Q4 2016 Earnings Call

Company Participants

- Jay Stanley Bullock, Chief Financial Officer & Executive Vice President
- Mark E. Watson, President, Chief Executive Officer & Director
- Susan Spivak Bernstein, Senior Vice President-Investor Relations

Other Participants

- Arash Soleimani, Analyst
- Charles Gregory Peters, Analyst
- Jeff Schmitt, Analyst
- Ken Billingsley, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good day and welcome to the Argo Group 2016 Fourth Quarter Earnings Call and Webcast. 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 call over to Ms. Susan Spivak Bernstein, Senior Vice President, Investor Relations. Ms. Spivak Bernstein, the floor is yours, ma'am.

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 2016 results. Last night, we issued our press release on earnings, which is available in the Investors section of our website at www.argolimited.com. Presenting on the call today is Mark Watson, Chief Executive Officer; and Jay Bullock, Chief Financial Officer. Also with us during Q&A is Axel Schmidt, our Chief Underwriting Officer. We are pleased to review the company's results for the quarter and the year, as well as provide you with management's perspective on the business. 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 either 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'm happy to turn the call over to Mark Watson, Chief Executive Officer of Argo Group. Mark?

Mark E. Watson {BIO 20610831 <GO>}

Thank you, Susan. Good morning to everyone and welcome to our fourth quarter and year-end conference call. I'd like to share my thoughts about the quarter, after which Jay Bullock, our Chief Financial Officer, will add more commentary to the financial results. We look forward to responding to any questions you may have following our remarks during the Q&A portion of the call.

After the market close yesterday, Argo reported operating earnings for the fourth quarter of 2016 of $19.8 million or $0.65 per diluted share, compared to $24.5 million or $0.78 per share in the 2015 period. Results in the quarter reflect an increase in property losses mainly related to certain catastrophic events. On an annual basis, our results reflected another solid underwriting effort, coupled with strong results from our investments portfolio, with operating earnings of 13.9% higher at $3.92 per share compared to $3.44 per share in 2015.

Net income of $1.07 per share for the fourth quarter of 2016, $4.75 per diluted share for the year 2016, and an annual return on average equity of 8.5%. I should also add that for the past four years, on a combined basis, our ROE has averaged 9.8%. We ended the year with book value of $59.73 per share, a 10% increase from December 31, 2005 (sic) [2015] (3:58).

And I should also say that for the past 15 years, we've grown book value per share on a compounded annual basis in excess of 10%. In 2016, this was accomplished despite catastrophic losses over 2.5 times the level experienced in 2015. As we've discussed in the past, we consider the compounded annual growth rate of book value per share as the measure that most clearly demonstrates value creation for our shareholders.

I also want to again highlight the improving underlying trends in our loss ratios excluding catastrophic losses and prior-year accident development. On an overall basis in the fourth quarter of 2016, our underlying loss ratio improved 2.3 points to 56.7% from 59.0% in the fourth quarter of 2015. On an annual basis, the loss ratio excluding cats and prior-year development improved to 55.4% from 56.4%. We're particularly pleased that the improvement was reflected in all of our business segments in the fourth quarter comparison. And for the year, three out of our four businesses reported better results, with the Syndicate basically flat in 2016 over 2015 for the year.

Taking a look behind the overall numbers, our U.S. businesses continue to perform quite well. In fact, underwriting income from our Commercial Specialty business in 2016 was $62.5 million. Let me say that again, $62.5 million in underwriting income, which was higher than the $49 million of underwriting income earned in our E&S business and twice the underwriting income that we earned in 2015 for Commercial Specialty. Nearly all of our businesses in Commercial Specialty reported an improved result over the prior year. I will go into further detail in a moment.

While the Syndicate and International Specialty segments were impacted by above-average catastrophic and property losses and intense market condition, they're continuing to grow and develop as a key strategic component of our platform. These businesses are now being led by Jose Hernandez, our new Head of International, and the acquisition of Ariel Re, which recently closed, we added further scale and diversity to our Bermuda and London-based businesses, continuing to advance our international growth objectives.

Gross written premiums in 2016 grew to over $2.1 billion, up 7.6% over the 2015 result. And our combined ratio increased modestly to 96.2% from 95% in 2015, reflecting the increase in property-related losses that I mentioned earlier. As reported results, catastrophic losses increased more than 2.5 times in 2016 from those of 2015 and we were less dependent on prior-year development, which I consider a real positive.

Prior-year favorable reserve development was $14.5 million for the fourth quarter of 2016 and $33.3 million for the year, fairly consistent to the 2015 experience. I'm pleased to note that net investment income grew 30% to $115.1 million, up from $88.6 million in 2015. Asset class diversification and an allocation to strategies away from our core bond holdings contributed strongly in both the fourth quarter and in 2016 to our overall investment results. Also, as discussed in previous calls, our expense ratio is showing favorable year-over-year improvement. In 2016, the expense ratio was 38.8% versus 39.2% in 2015.

Another initiative you've heard me talk about over the last few years is our investment in innovation to meet the changing needs of our clients. We're simplifying how we do business by leveraging technology to make Argo an easier carrier to do business with. While many of these investments in technology will take several quarters to demonstrate the value we think inherent in the ideas, we can point to several initiatives that get us quite excited that we're on the right path.

For example, we're developing a tool called Smart Search (8:34), which pulls important individual account risk information from a variety of internal and external data sources at the touch of a button. Built on a modern cloud computing platform, proprietary artificial intelligence algorithms help reduce underwriting errors and get us closer to our goal of delivering complex underwriting decisions at greatly increased speeds. This is just one of many examples of what our digital team is working on.

Another dynamic that is quite positive is the new additions to our management team on all levels. As our company's performance continues to advance and as others consolidate and retrench, we're attracting and hiring more of the great talent in our industry. As you've heard me say before, we now have more of the best people in the right positions in our company than at any other time during my tenure as the CEO of Argo.

You can see this in the underwriting results at our Commercial Specialty segment in addition to the solid momentum in many of our businesses. With an increasingly visible and respected brand, we have never been in a better position to execute on our long-term goal of being a leading global specialty underwriter and to continue delivering improving results as we did in 2016.

Now, let me briefly comment on each of our operating segments. On average, overall rates for the segment were up – on average, overall rates for the E&S segment were up modestly, as increases in specialty lines were offset by larger decreases in property lines, if you can believe that. For the quarter, our – for the quarter and year, our E&S business grew by 6% and 4% in 2006 (sic) [2016] (10:17).

Growth is primarily being driven by our casualty lines, historically one of our most profitable segments. Our advantage continues to be the strong relationships our business leaders and underwriters have with our customers. We're focused internally on underwriting excellence and value-adding actuarial analytics, and externally, by distinguishing ourselves in the marketplace on our service.

Perhaps the most positive result to comment on this year is our Commercial Specialty segment. In calendar – in 2016, this segment produced $62.5 million in underwriting income, up from $30.1 million in 2015. To put things in perspective, in 2012, we had an underwriting loss of $47.6 million in this segment. Kevin Rehnberg, our Head of the U.S. Insurance Operations since 2013, has had in his first priority restoring the historical profitability of our Commercial Specialty segment. And I'm happy to report that now, nearly all businesses are reporting near record results.

Overall, gross written premium was up 15.2% in the quarter and 18.7% for the year 2016, driven by our program, surety and professional lines businesses. Positive gains were also reported by our public entity business, Trident. Three years ago, we moved Ron Vindivich, a seasoned pro from our E&S operations to run the public entity business. In 2016, under Ron's leadership, Trident posted the best underwriting results in over 10 years.

In 2016, we hired Craig Landi, another industry leader, to run our professional lines business, Argo Pro. At Argo Pro, in 2016, gross written premium was up 20% for the (12:07) prior year. And I should also mention that our surety business, under the leadership of Josh Betz and his team, had its best year ever as measured both by gross written premium and underwriting income, despite challenges in the energy sectors, which are most important to our surety business. So, in summary for Commercial Specialty, we're firing on all cylinders and have never been better positioned.

And moving on to our International Businesses, 2016 presented challenges for the industry. While we suffered our share of losses, we weathered the catastrophic activity well. In October, we introduced Jose Hernandez as our new Head of our International Platform. We brought Jose on board given his experience building and running successful operations in several countries around the globe, particularly those where we at Argo operate.

Jose and the entire International and corporate team spent the last few months of 2016 completing the Ariel Re acquisition. The transaction was completed on a quick time horizon and the company well-positioned for the important January renewal season, and we're confident that he will continue to grow our International Business to reach our ambitious expectations.

Turning to Syndicate 1200, I wish I could tell you that the market conditions were improving, but the fact is competition remains fierce at Lloyd's. We did achieve 14.5% growth in gross written premiums in the fourth quarter and 4.2% in 2016, and this growth was achieved even as we reduced our ownership of the Syndicate slightly. The Lloyd's market continues to be more challenging now than in the last two decades.

We've been very vocal about the need for scale to effectively compete in this market, and the acquisition of Ariel Re provides us with much needed scale, which will improve our efficiency. Our advantage continues to be the market credibility of underwriting teams and distribution relationships. As with Lloyd's, our International Specialty segment continues to experience challenging market conditions. In the fourth quarter of 2016, we grew gross written premiums by 8.7%, driven primarily by new business in our Bermuda casualty and professional lines operations.

Premium from our operations in Brazil was up in the fourth quarter of 2016 compared to 2015, but declined modestly for all of 2016, primarily reflecting the country's economic recession and the depreciation of the – and the depreciation of the Brazilian real was down approximately 6% compared to 2015. Despite the challenging economic environment in Brazil, we continue to see strong growth in professional lines driven by our digital platform. And I'm happy to say that we made an operating profit for the year in our Brazilian business.

At Argo Re, in 2016, our reinsurance business was challenged by competitive market conditions, including excess capital in the space and related pressure on pricing. With our acquisition of Ariel Re, however, we expect to benefit from additional scale in that market. Earlier this month, we announced that Ryan Mather, former CEO of Ariel Re, will be running our reinsurance business going forward.

Ryan has over 25 years of industry experience, a tremendously profitable track record and a loyal following in the business. We're also very excited to have him and his team as part of Argo Group. Matthew Wilken, who's been running the reinsurance business at Argo Re for the past few years, will continue on working in conjunction with Ryan as his number two running all of our reinsurance business. And also, I'm not sure if I said this before, but it was actually Matthew's idea that we bring Argo Re and Ariel Re together. So, Matthew, well done.

Turning to our investments for the year, our core bond portfolio was up 1.9% and our risk portfolio was up nearly 13%. Our reported net investment income was $25.4 million for the fourth quarter, $5 million higher than the fourth quarter of 2015. As most of you know, in 2016, we began to include the performance from our alternative investments in investment income. Alternatives contributed $3.1 million in the quarter compared to $9.8

million last quarter and to a loss of $1.6 million in the fourth quarter of 2015. As a reminder, we expect the alternative contribution to be lumpy by quarter and have provided historical data in our press release tables.

For the fourth quarter of 2016, Argo's total return was flat, bringing year-to-date return to 4.3%. During the fourth quarter, Treasury yields increased, which negatively impacted our core bond portfolio, where most of our investment grade mandates were down about 1.3%. Offsetting this was our high-quality CLO and bank loan portfolios, which were up 1.6%. Furthermore, our actively managed currency EM debt, high-yield debt and equity mandates in our risk portfolio were up 3.1% in the fourth quarter of 2016. This has been a really good year for our investment portfolio, and I really want to thank Mark Rose for all of his hard work.

Moving on to capital management, I'm compelled to comment each quarter on our philosophy, but in reality has not changed. Our first use of capital is to support the balance sheet, our second is to grow the business, our third is to have capital available for opportunities as they arise, and the most recent example is the acquisition of Ariel Re. Once those are satisfied, we will have actively – we will continue to actively return excess capital to our shareholders in an effective manner.

In 2016, we repurchased 847,111 shares of stock for $47.1 million. In total, over the last six years, we've returned more than $374 million of capital to shareholders, with $266 million of capital through share repurchases and we paid $108 million in cash dividends. We continue to view our stock as one of the best investments available and will balance the return of capital to shareholders with our priority of building the Argo franchise and shareholder value in the long-run.

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

Jay Stanley Bullock {BIO 3644311 <GO>}

Thanks Mark, and good morning, everyone. I'll be brief in providing some detail on the financials, and then open it up to questions. As Mark highlighted, 2016 represented another strong result for Argo, not in the least measured by Group-wide underwriting profit of $54 million, supplemented by an increase in the investment results of over $28 million.

We're often asked a question of improvement in our margins, and the response is consistently the same. We strive to maximize underwriting profits, whether from better underwriting or a more efficient operation, and we look to augment growth in book value per share through thoughtful management of our investment portfolio. And looking at our underlying results, excluding catastrophe losses and prior-year development, you can see the continued progress in our loss ratio. Despite some one-time expenses, our expense ratio has improved. And as mentioned, it was a good year for investment results.

Moving on to some points of note on the financials, gross written premium was up 11.8% in the fourth quarter and 7.6% in 2016. When looking at the increase in gross written premium in 2016, it's partially driven by growth in our state funds fronting business in the Commercial Specialty segment. We cede 100% of the rest to (19:41) these state funds. It's more of a fee-based business and thus does not contribute to the net written or earned results. The smaller increase in net written premium is also due in part to reduced participation on the Syndicate.

It's worth repeating we're encouraged by the continued improvement in our core loss ratio. Our current accident year non-cat loss ratio is 56.7% in the fourth quarter of 2016 and 55.4% for the calendar year. Both compare favorably to the same metrics for 2015, demonstrating the continued improvement in our underlying business. By segment and for the Group, the current year accident loss ratios are displayed in the table in the press release, reconciling the various loss ratios, which we believe gives you a good look at the underlying profitability.

In addition, in 2016, we continued the trend of overall favorable reserve development from prior accident years. For the fourth quarter, we experienced net favorable development of $14.5 million, and for the calendar year 2016, it was $33.3 million. Of particular note was the contribution from several different businesses in our Commercial Specialty segment. That alone contributed almost $23 million to the annual result.

As always, all the relevant figures on loss development are displayed in the table in the press release. As mentioned, catastrophe losses in the quarter of just under $23 million were primarily related to Hurricane Matthew, additional late reported losses from Louisiana floods in Syndicate 1200 and the New Zealand earthquake. These losses accounted for approximately 6.4 points on the combined ratio.

For the year 2016, losses related to these claims, along with U.S. weather, including Texas hailstorms and the Canadian wildfires. Also, as we have talked about in prior calls, we continue to see a favorable trend in our expense ratio. We remain focused on organizing the business with a simplified approach in mind that will allow us not only to scale our existing operations more effectively, but also make it easier for customers to do business with us.

Our recent acquisition of Ariel Re puts us further along in the path in both our Lloyd's and Bermuda businesses. A couple of comments on investment returns. We saw a meaningful contribution to investment income from alternatives for the year of $23.9 million in 2016. And as you can see from the table in the release, these results have varied from $1.5 million loss in the first quarter to $12.5 million gain in the second.

These returns will continue to vary quarter-over-quarter, but we expect consistent positive returns over the long-run. The result for 2016 is a very good result and exceeded our expectations. The foreign currency movement through the income statement was a gain for the quarter of $9 million and $4.5 million for the year. This was due to favorable foreign exchange movements in the quarter, which resulted in a gain on non-dollar liabilities in the quarter.

For the fourth quarter of 2016, the effective tax rate for the Group was almost 30% versus our core assumption of 20%. The higher-than-expected rate was mainly due to approximately 79% of earnings being attributable to our U.S. operating platforms. In addition, the current quarter includes tax paid on the movement of capital to our Bermuda platform. The effective tax rate for 2016 was 19.4%, very close to our assumption of 20%.

Finally, on the balance sheet, as mentioned, we recently closed the acquisition of Ariel Re. What is not reflected on the year-end balance sheet, but which will be part of the first quarter presentation is the debt assumed of approximately $83 million with the acquisition and the $125 million drawn on our line of credit to fund a portion of the proceeds. For the year, we ended with a pre-tax unrealized embedded gain of $116 million in the investment portfolio compared to $84 million at December 31, 2015. The majority of the gains are part of our equity holdings. Our fixed income holdings remain very short in duration and carrying value currently approximates market value.

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

Q&A

Operator

Yes, sir. We will now begin the question-and-answer session. The first question we have will come from Greg Peters of Raymond James. Please go ahead.

Q - Charles Gregory Peters {BIO 4656608 <GO>}

Good morning, everyone, and thanks for the call. I wanted to follow-up on a couple of the comments you made. Jay, on investment income, obviously, the full-year result for 2016 was quite strong relative to 2015. And I'm just trying to figure out, from a modeling perspective, what 2017 should look like. So, any additional color you can provide regarding the pattern of alternative investments, et cetera, would be helpful.

A - Jay Stanley Bullock {BIO 3644311 <GO>}

Well, Greg, if you look at the – as I mentioned, there's a table in the press release that details the quarter-by-quarter alternative investment income. The other – the rest of investment income is off the – mainly off the core portfolio, and I would expect that to continue to progress with the increased cash flow that we've seen in the past year. As it relates to the alternatives, I think you really have to look at it as an annual result. It's very difficult to predict quarter-over-quarter. As I said, it probably exceeded our expectations.

We tended to assume, in this environment, 6%, 7% would be a pretty good outcome. Generally speaking, the underlying investments related to that vary anywhere between $200 million and $300 million depending on what we've got allocated to various strategies. So, if you take 6% times $250 million or $300 million, that gives you a sense as to what the annual result might be in a normal year. So, I would – if I were building a model, I might assume something in the range of $13 million to $16 million, $17 million evenly spread quarter-over-quarter, knowing that there will be some variance in how those quarterly results develop.

Q - Charles Gregory Peters {BIO 4656608 <GO>}

Thanks. Thanks for the clarification. And then, on the debt, the $125 million and the $83 million, what's the interest rate on that? And as part of – maybe this is a broader question for Mark. As part of the capital management process, would you consider just using cash flow to pay down that debt or what's your perspective there?

A - Mark E. Watson {BIO 20610831 <GO>}

Greg, I think right now, we're pretty comfortable with our leverage. Having said that, if there is an opportunity to pay off some of the things in our capital structure, and I wouldn't just limit it to the drawing on the line of credit, that's something that we'll consider as we do thinking about paying dividends, increasing dividends and/or buying back stock.

A - Jay Stanley Bullock {BIO 3644311 <GO>}

Greg, to answer the question on cost, the drawing on the line of credit, there's a disclosure in our 10-K about the pricing on the line of credit. I think it's – I believe it's pretty detailed. It's 1.625% over LIBOR. And then, as it relates to the debt that came with Ariel, it's structured very similarly to the trust preferreds that were put on, but that were issued in the market middle of the last decade LIBOR based plus – I believe it was 300-and-change basis points. And so, it has some structural advantages. So, I think to Mark's point, we've got a lot of flexibility and options with the capital structure and we'll be looking at alternatives over the next six months to two years.

Q - Charles Gregory Peters {BIO 4656608 <GO>}

Okay, thanks for that answer as well. And then just finally, Mark, in your comments, you talked about the challenges in the Syndicate with the combined ratio just for the year, I think, right under 100%. When we look at maybe just the broader combined ratio target for the whole organization, considering the acquisition, how should we think about management's financial objective for 2017 in terms of the combined ratio?

A - Mark E. Watson {BIO 20610831 <GO>}

Well, I think Jay and I have been pretty consistent in saying that we'd like to see a 100 basis point improvement in the combined ratio sequentially year-over-year. And I think that the Ariel Re reacquisition helps us to get there, because it does get us some scale in terms of operating efficiencies, primarily in London and to a lesser extent in Bermuda. As respects our Syndicate 1200, my commentary is as much about the London market as it is about our Syndicate. I think our Syndicate is very reflective of what's going on there. And but for an above-average absence of cat activity, I don't think our results would have been much different this year than a year ago.

They – if you look at across all of the Group, the place that absorbed the most amount of the cat losses for the year and mainly the fourth quarter was the Syndicate. But by the way, we would expect that amount of volatility, because we do write a fair amount of primary property cat exposure in the Syndicate. So, I – look, I think that we're moving in the right direction. I think that the Ariel Re transaction helps us lower cost. It gives us more flexibility and gives our colleagues at the Syndicate a little more flexibility.

So, I think we're on path to keep improving. As I pointed out in my remarks and I think Jay did too, if I had to point to any one thing to kind of mark progress, that would be one of the exhibits in the press release. I think it was page 15 that shows our reconciliation of loss ratios. And if you just go down the year-end columns and you look at current accident year ex-cat, you'll see that there continues to be a sequential improvement in every segment.

The Syndicate was flat. And by the way, the Syndicate was flat at 53%, so that's not bad. And the average for the whole Group now is 55.4%, which I'll put up against anybody when you consider our mix of business and the amount of liability exposure that runs at a longer tail on the book. So, I'm very happy with where we are today. And if you just look at our financial results for the last four years now, we've been making sequential progress year-over-year, and we just keep our head down and keep moving ahead.

Q - Charles Gregory Peters {BIO 4656608 <GO>}

On the current accident year loss ratio, the 55.4% that you pointed out, that – it's actually kind of surprising considering the headwinds of just the competitive marketplace. Is it your expectation that you might be able to get a little bit further improvement in 2017 with Ariel or do you think the current levels are pretty much as good as it gets?

A - Mark E. Watson {BIO 20610831 <GO>}

Well, I don't know if it's as good as it gets, but I was kind of happy with that number. Having said that, look, as we've said for the last – certainly, the last two years, that we have given up growth in the top-line for continued change in portfolio mix, so that we can let go of some of the risk that we don't think meets our pricing targets anymore and focus on bringing on risk that does. And one of the places that I always use as an example is E&S. So, in my remarks earlier today, we talked about all the things we're doing with technology to make it easier for our underwriters and easier for our clients to engage us. And then, I said, and we grew low single-digits. Well, the two don't go hand in hand.

Well, the reason for that is that for the businesses that we've invested and we're actually growing double-digits and pretty strong double-digits, but we're still letting go business that we don't think meets our pricing criteria. And so, that's why you see an overall growth rate in E&S of less than you might otherwise expect, given my comments. And I think that'll continue in 2017. I think that we will be presented with far more opportunities than we take advantage of, because we just don't think that they're adequately priced. I think that we'll continue mixing around our portfolio. So, in answer to your question, yes, I do think it's possible that we can still improve our loss ratio, but that's more a function of how we change our mix of business.

Q - Charles Gregory Peters {BIO 4656608 <GO>}

Great. Thanks for the answers.

Operator

Next, we have Arash Soleimani of KBW.

Q - Arash Soleimani {BIO 18869554 <GO>}

Thanks. Just building off of the last question, does that – so, does that imply from the 100 basis points of improvement that you're, I guess, expecting or targeting in 2017? So, should we expect a majority of that then, it sounds likes, to come from the expense ratio with potentially a portion of it coming from business mix changes within core loss ratio improvement?

A - Mark E. Watson {BIO 20610831 <GO>}

I'm going to quote my esteemed colleague Jay Bullock, who's in the room with me. We focus on underwriting margin and the combined ratio, and we don't just focus on either the loss ratio or the expense ratio. We're trying to drive improvement in both across the base (34:37).

Q - Arash Soleimani {BIO 18869554 <GO>}

Okay.

A - Mark E. Watson {BIO 20610831 <GO>}

And I can't tell you exactly where it's going to come from. I can just tell you that we're focused on both.

Q - Arash Soleimani {BIO 18869554 <GO>}

Okay, that's fair. And then, in terms of, I think, you have gotten on a New York real estate program with Brownstone (34:57). Can you just talk about, I guess, the premium impact that we should expect that to have?

A - Jay Stanley Bullock {BIO 3644311 <GO>}

Yeah. I think for an annual run rate, it's around $50 million once the program is fully on board. But that program, I think, just started in the fourth quarter or maybe just in the first quarter of this year.

A - Mark E. Watson {BIO 20610831 <GO>}

Yeah. But when we bring on new – when we bring on new programs like that, we don't necessarily write everything that's expiring, so.

A - Jay Stanley Bullock {BIO 3644311 <GO>}

Right.

A - Mark E. Watson {BIO 20610831 <GO>}

So, maybe $30 million, $35 million...

A - Jay Stanley Bullock {BIO 3644311 <GO>}

Right.

A - Mark E. Watson {BIO 20610831 <GO>}

Is a more conservative number to think about.

A - Jay Stanley Bullock {BIO 3644311 <GO>}

Fully – as a full run rate which will be probably into 2018 (35:36).

A - Mark E. Watson {BIO 20610831 <GO>}

Yeah.

Q - Arash Soleimani {BIO 18869554 <GO>}

Okay. And then, could you just talk a bit about – obviously, the tax outlook is a bit uncertain. But if there are any kind of cross-border issues that arise, does that change your view on pricing at all? Does that – as a Bermuda domiciled carrier, does that make you look at your underwriting differently? I just wanted to get your thoughts on that.

A - Mark E. Watson {BIO 20610831 <GO>}

Well, it's true that our holding company is based in Bermuda and it's true that we have a large trading platform in Bermuda for both insurance and reinsurance. But we have – we have almost – we have a ton of capital sitting in the U.S. that supports our underwriting businesses. And not knowing exactly what will happen, I can't answer the question with precision. But I can tell you that if the U.S. corporate tax rate goes down in the U.S., that's beneficial to us. If some tax comes up that impacts how we reinsure our U.S. businesses either with our own companies or with other companies, we have the ability to take more risk net here in the U.S. if we want to. So, my guess is for us, it's probably a net positive, but it's probably more neutral than anything else, keeping in mind that our effective tax rate is about 19% or 20% right now.

Q - Arash Soleimani {BIO 18869554 <GO>}

Okay, great. Thank you very much for the answers.

Operator

The next question we have will come from Jeff Schmitt of William Blair.

Q - Jeff Schmitt {BIO 19747235 <GO>}

Good morning, everyone. A quick question on...

A - Mark E. Watson {BIO 20610831 <GO>}

Good morning.

Q - Jeff Schmitt {BIO 19747235 <GO>}

A quick question on the loss environment. As you'd mentioned, the accident year loss ratios look really good in the quarter. We're hearing from others a trend up in verdict payouts, a more active plaintiff bar in the U.S. Is that something you're seeing at all or any hints of that?

A - Mark E. Watson {BIO 20610831 <GO>}

Well, I grew up in South Texas, where the plaintiffs' bar is about as active as it can get. So, look, I don't see it being materially – for our portfolio, I don't see it materially different today than it was a year ago.

Q - Jeff Schmitt {BIO 19747235 <GO>}

Okay. And then, on the capital management front, Mark, I know you'd hit on this. But are there any valuation parameters there? With the stock trading overbooked, did that change the equation at all?

A - Mark E. Watson {BIO 20610831 <GO>}

Well, if you only want to – if we just focus on repatriation for a minute, then I think that my colleagues on the board and I will probably give due consideration to whether it makes more sense to repatriate capital via dividends versus stock buybacks, including the consideration of a special dividend. Having said that, given that we just acquired Ariel and brought on a little bit more debt, we may want to settle down the whole balance sheet before we get too aggressive with capital repatriation. But I do think where we're trading, dividends maybe a better solution for our shareholders than buying back stock.

Q - Jeff Schmitt {BIO 19747235 <GO>}

Okay, great. Thank you.

Operator

Next, we have Matthew Carletti of JMP.

Hi, good morning. My name is (39:14) I'm asking question on behalf of Matt Carletti at JMP. And it's regarding the Commercial Specialty business. Mr. Watson had mentioned earlier the great improvement in this business, and I wanted to ask if there – and I wanted to ask regarding the ex-cat loss ratio improvement. What business lines are driving this and if there are any updates on the initiatives of this segment for 2017? Thank you.

A - Mark E. Watson {BIO 20610831 <GO>}

So, a lot of the improvement is coming from the growth in our surety business, as well as the growth in our professional liability business, which both run at a lower loss ratio than the other parts of Commercial Specialty. So, what you're seeing there is a change in the mix of business.

Q - Operator

Okay, thank you. And then, can you just also comment on why the expense ratio was sequentially higher in the quarter?

A - Jay Stanley Bullock {BIO 3644311 <GO>}

Yeah. There were some one-time things in the quarter. Are you speaking about Commercial Specialty in particular or are you talking about the Group?

Q - Operator

Just general.

A - Jay Stanley Bullock {BIO 3644311 <GO>}

In general, there were some one-time things in the quarter. We had cleared out a lot of the cash settled options earlier in the year, but we still have some outstanding. And when the stock price goes up, there's going to be an impact of that. Stock price was up just under 20% in the fourth quarter. We sort of expect a 2.5% to 3% increase in a quarter. So, that added $4 million or $5 million of additional expense in the quarter. So, that generated a decent chunk of that increase, and then there were some other smaller items, including a small amount related to transaction-related expenses for the Ariel.

A - Mark E. Watson {BIO 20610831 <GO>}

Right. And remember that the expense related to compensation is a non-cash charge.

Q - Operator

All right, thank you very much.

Next, we have Ken Billingsley of Compass Point.

Q - Ken Billingsley {BIO 6971717 <GO>}

Good morning. I did want to follow-up on the Commercial Specialty answer. I understand you're saying obviously it's surety and professional liability. Kind of two parts to the question. One, U.S. infrastructure spending, if the expectations remain there, do you see continued double-digit growth out of Commercial Specialty into 2017?

A - Mark E. Watson {BIO 20610831 <GO>}

I would say that depends on market pricing environment over the course of the year. But we certainly aspire to that, Ken, but we need to see how the market evolves over the course of the year.

Q - Ken Billingsley {BIO 6971717 <GO>}

And that leads right into my second question. How – you had two years of really strong growth, not just top-line growth, but improvements in the loss ratio and the combined ratio for Commercial Specialty. Obviously, I understand there is a business mix shift that's going on there. I would expect the expense ratio to rise if you write more surety. But how long can you continue to deliver double-digit growth and get, I guess, pricing improvement or really that not so much pricing improvement, it's just the change in the mix of the business?

A - Mark E. Watson {BIO 20610831 <GO>}

Yeah. It's mainly the – it is mainly the change in the mix of business that's driving margin improvement. And you're correct, that if we write more surety that runs at a higher expense ratio, but it runs at a lower loss ratio, which is why we keep trying to get everyone focused on combined ratio and not dwell on one or – either of the expense ratio or the loss ratio.

Q - Ken Billingsley {BIO 6971717 <GO>}

And how long can you carve out this type of production, which is getting that growth? Obviously, the mix will shift and the combined ratio will be what it is. I would imagine your competitors are taking notice. Is there – are there particular lines that you find that you are having a significant competitive advantage in and you're having a lot of opportunities? Or is this kind of general across the board and which would be at risk, as competitors see your production, may come in and try and carve out a slice themselves?

A - Mark E. Watson {BIO 20610831 <GO>}

Well, remember it doesn't take – it doesn't take that much for us to move the needle on a percentage basis relative to the competitors that I think you're talking about. So, I'm not sure that our modest growth in dollar terms really gets their attention. But I – look, I think that we're very good at executing. I think I mentioned earlier that Josh Betz and his team in Surety were doing really, really well. And I think they've got one of the best operations. So, I think that is their – I think they are very well positioned to keep growing, and I think they have a strong competitive advantage to do that, as an example.

Q - Ken Billingsley {BIO 6971717 <GO>}

Thank you. I want to ask a question on the Ariel Re. You'd commented – and please correct me if I'm wrong, but I thought you had commented that this new business also will create some flexibility in Bermuda and London. And on that flexibility, does that actually create maybe a substitute for the type of product that they're going to be working with or is this going to be new opportunities that they're going to be able to explore?

A - Mark E. Watson {BIO 20610831 <GO>}

Well, look, I think we have a platform that allows us to be a little bit more flexible in many different ways. And as you know, I like to talk about what we've done, not what we're going to do. So, stay tuned and let's talk about it in the end of the first quarter or the end of the – probably the end of the second quarter is a better time.

Q - Ken Billingsley {BIO 6971717 <GO>}

Okay. And then, on what you did - this is from the presentation. I believe the last 12-month net income for Ariel Re was about $29 million. Is this something that would be enhanced under your umbrella? And if so, does that assume that Ariel Re could add about 200 basis points to return on tangible equity, just if it continue to operate as it was? And is it something that you guys enhanced under your umbrella?

A - Mark E. Watson {BIO 20610831 <GO>}

Well, I think in the short-run, there is - well, in the short-run, we're just trying to get everybody on the same page. In the medium-term, so think the second half of this year, there is some cost savings to be had. And I think that particularly given the Lloyd's planning cycle, it's really hard for us to start to leverage and bring things together until the beginning of 2018. And that seemed a long way away last summer, when we started thinking about it. But now, it doesn't seem so far away. We have to start planning with Lloyd's in about four months' time.

Q - Ken Billingsley {BIO 6971717 <GO>}

Great. Well, thank you for taking my questions.

Operator

No sign of further questions. We'll go ahead and conclude today's question-and-answer session. I would now like to turn the conference back over to Mr. Mark Watson for any closing remarks. Sir?

A - Mark E. Watson {BIO 20610831 <GO>}

Thank you. And I'd like to thank everyone again for joining us this morning. You may have noticed that I mentioned a number of my colleagues during the call this morning, and that's because it takes a whole team to run this place. And I really think that, as I said in my remarks earlier, we have a great team. I'd like to thank everybody.

For every one I did mention today, there's probably 10 more people I should have. And we finished this year in a really good spot. I think we're continuing to invest in the future and in a good place to keep executing against that. And I just want to thank everybody for their hard work, and I look forward to talking to you all at the end of the first quarter. Thank you. That concludes my remarks.

Operator

And we thank you, sir and the rest of the management team for your time also today. The conference call has now concluded. Again, we thank you all for attending today's presentation. At this time, you may disconnect your lines. Thank you. Take care and have a great day.