Q4 2017 Earnings Call

Company Participants

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

Other Participants

- Christopher Campbell, Analyst
- Jeff Schmitt, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, and welcome to the Argo Group 2017 Fourth Quarter and Year-End Earnings Conference Call. All participants will be in listen-only mode. 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 Bernstein, Senior Vice President of Investor Relations. Please go ahead.

Susan Spivak Bernstein {BIO 1514699 <GO>}

Thank you, and good morning. Welcome to Argo Group's conference call for the fourth quarter and year-end 2017 results. Last night, we issued a press release on earnings, which is available on the Investors section of our website at www.argolimited.com. Also, this morning, you will find an investor supplement to review some additional slides that we'll be referring to on today's call.

Presenting on the call today is Mark Watson, Chief Executive Officer, who'll share his thoughts about the quarter and the year; after which, Mark Rose, our Chief Investment Officer, will discuss investment results; followed by Jay Bullock, the Chief Financial Officer, who will add some more commentary to the financial results. 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 such risks and uncertainties, please see Argo Group's filings with the SEC.

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

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

Good morning, and let me add my welcome to today's fourth quarter 2017 conference call. I'd like to spend a little bit of time this morning talking about how things went for all of 2017, where I think that puts us for 2018. And I'd also like to give some insight into what we've been doing in developing our digital platform. I've alluded to it frequently over the last couple of years, but I think, given the progress that we've made in 2017, I think it's a good time for us to spend a little bit of time talking about it.

For many reasons, 2017 was an important year for us. It's unfortunate that our financial results don't reflect the investments that we've made in our business, but they do give a sense for our risk management, diversification, and the strengthening of our underwriting and investment teams. The diversity of our product portfolio, combined with strong investment results and more than 20% growth in gross written premium for the year, demonstrate the breadth and strength of the team we put together. And in a year punctuated by significant industry-wide catastrophe results, our balance sheet held up well, and we finished the year in a position of financial strength.

Before I get to that, let me also first say that we made a few mistakes in the last couple of years, which we had to deal with in 2017. And while I discussed them at length last quarter, I think they're worth repeating a little bit here at year end. You heard me talk for a couple of years about how challenging it is to participate in the London market, mainly on its bureaucracy and the pricing. I think that you guys have heard more than once now that over the last few years, pricing for the property market in London is down about 40%. It is coming back in the first quarter of this year, which I'm happy to report.

Having said that, it would appear that we didn't heed our own warnings and perhaps wrote a bit more business in the market than we should have. And as it turns out, that old adage, that the market price is the market price, well, it's still the market price. While this is disappointing, I can also say that we recognized this early last year, meaning 2017, and began taking steps to change our underwriting guidelines and our pricing structure, which led to higher loss picks on current year business, and in some cases, as losses came through at higher than expected frequency, strengthening of reserves from prior years. Again, all things we talked about last quarter.

For Property and other lines we've talked about - sorry, on a positive note, we're clearly seeing the benefits of the actions taken on the property book as an example, but as you know there is a lag between premiums written and earned, and in many instances, we will not see the benefit in our financial results until the second half of 2018. Having said that, price increases for January 1 did mainly fall in the double-digit range.

The second challenge and frustration for us as well as the P&C industry as a whole was the frequent loss activity during the second half of 2017. As we know, timing is everything, and closing the Aerial Re acquisition in the first quarter of 2017 left us with a larger net retention for multiple reinsurance programs than we otherwise would have had And I think that we've done a good job of outlining this in our press release tables, showing the impact of these programs on our earned premium loss and expense ratios.

Having said that, if you turn to page 4 in the supplement that we posted this morning, it'll give you a sense for what our CAT activity was relative to our equity and relative to earnings. And we also published what we thought it would be, if we'd had the same reinsurance program in 2017 that we now have in place for 2018. I think many of you have heard me talk about this for a bit over the last quarter or so. But I think it's worth noting that the difference would have been about $40 million.

And so, if you flip back to page 3 and you look at our net income of $50 million for the year, this probably would have been closer to $90 million, had we been able to close the transaction earlier and combine our reinsurance programs. So, I don't mean to make excuses, but rather to just offer a little foreshadowing of how I think things would play out this year, should we see another series of similar events. Having said that, in a year that was as severe as 2011, from a CAT perspective, I think that we fared much better and generated an operating profit, which we did not do in 2011, thanks in part to our strong investment results.

When you look at the growth of the company over the past six years coupled with the addition of Ariel Re, our focus was on the ability to manage both our gross and net exposures to a single event, as well as a series of events as we experienced in 2017, including the California wildfires in the fourth quarter. I should have mentioned that earlier. The good news is that our net exposure relative to our internal models was within reason for all the events, including the wildfires, keeping in the mind that many of our competitors do not have wild wildfire models.

This is the net result of our growing exposure in continuation of our revolving capital structure. Some other things that I wanted to talk about on that front are, as of January 1, we were able to use a fair amount of third-party capital to support our property cat underwriting. In fact, about 80% of our property cat risk now is supported by third-party capital at one of our syndicate's at Lloyd's.

Now, let me spend a few minutes highlighting some of the financial results. As I mentioned a minute ago, net income was $50.3 million or $1.64 for the year compared to $146.7 million or $4.75 per share in 2016. Our results for the year were impacted in total by $166 million from CAT activity, and that reduced our pre-tax earnings by about $47 million. Jay will give you a little bit more detail in just a minute.

Despite these catastrophe losses, we're able to earn a profit for the quarter and for the year, which is, as alluded to a minute ago, I think, demonstrates the diversity of our portfolio and our focus on risk management. We maintained a strong balance sheet, so that we can support our customers when they need it most. And in the wake of the numerous events that we experienced in 2017, I think that showed that we've done a pretty good job.

We ended the year with book value per share of $61.48. Growth in book value per share plus dividends was just under 5% in 2017. This is obviously below what we would typically expect, but given the magnitude of global catastrophe activity and progress we've made on our internal investments, we believe that this result demonstrates the future potential earnings growth of our platform. As a result, we've grown book value per share plus dividends at 9.4% for the past 15 years.

And if you look on page 5 of our investor presentation, I think it's just a reminder of how we think about the company, which is we're very focused on growing book value per share, and there are really three measures that – there are three levers that make that happen: Underwriting margin; total return on invested assets; plus capital management. And when I think through the last 17 years of my stewardship under this company, it's really taken all three of those levers to grow our company.

If I focus on the last lever, capital management, I think that we continue to manage our capital effectively. During some of the volatility this year, we were able to buy our stock back at attractive prices. For the year, we repurchased a little more than 750,000 shares for $45 million and continue to believe that this represents an attractive use of our capital.

If you flip to page 6 of our presentation, it just shows a good table of how we've managed capital. And since we began repatriating capital in 2010, we've given back nearly $600 million between stock buybacks and dividends paid. However, our first priority remains to deploy capital into our business at attractive returns, and we believe that our balance sheet remains in a good position to take advantage of opportunities in the market and opportunistically repurchase shares.

Our business continues to show the progress we're making on the underwriting side. In the U.S., gross written premiums were up 24% during the fourth quarter, as we find attractive opportunities across many areas of our portfolio, including: Surety; Professional Liability; Excess & Surplus Lines; Casualty; and Rockwood, our mining business. For the year, premiums were up 18% in the U.S., and we expect more opportunities for growth in 2018 as the markets begin to show some signs of improvement. And just about across the board, we're starting to see pricing moving up in the first quarter of this year.

From a margin perspective, the ex-CAT accident year loss ratio was 58.2% for the year. This was up slightly from the prior period, which was 55.4%, but still a very attractive level on an absolute basis. Our calendar year loss ratio compares favorably again this year at 66.8% versus 70.7% for our peer group average. And if you look on slide 7, you'll see that this is the fifth year in a row that our loss ratio has been better than our peer group average.

And then, if you also look at slide 8, you can see that for the 13th year in a row, we've had reserve redundancies on our balance sheet. And I believe that this is also true for the last 14 out of 15 years. Our international business was more heavily impacted by catastrophes during 2017, as we would expect given the risk portfolio and remains an important part of our business for the future. Gross premium writtens were up 18% for the quarter and 34% for the year, primarily reflecting our acquisition of Ariel Re in February. We've also found select organic growth opportunities in Professional and Surety lines, while also trimming our portfolio of businesses that didn't meet our returns.

From a profitability perspective, the ex-CAT accident year loss ratio was 59.4% compared to 55.1% for the prior year. The increase was primarily due to attritional losses on the property book that I discussed at length last quarter. Again, we've taken significant action to remediate this book of business and expect the efforts to show up in our results in the second half of 2018.

Moving on to investments, in the fourth quarter, total return was 1.1%. And year-to-date we were up 5.5% versus 4.3% in 2016 or on a dollar return basis, we were up $243 million this year. Mark will talk more about this in a little bit.

This kind of brings us to where we start 2018, which is what I really wanted to talk about this morning. Over the course of the last 1.5 years, we've accelerated our investments in technology and have made considerable strides in building a leading internal digital effort to help reinvent Argo for the digital age. Why have we done this? Advancements in digital connectivity and processing power as well as in user adoption and distribution have finally reached a point at which we can change a customer's experience and how they view their risk and acquire coverage. Automation can enable us to better partner with our brokers and agents, create a leaner overall Argo platform, all while providing faster response times in binding policies and servicing claims.

New tech-enabled markets such as cyber, e-commerce, crypto, sharing and economies are developing quickly and changing the way people and businesses transact, thus we need to stay close to these trends and be prepared to move quickly to capture opportunities in these areas. How are we going about it? We've assembled a talented team from inside and outside of the insurance industry to internally develop software via a highly interactive approach.

We're partnering with startups that have developed tech that can solve meaningful, identified pain points in our business and invest in leading and emerging technologies. We're working to leverage machine learning, cheaper data processing, and vast amounts of new data resources from sensors, drones, governments, commercial outlets, social media, and other sources for faster and smarter underwriting. In fact, if you go to page 10, you can see some of these things laid out, and I'll come back to this in a little bit.

We're building technology to more efficiently connect with our distribution partners. We're offering turnkey all digital connections to alternative distribution sources that require no human interaction to rate, quote, bind, and issue, so the customer can transact in minutes. I believe, it's a differentiated approach from the undertaking in many of our competitors, and we've seen early success in this area. I'd like to go through just a few examples. But before I do that, I'd like to just point out that this is the work of a whole lot of people, including the Head of our Digital Team, Andy Breen; the Head of Operations, Phil Vedell; and our CIO, Jeff Strohschein. They're all working together, and this has been something that we started several years ago, but we're just getting there now. And there's a few ways that we really think about this.

And if you go to slide 11 for a minute, you'll see that we really put things into different buckets. We spend about 60% of our time, energy, and budget focused on digitizing our core business; 30% of our time figuring out how we can use technology and the digital team to grow adjacencies to our core business; and then the last 10% focusing on things that that we think might be disruptive to our industry going forward.

So, let me give you some examples of things that we've done, many of which are described on page 11. We've developed a product to give our E&S brokers an advantage. We've taken wait time from a few days to a few hours to receive a quote in our market for those brokers. Our software solution enables immediate pricing on roughly 80% of these submissions, minimizing referrals. So, this should give us -we should be the first one to quote, and hopefully, that puts us in a great advantage with our distribution partners.

To-date, 65% of the broker offices that have been rolled in this platform have gone on to generate a digital quote. In the fourth quarter, we saw a 231% increase in premium quoted through the platform compared to the third quarter of 2017. So, we're just getting going, and we're seeing good traction.

We launched Argo Risk Tech to help retail merchants better manage the risks of their businesses. Argo Risk Tech is a sensor-based technology that allows owners of retail establishments to reduce the frequency and severity of customer and employee accidents. We initially implemented this in our Argo Insurance business unit that's in the U.S., and to-date, have seen a general liability loss ratio on high-deductible, self-insured managed claims improve almost 30% better than parts of the book that have not implemented tech, or I should say, there's been 30 points of loss ratio improvement.

We rolled out the third release of our end-to-end enterprise policy administration system that we implemented a few years ago. And the end of 2017 marked a major milestone in this evolution, as we've now processed over $1 billion of premium through this system since inception. We incubated the start-up of the software, integrates affinity groups with their external partners and users for the purpose of discounted purchasing of which insurance is the largest spend. Since launch in January of 2017, this platform, which possesses strong network effect, had signed on 33 groups with an average user base of 14,000 users, or that equates to about 0.5 million total users in one of the markets where we operate.

In Brazil, our online broker-facing digital platform, Protector, which you've heard me talk about in the past, processed BRL 50 million of premium across roughly 100,000 transactions in 2017. Currently 2,300 brokers and agents in the market are on the platform and are actively using it to purchase professional lines equipment and bicycle insurance. Just to give you a few examples.

We built and launched the digital portal for brokers and policyholders for self-service. This account management platform offers state-of-the-art user experience. And its advanced search helps brokers and policyholders find what they're looking for quickly and efficiently. To-date, we've seen active user registration increase between 20% and 50%, and search activity is up as much as 128% month-over-month, keeping in mind that we just launched this a few months ago.

We've invested alongside some of our venture capital partners some of the leading funds in the world in artificial intelligence businesses that look to automate data entry that we can apply in our own business, tech-enabled brokerages with whom we can test our automatic pricing technology, and companies in emerging categories such as crypto and blockchain in order to stay close to these types of markets and technologies.

Our latest investment in a leading cryptocurrency payment processor allows us to potentially partner with the leader in the space, monitor how insurance and cryptocurrency continues to evolve that helps us assess opportunities to engage. This investment does not directly harness the risk of any individual cryptocurrency and has the potential to generate a strong return on invested capital on a standalone basis at the same time.

We've continued to deploy artificial intelligence and robotic process automation, or RPA, throughout our business. With partners in India, Brazil, and the U.S., we've built and deployed bots in target areas where individuals used to manually spend time leaking information from system-to-system. So, this is a lot more than just the chat bots that you've heard about recently in our industry. There are many more focused digital initiatives underway, and many of them are already embedded in our business. Some of them are table stakes in order to compete in today's market, while others will lead to tangible, differentiated financial outcomes.

I'll try to give you some of the tangible metrics on traction that we're seeing today, and I look forward to sharing more with you in the coming quarters, especially where we have clear, tangible financial metrics to go with them. I realize this was a lot to digest, but we've had a lot going on, and I'm happy to discuss this more in Q&A, if you would like.

And with that, I'd like to go back to our investment portfolio and turn the call over to Mark Rose, our Chief Investment Officer. Mark?

Mark H. Rose {BIO 1557365 <GO>}

Thank you, Mark. And I appreciate you going over the quarter percentage change, as well as the year of 1.1% and 5.5%, approximately. Let me add some color to this. Also, it's worth noting that with the acquisition of Ariel Re and the growth in the portfolio, our U.S. dollar return was $68 million higher in 2017 versus 2016 or totaled $243 million.

During 2017, the U.S. tenure ended where it began around 2.4%; the U.S. high yield returns 7.5% benefiting from spread compression; and the S&P was up 21.8%. Our $5 billion portfolio is made up of two distinct sub-portfolios: a $1.1 billion risk portfolio; and the remaining amount, which is the core bond portfolio. For the year, our multi-asset risk portfolio was up 14.1%, largely benefiting from the rally in U.S. and global stocks, our outperformance in high-yield credit, improved results from our hedge fund portfolio and a higher contribution from private equity structured investments. We think that this performance is worth noting, especially after achieving a solid 12.6% return in 2016.

During 2017, which includes the fourth quarter as well, we trimmed our equity holdings as they grew in market value and some high yield positions as spreads compressed. Our core bond portfolio for the year was up 3.1% versus 1.9% in 2016, which was slightly ahead of short-duration investment grade indices.

In the fourth quarter, recognizing that investment grade spreads were very tight as well, we reduced lower rated corporates and increased our short-duration treasury holdings. Our reported net investment income was $35 million for the fourth quarter of 2017, up $9.5 million versus the prior year and $4.1 million versus the third quarter of 2017. For 2017, our net investment income was $140 million versus $115 million in 2016, aided by portfolio growth and a bigger contribution from alternatives. Both our hedge funds and private equity portfolios outperformed in 2017 versus their performance in 2016.

With that, I'll turn the call over to Jay.

Jay S. Bullock {BIO 3644311 <GO>}

Thanks, Mark, and good morning everyone. Let me add some additional color on the financials, and then let's get to the questions. Last night, we reported results for the fourth quarter earnings per share of $0.95 versus $1.07 in the prior year's quarter.

Again, as in last quarter's results, there's a lot of moving pieces to the numbers, and we've included additional exhibits and disclosure on our press release to show our underwriting ratios adjusted for extraordinary items. We think this better reflects the underlying trends in the business. The primary unusual impacts on the results include catastrophe losses experienced in the quarter, improvement on the losses estimated for the third quarter, and the adjustments to earned premium we announced last quarter.

Starting with premium adjustments, as we mentioned on last quarter's call, post the acquisition of Ariel, we purchased additional reinsurance protection to align the combination of Ariel on and our existing businesses with our risk appetites. The cost of that protection that was recognized in the fourth quarter was $12.7 million. For the year, the total cost was $20.8 million roughly equivalent to the benefit on recoveries, we'll make on those contracts. So while the additional premium was neutral from an income perspective, that allowed us to manage the risk on our portfolio throughout the year. These specific costs will all be contained in the 2017 results.

Next, we have the adjustment related to the aggregate contract triggered by the losses incurred in the third quarter. Through nine months, as reported that adjustment was $14.5 million. And the fourth quarter results reflect $4.5 million of additional ceded premium. The contract itself had the effect of reducing retained losses by a much larger amount.

Next, as it relates to loss and loss adjustment expenses, as noted in our press release and in line with our pre-announcement relating to the Q4 CAT events, we reported $37.5 million in catastrophe losses. These losses resulted from the wildfires in California and certain other aggregate contracts written in our reinsurance business that were impacted by the accumulation of smaller events throughout 2017.As to the catastrophe losses reported in prior quarters of 2017, net to Argo, we saw an improvement of $7.6 million primarily related to the re-estimation of losses from Hurricane Harvey.

Commenting briefly on the accident year loss results, a slight increase in the U.S. results in the fourth quarter was primarily driven by certain non-catastrophe property losses incurred in the quarter. For the year, the U.S. current accident year non-CAT loss ratio was up by 0.6% representing the aforementioned property losses.

In our International segment, and again, as reported in the third quarter results and call, we increased our current accident year loss pick primarily related to property business in Syndicate 1200. The net effect of this was to raise the current year non-cat loss ratio for the International segment in the fourth quarter to 59.4% and for the full year to 57.2%.

While the results were continue to be impacted from the older business earning through, we expect improvement in the loss ratio as our underwriting strategies take effect. The impact of this should be seen by the middle of 2018. And as Mark mentioned, given the work that's going on and the results we see quarter by quarter, we're optimistic that we're getting the business on track.

Finally, on the prior-year movement, we finished the year with positive prior-year development of $8.2 million, marking, as Mark said, the 13th straight year of overall positive development. In this quarter, both operating segments contributed to the positive result. And as mentioned previously, the year's results include the impact of $10 million from the Ogden rate change in the UK and spillover claims for the fourth quarter 2016 catastrophe event, Hurricane Matthew.

Moving on to the expense ratio. Because some of the adjustments mentioned impact premium and are onetime in nature, it's worth commenting on the ratios as reported and as adjusted. The reported expense ratio in the quarter of 39.8% reflects the lower earned premium of $17.1 million and include charges of $2.2 million related to restructuring activities, primarily around premises and systems and a catch-up to the amortization of intangibles related to the Ariel Re acquisition, as we concluded in the fourth quarter on the final purchase accounting. Adjusting for these onetime items, the expense ratio would have been 37.5% in the quarter compared to 39.7% reported in the comparable quarter of 2016.

The ratio for the fourth quarter does benefit from a lower provision for compensation expense, but reflects ongoing investments in technology and people in support of our strategic plans, as evidenced by the strong growth, most notably in the U.S. business up to almost 24% in the fourth quarter.

Three other items of note. Interest expense for the year reflects the additional debt incurred with the Ariel acquisition and modestly higher LIBOR rates, impacting the floating rate component of our capital structure. The net results of our fee-based revenues and expenses reflects the onetime gain on the sale of a portion of that business, which was recorded in the third quarter. And finally, the net foreign currency exchange loss was a result of the weaker dollar in the year, offset by appreciation in non-dollar assets in our investment portfolio.

For the fourth quarter of 2017, we recorded a tax benefit of $16.6 million that was largely the result of revaluation of our deferred tax liabilities at the new lower U.S. statutory tax rate. Our deferred tax liabilities are primarily related to unrealized appreciation in our investment portfolio. For most of our deferred tax assets, we have full valuation allowances.

Related to U.S. tax reform, we've performed initial analysis of changes and do not expect a significant impact on our tax expense. As with any period, the geography in which we earn profits will determine our future effective tax rate.

Growth in most balance sheet accounts during the year results from the inclusion of the Ariel Re business in our year-end balance sheet and the increase in losses payable on recoveries from the events of the third and fourth quarter. As mentioned, we concluded on the purchase accounting for Ariel in the quarter that resulted in no material change to the approximate $40 million of intangibles we recorded at the acquisition. We ended the quarter with a pre-tax unrealized embedded gain of $181 million in the investment portfolio, roughly equal to the balance at the end of the third quarter. The majority of that gain are in our equity holdings.

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

Q&A

Operator

We will now begin the question-and-answer session. The first question comes from Jeff Schmidt with William Blair. Please, go ahead.

Q - Jeff Schmitt {BIO 19747235 <GO>}

Hi. Good morning, everyone. Apologize if I missed it, but did you mention how big the new property program was in the U.S.?

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

Size of the reinsurance program?

Q - Jeff Schmitt {BIO 19747235 <GO>}

Yeah. You'd mentioned that you added a – yeah, a new property program in the U.S.?

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

Yeah. I think the reference was, we have consolidated our reinsurance programs into a single program for 2018. That was – the purpose of the slide was to show the pro forma effect of that single reinsurance program. We haven't historically disclosed the size of our reinsurance programs. The comments that we've made is that we have well-established risk tolerances. And we continue to operate within those risk tolerances. I think it's important to note, when we acquired Ariel, we did not change any of those risk tolerances. So, the same parameters we were working with at the start of 2017 are the same parameters that we're working with at the start of 2018.

Q - Jeff Schmitt {BIO 19747235 <GO>}

Okay. All right. And then what are you seeing in terms of submission growth for the E&S book, and how big is that book now?

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

The submission growth has continued for the last – well, many years. But as I've said in the past, the most important thing is not so much how many submissions that we get, but rather how we deal with them, or to speak more figuratively, we've got plenty of business in the funnel. The challenge and the opportunity is to make sure that we're getting to the risks that we want to underwrite and avoiding those that we don't. And I think, what we've seen in the last couple of years with some of the investments and technology that I referred to earlier is that we're able to get – not only are we able to pick the risks that we want to get to quicker, but we're able to turn around quotations more quickly on the submissions that we like.

Q - Jeff Schmitt {BIO 19747235 <GO>}

Okay. That's helpful. And then one last one. What are you seeing in terms of pricing in the workers' comp market, particularly in California?

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

Yeah. We're not really California comp experts anymore. We gave that up 17 years ago.

Q - Jeff Schmitt {BIO 19747235 <GO>}

Yes, but are you...

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

We have so little risk on our books in California comp but that I don't think I can answer that question.

Q - Jeff Schmitt {BIO 19747235 <GO>}

Yes. Okay. Thank you.

Operator

The next question comes from Christopher Campbell with KBW. Please, go ahead.

Q - Christopher Campbell {BIO 20262752 <GO>}

Hi. Good morning, gentlemen.

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

Good morning.

Q - Christopher Campbell {BIO 20262752 <GO>}

All right. First question, just looking at the U.S. current year core loss ratios as adjusted, there was about 240 bps year-over-year deterioration for the quarter. And maybe I missed this in the opening script, but were these results more attritional, mix driven, or one-offs? Any additional color you can provide on the trends there would be helpful.

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

The attritional losses, by definition, so we're talking current accident year non-CAT loss ratio, so they're are attritional by definition. The main impact was an uptick in some one-off property losses in the fourth quarter. So, the way I think about it is, does it seem trend-worthy to us, no.

And there were some larger than expected property losses in the fourth quarter. As I think around the rest of the U.S. businesses, most businesses are performing pretty close to their original loss picks.

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

And also one of the faster-growing parts of the business in the U.S. is Casualty, which runs at a higher loss ratio, but a lower expense ratio.

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

Yeah. So, just to be clear, the current accident year ex-CAT loss ratio for the U.S. increased by 0.6% year-over-year.

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

Yeah, I think I may have misspoke in my remarks earlier.

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

Oh, okay.

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

Yeah.

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

All right. Okay.

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

So, just tell everyone what the two numbers are.

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

Yeah. The two numbers are $57.6 million, 2016; and $58.2 million, 2017. And that 0.6% was the impact of the fourth quarter related to those property losses.

Q - Christopher Campbell {BIO 20262752 <GO>}

Okay. Got it. Yeah. I was just looking at the quarter-over-quarter numbers. Okay. Got it. And then just another question like kind of the premium growth. And when I'm looking at U.S., sessions were down pretty meaningfully in U.S. Liability and Professional lines. Can we get an update on what your reinsurance strategy is here and kind of your current thoughts on the casualty market in the U.S.?

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

So, I'll start, and then I'll let Jay jump in. We're pretty positive about the casualty market, at least the parts – let me rephrase that. Of the parts of the casualty market that we're operating in, we're pretty positive that there's room and opportunity for growth in 2018. Having said that, there's a whole lot of it that's pretty competitive. We haven't really changed our reinsurance strategy, I don't think at all in the U.S. So, that may be more of a timing issue than anything else what you're looking at.

Jay, do you want to add anything?

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

Yeah. No, I think it is. But just to amplify on that a bit, there's not one strategy for those entire portfolios. And I say that, because in some instances we employ excess of loss. In others, we have certain strategic quota shares in place, where we can get paid an appropriate and profitable ceding commission to underwrite some of those, and allows us to put out some larger limits. So, I think, in particular, some of that impact is probably being seen in Professional lines business.

Q - Christopher Campbell {BIO 20262752 <GO>}

And shifting to the portfolio, I know your Argo duration's pretty low relative to its liability. And then as rate's rising, how should we be thinking about the potential to kind of either push out the duration, take more credit risk, et cetera. How should we be thinking about the upside from the portfolio?

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

We should be thinking that unless we're going to get paid to take duration risk or credit risk, we're not going to do it. Mark, you want to add anything?

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

Yeah. We run our core portfolio, which is mainly where you're focused, when you say, duration with three different managers. I have calls pretty regularly with them, and they have intermediary targets where they say, okay, if we get to here on the U.S. tenure, we're going to add a little more here and here. And they're talking to their strategists, too, saying, it could go here, but we really don't see it blowing out much more.

So, we look at duration, yes, we're not getting paid very well for it, but we will tactically shift it when things move out, and we think market's too far forward. But I think the theme right now in both the equity and debt markets is you really got to think tactically and focus on – I don't think you can just buy things and lock it away right now. It's very difficult to see that kind of environment here.

Q - Christopher Campbell {BIO 20262752 <GO>}

Okay. That's very helpful. And then just one more. Jay, you had mentioned you don't expect an impact from tax reform, so should we still be thinking about a 20% operating tax rate going forward?

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

Yeah. I've run the numbers several different ways, and it kind of keeps coming out in that same zip code. So, I think that's the appropriate number. One of the things that's important is we don't know what the tax reform is until they write the rules, right. But even if read in their most punitive fashion, I still think 20% is the right number.

Q - Christopher Campbell {BIO 20262752 <GO>}

Well, thanks for all the answers. Best of luck in 2018.

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

Thank you.

Operator

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

Good morning. This is Marcos (42:10) in for Greg. So, tough year, but it seems like this year's outlook includes a better ability to leverage reinsurance as a result of last year's merger and the run-off of the un-performing books, which should lead to about a combined ratio. But, I want to circle back to some of Mark's comments around last year's high level of alternative private equity income. So, should we be expecting a similar level of income this year? It seems like last year's going to be a tough comp.

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

I would say every year is a tough comp with our private equity and hedge fund portfolio. Some of that was the benefit of selling SureTec, which we explained on, I believe, it was the second quarter. I think Jay and I run a model, and we will go through it with you. But yeah, this year was a tremendous year. We still expect a good year in 2018, but it's hard to predict the markets. I think if you take my last comments on duration and the equity markets, we're thinking you have to be tactical and thoughtful. And we don't see the long ball being pitched this year?

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

Yeah. So if I can just add, I think we've been pretty consistent in suggesting that there is a fair amount of volatility from one quarter to the next and how that part of the income statement performs. Having said that, a whole lot of the alternative strategies that Mark is invested in are credit strategies. And so we'll see what happens with the markets, but I'm more concerned with overall market volatility than alternatives volatility.

Q - Operator

Got it. Got it. Can you guys perhaps also comment your January 1 renewals and perhaps walk us through the revaluation of the CAT losses this quarter?

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

So as we kind of thought three months ago, we thought pricing would change its downward trend and start moving up. We weren't sure the rate at which pricing would move up. As I mentioned in my remarks, pretty much across the board, we're seeing price increases on the January 1. Well, I should say, all of January and the beginning of February. And the rate of change is directly related to whether or not risks are loss-affected or portfolios were adequately priced to begin with. So if they were loss-affected and/or they were inadequately priced, we're seeing more price increase than other parts of the portfolio that are priced just fine.

Jay do you want to add anything?

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

All right. No – well, yes, I'll add on your second part of your question, which was the revaluation of the CAT losses. If you think about the timing of the third quarter, that was pretty close to the events. At that point in time what you do is you pull out a map, and you put pens in it, and you figure out where your risks are. Obviously, there is more sophisticated tools than that, but you don't have a lot of reported losses as the next 90 days progressed. In some instances, we were seeing slower reporting of losses, and that's really what has led to us to conclude that our initial estimate was a bit high, but only a bit high. A $7 million reduction on the size of those losses is pretty modest.

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

Yeah. And I'd like to go back to your preamble before your question. You're right that we're using more reinsurance, but I think there's a better way to frame that. And so if you don't mind, I'd like to go ahead and reframe that, which is there are different forms of capital that we have to support our business. And one of the things that we've talked about in the past, and I alluded to it earlier but I should have been more specific, we use a fair amount of reinsurance as capital to support a lot of the CAT activity in our books.

And one of the goals of acquiring Ariel Re and having Ryan Mather and his team join us, was putting together their underwriting portfolio with ours. And the result has been that we found a lot of interest in people – of investors and non-traditional reinsurers that have paid us to originate risk for them. And so it's been a pretty intended strategic shift for January 1. And I think it's probably more apt to refer to Ryan and his team now as asset managers as much as risk takers or certainly risk originators. And as Jay said a minute ago, for some of the reinsurance programs that we have in other portfolios, a lot of them are structured in such a way that, again, we're getting paid to originate risk for others.

Q - Operator

Got it. Got it. That does sound a lot better. I guess, just one last one, and I'll regroup. Can you guys perhaps just comment on the recent M&A activities surrounding reinsurers, following the AIG/Validus deal, looks like SoftBank will likely acquire Swiss Re; and there is also talk of Allianz looking into XL Group.

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

Well, Jay is a former investment banker, but he is forbidden to speculate now that he is the CFO of our company.

Q - Operator

All right. So, no color there, no chatter?

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

There's always a motivated buyer and a motivated seller somewhere.

Q - Operator

All right. All right. Well, thanks, guys.

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

Thank you.

Operator

This concludes our question-and-answer session. I would like to turn the conference back over to Mark Watson for any closing remarks.

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

Thank you. I'd like to thank everybody for joining the call today. It lasted a bit longer than it normally does. But there is a lot going on in 2017 to set up 2018. And I think part of it I just mentioned a minute ago, which is I think that as we look forward in 2018 to the financial results, I think you will see us ceding more premium in 2018 and 2017, and that's absolutely by design. We're finally at a point where people are paying us to originate risk for them. So, that's an important thing for us to talk about in 2018. I think we begin the year in a really good place, both in terms of our balance sheet, as well as the pricing environment.

And then the last thing, which I spent a little bit of time talking about is I think the investments that we've made in technology and the investments that we've made in our digital team are starting to pay off.

It's hard to quantify that financially, but as the year goes on, and that we're - I should say, the next couple of years go on, I think we'll be able to be more precise in the financial benefits that we're getting from the investments that we're making today. And just as a reminder a lot of the income that we're generating today is from investments that we made 5 or 10 years ago.

So, I'd like to thank all of my colleagues at Argo for a really hard working year. As I said in the beginning, the financial results don't really reflect all the hard work that was done by everyone at Argo. So, I'd like to thank everybody for all of their hard work. I look forward to talking to everyone at the end of the first quarter. I think that'll be a really good time to see some of the changes that we've made and the financial impact of them for 2018.

And with that, I'll turn the call back over to Susan Spivak, our Head of Investor Relations.

A - Susan Spivak Bernstein {BIO 1514699 <GO>}

Thank you, Mark. I just want to mention that tomorrow, Mark, will be making an additional presentation at an investor conference, and that there will be a link in the Investors section of our website. And we hope that all of you will join in and take the opportunity to hear more about how we see Argo positioned for the future. So, that's at 12:35 PM Eastern Time and just look for the link in the Investors section of our website.

Thank you. I look forward to the end of the first quarter call.

Operator

The conference is now concluded. Thank you for attending today's presentation. You may now disconnect.