Company Name: Travelers
Company Ticker: TRV US
Date: 2016-07-21
Event Description: Q2 2016 Earnings Call

Market Cap: 33,648.20
Current PX: 116.72
YTD Change($): +3.86
YTD Change(%): +3.420

Bloomberg Estimates - EPS
Current Quarter: 2.276
Current Year: 9.432
Bloomberg Estimates - Sales
Current Quarter: 6870.875
Current Year: 27143.100

Q2 2016 Earnings Call

Company Participants

- Alan D. Schnitzer
- Jay S. Benet
- Brian William MacLean
- Michael F. Klein
- William Herbert Heyman
- Gabriella Nawi

Other Participants

- Randy Binner
- Kai Pan
- Michael Nannizzi
- Ryan J. Tunis
- Amit Kumar
- Charles Joseph Sebaski
- Jay Gelb
- Jon Paul Newsome
- Jay Arman Cohen
- Larry Greenberg

MANAGEMENT DISCUSSION SECTION

Alan D. Schnitzer

Q2 Highlights

Operating Income and Underwriting Results

- This morning we reported second quarter operating income of $649mm or $2.20 per share and an operating return on equity of 11.6%
- Our underwriting results remain strong as reflected in our 93.1% combined ratio for the quarter, despite the impacts of higher catastrophe and non-cat weather-related losses y-over-y
- For the six months, we reported operating income of $1.35B, or $4.52 per share, and an operating return on equity of 12%

Interest Rates, Risk Selection and Pricing

- Given the cumulative impact of eight or so years of declining interest rates on our investment portfolio and also relative to the fresh lows in the risk free rate, we feel terrific about the returns we continue to generate
- Our expertise in risk selection and pricing, our thoughtful and consistent investment strategy and our active approach to capital management all come together to enable us to achieve our objectives of delivering superior

returns and creating shareholder value

Production

- Turning to production, Q2 was another example of the successful execution of our marketplace strategies
- We're very pleased with the record volume of premium that we wrote in the quarter and we continue to be very pleased with the modeled returns in the business we're writing

Commercial Businesses

Renewal Premium Change

- In our commercial businesses, retentions remained high and renewal premium change was positive
- Underneath that, consistent with our very granular approach to execution, in Middle Market we retained 90% of the premium from our best performing accounts with only a modest decline in renewal rate change on that business
- On our poor performing accounts, we achieved renewal rate change in excess of loss trend
- You might have noticed that renewal rate change in domestic Business Insurance was slightly positive as compared to slightly negative in Q1 and renewal rate change in Middle Market improved by a full point
  - We don't forecast rate and we're not calling a bottom, but the significance of this to us is that the market remains remarkably stable and we're generally successful in achieving our written return objectives

New Business and Personal Insurance

- In terms of new business, we are actively seeking and finding opportunities that meet our return thresholds and we delivered strong new business growth in our commercial businesses, including 10% growth in new business and domestic Business Insurance
- In Personal Insurance, net written premiums grew 9% to a record of over $2.1B with accelerating momentum in both auto and homeowners
- New business was up 21% y-over-y driven by the success of the Quantum product
  - Quantum Auto 2.0 continues to meet our financial expectations and is successfully enhancing our market position

Leverage and Distribution Partners

- Our success in the marketplace across all our businesses really speaks to the value of the talent that we have in the home office and in the field and their ability to leverage our data and analytics and work with our distribution partners to deliver great products and services at fair prices to our customers
- Franchise value matters

Claim Organization

- Before I turn the call over to Jay Benet, I'd like to acknowledge and thank all of the colleagues in the Claim organization for their extraordinary efforts in handling the claims of our customers affected by severe weather and fire so far this year

- These experts are on the front line for us, delivering on the promise we extend with every policy that we write and it has been a very active year so far for them
  - Their responsiveness and expertise are great for our customers and an important competitive advantage for us

Canada

- In Canada, where we saw significant wildfires in the Fort McMurray area, both our customers and we benefited from the work we've done to replicate our U.S. claim model, which enables us to respond to large-scale events with our own highly-trained professionals and resources without resorting to independent adjusters

Closing Remarks

So, all in all, solid results for the quarter in H1, particularly in light of the weather and wildfires, and continued excellent execution in the marketplace

Jay S. Benet

Financial Highlights

Operating Income and Operating Income on Equity

- As I did in Q1, I'd like to start by saying that we were pleased with our results, operating income of $649mm and operating return on equity of 11.6%, despite them being lower than in the prior-year quarter
- These reductions did not result from significant changes in underlying business trends
- Notably, as indicated on page four of the webcast, the q-over-q decrease in operating income was impacted by, among other things, PCS CAT events and lower fixed income, net investment income

Losses and Fixed Income

- Losses from PCS-CAT events that met or exceeded our threshold we're recording as cats were $79mm higher after-tax than in the prior-year quarter
  - While losses from PCS-CAT events that fell below our cat thresholds, which we recorded as part of non-cat weather-related losses within underlying underwriting results were $56mm higher after-tax than in the prior-year quarter
- And fixed income NII was $21mm lower after-tax, primarily due to the continuing low interest rate environment as we had anticipated in the outlook section of our first quarter 2016, 10-Q.
  - Everything else was pretty much a wash

Reserve Development

- We continued to experience net favorable prior-year reserve development, which totaled $288mm pre-tax or $192mm after-tax this quarter, up from $207mm pre-tax or $133mm after-tax in the prior-year quarter

Business and International Insurance

- In Business and International Insurance, net favorable development of $138mm pre-tax, or $94mm after-tax, primarily resulted from better than expected loss in domestic workers' comp for accident years 2006 and prior and accident year 2015
- Better than expected loss experience in domestic general liability for accident years 2011 and 2015 and better than expected loss experience in our European operations partially offset by an $82mm pre-tax or $53mm after-tax increase to environmental reserves

Bond & Specialty Insurance

- In Bond & Specialty Insurance, net favorable development of $150mm pre-tax or $98mm after-tax primarily resulted from better than expected loss experience in fidelity and surety for accident years 2010, 2013 and 2014 and better than expected loss experience in GL for accident years 2007 through 2011
  - YTD, on a combined stat basis for all of our U.S. subs, all accident years have developed favorably or had de minimis unfavorable development

Commercial Multi-Apparel and CMP

- In addition, other than commercial multi-apparel, all product lines have developed favorably YTD.
- While CMP has developed unfavorably by $42mm YTD, you may recall my telling you in Q1 that there was an offsetting favorable development in the property product line as middle market property losses that had been recorded in the property line at year-end 2015 were subsequently determined to be CMP related

Cash Flows

- Operating cash flows of $443mm were very strong particularly recognizing that they were net of the $524mm payment we made this quarter as final settlement of the PPG asbestos litigation
- We ended the quarter with holding company liquidity of $1.75B and all of our capital ratios were at or better than their target levels

Net Unrealized Investments

- Net unrealized investment gains increased to approximately $3.6B pre-tax or $2.3B after-tax, up from $2B and $1.3B, respectively at the beginning of the year, while book value per share of $85.73 and adjusted book value per share of $77.61 increased 7% and 3%, respectively, also from the beginning of the year

Capital

- We continue to generate much more capital than we need to support our business and, consistent with our ongoing capital management strategy, we returned $747mm of excess capital to our shareholders this quarter through dividends of $197mm and share repurchases of $550mm
- YTD, we've returned over $1.5B to our shareholders through dividends and share repurchases

Cat Reinsurance Coverage

- Before turning the microphone over to Brian, there's one additional topic I'd like to cover, our cat reinsurance coverage
  - In addition to our Corporate Cat Aggregate XOL Treaty, which had renewed at the beginning of the year, our cat reinsurance includes cat bonds that are specific to the Northeast U.S., along with the Northeast Gen Cat Treaty

Cat Bonds

- With respect to the cat bonds, one that had provided up to $300mm of coverage for certain losses, expired as scheduled in May 2016 and, given our current risk profile, we decided not to replace it
  - With respect to the remaining cat bond, which will not expire until May 2018, the attachment point and maximum limit were reset, as required annually, to adjust the modeled expected loss of the layer within a predetermined range
- For the year beginning May 16, 2016, we will begin recovering amounts under this cat bond if losses in the covered area for a single occurrence reach an additional attachment amount of $1.968B.
  - The full $300mm coverage amount is available on a proportional basis until such covered losses reach a maximum $2.468B.

Northeast Gen Cat Treaty

- And finally, our Northeast Gen Cat Treaty was renewed on July 1
- This treaty provides up to $800mm, part of $850mm of coverage, subject to $2.25B retention for certain losses arising from hurricanes, tornados, hailstorms, earthquakes and winter storm or freeze losses from Virginia to Maine
- A more complete description of our cat reinsurance coverage, including a description of earthquake and International coverage, is included in our second quarter 10-Q, which we filed earlier today, as well as in our 2015 10-K.
  - While the total cost of these treaties is small in relation to our operating income, we were able to save some money by not replacing the expiring cat bond

Brian William MacLean

Operating Highlights

Business and International Insurance

- In Business and International Insurance, we're pleased with the results this quarter
- In domestic Business Insurance, we achieved very strong retention, along with a modest increase in renewal rate change vs Q1, and higher levels of new business
- Our strategy has not changed as we strive to retain our best performing accounts, get rate where needed, and write new business when it meets our target returns
  - This has been our strategy for some time and as a result, we continue to be viewed as a stable and financially strong market by our distributors and customers

- Along with the meaningful competitive advantages that we deliver, this consistent leadership position is resulting in additional growth opportunities for us

Operating Income and Cat Losses

- Turning to the financial results for the segment, operating income was $393mm, with a combined ratio of 97.5%
- Cat losses for the quarter were $143mm net after-tax, which included $61mm from the Canadian wildfires
  - Excluding the Canadian fires, cat losses were slightly higher than the prior-year quarter

Underlying Combined Ratio

- The underlying combined ratio, which excludes the impact of cats in prior-year reserve development, was 95.5%, up 2.4 points compared to Q2 2015
- The loss ratio increased by 1.7 points, driven primarily by non-cat weather, which was higher than both the prior-year quarter and our expectation
- The expense ratio was up 0.7 point over last year, driven primarily by commissions, as Q2 2015 benefited from a one-time favorable adjustment

Net Written Premiums

- Net written premiums for the quarter were in line with the prior-year quarter, with domestic Business Insurance premiums up about 2%
- Given the returns that we are generating in this business, our focus continues to be on retention
- And so we were very pleased that retention remained at 85% for the quarter
- Renewal premium change was just over 2 points, including renewal rate change that was slightly positive
  - New business of $525mm was up 10% vs Q2 2015

Select

Retention and Renewal Premium

- Turning to the individual businesses within Business Insurance, beginning with Select, we achieved retention of 82% and renewal premium change of nearly 6%
- Rate change was down slightly vs
- Q1 2016, while exposure was in line with recent periods, and new business was up slightly y-over-y

Middle Market

- In Middle Market, retention remained very strong at 87%, with renewal premium change of about 1.5 point, in line with recent quarters
- In terms of new business opportunities, given our leadership position in the market, submissions were up y-over-y

- Accordingly, we had more opportunities to quote on the types and classes of business we find attractive, and to grow our new business while maintaining our return thresholds

Other Business Insurance

- In Other Business Insurance, retention of 82% was up 1 point y-over-y, while renewal premium change was a 0.5 point, and new business of $154mm was consistent with Q2 2015

Other Business Insurance

- As we've mentioned in the past, Other Business Insurance includes our National Property business
- While there continues to be some rate pressure in this business, returns remain attractive, and as a result, retention is our priority
- As you can see on page 13 of the webcast, excluding National Property, renewal rate change for Other Business Insurance remains positive and was relatively consistent with recent quarters

Net Written Premiums

- In International, net written premiums for Q2 were down about 12% q-over-q
  - Excluding the impact of foreign exchange, net written premiums were down about 9%, driven by disciplined underwriting actions in our UK business, along with lower economic activity, impacting the marine and energy lines of our Lloyd's business

New Business

- New business of $107mm was up 67% y-over-y, driven primarily by Optima, our new strategic Personal Lines auto product in Canada, which was modeled after our U.S.-based Quantum Auto 2.0 product
  - So, all in, a good quarter for the segment with strong production and profitability

Bond & Specialty Insurance and Operating Income

- I'll turn now to Bond & Specialty Insurance, where we had another terrific quarter
- Operating income of $202mm was up significantly from the prior-year quarter, driven by a higher level of net favorable prior-year reserve development
- The underlying combined ratio of 80.9% remains exceptionally strong

Net Written Premiums

- As for top line, net written premiums for the quarter were in line with the prior year as growth in Management Liability was offset by lower surety premium
- The lower surety volume was due almost entirely to favorable one-time reinsurance impacts in the prior-year quarter

Management Liability Business

- Across our Management Liability business, retention remained at historically high levels and new business volumes were up as we continue to execute our strategy of retaining our best accounts, and writing more business in our return adequate product segment
  - We continue to feel great about this segment's performance

Personal Insurance and Net Written Premiums

- In Personal Insurance, results were again strong and we remain particularly pleased with our ability to add top line growth at appropriate financial returns
- Net written premiums for the quarter of $2.1B were an all-time high with double-digit growth in Agency Auto, while growth also accelerated in Agency Homeowners & Other
- In both products, we continue to produce strong retention and new business levels
- Agent and consumer receptivity to Quantum Auto 2.0 remains exceptional, and importantly, a significant amount of Quantum Auto 2.0 business are now coming through their renewal cycles
  - We're pleased with the retention rates we're seeing on those policies

Homeowners

- In Homeowners, our growth momentum is building due to crossover benefits from Quantum Auto 2.0 as well as pricing changes and improvements to agent and customer experience

Profitability

- Turning to profitability, operating income for the segment was down compared to the prior-year quarter due primarily to lower net favorable prior-year reserve development
  - The underlying combined ratio of 89.5% was in line with our expectation but up about a point from the prior year, driven by the impact of the significant new business volume in recent years, and normal quarterly volatility in weather and other loss activity

Agency Auto

- In Agency Auto, the 101.3 combined ratio included 2.7 points in cats, primarily resulting from hailstorms
- Weather also impacted the underlying combined ratio with 1.7 points of non-cat weather-related losses, which is approximately 1 point higher than both our expectations and Q2 2015
  - The remaining increase in the underlying combined ratio was driven by the high levels of new business that I just mentioned

Quantum Auto 2.0 Business

- As we've noted before, the Quantum Auto 2.0 business is priced to our long-term target returns and loss experience is performing in line with our expectation

Agency Homeowners & Other

- Turning to Agency Homeowners & Other, underlying financial results remain strong

- Q2 underlying combined ratio of 78.2% is well within our target return levels as we continue to execute our disciplined underwriting and pricing strategies
- So, overall for Personal Insurance, we feel great about the growth and the financial returns that the business is generating

Management Team

- Before I turn it back to Gabby, I would like to take a moment to recognize Doreen Spadorcia, who announced her retirement from Travelers, effective September 1 of this year
  - Over the past 30 years, Doreen has played an important role on our management team and we wish her well as she enjoys a new chapter of her life

QUESTION AND ANSWER SECTION

<**Q - Randy Binner**>: I wanted to talk about the underlying combined ratio in Business and International. And I think in the comments and in the press release, you attributed the increase of 2.4% to non-cat weather but as well as loss costs not being covered by earned pricing. Can we get more granular on that because we're at a point in the cycle where not covering loss cost with earned trend is potentially an issue, and just wanted to get a better detail on that?

<**A - Alan D. Schnitzer**>: I'll take that. So the underlying combined ratio in that segment, you're right, was down 2.4 points. Part of that was commission and that was a y-over-y comparison thing, nothing going on there.

The other piece of that was in the loss ratio. The majority of that does come from non-cat weather. There is a relatively small piece of earned rate vs. loss trend coming through. And one of the reasons we showed you page four in the webcast was to try to put that in a little bit of context. So really what's impacting y-over-y is the weather.

As we said before, we've tried to make clear that rate and loss trend is one small piece of what goes on but there's also taxes, expenses, base year, mix, the impact of changes in claims handling, things like that. Everything else, as we would have expected, was a wash. So there's nothing in that earned rate vs. loss trend that was surprising to us or that we think shouldn't had been evident from the written information we've provided over the last year or so.

<**Q - Randy Binner**>: Is the piece of it though that's the loss trend vs. earned pricing is that – I think you're saying that it's not surprising you but it does seem to be changing. Is it a bigger piece of the equation than it has been in the last few quarters?

<**A - Alan D. Schnitzer**>: Well, it's the earned impact of what we've been disclosing as written over the past year. So it's earning in as we would have expected and we called it out just in the interest of transparency. But, again, nothing that surprises us and given where our written and earned returns are, nothing that we're not comfortable with.

<**Q - Randy Binner**>: And then [indiscernible] (24:11) so then...

<**A - Alan D. Schnitzer**>: And I'd add...

<**A - Alan D. Schnitzer**>: I was just going to say as I said in my prepared remarks, Randy, we're very comfortable with the model returns on the business we're writing and so just to give you a little bit more context.

<**Q - Randy Binner**>: And then with non-cat weather this would be truly episodic. Nothing trend wise you're seeing in that?

<**A - Alan D. Schnitzer**>: Nothing trend-wise in that. It's a normal volatility and non-cat weather.

<**Q - Kai Pan**>: First question is on the pricing, slight uptick in Q2. Could you give a little bit more granularity in terms by lines or by account size? What do you see underlying sort of trends there in term of – both from the supply and demand side and what do you see could potentially be the upside pricing as well as the downside to that pricing?

<A - Brian William MacLean>: I'll start a couple of broad dynamics. I think not surprisingly auto is the line where we're seeing the most positive pricing movement. Comp is I think the line with the most pressure. And that's I think really consistent in workers' comp, if you see what's coming out of NCCI and other competitors that's not surprising.

From an account size perspective, larger accounts under more pressure. So, we've talked a lot and others have talked about a large property business. We think that's somewhat consistent with the returns that have been in that business. But some pressure is there. I think even larger casualty business is under a little more pressure than the middle and small type of business. I don't think from an industry perspective there's anything appreciable. But that would be the broad strokes.

<Q - Kai Pan>: Then a follow up on the reserve side. It looks like reserve continued to be strong. And I just wanted to focus on sort of three areas. One is that the workers comp release in 2015 is that sort of like – is that too early for a long tail line of business? And secondly, the $82mm environmental charges looks like we are having those amounts for at least for the last five years to six years. Just wondering, like why wouldn't you book if you know the pattern is there, why wouldn't you book a big charge upfront? And then, the third piece is, pretty strong like a Bond & Specialty [ph] continue release (26:55) any underlying loss cost trends there will be appreciated? Thank you so much.

<A - Jay S. Benet>: Let's try to take them in order. So, as far as the workers' comp, you're absolutely right, when you have a very long tail line of business, you look very, very carefully at things that happen in the short term and don't necessarily react to them. In the case of the workers' comp what you're seeing here is favorable development in 2015 that related to a relatively short component of it relating to medical where medical bills come in quickly, they get resolved quickly and the assumption that we had put in there for medical inflation was just too high. So while the line itself is a long tail line, there are components of it that are more short tail and that's primarily what we reacted to there.

As far as the environmental piece is concerned, I think if you look at us, as well as the industry, you'll see a similar pattern, if you will, of people trying to, at various points in time, estimate what the ultimate is going to be for environmental losses and recognizing that you're dealing with something that is a very difficult kind of reserve to truly evaluate. So in doing so you have to make various assumptions as to what the future is going to look like in terms of new claims, new policyholders, what the average frequency and severity might be associated with things that have been reported or not reported. And it's those assumptions that you're constantly updating as time goes on.

So what we disclosed and I'll point you to the 10-Q, what we disclosed this year is actually very similar to what we've disclosed in prior periods and what you've seen other companies disclose that there really hasn't been a change in the environment per se. Things have gotten a little better. But the rate of them getting better has just been less than what was previously assumed or hoped for and that's a chunk of the reserve addition.

In addition to that, we're always subject to judicial rulings or other things that take place episodically in various jurisdictions. And there was one that came out of the Northwest that increased modestly, some of our claim costs there that we also recognized.

And then, finally, on the Bond & Specialty, this was a quarter for a fairly large prior-year reserve development benefit. I wouldn't say there was anything unusual about it. This is, as you know, it's a high severity, low frequency business. It's one where information emerges slowly. As it emerges, you're always evaluating whether or not it's blossomed to a level where you really feel action is appropriate.

So there are things that have been taking place whether it's in items related to the financial crisis or whatever that we've been watching. Things got to a point this quarter where we recognized that it was appropriate to take some reserve action. It wasn't any one product line. It wasn't any one particular claim or things like that. It was pretty much spread across the whole Management Liability and Surety book of business.

<Q - Michael Nannizzi>: Can you talk a little bit about – when we talked about non-cat weather in BI and Personal Auto? Can you talk about non-cat weather in Homeowners' book and how that has looked recently?

<A - Brian William MacLean>: In this quarter, similarly, there was some, but not to the same degree. So, just to quantify it, because I said about 1 point on the auto side, it was probably about a 0.5 point on the Personal Property side, of some impact there. So some, but not as dramatic of that, again, that's specifically the PCS event [ph] that I discussed (31:27).

<Q - Michael Nannizzi>: I'm just curious because it looks like, in the last few quarters like, especially in BI, we've talked about non-cat weather impacting the underlying, and sort of the driver for the y-over-y comps being negative. And then, in auto, looks like it was a factor this quarter as well. But when I look at my estimates and your results over the last several quarters, Homeowners has been consistently better, and I think better even relative to your outlook, as you've disclosed in your Qs. So I'm just trying to understand why the impact is potentially disproportionate in these areas? Is it because the nature of the risk is different, or reinsurance, or it – or something else that's causing non-cat weather to be – looks like a tailwind in one, potentially, and a headwind in the others?

<A - Michael F. Klein>: What you're seeing is a combination of factors in the home product, and weather is one of them. In the case of this quarter, I think what you see is, to Brian's point on the net impact, it's a couple moving parts underneath. You've got the weather impact, but we've also had underlying experience on fire, non-weather, water losses that, again, also fluctuate quarter-to-quarter. So when Brian talked about weather and other normal quarterly fluctuations, that's really what he's talking about. And this quarter was an example of that, where we had some other non-cat weather, again, non-weather water, fire experience that came in better than expected. And importantly, for the y-over-y comparison this quarter, there actually was a significant individual risk fire loss in Q2 last year that helps the q-over-q comparison, just to give you a little bit of color on that.

<Q - Michael Nannizzi>: And then maybe, Brian, on BI so it sounds like, from Alan's comments, that the lift in the expense ratio was commission related. I'm guessing that means that that should continue, because I'm also just sort of trying to square that...?

<Q - Michael Nannizzi>: Because at 33 – no? It's not. Okay.

<A - Brian William MacLean>: Last year in Q2, we had a takedown in our contingent commission accrual that reduced the number, so that created a y-over-y kind of difference.

<A - Alan D. Schnitzer>: The delta's not really in the base commissions. The delta's in these other things.

<A - Alan D. Schnitzer>: That cause quarter-to-quarter variances.

<Q - Michael Nannizzi>: So my point, the 33.3 expense ratio in this quarter, forget the comps, but just the absolute number this quarter, is that how we should be thinking about it? It sounds like there were one-offs last year, but this quarter, is that how we should be thinking about the expense ratio from here?

<A - Alan D. Schnitzer>: It's Alan, Michael. I guess I would say that we try not to forecast on these individual pieces, but what I'd suggest is maybe you go back over the last – I don't know, somewhere between two and four quarters, and average the number and maybe use that as sort of a proxy for a go-forward number. But there's always going be some volatility quarter-to-quarter.

<Q - Michael Nannizzi>: Just because it does screen relatively high when I go back...?

<Q - Michael Nannizzi>: It sounds like maybe there's some volatility. I was just trying to understand what drove some episode of a higher expense ratio that should cause that to normalize, as you're sort of suggesting it should. But maybe I can follow up afterwards. Thanks.

<Q - Ryan J. Tunis>: My first question I guess is for Brian. I was just hoping for a little bit more color on what's been driving the solid new business growth in middle markets. I think you mentioned submissions are up but, I guess, sort of like over the past couple of quarters it has been pretty strong, and just sort of what you're seeing on the new business front?

<A - Brian William MacLean>: It's a couple of factors. We believe, as I tried to say in my comments, driven by the fact that I think we're in a pretty strong position in the marketplace, we've been executing in a very stable and effective way, I think, for a long period of time. We've got some real competitive advantages.

The overall market is pretty stable ,but there has been some pretty well-publicized dislocations, and at least a couple of very large carriers have been very open about taking profit improvement actions, and so that's created some specific opportunities. But I think, we think more broadly, has also created a little bit of a mood in the marketplace of flight to quality.

So like I said, we've seen our submission activity up a decent amount and we've also, consistent with that, been driving a message to our organization, not strategically to do anything different with returns, but to be more active and to be out there quoting more. So just to be blunt about it, we're pushing our place pretty hard right now, to be real active in the marketplace and get out the quotes and not compromise on returns. But try to meet the opportunity of the submission activity. And that's been paying off and specifically, our Core Middle Market Commercial Accounts business and the construction areas.

<A - Jay S. Benet>: Ryan, I would add to that, that part of our motivation behind pushing a little bit more activity is just where returns are, product returns in the marketplace, after five or so years of price increases. And so there's a lot out there that's potentially attractive to us, consistent – and this is really important, consistent with our return objectives. So we're not making any compromises on that.

<Q - Ryan J. Tunis>: Okay. That makes a lot of sense. I guess my other question was just on just looking at the margin trajectory in Agency Auto, and how to think about that on a go-forward basis. I guess YTD, there have been a couple things that seemed to be have been weighing on the loss – on the accident year loss ratio sum. There's the new business drag. Then there's the elevated non-cat weather. But something that we thought was interesting was, looking in the 10-Q, it looks like the language looking into 2017 was that margins would remain kind of where they've been. And I'm kind of curious, as you lap the elevated new business and you get rid of the lower non-cat weather, why would margins not be improving kind of as you look out into 2017?

<A - Alan D. Schnitzer>: So I think just couple quick comments then I'll pass it to Michael. Certainly we view the non-cat weather as episodic and so we think that should absolutely return to normal levels.

On the new business dynamic, the good news is that we continue to write some significant levels of new business through that product. So we feel great that we are building real embedded value in that portfolio but it is going to take longer. The stronger the production top line is the longer it is going to take for that to really work through the loss ratio.

The other point I'd make is the Quantum 2.0 product also was designed to have a lower expense ratio and a little bit higher on the loss side. So you have to look at the combined in total to get that product.

<A - Jay S. Benet>: Hi, Ryan. If I could just clarify something, one of the things we actually added to the Q this quarter was in the outlook section we had previously spoken to underlying underwriting margins. And we thought it was important to add combined ratio because people often use those terms interchangeably. And as you know, the combined ratio is a function of the premium volume whereas the margins are just dollars.

And just to clarify what we're seeing here in the Q for auto, which I think is what we're talking about, the early part of 2017 the company expects underlying underwriting margins, the dollars to be slightly higher because of what's taking place with writing higher volumes of business that's profitable. But writing a higher percentage of new business relative to the base is also causing a slight uptick in the underlying combined ratio. So you have this feature here where the dollars are going up, at the same time that the combined ratio is going up. So I just wanted to clarify that.

<Q - Ryan J. Tunis>: Yeah. That's helpful. I think I was a little bit confused by that. Thanks guys. Appreciate it.

<A - Brian William MacLean>: Ryan, the other factor just to note, it's not all this new business impact from what we're writing. As Michael explained a second ago, we haven't had this in the last quarter or so, this favorable non-weather loss activity. And as we also highlight in the 10-Q we expect that to return to the more normal level. So, that's also having, on a go-forward basis, a slight adverse impact.

<A - Michael F. Klein>: Underneath it...

<Q - Ryan J. Tunis>: Thanks.

<A - Michael F. Klein>: This is Michael Klein. The only thing I would add is underneath it, just to reiterate right, Quantum Auto 2.0 was priced at the same return level as the book of business has been priced to. It really is the dynamic of preponderance of newer – think of it as younger business, right. The portfolio is getting younger because of the outsized growth that we've seen over the last couple of years. But the long-term return targets for the product remain consistent with where they've been.

Operator

Thank you. Our next question comes from Amit Kumar of Macquarie. Please go ahead.

<Q - Amit Kumar>: Thanks, and good morning. Two quick questions, probably these are follow-ups and I apologize if I'm still not clear. Just going back to the discussion on BI and what Randy was asking, if you ex out all the moving parts, and just focus on the underlying discussion on the negative loss cost trends vs. – on pricing, is it episodic is what you are saying or is this the usual sort of trend line, i.e.; you've talked about this in the past that over time this equation would get flipped now we're at the point where it has flipped? I'm trying to understand that.

<A - Alan D. Schnitzer>: Yeah, it's not episodic. There is a trend there. But I think what we've told you in the past is there is some danger to looking at that very narrow definition of rate vs. loss trend. Obviously anybody can look at rate which is sort of around zero and loss trend which is something north of zero on a written basis and it has been moving in that direction for some number of quarters.

So as anybody, as we would have expected as that earns in over time, there will be some negative pressure on margin but what we've said in the past is, you've got to look at that in the context of all the other moving pieces that impact underlying underwriting margin. Things like we have a tax impact y-over-y this quarter, there's expenses, there's base year, there's mix. All those other things go into that number. And what we've shown you this quarter is all that comes out to about a wash. And I guess I'd also point you to the outlook where we give you a sense of over the next four quarters or so that we would expect the underlying underwriting margins obviously subject to the volatility of weather and what not to continue to be probably consistent.

<A - Brian William MacLean>: The other thing I'd emphasize. This is Brian. Is that there's a lot of things in there that we have to react to and there are other things in there that we are actively managing. And so you shouldn't have the impression that we're just sitting by and as Alan just said, pricing is at roughly zero this quarter. Rate and loss trend is something north of that. That we're just conceding that margins will receive. We're managing our mix. We're taking actions in underwriting selection. We're taking actions in claim execution which are all impacting our loss trend. And then we're reacting to weather volatility, et cetera, that might be moving through the business. So there's no denying that the sheer arithmetic of that narrow piece, the loss trend and the rate right now is a negative. We've said in the past that it's relatively modest and it continues to be relatively modest and then there are all the other impacts that are going through.

<Q - Amit Kumar>: Got it. That's a fair comment. The second question I had was just going back to the discussion on Quantum 2.0. In the past, when we've talked about loss cost trends, frequency was pegged at 0.5 point, severity was at 2.5 points. Has there been any evolution in that number, or is it still the same?

<A - Jay S. Benet>: Nope. We didn't see anything different in the core underlying trends of what was going on in the auto book. So we would be at exactly those numbers you just said, about a 0.5 point of frequency, 2.5 points of severity.

<Q - Amit Kumar>: Got it. Okay.

<A - Jay S. Benet>: And as we've said in the Quantum Auto 2.0, specifically, still running consistent with our loss expectation.

<Q - Amit Kumar>: Got it. That's all I have. Thanks for the answers.

Operator

Thank you. Our next question comes from Charles Sebaski of BMO Capital Markets. Please go ahead.

<Q - Charles Joseph Sebaski>: Good morning. Thanks for getting me in. I guess, I'd like to follow up again on following Amit on Quantum 2.0 and the Agency Auto book. And the clarity – I realize there's an additional disclosure in the Q but how you guys expect the auto book to evolve out? I guess, the commentary of early 2017 being +/- 16%, which is +/- 15%, and you say that you are underwriting to the same return dynamic? But, I guess, this has been a book influx, that coming out of 2011 and 2012 where it's been underperforming and the introduction of Quantum 2.0. Just where is a run rate on what we should expect that there's so many moving parts, but it seemed like this should be a story that was improving? And I guess the commentary seems to be that it has maybe gotten as good as it's going to get. Is that right?

<A - Brian William MacLean>: So the message, absolutely, is not this is as good as it's going to get. The core from a profitability perspective – well let me start with a top line perspective because what's the story on Quantum 2.0. We have been pleasantly surprised with the traction the product has gotten in the business and in the marketplace. We clearly went in with an expectation that this would enhance growth and we've done better than our original expectations there. And you can see the numbers. So we feel good about that. And we're not sure where that's going to go exactly in the future. But we think that we're going be able to sustain some pretty decent amount of growth going forward.

From the profitability perspective, just as is true of all business that we've ever written in this product, it matures over the years. And so there's a tenure impact. And as Michael just said, the younger tenured business is typically not as profitable as we write the business where we're targeting a tenured longer-term return and we're on track to do that. So, as this portfolio matures, and as Quantum 2.0 – as we get more and more of the aging of the book, we believe the trend should absolutely be improving profitability on this business.

<Q - Charles Joseph Sebaski>: Okay. I guess, on that, could you give us some additional insight on the tenure, the curing of the auto book? On what is the average policy life for you guys on this? I guess, when I think of some commercial accounts that might be longer, it seems that auto is still, is a quicker turn product. So, this introduction of new growth that's really been strong. What's the timeline for curing on an auto book and how long do you on average keep auto policies?

<A - Michael F. Klein>: So, Charles, I don't know that I'll get into the specifics of the policy life expectancy et cetera but to give you a little bit more color – this is Michael.

<Q - Charles Joseph Sebaski>: Yeah.

<A - Michael F. Klein>: On the aging of the auto book, you have to really think about both components of what's going on here, right? So, first you need to think about a vintage and think about a book of business we write in a given policy year. And that new business that we write in that term that comes on at a higher loss ratio early and then as we renew it, it improves. If you look at the production statistics that we've been disclosing and the high levels of new business, what's happening inside the portfolio then which is the second piece is on average the portfolio is getting younger, right? And if younger business carries a higher loss ratio that's what we describe as the increase in the combined.

So when you look at the outlook for H2 2016, we say the combined ratio will be higher due to the impact of the higher new business levels we've been writing. That is the underlying dynamic that's flowing through the book. That does continue into H1 2017. It just gets offset by an expectation of return to normalized non-cat weather levels. And so, the underlying dynamic of the book getting younger, meaning less tenured, right because we've had the accounts not as long, continues into 2017. Recognize also though that as we write more Quantum Auto 2.0 business there is a benefit to the combined ratio from an offsetting improvement in the expense ratio because it carries a commission.

So, that underlying aging of the book or reducing average tenure of the book does continue into 2017. It just gets offset by again an expectation of return to more normalized weather. That's why the outlook reads as it does.

<A - Jay S. Benet>: It's an assumption not an expectation.

<A - Michael F. Klein>: Sorry. It's an assumption, yeah. Sorry, Jay.

<A - Alan D. Schnitzer>: So, one other point on that. So, again, as Michael said, we're not going to give you explicitly the target we have for life expectancy on policies. We think that's part of our competitive kind of conversation. We clearly accept that hitting the expectations of retaining the business is important, which is why in my comments I emphasized that, as we're going into year two, and in some cases year three for the Quantum Auto 2.0 product, we feel really good that we are hitting the retention rates we expected. So whatever our expectation was for life expectancy, along with our statement about losses are progressing, so is the retention of the business. And you can look at our long-term retention and begin to deduce some kind of policy life expectancy by just doing the arithmetic.

<Q - Charles Joseph Sebaski>: Thank you very much for the answers.

Operator

Thank you. Our next question comes from Jay Gelb of Barclays. Please go ahead.

<Q - Jay Gelb>: Thank you. I was hoping to get a bit more insight on the pace of share buybacks, it's slowed over the past few quarters on a linked-quarter basis, and the slowdown in share buybacks was actually a little greater than the reduction in earnings from H1 2015 to H1 2016. Can you give us a bit more insight on that?

<A - Jay S. Benet>: Yeah, Jay. This is Jay. I think you're looking back at a period of time where – as we've said in the past, over time, share buybacks are going to be enabled by earnings. And while there's pension contributions and whatever, it's the earnings of the place over time that will drive what the total share buybacks and dividends are. And what you saw, and I think you even asked the question in the past, can we continue to buy back at levels that are higher than our earnings, well, this is the flip side of it. This is just an indication of the timing element of when we look and see what the future quarter projections are. They obviously come out to be whatever they'll be. And we're just picking numbers in the particular quarter that we're doing the share buybacks over a long-term view to say, in this particular quarter, $550mm sounds like the right number. So, I wouldn't read anything into it in terms of a change in philosophy or a change in execution. It's just going be – what we would refer to as the normal quarterly variation in a policy and a discipline that's been set for a long period of time.

<Q - Jay Gelb>: I see. Okay. Thank you for that. Second one, what was the overall impact in the combined ratio in Q2 from non-cat weather – on a combined ratio basis?

<A - Jay S. Benet>: We're looking.

<Q - Jay Gelb>: Okay. And while you're – if you have that number – I also want to ask about – I know the UK leave vote is not significant relative to Travelers' in its overall business, but if you have any thoughts on that, I think that will be real helpful for us.

<A - Alan D. Schnitzer>: Sure. In terms of Brexit, the most significant impact to us will be whatever it means for overall economic activity. The amount of premium that we write out of the UK that relies on passporting is very, very small. It's something like 5% of our overall International premium, and about half of that's through Lloyd's, and we assume that, one way or another, Lloyd's will address the passporting issue – as will we, by the way. Long way to go to see how that's going to work out and what the ultimate arrangements are going to be. But other than the overall macro impact, we don't expect any significant impact to us.

<Q - Jay Gelb>: Appreciate that, Alan.

<A - Alan D. Schnitzer>: Thank you.

Operator

Thank you. Our next question comes from Paul Newsome of Sandler O'Neill. Please go ahead.

<Q - Jon Paul Newsome>: Good morning, and congratulations on the quarter. I wanted to ask about the competitive landscape in the Personal Lines business. We've had a few management changes of recent note, like places like Progressive and State Farm. And I'm wondering if the components of who is being competitive out there have changed in the last year?

<A - Michael F. Klein>: Yeah. Paul, this is Michael Klein. I would say, broadly speaking, the answer to that question is no. Competitive dynamics are very local in the business as well. And so, while there have been changes in management at some national competitors and frankly, some local regional as well, the broad competitive dynamics in the business remain consistent. When we look at the rate filing monitoring that we do in the business, to assess the rates that carriers are taking in particular states in auto or home, we don't see a lot of shift in behavior there. So I would say the competitive dynamics are broadly consistent.

<Q - Jon Paul Newsome>: The general idea that the agency folks keep losing share, and the regionals and the direct people are the most competitive. Is that still kind of [ph] really (56:23) the case?

<A - Michael F. Klein>: I think, if you look at the latest A.M. Best data, you continue to see some incremental shift in share by channel. Interestingly, I think, consistent with the last couple of years, the majority of the gains you're seeing in the sort of online direct channel are actually coming from captive, and less and less from independent agency. But broadly, I think those trends continue.

<Q - Jon Paul Newsome>: Great. Thanks. Appreciate it.

<A - Jay S. Benet>: This is Jay Benet. Somebody had asked the question about, what was the impact on the combined ratio of non-cat weather? And I'll give you the number, but I also have to give you a little bit of a preface to it. We are parsing things very thin here, and talking strictly about that.

So if you asked the question, what's the impact of non-cat weather on the combined ratio on a consolidated basis, we would say it's 150BPS. But I'd also point out that, if you asked the question about well, what about other losses? That goes in a different direction. And what about mix? And that goes in a different direction. So we will answer your question, but there's lots and lots of things that are taking place here that make the one number not necessarily indicative of the trends or of what's going to – or what the expectation is. So I would just urge you to go back to the Q and the outlook to see what all of this, to us, actually translates into.

Operator

Thank you. Our next question comes from Jay Cohen of Bank of America Merrill Lynch. Please go ahead.

<Q - Jay Arman Cohen>: Yes. Thank you. Just to follow up the language in the Q on the commercial, on the Business Insurance segment where you extended your commentary on the margin into 2017, again, the broadly consistent language, I assume that's largely because H1 2016 had a high level of loss activity of non-cat weather. Is that fair?

<A - Alan D. Schnitzer>: That's right. There's some large losses in non-cat weather that in the outlook we would expect would return to normal levels we would assume.

<Q - Jay Arman Cohen>: Got it. Thanks. And then the second question maybe for Bill Heyman because he hasn't had a chance to speak yet. Obviously as we would expect, the non-fixed income returns are always going to be variable. Can you give us a sense – given how the portfolio is constructed today, what is an expected return for that portfolio at this point?

<A - William Herbert Heyman>: Thanks, Jay. I think an expected return for non-fixed income ought to be in the high-single digits pre-tax. If you look at this quarter, we made a bit more in real estate than we figured. Real estate has two components: rentals from properties we own and NII from real estate funds. Hedge funds were below what we expected but positive. And the big variable was private equity. Where the portfolio was almost flat maybe few million dollars, we would have expected about $50mm pre-tax.

Now what's interesting is the cash flow from that portfolio has remained at historic levels and it simply hasn't contained as much NII in the past. So we would aim for a double digit pre-tax return on these assets. And if we didn't feel we could do that we probably would reduce our allocation. But I think a fair expectation is high-single digits pre-tax.

<Q - Jay Arman Cohen>: That's great. Thanks so much.

<A - Gabriella Nawi>: Great. And the next question will be our last question. Thank you.

Operator

Thank you. Our final question comes from Larry Greenberg of Janney. Please go ahead.

<Q - Larry Greenberg>: Hi. Thanks. And I'll apologize for going back to this but, I mean, just listening to some of the chatter that's out there this morning there's something of a view that you guys elaborating on the pricing loss trend relationship in Business Insurance suggests that you're seeing or thinking something new. And, if I hear what you're saying, it really doesn't appear to be the case. And I just want to be sure that I've got that right.

<A - Alan D. Schnitzer>: Yeah. Larry, it's Alan. Let me be clear about it. There's nothing that's changed. There's nothing that's surprising us and everything is consistent with what we have reported to you on a written basis over the last fourth quarters.

The real reason we put in there is we wanted to be completely transparent about it. It's a very small piece, but we thought, gee, if we didn't put it in there you or somebody would have said to us, gee, how can this not be happening because we're looking your written numbers over the last three or fourth quarters. So, I will just reiterate it. It's small. It's within our expectations. It's wrapped up with all the other things that are typically moving around in the quarter. It's about a wash in terms of the y-over-y impact. And no message intended in terms of anything out of the ordinary. Completely expected. Completely consistent with what we've seen on a written basis. And we continue to be very pleased with the model returns on the business that we're writing.

<Q - Larry Greenberg>: Great. And then just my follow up, Jay, in your discussion on non-renewing that cat bond, I think you said that the reason was due to your current risk profile. And, I'm just curious about that comment and if you can elaborate a little bit on that?

<A - Jay S. Benet>: Primarily our cat program is one that protects capital, not one that really deals with income protection.

If you look at where the limits are and things of that sort, and where the attachment points are, it's pretty high up there. So, in any given period, we're looking at the entirety of it, where our property exposures are and just giving away the book has evolved over the last few years we just felt that this wasn't really adding much on a risk vs. cost basis. So, we decided not to renew it.

<Q - Larry Greenberg>: Okay. Thank you.

Gabriella Nawi

Okay. That's it. It concludes our call for today. As always, we, Investor Relations, are available for follow-up questions. Have a great day. Thank you.

Operator

Thank you. Ladies and gentlemen, that does conclude the conference call for today. We thank you for your participation and ask that you please disconnect all lines. Thank you, and have a good day.