helping me in the strategic level.

With the loss ratio in a good position, the expense ratio improving and strong growth adding scale to our existing platform. We're moving toward our targeted return on capital of 700 basis points above the risk free rate, which as I said a minute ago gets us to a 10% return on capital. Also as our underlying results demonstrate, we made a lot of progress in 2018 and now we have our - and clearly focused on 2019.

Turning to our U.S. Operations in particular, 2018 was a very good year in the U.S. We saw momentum build each quarter and ended the year strongly positioned to meet our own high growth and profitability goals for 2019. In both the fourth quarter and calendar year 2018, the U.S. Operations generated strong top line growth and top quartile loss ratios. In fact we achieved record breaking top line growth as gross written premiums rose about 12% in both the fourth quarter and in 2018 compared to the same periods in 2017.

Since 2013 we've grown our U.S. top line premiums 11% a year on a compounded annual basis. In fact growth would have been higher had we not been shutting unprofitable business as we shifted the mix towards portfolios of risk with the best loss ratios, which include professional surety and construction. And just to put things in perspective, we've shed over $0.5 billion of premium over the last several years. And as more growth comes from the retail business, we're also spending less on acquisition costs.

We attribute much of the success in the U.S. to our adoption of technology which is a key strategic priority, the results of which you can see in our 2018 numbers. The use of digital tools and process optimization has not just increased efficiency and scale, but has also helped in risk selection (00:09:56) businesses not to underwrite. So far the digital investments have been limited to improving the U.S. business, going forward, the strategy is to take what we've learned in the U.S. and leverage the process to improve our International business. We're executing on that strategy, and I will provide more detail on our digital initiatives in just a moment.

Now moving on to our International Operations. For the full year, gross written premiums were up 6.4% in 2018 compared to 2017. International underwriting results in both 2018 and the prior year were impacted by a high level of catastrophe losses and mask the improvement in the core business as evidenced by the accident-year loss ratio excluding catastrophe losses. Even with - our results improved by $125 million from a loss of $111 million in 2017 to a little over $6 million in underwriting profit in 2018. And that gives us a - that was with a non-CAT loss ratio of 58.8% in 2017, going down to 57% in 2018.

To just break down the International business a little bit more. In our London market business like others in the market, we spent much of 2018 remediating some of the areas of our insurance portfolio where performance has not met our expectations. Rather than wait for pricing improvements, we made aggressive changes to our strategy dropping (00:11:36) unprofitable businesses and concentrating instead on risks whose pricing has the marginal - has the most margin potential. These actions are similar to those taken in the U.S. a few years ago to build a portfolio of risk generating best-in-class loss ratios.

Moving on to Bermuda, our Bermuda insurance platform showed strong growth in the fourth quarter and calendar year 2018, giving us both scale and product diversity. We saw an immediate benefit in 2018 of combining the two reinsurance platforms, Ariel Re and Argo Re. With reduced volatility and greater strength of the combined platforms, we've now made the transition to a risk originator on behalf of third-parties.

Let's talk about digital a little bit more now. During the course of the year, we made a - we did a number of things, and I think that that you can see that the investments that we made several years ago are benefiting our current results. Today, we're investing for the future. We're confident that our digital efforts are driving positive financial results in our underwriting process. And as the results become more measurable, we'll be able to communicate exactly how our investments are being translated into stronger returns. I'll provide a bit more color here and we'll continue to update you as we progress on this initiative.

First, digital tools have streamlined the underwriting process by cutting the time it takes to respond to broker submissions from days to hours. Also we embarked upon a key tenant of our digital strategy which is to have our digital products run key processes and the first version of this is now deployed for our high volume business where we can handle most submissions now in under an hour and that's about 75% of our high volume business, particularly our E&S operations. We're now well positioned heading into 2019 to further automate key elements of that process providing even faster decisioning out of our distribution partners and their insurers.

Next, we're beginning to see an improvement in loss ratios in the businesses where we leverage digital tools and risk selection and pricing claims and reserving. I will talk about an example shortly where we use the - where the use of technology in the claims process restored profitability to an underperforming business line. And at the same time, head count at the company has been stable, thus improving scale. We built our digital team without growing our overall staff. In fact, we haven't had to add staff that would have previously been required to scale up the business, and we've avoided backfilling certain positions as they've come open. Or to say things differently, as we've been dialing up digital and dialing up our premium, our head count group-wide has remained relatively flat.

Let me discuss a couple of specific examples. First, the size of the effort, our digital budget last year was measured in millions of dollars not tens of millions of dollars. On businesses where the team has been focused, we've seen significant growth. One example is our casualty lines unit inside our excess and surplus lines business. Over the past two years, that business has grown by $80 million from $285 million to about $365 million in 2018, due in large part to the tools and process enhancements brought about by our digital investment. That business comes with the contribution margin of approximately 17%. In other words, what is left over after we set up the loss reserve to - and pay to acquire that business. And that margin - at that margin, those investments added over $15 million over the past two years to the unit's underwriting result. So you can quickly see how success can more than pay for the cost of the entire digital effort. That's what leads me to want to invest more.

Second, let me point out how investment in technology help to restore profitability at Argo Insurance, one of our retail subsidiaries in the U.S. One of our original investments is in an insured tech company called Gleason Technology, which we initially made in 2014. The Argo Risk Tech platform has allowed us to deploy a sensor-based inspection platform to 100% of our supermarkets' clients locations over the last 30 months. The platform has enabled nearly 200,000 inspections per day every day to prevent customer accidents. This proactive client activity has allowed our retail niche to swing to a consistent loss ratio under 57% in 2018 from a loss ratio of 98.9% in 2015.

Additionally, in late 2017, we launched the ability of our clients to report customer accidents in real time on the same platform, which is the key advantage in our claims process. And the reason for that is, there is a direct correlation between the length of time our clients take to report the incident to the cost of a claim. With the most recent success of this claims reporting component of the Argo Risk Tech platform, we will be expanding its use in this capacity in 2019 to our other Argo business units. Again getting closer to our customer needs and executing with digital tools are key components of our overall strategy.

What does all this mean in real dollars? After posting a $17.3 million underwriting loss in 2015 at Argo Insurance, the 2018 underwriting profit was $2.8 million, a huge percentage improvement.

So, let's move on from the operations and talk about capital management a little bit more. We're finally stable - sorry, we're financially stable and operationally nimble with the ability to go in and out of markets and to take our available capital and put it quickly into opportunities as they arise. If we do not see immediate opportunities we've demonstrated that we will repatriate to shareholders.

As you know, our number one priority remains deploying our capital into the businesses where we see attractive returns. We will be disciplined in these efforts and will carefully weigh what these investments mean in terms of shareholder value. However, if we do not see opportunities to redeploy the capital in the business, we will return capital to our shareholders through share repurchases in addition to quarterly cash dividend through both stock and special cash dividend to shareholders.

As stewards of our capital, I think we've done a good job investing in our businesses and at the same time last year returning approximately $70 million of capital to our shareholders in the form of stock repurchases and our annual cash dividends. In addition, we issued a one-time special dividend of 15% earlier in the year. And between stock buybacks and dividends paid over the past several years, we've repatriated over $635 million of capital since 2010.

So in summary, our business shows significant strength and agility in a difficult market. Our underlying underwriting results continue to improve. We are growing in the areas where we see the most profit potential. The expense ratio is improving and we are focused on cost discipline. We expect the combination of the above to push us towards our long-term ROE target of 700 basis points above the risk free rate and ultimately generate higher returns for our shareholders. We look forward to updating you on our continued progress at the end of our first quarter.

And with that I would like to turn the call over to Mark Rose, our Chief Investment Officer to talk about investments. Thank you, operator.

Mark H. Rose {BIO 1557365 <GO>}

Thanks, Mark and good morning. I will take you through Argo's investment performance for the quarter. The fourth quarter total return was negative 1.7%, which was lower than the 1.1% positive in the fourth quarter of 2017.

For the full year, total return was negative 0.6% versus a positive 5.6% in 2017. Our weak quarter occurred in the midst of a eighth Fed hike in approximately two years, while several economic and market indicators were beginning to weaken. Our equity portfolio declined $76 million in the quarter, driving the lion share of our losses.

As you probably have observed, the capital markets have so far experienced a significant recovery in 2019, while the quarter end and year are far from over. We are pleased to say that so far our total portfolio has recovered its entire market value - I'm sorry - entire market value decline of the fourth quarter in 2018. The risk portion of our portfolio has recovered half of its fourth quarter decline.

Our reported net investment income for the quarter was $29.4 million and $133 million for the full year 2018. This compares favorably to net investment income of $129 million in 2017, which excludes the impact of a one-time sale of a strategic investment. Driving net investment income growth in 2018 was a larger portfolio and higher rates, which was offset by a weaker fourth quarter in alternatives, which was negative $0.9 million.

One heads up, we hold approximately $135 million in private equity structured funds, which report on a quarterly lag, so the first quarter of 2019 will be their fourth quarter of 2018. This may contribute to another weak quarter in the alternative contribution to net investment income.

With that, I will turn the call over to Jay Bullock, our CFO.

Jay S. Bullock {BIO 3644311 <GO>}

Thanks, Mark, and good morning everyone. I'll focus my comments today on some key highlights and explanations to the financials we reported last night and then we'll take questions. From top to bottom of the financial results, 2018 was a year of improvement. We achieved growth in our most profitable business lines, maintained best-in-class current accident year loss ratios, reported our 14th consecutive year of overall positive prior year development, saw a significant reduction in losses from catastrophic events that were almost as large as those in 2017, and made material progress towards our long-term goal of reducing our expense ratio.

With this progress, we saw a return to underwriting profitability with $36.2 million of underwriting income in 2018 from a loss of $113.3 million in 2017. Similarly, we reported a significant increase in our adjusted operating income, which for 2018 was $111 million compared to $5.5 million in 2017.

The combined ratio for 2018 of 97.9% was 9.3 points better than the prior year. A couple of items of note related to revenue, in the U.S. segment the growth in gross written premium in the quarter outpaced the growth in net written premium. As noted in our release, the proportion of retained premiums was impacted in the quarter by reinstatement premiums paid post loss events, other strategic changes to the reinsurance structure, and to a lesser extent by growth in certain fronted business.

In the International segment, as noted, the growth in gross written premium was pronounced in the property division. This was the result of inwards reinstatement premiums in our reinsurance business, and to a lesser extent by the expansion of our European business. The percentage growth is somewhat exaggerated here as the fourth quarter base is a relatively smaller number on a gross written basis.

The overall loss ratio for the quarter was 62%, compared to 66.9% in 2017, and for the year was 60.1%, compared to 66.8%.

For the quarter, the current accident year loss ratio, excluding CATs improved to 58.9% from 61.8%, and for the year to 57.8% from 58.6%. This despite a number of large Marine and Energy losses experienced in the fourth quarter in the London operation.

The important thing to note here is that both, the International and to a lesser extent the U.S. reported improvement in the current accident year ex-CAT loss ratios for the quarter and the year, and particularly the underwriting actions that were implemented in 2017 and 2018 in our International business, are more clearly flowing through the results.

In the fourth quarter of 2018, development on prior year reserves was favorable by $13.9 million, compared to a favorable development of $12.6 million in the fourth quarter of 2017. Favorable development for the year was $18 million, compared to $8.2 million in 2017. Both, the U.S. and International segments contributed to that result.

Finishing up on margins, the expense ratio for the quarter improved by 230 basis points compared to the 2017 fourth quarter, while the annual expense ratio improved by 260 basis points. Excluding the effects of net reinstatement in CAT-related premium adjustments, the expense ratio was 36.7% in the 2018 fourth quarter compared to 39.5% in the same period of 2017.

As footnoted in the release, the outwards re-instatement premiums in the quarter were approximately $9.4 million, compared to $3.5 million in 2017. The adjusted expense ratio continues to reflect the effects of our efficiency and digital initiatives.

During 2018, our non-acquisition expense was essentially flat, while at the same time, gross written premium was up by $260 million or almost 10%.

Moving into (00:26:22) some other topics impacting the financials. Following on, on Mark Rose's comments on investments, our core portfolio continues to perform quite well, with net investment income growing over 25% for both, the three months and year ended December 31, 2018.

However due to market volatility experienced in the fourth quarter of 2018, our alternative investments reported a loss of approximately $1 million. And as Mark mentioned, due to the lag in reporting, the first quarter's result will include the highly volatile December result, offset by the recovery in the first two months of the year.

A couple of more items to note. The tax benefit in the fourth quarter of 2018 was $16 million, reflects the income attribution from our main tax and jurisdiction, essentially we had income in Bermuda, and given the mark-to-market of the equity securities net losses in the U.S.

As we've discussed in prior quarters, we continue to evaluate the impact of U.S. tax changes and our tax planning strategies, and believe that tax changes in the U.S. and other international jurisdictions may support a lower expected tax rate. We'll be updating that in the future.

Next, to the balance sheet. The biggest impact on the capital accounts in 2018 was the volatile financial markets. The change in equity securities resulted in an unrealized loss of $105 million in our income statement – through the income statement, while the change in unrealized losses on fixed maturity securities in 2018 were $75 million reported through AOCI. As mentioned, much of that has been recovered in the first weeks of 2019.

So in conclusion, our long-term objectives are well supported by targeted growth of our top line, underwriting discipline as evidenced by strong current accident year ex-loss ratios, improving expense ratios reflecting both, scale and operating efficiencies and our strong risk management framework.

Operator, that concludes our prepared remarks and we're now ready to take questions.

Q&A

Operator

Our first question comes from Christopher Campbell with KBW. Please go ahead.

Q - Christopher Campbell {BIO 20262752 <GO>}

Yes. Hi, good morning. Congrats on the quarter.

A - Mark H. Rose {BIO 1557365 <GO>}

Thank you.

A - Mark E. Watson III {BIO 1463509 <GO>}

Thank you.

Q - Christopher Campbell {BIO 20262752 <GO>}

My first question is on the expense ratios, and then the ROE discussion. I guess, a meaningful pickup in the expense ratio for the year, but it's kind of still around 38%, I guess, how low do you think this could go in 2019 and 2020? And then what levers do you think you need to pull to help close that, that ROE gap and that would be the timing of that?

A - Mark E. Watson III {BIO 1463509 <GO>}

So, Chris, this is Mark. So over the next 18 months to 24 months our focus is to close the underwriting margin gap by another 200 to 300 basis points. We think most of that will come from expense ratio improvement.

We do believe there will still be some underwriting improvement as we continue our portfolio optimization across the group. I think a lot of that improvement will come - well, actually, I think it may come evenly from both parts. But I think the most opportunity right now for margin improvement comes with expense ratio improvement. That's a combination of getting more impact from the digital initiatives that you heard me talk about earlier.

So think about - we have an opportunity to automate more things. And as I've said in my remarks earlier, we've been able to grow without having to add payroll. And so, I think, continuing to grow and keep expenses growing at a lower rate than the top line will help improve margin.

And then the last part is distribution. In some parts of the group, our distribution is very expensive - the cost of acquiring customers is just too expensive. And look for us over the course of 2019 to talk about business that we're letting go of. And while that may have a dent on the top line a little bit, it will still have a meaningful positive impact on the bottom line.

So, I think over the next 18 to 24 months, our goal is to improve underwriting margin by another 200 to 300 basis points and that gets us to our targeted return on equity.

Q - Christopher Campbell {BIO 20262752 <GO>}

Great. And that's very helpful. And then, just thinking also on the ROE, so is - not sure exactly where you guys ended the year, but is the investment asset duration is still pretty meaningfully below the liability duration? And then, I guess just, even if it is still that way, if they were more normalized and matched, I guess how much ROE could you pick-up from that as well?

A - Mark E. Watson III {BIO 1463509 <GO>}

So, let me let Mark Rose answer the first part of that question, and then I'll have Jay answer the second part.

A - Mark H. Rose {BIO 1557365 <GO>}

I'm sorry. Could you repeat the first part once?

Q - Christopher Campbell {BIO 20262752 <GO>}

Yeah. Just in terms of the asset duration, I remembered the last numbers in my mind, are you guys are at - maybe at a 2.3 or low two-year investment asset duration, where the liability duration or the underwriting portfolio might be around four, so I guess, just what are the current numbers on that and then just what would be the ROE on that?

A - Mark H. Rose {BIO 1557365 <GO>}

Yeah. So, so when you look at the portfolio duration, it's driven by multiple factors. One is, some portfolios are offsetting assets that are shorter, but they need to hold more assets, because of the statutory requirements in those portfolios. So what we find is, we are holding more high quality fixed income assets versus our liabilities overall. So, with more assets, we simply run a shorter duration than the liability duration and we're still roughly matched.

So, we're kind of over hedged in safe assets to begin with, so we have the freedom to manage that duration, A, for fitting. And, B, we also look at duration of risk on when we think interest rates could be volatile.

A - Jay S. Bullock {BIO 3644311 <GO>}

And, Chris, now to your second question, and that is if we extended, I think, the question boils down to, if we extend the duration to match or exceed liabilities, we could take the bet on either side, what would the impact be on ROE?

It's really as much a risk management question as anything, based on the fact that the yield curve continues to be and has been so flat. So, you can get a marginal increase. So just look at the difference in the 2 in the 10 or 10 and the 30 (00:33:45), you can get a very marginal increase in ROE.

And, it's factually correct that that would generate more income, but you're taking a kind of a leverage bet on where you are on the curve and it's kind of an asymmetrical outcome, if rates really do start to increase. So, that has been largely, what's driven the decision to maintain a shorter duration over the last several years.

You can look at it in hindsight and say, you left some money on the table, which we did. But, based on the risk management decision, I would do it again. It's the right thing to do. Because, it always looks like the rates should move up as it does currently.

A - Mark H. Rose {BIO 1557365 <GO>}

And the benefit of being shorter on the curve is that you can reinvest faster when the rates do move up.

A - Jay S. Bullock {BIO 3644311 <GO>}

That's right.

A - Mark H. Rose {BIO 1557365 <GO>}

So you do get a pick up later on.

A - Jay S. Bullock {BIO 3644311 <GO>}

That's right.

Q - Christopher Campbell {BIO 20262752 <GO>}

Okay. Got it. Very helpful. And then I guess can you just discuss the approach to your 1/1 reinsurance renewals. I guess what percentage of your programs renew at 1/1? And then, just what are your thoughts, just in terms of increasing limits, decreasing retentions, third-party sessions. Those kind of things?

A - Mark E. Watson III {BIO 1463509 <GO>}

Okay. Well, that was a series of very broad questions that we can spend an hour answering. So, for 1/1, we were able to – actually, it's a really good question, Chris. Because at 1/1, we were able to keep, both our reinsurance programs and our retro programs and the capital supporting our business intact for 2019 structurally almost exactly the way that we did for 2018, and I think that's a huge feature of our risk management in terms of our ability to manage volatility.

And also it just reemphasizes that for our CAT exposure in particular, that we're still originating risk for others given that most of the risk we push out to the capital markets and other third-party capital providers beyond just our traditional reinsurers and retrocessionaires. So, we're really, really pleased that we were able to put the same structure in place for 2019 that we had in 2018.

In terms of business coming in the door for our reinsurance business, we readjusted place where we sat on some of the programs taking a little bit more in some places, where we could get rate and perhaps walking away for a couple of accounts, where we didn't think we were getting paid.

Most of the loss-affected business doesn't really renew until later in the year. So, how things played out on the 1st of January, I don't think is a very good indication of where they will be at the end of the first, well, really the second quarter.

So, I think the best time to really kind of talk about market commentary may be a little bit at the end of the first quarter, but much more so in the second quarter. And also, it's just a pleasant reminder that about 90% of our business is insurance, not reinsurance. And we've been able to renew – I guess, we probably renewed a quarter of our insurance business, reinsurance programs, at the first of the year and the rest of them will come through the next six months of the year.

Q - Christopher Campbell {BIO 20262752 <GO>}

Okay. Great. Well, that's very helpful. And then just one final one on, Lloyd's, I guess just what are you seeing in the casualty lines and pricing over there and then just in terms of market discipline. Can we get an update on that?

A - Mark E. Watson III {BIO 1463509 <GO>}

Well, I talked about it a little bit in my remarks earlier, but if I just kind of speak generally about the market, I think that the top decile initiative that Lloyd's initiated last year was helpful to the market. We had started making some changes in 2017. And a lot of the initiatives that Lloyd's pushed through last year, we were already in the middle of.

And, we kind of saw that, when it came time to file our business plan for 2019, we were able to have Lloyd's approve our business plan almost as is. We still have all the classes of business, whereas most of our competitors were encouraged or pushed to eliminate one or two lines of business or more, depending upon the syndicate. And that's because we had already reduced our exposure to several lines of business.

So I think, there's still - look, the London market is very competitive, and we've been focused on originating risk across the group, not just in London. But I think that the changes that were made in the latter half of last year at a market level are now inuring to the benefit of us this year keeping in mind that when we talk about what we view as rate increases over the course of 2019 relative to 2018 may be less than some of our competitors because of the changes that we made in portfolio in rate increases that we were able to drive from 2016 to 2017 and 2017 to 2018.

Q - Christopher Campbell {BIO 20262752 <GO>}

Got it. Makes a lot of sense. All right, thanks for all the answers. Best of luck in 2019.

A - Mark E. Watson III {BIO 1463509 <GO>}

Thank you.

A - Mark H. Rose {BIO 1557365 <GO>}

Thank you.

Operator

Our next question comes from Bijan Moazami with Compass Point Research. Please go ahead.

Q - Bijan Moazami {BIO 2087745 <GO>}

Good morning, everyone. I guess I have a question for you Jay and a follow-up for Mark. I guess, Jay, if my math is right, your corporate expenses went from 6.5 points of the earned premium in the fourth quarter of last year to 2.3 points of the earned premium in the fourth quarter of this year. Could you spend a little time in terms of why that there was a big drop in there and what we should be considering a run rate number going forward?

A - Jay S. Bullock {BIO 3644311 <GO>}

Yeah. Bijan, I would focus more on the overall group numbers. The items last year, there were some transition expenses related to our IT outsourcing that were retained at the corporate level, and so last year's corporate numbers would be slightly higher. So, if you think about that, there's a portion that's being allocated to both segments this year that wasn't last year.

As I said, our overall spend was relatively flat this year, and yet we were able to achieve growth. And so I would - so my point is that, I think, what you see this year is a reasonably accurate reflection of the overall cost base for the organization.

Q - Bijan Moazami {BIO 2087745 <GO>}

Right, so about $10 million, $10.5 a half million in corporate expenses, correct, per quarter?

A - Jay S. Bullock {BIO 3644311 <GO>}

If you did – if you reversed and do the math, that's what the math would show you, yes.

Q - Bijan Moazami {BIO 2087745 <GO>}

Perfect. And the follow-up I guess for Mark, International Operations, 98.5% ex-CAT combined ratio. If you make some kind of an allocation of corporate expenses, and considering that it has a higher catastrophe exposure than the rest of your business, are you guys earning your cost of capital in that business? And if not, with all the expense initiatives and rate increases, would you be getting to that point by the end of 2019?

A - Mark E. Watson III {BIO 1463509 <GO>}

Yeah. Well, so clearly when you have a year with a lot of CAT activity, it's hard to earn your cost of capital. When I look at the changes that we've made to the portfolio, including where we allocate our – well, when I look at how we allocate the amount of CAT that we want to keep net among the different parts of the business, clearly, we're going to allocate the capital or we're going to allocate the capacity, where we think we can get the highest return. So, not surprisingly, our property exposure has come down year-over-year in London and there is a chance that it will come down a little bit more this year.

But, a lot of the change that we wanted to make in our property portfolio, we made last year in terms of CAT exposure, I think this year is more focused on making sure that we actually have the right structure for the property programs that we're still underwriting, excluding CAT. I think that's the biggest opportunity for improvement.

Operator

Our next question comes from Greg Peters with Raymond James. Please go ahead.

Q - C. Gregory Peters {BIO 3111497 <GO>}

Good morning. Thanks for taking my questions. I just guess I wanted to step back. We're well into the fourth quarter earnings season, a lot of insurance companies have reported. And this new accounting standard, where you guys are being forced to now run through unrealized gains and losses has really affected and impacted the book value per share calculation for almost everyone. And I'm just curious about management's perspective on evaluating performance. I know one measure that insurance companies used to use as a gauge for value creation would be just book value growth, plus dividends. And I'm just curious about your perspective on this, Mark and Jay.

A - Mark E. Watson III {BIO 1463509 <GO>}

Jay, I'll let you go first.

A - Jay S. Bullock {BIO 3644311 <GO>}

Well, yeah. I mean, look, I think since I've been here, we've been pretty consistent about not running the business to react to changes in accounting. It's the fundamentals about creating value, about cash flow and about book value generation over the long run.

So, that mark-to-market on the equity portfolio, that's running through the income statement, I mean, used to be on the balance sheet. So, it was a component of the change in book value. It now amplifies a positive or negative result on the P&L. But as you'll note on page 21 of our press release, we've tried to give you a look at the ROE without that change, which was 8.3% for the year.

So, we're trying to make sure that people can reach back and sort of what they're familiar with, and move things around a bit. But it really hasn't changed the way that we have thought about running the business or the composition of the portfolio. The composition of the portfolio is really based on where we see the best value in the capital markets. And coupled with a focus on the risk allocation to the underwriting business versus the risk allocation to the investment business.

A - Mark E. Watson III {BIO 1463509 <GO>}

Yeah, I think what it highlights is that, that there is a fair amount of volatility on both sides of the balance sheet. And as Jay just said, the balance sheet gets mark-to-market every quarter. I'm not sure that there was as much emphasis or discussion. And as you and others have heard us say repeatedly for a long time, our focus is - really is on growth in book value per share plus dividends. And so, I guess, this comes back to it. It highlights that the - that there is some volatility in everyone's investment portfolio because we're managing - or at least in our case, we're managing it to a total return basis. And I look at how much the portfolio was already up in the first half of this quarter and so we've made back the majority of the downside that we saw in the fourth quarter.

And it's also just a reminder that that when we think about growth in book value per share, there's three things that make it happen and I touched on all of them earlier. Well, I touched on two of the three and then Mark Rose touched on the third, it's underwriting - the underwriting result, the total return on the investment portfolio and capital management. And so the new accounting change does add more volatility but I think over time, we're rewarded for taking a more total return approach to our investment portfolio just as we're rewarded for taking a certain amount of risk net on our balance sheet.

Q - C. Gregory Peters {BIO 3111497 <GO>}

Great. That's a good answer. So I've two other questions. Again in the context of commentary we've heard from so many other companies that reported, it seems like the pricing environment and I know you commented a little bit about reinsurance, but just more broadly speaking, it seemed like the pricing environment is stable to slightly positive at least that's what we've heard from many of your peers. Maybe you could spend a second or more than a second, how about a minute and just add some color around your specific areas of concentration and how you see pricing developing through the year?

A - Mark E. Watson III {BIO 1463509 <GO>}

Yes. So in my remarks earlier, I was talking about the parts of the group where we saw the most margin opportunity and I highlighted a few of them, our surety business, Argo Pro and some of our casualty business. And I think that when I look at the margins there, so not – not just the loss ratio, but – but the all in expense. So underwriting margin, look I think things are priced pretty well for our portfolios, I think they're priced pretty well, where they are and we can grow with market pricing, where it is.

Having said that, we are seeing some improvement in the market in general, almost across the board, but it's low single digit. Now for business that's underpriced, so think CAT-exposed property or transportation, which we've been talking about for years, you may recall that we exited most of our transportation business five years ago.

And so we don't really talk too much about rate increases there, because there isn't much left whereas many of our competitors are talking about 20%, 30% rate increases. Okay, well, that's great as compared to what. And so when you look at where you're seeing a lot of rate increase, it's because it needs it. When there are a lot of – again just to come back to our portfolio, there's a lot of risk on the books today that we think is adequately priced where it is to drive margin. So for us, the opportunity and the challenge is to see for the portfolios that are underperforming. Do we need to raise price? Do we need to exit? Can we find a less expensive way to originate that business? So there are a number of levers that we're trying to pull depending upon the exact line of business and geography that we're talking about.

So, that's still kind of a general answer, but it's hard to get any more specific without drilling into $10 million and $20 million portfolios that we have. But I think that the market trend is moving upward. The market trend does need to move upward. And as competitors exit different markets, that presents opportunity for us. And you're starting to see a fair amount of product exit in London. You're seeing market exit in other parts of the world. And again, that presents opportunity for us just as there was a fair amount of consolidation and restructuring a few years ago that we talked about in the marketplace where we thought that would be an opportunity for us, it was and so, we just need to keep looking at where we can get the best return on our allocated capital going forward and improve our operations where we need to.

Q - C. Gregory Peters {BIO 3111497 <GO>}

Thanks for that answer. I just wanted to I guess finish up with the question around reserve development. And again in the context of what I've seen from other companies' report, not only for the quarter book, for the year-end, it seems like it's been a mixed bag.

As you noted Mark, a number of companies in the transportation space have reported challenging reserves. We've seen a number of companies report not only quarter-over-quarter, but year-over-year declines in favorable reserve development. And by contrast you guys have reported an improvement in favorable – your reserve development prior period. So I was just curious and I know you don't budget things like this, but I'm just curious about your perspective of the moving pieces within the favorable reserve development and how we should think about that going forward?

A - Mark E. Watson III {BIO 1463509 <GO>}

Well, if you look at our prior reserve development over the last 14 years, it's been positive and we're very proud of that and we're very focused on making sure that continues. As my colleagues on the board said to me years ago, before it was positive, that's a high-class problem. And I'd say it that way, because if you over reserve, then you may price – if you set your loss picks too high, then that means you may have overpriced your product and you're subject to adverse selection. I think one of the – I think there's two reasons, why you see less positive prior year development than you might have in the past?

If you go back five years, 10 years ago, we as a market expected more loss cost inflation that we've seen and we price that into our products. And when that didn't happen, that led to lower expected or lower paid losses than we expected. And so that of course result in positive prior year development.

And the second thing is, we as an industry have a lot more data today, and we're able to more precisely price our product and so I think that though – I think a lot of us have had don't need to hedge quite as much to get it right today, as we did perhaps a decade ago. Certainly, those two things are true for ourselves, but I think that those are a pretty good reflection of most of the better performing companies in our industry.

I mean, there are there are others that may have (00:52:58) it a little bit for different reasons. But as we all know with the accounting changes that happened a couple of decades ago, it's a lot harder. It's a lot harder to do that today than before. So I think there's a lot more precision around people's loss picks certainly for mature books of business. There's still a lot – a higher margin of error for a new business. But for people who've got seasoned books of business, they've got a lot more data and can be more precise. And so I think that leads to a little bit less prior year development plus or minus.

Q - C. Gregory Peters {BIO 3111497 <GO>}

Okay, great. And then – and just two items just to come back from comments on the call, just to clarify. One was around your tech spend, it didn't sound like it was a significant budget but it's still an item. And then secondly, Jay, your comments around tax rate assumptions going forward. Just if you can reiterate that for me, I'd appreciate it. Thank you.

A - Mark E. Watson III {BIO 1463509 <GO>}

Yeah. So I think I'd said in my remarks earlier that we've been spending millions of dollars a year not tens of millions of dollars, but we're starting to get a benefit that we think can be measured in tens of millions of dollars which encourages us to really think about how we can push a little harder in 2019 particularly take the knowhow in the U.S. and redeploy it in our International business. Jay, you want to talk about tax?

A - Jay S. Bullock {BIO 3644311 <GO>}

Yeah, I think what I said on that – well, I know what I said – what I said a moment ago was with the changes – we've all been reacting to the changing tax environment throughout this year. We're still tweaking the structure a bit, but it looks to me like our long-term assumption on what we expect the tax rate to be which by the way if you look historically over the last 10 years, that 20% expected tax rate was pretty close. It looks like we may feel that we're moving into a period where it's slightly below that.

So the idea I think – sorry, from our perspective is the expectation maybe somewhere in the high teens as opposed to 2020. And we'll make that, we'll make that change as we report earnings in – throughout the year.

Q - C. Gregory Peters {BIO 3111497 <GO>}

Great. Thank you for your answers.

Operator

Our next question comes from Bob Farnam with Boenning & Scattergood. Please go ahead.

Q - Bob Farnam {BIO 15005467 <GO>}

Good morning. I have two questions. One is on the change in the reinsurance program from 2017, 2018. Just to get an apples-to-apples comparison on the CATs, have you done an exercise to look to see what, for example, 2018 would have (00:55:52) if you didn't change the program versus what it is now?

A - Mark E. Watson III {BIO 1463509 <GO>}

Well, no. But if you think about what I've said earlier that our CAT – that our net exposure this year was about half of the year ago, it's probably the same. So if we'd had the same program last year as this year, we would have twice as much loss this year as we did.

Q - Bob Farnam {BIO 15005467 <GO>}

Yeah. Okay.

A - Mark E. Watson III {BIO 1463509 <GO>}

I mean I'm just – Bob, I'm just generalizing but that's a notionally correct amount.

Q - Bob Farnam {BIO 15005467 <GO>}

Yes. I doubt, I'll keep that in mind.

A - Mark E. Watson III {BIO 1463509 <GO>}

Yeah.

Q - Bob Farnam {BIO 15005467 <GO>}

And Mark with your comments on the digital initiatives, on the grocery store example that you gave, I'm just curious, just so how does technology help to lower losses in a grocery store?

A - Mark E. Watson III {BIO 1463509 <GO>}

So what we're – there're already sensors around the premises that – that measure, well in this case the example I was using was, would be water spilled on the floor which caused the slip and fall. And so, this allows us to make sure the people who are out checking the – so basically grocery store employees walk around and make sure that everything is okay and as they walk around the sensors capture them and also we have sensors that figure out whether there is water on the floor, we have sensors that check for food temperature. There seems to be a sensor for everything, and I'm exaggerating to make a point. But what happens – so the premises owner in this case is supermarket is able to more quickly see if there's something that's happened that might cause an accident, somebody that slips and falls.

Q - Bob Farnam {BIO 15005467 <GO>}

Right. So you have basically sensors located throughout the grocery store to capture this type of data?

A - Mark E. Watson III {BIO 1463509 <GO>}

That's right.

Q - Bob Farnam {BIO 15005467 <GO>}

All right. Great. That's – I just want a clarification of that. Thanks for that.

Operator

Our final question comes from Jeff Schmitt with William Blair. Please go ahead.

Q - Jeff Schmitt {BIO 19747235 <GO>}

Hi. Good morning everyone. The growth in the U.S. continues to look really good. I think it was about 12% throughout the year. Could you discuss what was the level of rate in premium growth you're seeing just in the E&S book?

A - Mark E. Watson III {BIO 1463509 <GO>}

It's been a pretty even mix between our E&S business and our retail business and it's a little – I mean, it's a little lumpy from one product to the next, but we're seeing pretty good growth in general both in our retail business and our E&S business.

Q - Jeff Schmitt {BIO 19747235 <GO>}

I mean, I guess you're not seeing higher growth in E&S with some of these digital efforts I guess so with AIG Lloyd sort of pulling out of the – pulling back in the market?

A - Mark E. Watson III {BIO 1463509 <GO>}

Well, we are, but at the same time we've had a lot of success with our retail businesses as well. And so, I mean, we just see - we've just been very fortunate across the board in both of our businesses. You're right, that is those big guys pull back, that that's market opportunity for us. But we're also seeing market opportunity in our retail business as well. And that runs at a better margin. So, we're more focused on that.

Q - Jeff Schmitt {BIO 19747235 <GO>}

Okay. Yeah, which I was going to ask how our margins in the E&S sort of holding up, or how does the combined ratio look?

A - Mark E. Watson III {BIO 1463509 <GO>}

Yeah. So I mean the difference is only a couple of points. So everything is holding up right now. We're just trying to figure out where we can get the most leverage out of the product initiatives that we've started. And when I think about what we've done with digital, I mean you're right that there has been more E&S benefit, but I would say as the year progressed last year and more of it was focused on retail. And that's just kind of been a function of who and the company has been in the queue. So I think you'll see equal opportunities - we will see equal opportunities for us for both E&S and retail going forward. And I would say I'm pretty bullish on both not one over the other.

Q - Jeff Schmitt {BIO 19747235 <GO>}

Okay, that's helpful. Thank you.

Operator

This will now conclude the question-and-answer session. I would now like to turn the conference back over to Mark Watson, CEO for any closing remarks.

A - Mark E. Watson III {BIO 1463509 <GO>}

Thank you. And I would like to thank everyone at Argo who worked their tail off last year. As I said at the beginning of the call, our underwriting results are in part masked by the volatility from again an extraordinary year of CAT activity, and a fair amount of capital market's volatility in the fourth quarter. But when I look through all of that and look at how we finished the year, I think we finished 2018 in the strongest place we've been. And I'm really appreciative of all of my colleagues at Argo for all their hard work, and I'm really looking forward to talking to everyone about 2019.

And with that operator, that concludes my remarks.

Operator

The conference has now concluded. Thank you for attending today's presentation and you may now disconnect.