The Travelers Companies, Inc. NYSE:TRV

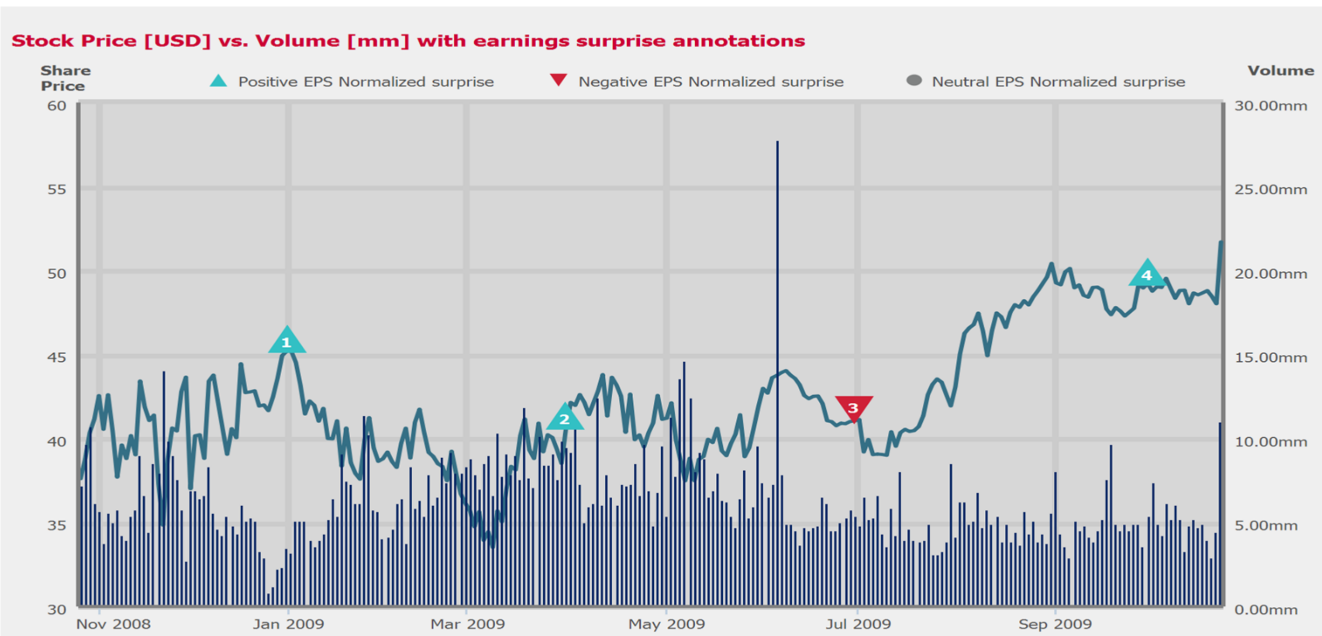
FQ3 2009 Earnings Call Transcripts

Thursday, October 22, 2009 1:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ3 2009-			-FQ4 2009-	-FY 2009-	-FY 2010-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	1.32	1.61	21.97	1.46	5.66	NA
Revenue (mm)	5426.83	5421.00	(0.11 %)	5353.53	21428.53	NA

Currency: USD
Consensus as of Oct-23-2009 1:12 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ4 2008	1.45	1.58	1 8.97 %
FQ1 2009	1.30	1.34	2 3.08 %
FQ2 2009	1.27	1.25	3 (1.57 %)
FQ3 2009	1.32	1.61	4 21.97 %

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Call Participants

EXECUTIVES

Bill Hannon

Brian W. MacLean

Doreen Spadorcia

Gabriella Nawi

Jay Benet

Jay Fishman

John J. Albano

Matthew Heimermann

Michael Nannizzi

Paul Newsome

Vinay Misquith

ANALYSTS

Alan D. Schnitzer

Brian Meredith

Ian Gutterman

Jay Cohen

Jay Gelb

Larry Greenberg

Mark Dwell

Presentation

Operator

Good morning ladies and gentlemen and welcome to the third quarter earnings review for Travelers. We ask that you hold all questions until the completion of the formal remarks at which time you will be given instructions for the question-and-answer session.

As a reminder, this call is being recorded today, October 22, 2009. At this time I would like to turn the call over to Ms. Gabriella Nawi, Senior Vice President of Investor Relations.

Gabriella Nawi

Thank you. Good morning gentlemen and ladies and welcome to the Travelers discussion of our third quarter 2009 results. Hopefully all of you have seen our press release, financial supplement, and webcast presentation released earlier this morning. All of these materials can be found on our website at www.Travelers.com under the Investors section.

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

Before I turn it over to Jay, I'd like to draw your attention on Page 1 of the webcast. Our presentation today includes certain forward-looking information as defined in the Private Securities Litigation Reform Act of 1995. All statements, other than statements of historical facts, may be forward-looking statements. Specifically, our earnings guidance is forward-looking, and we may make other forward-looking statements about upcoming results of operation, financial [inaudible] and liquidity, sufficiency of the company's reserves, and other [inaudible].

The company cautions investors that any forward-looking statements involves risks and uncertainties and is not a guarantee of future performance. Actual results may be [inaudible] current expectations due to a variety of factors. These factors are described in our earnings press release and in our most recent 10-Q and 10-K filed with the SEC. We do not undertake any obligation to update forward-looking statements. Also in our remarks or responses to questions we may mention Travelers operating income which we use as a measure of profit and other measures that may be non-GAAP financial measures. Reconciliations are available on our recent earnings press release, financial supplement, and other materials that are available in the Investor section on our website.

Thank you and let me pass it to Jay Fishman.

Jay Fishman

Thank you, Gabi. Good morning, everyone and thank you for joining us today. We're pleased to be with you this morning reporting another strong quarter. In addition to posting operating income of $914 million and an operating return on equity in excess of 14%, based upon our confidence in our underlying operations, we've increased our regular quarterly dividend by 10% to $0.33 a share. We repurchased $1 billion of our own stock in the third quarter.

We raised our estimate for fourth quarter repurchases to $1.5 billion and our Board authorized an additional $6 billion for our share repurchase program. As these actions demonstrate, we continue to execute our strategy of generating solid current returns and returning excess capital to shareholders.

Since the middle of 2006 when we commenced our share buyback program, we've repurchased nearly $8 billion of our own shares at an overall average cost of $48.67. The $8 billion represents approximately 27% of the market capitalization of the company when we commenced the program. As we've indicated before, this is not tactical, but rather strategic. We continue to leverage our competitive advantages to execute successfully in the marketplace, generate top tier earnings, and return excess capital to our shareholders.

A lot of good things happened this quarter, evidenced by strong underwriting results as well as much improved investment performance. On the underwriting side, results continue to be quite solid and benefited from net favorable reserve development in excess of $200 million after tax, even after completing our annual asbestos review. In our ongoing businesses, loss costs remain quite benign, and the third quarter also benefited from a re-estimation of 2009 loss estimates to lower levels.

On the investment front, our long-term fixed income portfolio continued to produce consistent returns. On the short-term front, investment yields remain quite negligible, and this continues to impact investment income in our short-term investment pool which at the end of the quarter stood at $6.6 billion. The pool right now may be somewhat larger than it needs to be, and we will look at that carefully but, in any event, there's not much we can do about the low yields. We do view it as an income opportunity when short rates increased to more normal historical levels.

In the alternative investments' arena, hedge funds and private equity returned to levels more consistent with long term historical performance although our real estate investment income continued to be challenged by the current environment. Given all that's gone on over the past two years, we're quite pleased with our results.

From a revenue perspective, net written premiums declined 3% from the prior year quarter, primarily due to reduced exposures from existing customers, largely attributable to declining economic activity in recent quarters. A simple example of this is workers compensation, in that as unemployment rises and payrolls decline, premiums drop accordingly. Overall we have been successful in offsetting the impact on net written premiums on some of our exposure decline with renewal rate gains, solid retention, and new business.

In that regard, renewal rate gains were positive in each of our business segments and our strategy remains to seek rate where needed so that the pricing of our product reflects our long-term return expectations. Institutionally, however, as we have said all along, we remain cautious about the magnitude of future rate gains that are achievable given general economic conditions. Nonetheless, solid retention and new business levels continue to demonstrate our strong position in the market and we're going to continue to deal with this market one quarter at a time.

In response to a question last quarter, we had indicated that if rate gains remained on pace and loss trends remained generally the same, we believed we would be able to reach a point in business insurance by the end of this year where premiums on a written basis could be in an improving margin position.

In fact, the rate gains we did achieve in business insurance were down a little from the previous pace as you can see by the small change in the slope of the line on Page 8 of the webcast. As a consequence, we are not likely to achieve the margin crossover point by the end of this year.

It's been some time since we've spoken about cost efficiency but with a specific example, we want to demonstrate that we've not forgotten this important element of managing a business. We shared with you before the remarkable success we're having with Travelers Express, our new small commercial business platform. The platform is doing what we hoped it would do. Submissions are up, quotes are up, and new business is up year-over-year.

An important element of the program is the increased automation that it has brought to independent agents' desks, resulting in much faster turnaround times and much less human intervention. As a result of the success of the platform, we are now consolidating our small commercial underwriting centers from 36 to 12, allowing us to reduce the number of underwriters we need to staff those centers.

At the same time, we are increasing our select sales organization by nearly 50 individuals to make sure that our technology platform is front and center in our agents' offices. This will result in lower costs positioned against increased revenue and greater efficiency. We estimate that these changes will result in annual savings in excess of $9 million per year. While this is not on its own a blockbuster cost action, you should know that this is representative of the way we think about things day in and day out.

In closing, we feel very good about what we've been able to accomplish in this extended period of financial turmoil and marketplace disruption and we believe that our results over this period of time have been quite impressive. Furthermore, the results are a function of our culture, which consist of the best evaluators of risk and return in both our underwriting and investment operations that we possibly can be, no matter what the market conditions are.

So far, so good. With that, let me turn it over to Jay.

Jay Benet

Thanks, Jay. Turning to Page 4, while capital leverage and liquidity measures were once again at or better than target, withholding company liquidity at $2.6 billion were more than twice its target, this after $1 billion of share repurchases and

$166 million of common dividends in the quarter. Our book value per share of $51.24 increased 18% year-to-date with a little more than half of this increase coming from a very sizable change in net unrealized gains and losses which ended the quarter in a pretax gain position of $3.4 billion.

These net unrealized investment gains are the primary reason that our investment portfolio increased over $76 billion as of September 30. We also reported after tax net realized investment gains of $21 million in the quarter, including impairment of only $12 million after tax. The dollar amount of investments for which fair value was continuously less than 80% of amortized cost which was only $374 million at the end of the most recent quarter is now down to only $187 million at the end of the current quarter.

Since many investors and analysts are closely monitoring valuations of commercial real estate related investments, we've provided an update to our previous disclosures in the appendix to this webcast. Overall our investment portfolio continues to be very high quality and well diversified across industries, investment types, and individual issuers.

I'd also like to point out that while not a third quarter transaction, we did sell half of our Verisk holdings, formerly known as [Isell] in connection with their fourth quarter IPO, receiving gross proceeds of $184 million and producing $103 million after tax net realized gain. It will be included in our fourth quarter results.

Page 5 provides a comparative analysis of third quarter and year-to-date operating income and GAAP combined ratios. Net favorable prior year reserve development was $202 million after tax in the current quarter, comparable to the prior year quarter, while all three of our business segments once again experienced favorable development as a result of better-than-expected loss experience, most of the $202 million related to business insurance.

Within BI, reserve development included a $120 million after tax increase to asbestos reserve which was primarily driven by a slight increase in our assumption for projected defense costs related to many policyholders. Overall the company's assessment of the underlying asbestos environment did not change in any significant way from recent periods. An update to our asbestos reserve disclosures is also included as an appendix to this webcast presentation.

The current quarter also benefited from a significant reduction in cap losses which were down to $103 million after tax as compared to $682 million after tax in the third quarter of last year when Hurricanes Ike, Gustav, and Dolly made landfall in the US. Also impacting the current quarter was a $46 million after tax benefit from a re-estimation of current year loss ratios, mostly in BI due to better-than-expected frequency trends.

Our GAAP combined ratios, whether as reported or as adjusted, speak to why we remain quite pleased with the underlying profitability of our businesses. Net investment income of $616 million after tax is shown on Page 6 was $29 million higher than the prior year quarter. This is the first time we've seen quarter-over-quarter growth in NII in almost two years.

The long-term fixed income portfolio's after-tax yield was 3.7%, consistent with the prior year quarter, while the short-term portfolio yielded only 20 basis points, down from 170 basis points. The non-fixed income portfolio yielded 4.3%, much better than the negative returns we had been experiencing since the third quarter of last year.

The three major contributors to operating return on equity are shown on Page 7 of the webcast. Fixed income NII less interest on corporate debt, what we refer to as the passage of time component, contributed 8.2 points year-to-date, down slightly from recent periods, primarily due to lower short term interest rates.

Non fixed income NII, a much smaller contributor operating ROE, contributed a negative 0.6 points and underwriting income contributed 5 points. Consistent with the analysis we provided in the second quarter webcast, year-to-date ROE included a 180-point negative impact from non-fixed income and short-term yields. Year-to-date, the non-fixed income portfolio yielded a negative 3.1% after tax rather than a more normal level of positive 7% and the short-term rates averaged 30 basis points after tax rather than a more normal level of 2.5%.

Nonetheless, cumulatively from January of 2005, we produced an average annual operating ROE of approximately 14.2% consistent with our stated longer-term goal of mid-teens ROE.

Before turning the mike over to Brian, I'd like to say a few words about a subject that has become quite topical these days: inflation. We've heard a lot of speculation about the impact of inflation on P&C insurers. Particularly on reserve levels for long tail lines of business, such as workers' comp and liability. You should note that the nominal duration of our reserves for these lines may be less than you think; under 7 years for comp and under 6 years for liability.

You should also note that examining the impact of inflation on the entire company is a very complex exercise, one that we continue to study and refine. While economists seem to indicate that inflation risk is low in the short term, longer term outlooks for inflation remain mixed. So, we will continue to examine the potential impact of inflation on our company, along with action that should be considered.

Now, Brian is going to provide some further insights into our results for the quarter.

Brian W. MacLean

Jay Fishman gave a broad overview of our market and I will go through the segment's specific results and I will start with some comments on renewal rates across the company.

As Jay commented, the improvement in the renewal rate environment has been of particular importance and we are pleased that for the second consecutive quarter, all 3 business segments experienced positive rate change. You can see on slide 8 that although none of these shifts are dramatic in any 1 quarter, they are a sign of consistent improvement. This is particularly true in our commercial businesses, where we are at a very different point than we were 16 months ago.

Turning to the business insurance segment on Slide 9, operating earnings were up from last year, primarily driven by reduced CAT activity and other favorable loss experience in the current year. Adjusting for catastrophes and prior year developments, the year-to-date combined ratio was 94:5, or 60 basis points higher than last year. This modest margin compression is significantly better than anticipated and reflective of a number of factors, including better than expected pricing, better than expected loss trend primarily driven by frequency, and lower than normal non-CAT weather charges.

Net written premiums are down 5% compared to the prior year. This is a result of the economic contraction, which has led to a decrease in exposures. As our insurance payrolls receipts and general business activity goes down, so does our premiums. These impacts are consistent with our expectations and have been incorporated in our guidance. Given the environment, we are extremely pleased with our top line results.

Turning to the production statistics, on Slide 10, overall retentions remain strong with some modest decline in select accounts and modest improvement in commercial or middle market business. The select retention is being driven by our pricing action, which you can see in the 3% increase in renewal premium levels.

In commercial accounts and other business insurance, renewal premium changes were slightly negative, but underlying rate change was, again, positive, and higher compared to last quarter. You can see this in the next page, which takes the renewal premium change data and splits it into its two primary components: pure rate and exposure change.

Across all of business insurance, rate is continuing to improve, while exposure is declining. With loss costs at or better than expected levels, margins continue to remain attractive. New business results, shown on the next page are up 1% quarter over quarter.

In select accounts, we've been talking about a flat form rollout and that continues to drive significant new business in the small account side or small business part of this marketplace.

In the individually underwritten businesses, which include the upper end of select commercial accounts and other business insurance, we continue to feel great about the flow of new opportunity. But, in general, a little less bullish about market pricing.

We continue to be very pleased with our effective execution and position in the marketplace. Our ability to differentiate ourselves continues to demonstrate itself in our results. Our competitive advantages: breadth of product, industry leading metrics, point-of-sale capabilities, and leadership position with independent agents, has never mattered more. We have tremendous optimism about our opportunities and have strong controls and metrics to ensure we are executing appropriately.

Although we continue to see the impact of the economic downturn in many of our businesses, we remain very pleased with the results this quarter and are well-positioned for the future.

Moving to the financial professional and international insurance segments, Slide 13. Operating earnings were up, and the combined ratio was down, compared to the prior year quarter, due primarily to lower catastrophe losses and improved large loss experience. Across this segment, margins on a written basis are holding steady. In most of those products where current margins indicate that we need rate, we are getting it.

Net written premiums for the segment after adjusting for the impacted changes and foreign exchange rates, were down slightly in the quarter from the prior year, mainly due to fewer construction surety opportunities in the marketplace and disciplined underwriting in our professional liability book and business.

While we had growth in our Ireland and Lloyd businesses, we feel very good about the top-line story in the segment and let me turn to Slide 14 to go over some production statistics. Here you can see the reduction in surety premiums quarter over quarter, which is a result of decreased economic activity, particularly construction spending and underwriting. We remain a clear market leader in this business and in these more challenging economic times; this has helped us to maintain our excellent profit margins.

On the management liability side, the key dynamic continues to be the rate improvement inside renewal premium change. Renewal premium has increased to 3%, but pure rate change at plus 4. And we are particularly pleased about where we are able to get the rate. Rate is up 10% on the financial institutions book and 4% on the professional liability book.

We feel great about these rate improvements but given the return levels on these products in the general marketplace, the strengthening was needed. The tension is down quarter over quarter in the management liability business but the main driver here is disciplined underwriting to address meeting profitable targets. In our international business retention was down just slightly versus the prior year quarter again primarily a result of disciplined underwriting. Renewal change premium was positive with underlying rate improvement at 3%. New business is up double digits compared to the third quarter last year driven by continued strong growth and personal line product in Ireland. A critical component of this result is our ability to leverage the strength of our franchise and infuse talent and operational best practices from our U.S. personal insurance organization.

We continue to monitor the analysis on impact of the financial marketplace disruption on our management liability business which we've shared with you over the past couple of years and our conclusions remain the same. Our loss estimates continue to be within expectations and are incorporated in our current earnings guidance. Similar to business insurance overall, we're encouraged by our top line performance in loss costs are at or better than expectations. Particularly in light of the difficult economic conditions we remain very pleased with these results and believe we are in a great position as conditions improve.

Turning to Slide 15, in personal insurance both the auto and property businesses continue to demonstrate sound fundamentals and sustained earnings power. Operating earnings are up dramatically from the same quarter last year due to less major CAT activity, that is there were no Atlantic hurricanes. Agency net written premiums which exclude any premiums attributable to our recently announced direct consumer initiative are up 1% compared to the prior year. By line the auto premiums are down 3% due to lower policy growth and retention resulting from our pricing discipline and property premiums are up 5% compared to the prior year due to the continued to the strong price change and new business growth.

Looking at Slide 16, agency auto combined ratio of 97 was consistent with third quarter 2008 with underlying current year favorable frequency trend. Agency properties combined ratio of 89 was 8 points higher than third quarter 2008 when adjusted for cats. It's important to note that although there was no impact from hurricanes in the current year quarter the aggregate impact of other weather events multiple wind and hail events generated total losses that were normal for the quarter. Additionally, the loss trend within these events was up compared to the prior year due to year over year increases in cost of labor and materials associated with weather related losses.

Turning to Slide 17 we continue to be pleased with our agency auto production results, especially in light of current market conditions. While policies enforce are down retention is essentially flat compared to third quarter 2008 with improved renewal premium change. New business volume has flattened out following 4 quarters of successive declines. Property production results remain strong across all of the metrics. We remain pleased with our ability to increase new business volumes while maintaining our margin advantage despite challenging market conditions.

So an interesting quarter, one could ask why we continue to feel great about our results and prospects going forward when general economic conditions remain difficult and the marketplace disruption which negatively impacted some of our major competitors has lessened. Well look at our results, our top line is down marginally but fundamentally due to contraction in the economy, and we believe we are still growing share. Our retentions remain strong. We continue to see rate improvement in all the business segments and our margins are well within target. These are the same general trends we've been seeing over the past several years and we believe these results are less about near term economic or insurance market place conditions and more about the capabilities and advantages we've been building for years. It's clear to us that customers continue to be concerned with the quality and financial stability of their insurance provider our competitive advantages matter and fundamentally that's what's driving our strong results and bullish attitude.

With that let me turn it back to Jay Benet.

Jay Benet

Thanks Brian. Given our third quarter performance and its implications for the remainder of the year we're increasing our guidance for fully diluted operating income per share for full year 2009 to a range $5.30 to $5.50 compared to our previously announced range of $4.80 to $5.05. As indicated on page 18 our guidance assumes fourth quarter cap losses of $83 million after tax or $0.15 per diluted share. No additional prior year reserve developments, either favorable or unfavorable. No significant changes in short term interest rates from their extremely low current levels. No significant change in private equity and hedge fund valuations for the remainder of the year as we are assuming unchanged capital market conditions. Lower real estate partnership valuations due to continuing downward trend in commercial real estate values. Fourth quarter share purchases of a $1.5 billion bringing the total assumed for the year to $3.3 billion of share purchases. No significant change in average invested assets, ex unrealized gains and losses, and finally weighted average diluted share count of approximately 570 million.

With that let me turn it back to Jay.

Jay Fishman

Jay, thank you. Before we open it up to questions let me just attempt to preempt one. That is we have no investment in the Gallient Funds, and we have no insurance exposure to the Gallient Funds and hopefully that will address a question that a number of you would ask.
With that operator, we will open it up.

Question and Answer

Operator

[Operator Instructions] Our first question comes from the line of Jay Gelb - Barclays Capital.

Jay Gelb

My first question is on capital management with the additional $6 billion in share repurchase authorization would Travelers anticipate completing that full authorization in 2010 given the current run rate of share buy backs?

Jay Fishman

We're reluctant Jay to make predictions of cash flow or capital needs. The world is volatile, storms come and go. The only observation that I'd make is that we repurchased $8 billion over a 3-year period. We started the program in the middle of '06 we're obviously middle of '09 and that included at least 1 bad year in the catastrophe arena. So we're just going to keep doing what we've been doing which is to produce our earnings measuring our excess capital and returning it and it will go as long as it needs to go and when we're done if things are looking good, we'll reauthorize some more.

Jay Gelb

I'll come at it another way. Is there an upper boundary that Travelers is comfortable with in terms of debt to capital ratio if its 20% currently?

Jay Fishman

The range that we operate our debt to capital ratio in is we talked about before is a 15% to 25% range. That's a little more complicated than that because each one of the rating agencies has their own real formula, but the proxy for all of them is about 20%. I'm sorry 15% to 25% and we've selected to be in the middle of the range, but we could certainly be comfortable higher but at this point we're at the 20 and that's where we've been for a while.

Jay Benet

Yes, but Jay I wouldn't anticipate us raising our debt to capital ratios for the purpose of buying back shares. We are at a level from an operating perspective that we're quite comfortable with and that additional debt capacity I think is the way the prudent and thoughtful financial companies manage themselves. So the answer is we would not leverage up the company that extra 5 points which would take to the edge of the rating range for the purpose of repurchasing shares.

Jay Gelb

That's helpful and then more broadly, could you talk about to what extent we might see some recovery in premium volume as the economy recovers. I guess what I'm getting at is, is insurance buying trends more of a midcycle or even late cycle reflection within a recovering economy?

Jay Benet

Well I'm not sure, I mean we are very driven by payroll numbers obviously and business receipts and so I haven't really thought about that one very much Jay and I'd like to think about it some more. My immediate reaction to is that we're more lagger than a leader but again it's not something I've thought about a great deal. I don't think we have and want to think about it some more. A number of these things will initially show up in audit premium in ordered adjustments so a company will make an estimate of their payroll or their receipts at the beginning of the policy period and in the event that you end up with meaningfully different economic activity and in fact payrolls changed you can end up with an adjusted reflecting additional premium down the road. Again, my guess would be more of a follower than a leader, but we should think about that some more.

Operator

[Operator Instructions] Your next question comes from Michael Nannizzi - Oppenheimer & Co.

Michael Nannizzi

Could you explain the re-estimation of loss estimates on the 2009 business segment? What I'm basically trying to figure out here is if the re-estimation was frequency driven, was it related to the short, tailed lines mostly written at the beginning of the year that you assume will mature before next hurricane season or was it something else?

Jay Fishman

I'll answer it by first attempting to say how we go about doing this whole thing. We start the year with an estimate of what we think our loss ratios are going to be relative to the premiums we're going to write for each one of our lines of business and as the year progresses, we evaluate information, whether it's frequency statistics, severity statistics, or pricing and everything else that goes into what comprises a loss ratio and evaluate whether we should be moving off of what we refer to as the initial loss [fic]. As the year progressed, we did see frequency trends in several different areas were much lower than we had expected them to be and we adjusted the loss [fic] accordingly and what happens when you adjust the loss [fic] in the third quarter, you start evaluating is it relating exclusivity to activity that's taking place in the third quarter or is this information that's telling you that you need it to look back to the first and second quarter and effectively have a catch up adjustment, so for the purposes of transparency, recognizing these changes in estimate are recurring elements of our business and everybody else's business. We just want to make sure that we provide you with that information and you see that historically we provide very granular information about prior year development and this is a similar thing, but it deals with prior quarters of the current year.

Brian W. MacLean

Mike, this is Brian. It is looking at frequency trends that have emerged over the year but not just on the short tail stuff. Comp was a decent part of this process too, so its frequency driven by more across all the lines of business.

Michael Nannizzi

I guess the comment in the opening about inflation and talking about longer duration lines, I just wanted to understand how you're reconciling your outlook on inflation with these longer tailed lines if maybe severity is going to potentially be a driver in those longer tailed lines.

Jay Fishman

To back up for a second, I'm not sure that we actually have an outlook on inflation meaning that's substantively process wise different from anything that we've ever done, meaning we always make estimations of loss costs over the lifetime of a block of businesses that are being written, so we think about comp pays and we think about general liability pays this year, we think about it last year, we think about it 10 years ago, and we're always making estimations of what future claim costs will be and we haven't changed anything in particular relative to a different focus on inflation than we have before. I just want to make sure that we're clear on this.

We haven't changed anything other than to begin to recognize that you all seem to have an interest in talking about inflation and the point that Jay made which I think is actually quite consistent with Brian's comments is that the duration of even our long tail liabilities is shorter than most people tend to think, meaning that there is a significant amount of cash disbursement claim payment that takes place in the very early part of the cycle, the tail of the payment cycle. The tail may be quite long, but significant amounts of the payments are done early and so it's not difficult to get an early read of both frequency and severity even in long tail lines. I hope that's clear. If it's not let me know, we'll try it another way.

Operator

(Operator Instructions) Your next question comes from Paul Newsome - Sandler O'Neill & Partners L.P.

Paul Newsome

I was hoping you could touch on the asbestos charge and the comment that it came from increased defense costs. I'm specifically wondering if that is something that we should be looking at beyond asbestos and I have had a couple of companies that have mentioned something along those lines.

Jay Benet

Paul, this is Jay. The way we evaluate asbestos reserves has many different components. Historically you've heard us talk about settling large cases, getting them off the books through final settlement, and that process was something that was very big in recent years and has tailed off as we've really gotten away from having these large exposures. So what we're really left with we refer to more as a frequency book if you will.

What we try to describe in the disclosures and hopefully it came across is we're making projections. Those projections are going out over time. If you think about a graph with a sloping line of costs and claims and things of that sort, we're periodically re-evaluating what the slope of that line is. We're not seeing any major change in the environment, but what we are seeing is a little higher amount of defense costs on policy holders and our projections over the many years that relate to asbestos, we have to take that into account, it's not related to any one policy holder or any handful of policy holders. It's spread out over a big base. So when you apply the base and the increment, we get essentially what you're seeing here.

Jay Fishman

I'm looking at Doreen to see in fact - I haven't heard anything about a perception of increased defense costs around the organization in the rest of our claims. Is there anything that you're aware of, Doreen?

Doreen Spadorcia

No. Good morning everybody. Apart from asbestos and what Jay Benet just said, we actually don't see any increase in defense costs, and I'll give you a couple of different categories that we watch. We watch the ratio between [inaudible] losses and claims and see whether we're seeing more of those or less of those, so we watch that ratio.

The other thing we look at is how many of the cases we can have our staff counsel defend which our in-house lawyers that are licensed around the country and those typically drive a different cost structure as well, and we've improved the penetration of those cases going to staff counsel, so we actually don't see that trend at all and see it probably a little bit of the other way.

Paul Newsome

That's great. And separately, could you maybe comment on some of the excess surplus lines business a lot of your competitors are commenting that companies like Travelers, the big standard carriers, are increasingly entering the excess and surplus lines which I guess would suggest a loosening of terms and conditions and whether or not that's really the case, obviously whatever your thoughts are on that would be great.

John J. Albano

The answer is no. We're not seeing indications of terms and conditioning loosening, we're really not. Nor are we, that I'm aware of in any way, actively engaging in broadening out our profile in the excess and surplus business in any way differently than we had before. I don't know if you heard that anecdotally from other carriers, but we can tell you from what we're doing, it's not so.

Paul Newsome

It's a question and the excess and surplus guys are complaining about that. It's tough to tell exactly where it's coming from.

Operator

(Operator Instructions) Your next question comes from Matthew Heimermann - JPMorgan.

Matthew Heimermann

First question I guess would be could you guys quantify the exposure you have to either contractors, installers of drywall, in the southeast? I don't know whether that's premiums, limits, or even claims notices today, if any?

Jay Fishman

I guess I'll come at it a couple of different ways. As far as residential contractors in particular, we're certainly not a big player in the liability lines for residential contractors. If your question specifically is regarding the Chinese drywall situation, we talked about that a little bit on the last call and my recollection is that most of it is going back to what was it, do you remember the dates, Doreen?

Doreen Spadorcia

Good morning again. We did speak about this. I think it was in response to a question that John answered. There really hasn't been material change to what we spoke about last quarter. We do have some claims but it's a very low volume of claims for Chinese drywall.

And just as a reminder, I think John already mentioned we do not have a significant book of business with residential contractors or foreign manufacturers. And those are really the two primary targets. There's been about 700 lawsuits filed around the country. And we have really a very small number of insureds that have been brought into that and they are primarily either importers or property managers, things of that sort.

And it's basically - it's like an '06 issue. There's been a lot of restrictions from the consumer protection federal organization since '08. And most of the exposure as we see it when the reports are published like about 60% of the assumptions are in Florida homes. So you start kind of whittling down the time period where the materials were used and who the targets are of the litigations. And really what we're seeing is pretty much what we expected we would see given our book of business.

Matthew Heimermann

And Doreen, and if you're not comfortable because we're doing this very real time, just when you look at the accounts that have had some claim activity, what would you guesstimate the average annual general liability limit to be? I'm not presuming that the [polishes] will respond. But a very natural question is what level of limits could be exposed to those sorts of claims?

Doreen Spadorcia

They're very consistent with our usual limits, $1 million to $2 million. And the other thing I'd say is there are several home owner claims, but even that they're very, very small numbers. And generally first party contracts do not cover the kind of exposures as well.

Jay Fishman

But we'll always look at every individual claim as we always do. We make no general policy statements. We treat each claim individually as it comes in and we make determinations. So don't read this into a determination of claim handling activity. This is just early insight in information that we have to the issue you're raising.

Doreen Spadorcia

Exactly. And if any changes occur in prior quarters, we'll of course update the information.

Matthew Heimermann

I guess one follow-up with respect to this question is does most of your, with the exposure that you have to contractors be primarily admitted or non-admitted paper?

Jay Fishman

Most of it would be admitted.

Matthew Heimermann

If I can speak…

Jay Benet

Let me come back for a second because it's important. And typically when we're asked questions we answer with data. This is just so early that it's difficult to do that. But if you go back to a matter of underwriting orientation, the kinds of accounts that over a long period of time we've written versus what we've not written is as you've described it. Residential contractors have not been in that segment of the business that we have had a significant orientation to. It's really been, and I'm doing this to some extent by memory and anecdotally, but it is largely by exception rather than as a class of business that we sought to write.

Jay Fishman

That's correct. And it's really based on some of the concerns that we had in prior years regarding construction defect issues. And so we're not a big player in that market place.

Doreen Spadorcia

And our claims to date are not generally out of the construction book.

Jay Fishman

That's an important element as well. So more to follow on this and as we have data, we think it can be - again, we will attempt to answer this quantitatively to the extent that it arises as an issue and the extent we can we will try to.

Matthew Heimermann

One quick one just on the professional liability book, you made comments in the press release and on the call but how is your posture appetite changing within that market?

Jay Fishman

Well, we certainly have an appetite for the market but we're just finding that mainly because of capacity in the marketplace it's just hard to get rate to offset the trend. So we're really going to focus on profitability and get rate where we can and avoid the exposures where we can.

Matthew Heimermann

I guess, I was just curious if there were any classes or industry categories in particular that you're feeling more or less optimistic about.

Jay Fishman

There's definitely some variability among the classes of business but I'd say overall it's a pretty consistent story.

Operator

Your next question comes from the line Jay Cohen - Bank of America.

Jay Cohen

A couple questions - first is on the Verisk transaction you talked about your expected realized gain. Is there also an unrealized gain for the portion that you haven't sold? Does that get marked up as well?

Jay Fishman

Yes, that's exactly right, Jay. In fact, as of 9/30, within the unrealized gain that I mentioned before $3.4 billion, there is an unrealized gain associated with Verisk. And what happens is in the early part of October with the sale we will adjust the unrealized gains accordingly as the markets shows us what the value of Versik is going forward. And to the piece that we sold we gave you the information as to what the realized gain is going to be.

Jay Cohen

And then separately, claims frequency, that continues to be a very positive part of the industry and certainly your story. Do you have any better insights into why we're seeing this continued favorable frequency, and do you believe part of it relates to the weak economy?

Brian W. MacLean

Jay, this is Brian. I mean, and start with broadly, yes, we have insights, but we also will readily admit that those insights are far from perfect. So we're constantly trying to figure out as best we can why. Comp frequency, the industry data out there and ours is similar to it. It's very, very favorable. Probably some of that is the economy but probably not exclusively.

Auto frequency to us continues to look like all of the economics statistics would lead you to think which is as miles driven goes up then frequency should go up a little, etc. But so those all seem to be in line. But we absolutely don't have perfect insight into why. We have been looking at an extended period of positive for the industry, as in good, frequency trends and we just keep looking at it.

Jay Fishman

And it's predominantly I would say speculation on our part because we can't. There's no way to really prove this. We speculate that part of the comp story is embedded in the economy moving increasingly away from the manufacturing base and increasingly to a service and office space. Those are just things that you, that seem somewhat obvious. But there are so many lines that have been the beneficiary of decreasing frequency.

It does seem to be systemic and behavioral. That doesn't mean absolute and comprehensive. That just means that it's a phenomena that is occurring. And all we have, I think, is informed insight rather than a real substantive understanding of why. But there is certainly a behavioral dynamic to it that's been suspended.

Brian W. MacLean

But with that said, we've been seeing frequency, positive frequency for quite a while. Have the latest economic conditions made that a little more positive? Yes.

Jay Fishman

Positive meaning good.

Brian W. MacLean

Good, again, good. But we don't think it's just the economic factors. There's a lot of other things going on.

Operator

Your next question comes from the line of Mark Dwell - RBC Capital Markets.

Mark Dwell

Most of my questions have been answered, but one question just in terms of where you're seeing, you're getting your rate increases. Are you able to differentiate in terms of whether you're seeing that more on property-oriented risks or casualty-oriented risks? Or is there really no difference?

Jay Fishman

Well, first, we absolutely have the ability to see it in a remarkably granular way, not only down to the individual line of business, the individual account and if you want to aggregate it, the individual office. So we have terrific visibility into it.

I think going more granular, providing insight and information that is more granular to all of you is disclosure that goes beyond thoughtful competitive positioning. You're talking about our pricing strategy in the market. We're trying to give you some guide post direction about what's happening but really don't think it's in our shareholders' best interest to be more granular about that disclosure.

Operator

Your next question comes from the line of Vinay Misquith - Credit Suisse.

Vinay Misquith

The first question was in capital. I was curious about how much of excess capital you estimate you would have by year end '09 after your $1.5 billion dollar share repurchase?

Jay Fishman

Everybody is looking at me. I'm not sure that we project out and disclose what our excess capital is. What we really do is try to describe a philosophy. And the philosophy has been to start with the operating company capital levels and make sure that relative to the targets we set that those operating companies are at or above target and the profitability of the company that you are seeing in the third quarter and year-to-date is providing capital in those companies that are at or above the target levels. We then look at, as we talked about earlier, taking out of the operating companies what we don't need, bringing it up to the holding company and having a debt-to-capital ratio that is targeted at the 20%. And then managing our holding company cash to have $1.1 billion of holding company cash, which represents a year's worth of interest and dividends. And, as you can see, at the end of the third quarter, we are sitting there with, I think, is about $2.6 billion dollars of holding company cash.

So at a minimum, you can look at third quarter, and say, "Well, at the holding company cash level relative to the target, we've got an extra $1.5 billion." We've already talked about having a $1.5 billion share repurchases in the fourth quarter, but then, all the dynamics are going to keep working within the company in the terms of profitability and whatever.

I think that's the best answer I can give you, but overall, you go back to the statement we made that the company remains well capitalized in a great liquidity position and we like where we are, and we like the ability to return the excess to the shareholders.

Vinay Misquith

What I was trying to get at was for next year, would you be able to repurchase more stock than your operating earnings? I guess that was my real question.

Jay Fishman

As Jay said before, we are not projecting out what, exactly, we are going to do. We will think about that as part of any kind of guidance discussion we have for next year. But I would say it's premature at this point in time.

Vinay Misquith

Fair enough. The second question was on the investment portfolio, you had a secure and better [inaudible] portfolio than what appears. Are you now willing to take on more risk now that the market has stabilized?

Jay Fishman

We've said, in the past, that, and I'll describe it as on the margin, that we were certainly willing, if we were being appropriately compensated, to take on what you describe as greater risk/greater volatility portfolio. But, fundamentally, it would be on the margin. It wouldn't be a substantive shift in the strategy of the company. I give enormous credit to Dave Roland, to Damien, and to Bill Hannon, in that there is never an issue. Our investment organization is there to make us an effective insurance company, not the other way around. And so our goal is to take only that level of risk that we need to, to be a successful insurance company. But, even at that, to be paid to take that risk appropriately.

At the point in time we often ask about alternative investments, the fact is that what we consider the quality names in that space, continue to have a capital capacity themselves, uncalled facilities they are still working on. So the fundraising that has been going on in both the hedge fund and private equity areas has actually been quite minimal. And so the opportunity to actually commit additional dollars to the alternative investments, even if we thought we were getting appropriately paid for that, right now just isn't there. They are not in the fundraising business.

Another point, which we watch periodically, you actually take a look at spread between, say broadly, between BBB and AAA. What you'll actually find right now is that they have tightened considerably. And, from some stuff I was just looking at this morning, you've got BBB spreads actually down to about 118 basis points over AAA; coming off of a position of almost 200 basis points as little as 6 to 8 weeks ago.

I know Bill is chomping at the bit, and Bill, I will give you the opportunity. But that is just not for us at the moment. Go ahead, Bill.

Bill Hannon

I wouldn't add much to that, actually. We think in the last 3 or 4 months, risk is once again priced pretty tight. We committed a fair amount to credit in the latter part of last year and that's worked out. But, right now, we are in a pretty conservative mode, and, if anything, we are increasing the credit quality in the portfolio. We have sold marginal names in the last 6 weeks.

Jay Fishman

And, in fact, on the margin again, shortened the portfolio a little over the last, what Bill, 3 or 4 months?

Bill Hannon

Yes. Duration has come down from the last quarter. Counting the short term, it's probably at about 3.7, which is historically low for us and about where we like it to be.

Operator

Your next question comes from the line of Brian Meredith - UBS.

Brian Meredith

Good morning everybody. A couple quick questions for you. First one, on the surety business; you talk about premiums down because of, obviously, construction activity declining, but what do you think that means for potential increase in loss activity over the next 10 to 12 months and are you reserving for any expectations of increased loss activity in that line?

Alan D. Schnitzer

The margins on those businesses continue to perform very well and we manage that book and we have managed that book going back several years very carefully. So from a historical perspective, our view of the credit scoring of those businesses is actually at a near all-time high. We feel, right now, it could deteriorate, we'll see where that goes. But, from a historical perspective our credit outlook is very good. We certainly consider that, and we take it into account as we price in reserve.

Brian W. MacLean

This is Brian. I mean, we've talked about this in the past, but our surety business, we are more involved with the ongoing operations of our accounts than in any other line of business and we understand your question and appreciate that in segments of the industry there could be concerns as contractors start to stretch and bid on jobs that they maybe normally wouldn't do. We are really confident that that is not happening in our book and --

Jay Fishman

And to show you, actually, the level of attention it's getting, because Alan started, Brian answered, and I'll chime in a little bit too, here. What people often forget, particularly in a large construction surety business, is that we are dealing with partially collateralized obligations. Meaning, we have an obligation to finish a project, we have an obligation to finish a project that the contractor defaults, but we step in to the remainder of the proceeds that are obligated to the project from the owner. Which, in many cases, are governmental, state authorities, and things of that nature.

And so to Brian's point, the real core issue, the real core underwriting issue is: How good is the bidding? How aggressive has it become? And we are pretty good at being involved in the bidding process of our primary accounts. And then, being on-scene and on-site to make sure that the project doesn't get upside down; to make sure that the payments are being made consistent with the project flow; the work is being done appropriately, because our risk stands in if it gets out of kilter if the remainder of the proceeds can't provide enough to finish the project. And so it is often misunderstood in the analytical community that somehow, we have this enormous, uncollateralized exposure if someone defaults. That's just not how the business really works.

Jay Benet

For most of our surety clients, we understand their businesses and their exposures as well as they do. So we're intimately involved.

Brian Meredith

Great. Next question, can you give us your view on what you think the M&A environment is going to look like for the P&C industry for the next 12 months, and how does Travelers fit into that?

Jay Fishman

You probably have as good an insight into that as I do. Obviously, with the government stepping in, in the last 12 months, the way they have done. They have taken what would, I think, have otherwise been a more robust merger and acquisition environment and created lifelines for a number of companies to continue to do business. So again, I'll come back to this. Our focus is just given what we've been able to do and how well we are performing, our focus continues to be what we can do internally. And we're just going to keep doing this, and that doesn't mean, as I say all the time, that we don't look at things and we're not thoughtful about it.

But we're probably the best acquirer in the business. We're certainly the most experienced. And so our view is that we have the skills to be able to do it if opportunities emerge. But on the other hand we also understand that the risk involved in those things is significant and we're always going to measure that risk against its potential return. But I don't know. It's just such a remarkable, unique, one and only environment. I'm just - obviously none of us have seen anything like this so it's very difficult to really understand what the next couple years looks like.

Operator

Your next question comes from the line of Ian Gutterman - Adage Capital.

Ian Gutterman

Wanted to follow up on the retention and select accounts. I understand what you're saying that you've pushed pricing there. But pricing is up in really most of your lines and they're not seeing the same retention impact. So I'm wondering if there's a reason it's making more of a difference in Select.

And to be honest, my guess is I would have thought it would have been better in Select just because you have more overlap there with Hartford and I would have thought with their troubles you would have had a lot of nervous agents approach you for book rolls and things like that that would have helped your retention in select. So can you discuss a little bit more why select had more of a retention [inaudible] than the other lines?

Jay Fishman

And there are really two separate issues to be discussed. The first is in Select Express the important element there is that the advent of that platform broadened out our underwriting orientation significantly. I don't have the statistics at hand but before we had selected express the concentration of our business and what we referred to internally as the BOBS, businesses, offices, building, and stores was significant. And Travelers Express broadened that out by a fair amount.

And as a consequence we ended up much as we did in [Quantum]. And I do think of this as a [Quantum] like program. It's a [multivaried] program that's being applied in areas where our own expertise isn't - our own experience, expertise, good experience, not deep or unexperienced in deep. What we're seeing now is the beginning of loss patterns. And so we are getting a whole lot smarter very quickly about in some of these classes where we need price and where we can have price accommodation.

And so what you're seeing on the small commercial business is a price-driven behavior based upon underlying data that we now see and can make thoughtful pricing decisions about and the impact that that's having on some renewable accounts in the marketplace. And that's to be expected. There isn't anything that's going on here that one wouldn't anticipate in the roll out of a new multivaried product that expands underwriting appetite orientation beyond historical patterns.

So we're expecting it and for those who would ask if that's showing up. I would say predominantly that phenomenon is showing up predominantly in commercial multi-peril in our Select Express business and nothing that we wouldn't have anticipated.

The other piece of it is in the non - Select actually has two elements. There's the extraordinary flow business that flows into Express, very small accounts, not much touch. And then there's a larger end of small accounts that actually that we refer to as plus. And that business does require more of a union touch.

The plus business we find ourselves and always have competing more with regional carriers, local and regional carriers who actually perceive that plus business as the equivalent of their middle market. And as the market has heated up a little bit, we've seen some additional price competitiveness in the plus accounts. And as we do everywhere else, we kind of draw the line and we decide where we're going to respond and where we're not. And so the answer, Ian, is in those two elements. One being in Select Express as we drive our pricing strategy to more accurately reflect the pricing experience and one being in plus that perhaps, I'm speculating here, but it's perhaps indicative of a little more aggressive competition in that kind of regional market and middle market business.

Jay Benet

That's absolutely correct. I guess the only other thing I would add is that while you'll see on Slide 10 the retention in Select moving down by one point, you also see the renewal premium change going up by two points, which is in fact driven in large measure by the pricing dynamic that's going on in the [inaudible] arena. So you can see both sides of the issue right there.

Ian Gutterman

I guess I'm just looking year-over-year it's down from 82 to 79. Do you feel like we're towards, we're mostly through those two impacts? Or are we maybe in the middle and maybe it can tick down towards the mid-70s before it bottoms out?

Jay Fishman

I'd be reluctant to forecast what the retention would be going forward.

Ian Gutterman

I guess I meant specifically the impact of the Express reunderwriting. Is that process mostly through?

Jay Fishman

I wouldn't refer to that as reunderwriting. It is clearly not reunderwriting. Actually it is much more about the same thing we do in every one of our businesses which is we get data, we incorporate it into our pricing strategy, we make pricing decisions. We do that every day. The only thing that's a bit different about Select Express, our classes of business that before the introduction of the product we didn't have the kind of in-depth cost, loss experience, costing experience that we have in other lines.

I don't know. I'd be speculating. We should get the answer and get back. We can have a view on that. It's now impossible. I just haven't thought about that and haven't spoken with Mark or anyone else to have a perspective.

Ian Gutterman

Just the last part, the Hartford part, you haven't seen the ability or nervous agents asking you to take more business in select because of that?

Jay Benet

I would say broadly. We've talked in the past about how we track wins, losses and how we're doing against our major competition and that is still a very, very positive picture for us. So we're seeing that activity with numerous names and continue to see it. I'd say as the economy has gotten a little less anxiety than it had three to six months ago there's probably a little less anxiety in our marketplace. But there's still a pretty strong concern with wanting to be with really solid carriers and worrying about the alternative.

Jay Fishman

The slides that we showed at investor day in terms of us being in a net gain position with really all of our major competitors…

Alan D. Schnitzer

This is Alan Schnitzer. I want to clarify a response to the question. It was a question about professional liability. And I just want to clarify that the disclosure in my response was related to a specific book of business within management liability. I wouldn't want to leave anybody with the impression that my comments related to the larger management liability business, for example, the private non-profit business, which is our largest book of business and the management liability business overall it's a much different, much more favorable profitability dynamic. So my comments were narrowly related to the professional liability book.

Gabriella Nawi

Operator?

Operator

Yes, ma'am? I'm sorry.

Gabriella Nawi

Last question from Larry Greenberg.

Operator

Mr. Greenberg, your line is open.

Larry Greenberg

I know it's still very early in the initiative, but can you share with us anything new, surprises relative to expectations in the direct-to-consumer initiative? And then secondly, it's been a little while now since the management change in personal lines and small commercial. Has there been any change in strategy or structure to that operation post that change?

Jay Fishman

Why don't I take the first and you take the second? There's nothing new to report on our director consumer initiative. We are clearly in the earliest of early days. It is an R&D program. As we promised, we continue to lose money on the program. That we're being successful in that regard. As reflected obviously in the package that you have, the long-term venture we've… Anne MacDonald is our new Chief Marketing Officer who is sitting at the end of the table and I'm now just more convinced that we're developing real insights, real perspectives on getting smarter. But there's nothing new in the initiative to report.

Jay Benet

And on the management changes the short answer is that we're still moving along in the same direction as we were before. Greg Toczydlowski has been in PI and was managing a lot of those operations [technical difficulty] insurance group and so strategically, no, we're just as we always have, we're constantly tweaking things and looking to improve what we do, but no, there hasn't been any fundamental shift in strategy.

Operator

There are no more questions at this time, so I'd like to turn the call back over to Ms. Nawi for closing remarks.

Gabriella Nawi

Thank you all for joining today and if you have any additional questions, please contact either myself or Andy Hersom in Investor Relations. Thanks again and have a good day.