S&P Capital IQ

CONTENTS

Arch Capital Group Ltd. NasdaqGS:ACGL

FQ1 2009 Earnings Call Transcripts

Wednesday, April 29, 2009 3:00 PM GMT

S&P Capital IQ Estimates

	-FQ1 2009-			-FQ2 2009-	-FY 2009-	-FY 2010-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.86	0.90	▲4.65	0.83	3.15	3.23
Revenue (mm)	805.27	822.86	▲2.18	693.93	2903.94	3033.92

Currency: USD

Consensus as of Apr-29-2009 3:51 PM GMT

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	- EPS NORMALIZED -		
	CONSENSUS	ACTUAL	SURPRISE
FQ1 2008	0.89	0.93	▲4.49 %
FQ2 2008	0.87	0.94	▲8.05 %
FQ3 2008	0.20	0.34	▲70.00 %
FQ4 2008	0.36	0.48	▲33.33 %

Call Participants

EXECUTIVES

Constantine P. Iordanou
Chairman and Chief Executive Officer

John C. R. Hele
Former Chief Financial Officer, Principal Accounting Officer, Executive Vice President and Treasurer

ANALYSTS

Jay H. Gelb
Barclays PLC, Research Division

Joshua David Shanker
Citigroup Inc, Research Division

Matthew G. Heimermann
JP Morgan Chase & Co, Research Division

Michael George Paisan
Stifel, Nicolaus & Company, Incorporated, Research Division

Vinay Gerard Misquith
Crédit Suisse AG, Research Division

Presentation

Operator

Good day, ladies and gentlemen and welcome to the First Quarter 2009 Arch Capital Group Earnings Conference Call. My name is Francine [ph] and I will be your coordinator for today. [Operator Instructions]

Before the company gets started with this update, management wants to first remind everyone that certain statements in today's press release and discussed on this call may constitute forward-looking statements under the Federal Securities Laws. These statements are based upon management's current assessments and assumptions and are subject to a number of risks and uncertainties. Consequently, actual results may differ materially from those expressed or implied. For more information on the risks and other factors that may affect future performance, investors should review periodic reports that are filed by the company with the SEC from time to time.

Additionally, certain statements contained in the call that are not based on historical facts are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. The company intends forward-looking statements in the call to be subject to the Safe Harbor created thereby. Management will also make reference to some non-GAAP measures or financial performance. The reconciliation to GAAP and definition of operating income can be found in the company's current report on Form 8-K furnished to the SEC yesterday, which contains the company's earnings press release, and is available on the company's website.

I would now like to turn the presentation over to your host for today's call, Mr. Dinos Iordanou and Mr. John Hele, please proceed.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Thank you, Francine [ph]. Good morning, everyone and thank you for joining us today. I'm very happy to first welcome and then introduce John Hele, who joined Arch on April 1 as Executive Vice President and Chief Financial Officer. This is his first call with all of you. Some of you know him from his prior engagements and he's looking forward to talking to you in the quarters ahead. We are really delighted he has joined our group and I'm looking forward in working with him for many years to come. However, I have to admit that with the leaders of both our insurance and reinsurance business being actuaries, and now with our new CFO being also an actuary, I'm starting to develop a complex. So I talked to my wife and she suggested that I should start taking some of the exams towards getting an accreditation to the actuarial society. She mentioned that I was pretty good in math when I was in college. But then I looked at my age and I figure I'm too old for that.

Now on a more serious note, after a challenging 2008, it is really gratifying to start '09 with a good quarter and an improving insurance marketplace. On an operating basis, we had a good quarter from both an underwriting perspective and also an investment perspective. A combined ratio of 86.7 was satisfactory in the current environment aided by light cat activity. Our total return on the investment portfolio was 123 basis points for the quarter in local currencies and 109 basis points after factoring in the FX movements.

We continue to be cautious in our investment's strategy as we believe that government responses and stimulus packages across the globe will eventually create significant inflationary pressures. We also remain cautious of the affects of the global recession on creditworthiness. As a result, we have shortened the duration of the portfolio to approximately three years and continue to be very conservative on the credit quality of new money invested. John will give you more details on our investment portfolio and performance in a few moments.

Our annualized return on common equity was 21.1% and our book value per share grew by $3.25 to $54.61, a 6.3% increase from the end of the fourth quarter of '08. Our cash flow from operations continues to be very strong at $295 million for the quarter. Now let me comment a bit on the performance of our operating units. Our gross written premium and net written premiums for the quarter were essentially flat at a billion and 25 and 823 million respectively. Our insurance group experienced growth of approximately 2% on gross and 10% on net. The increase in the net writings was attributable to the change in mix of business and adjustments to the structures of certain reinsurance placements.

Our reinsurance group, gross written premium were down 10%, and while their net volume was down only 7%. The reduction in both gross and net return was attributable to the movement of the January 1 contract to December 31, 2008, which we discussed in our last call on the fourth quarter call as well as to the non-renewal to unattractive rate environment of their substandard auto treaty we had on the books for the past six years. The environment for our reinsurance business was actually better than we had anticipated, with opportunities to grow in quite a few segments. Although, this is not obvious from our reported numbers because of the two issues that I have mentioned just a minute ago.

The pricing environment continues to improve in the reinsurance sector and became more stable in the insurance sector. In the quarter, our reinsurance operations continued to decrease their exposure to casualty and nonstandard order. Let me remind you that in our reinsurance group financials, we include all of the D&O in professional lines in the casualty sector. Conversely, our volume in property, property cat in marine is growing. This growth is coming from both a treaty and our faculty books of business. Our outlook with regard to price levels, profitability and growth continues to be positive for those lines of business.

Our insurance group recorded growth in E&S property, the program business, executive assurance and national accounts. The property and D&O growth is primarily rate related, while programs and national accounts business is growing because of new opportunities. The increase in program volume is due to the new programs bound in early 2008 and are now coming online and building momentum in the marketplace. The increase in national accounts premium primarily is from the movement of business from carriers having financial difficulties. We continue to be cautious on primary E&S and excess casualty and healthcare because of our view of the absolute rate levels that we see in the marketplace. We remain in a defensive mode unsurely because of the economic environment, we are continuing to substantially reduce our aviation and onshore energy exposures because of rate.

Let me now give you a bit of a flavor on what we see on the rate environment. We remain of the view that the best opportunities is in the cat business are in the U.S. wind and quake with rate increases ranging from 15 to 25%. Even though, we don't have significant exposure to European wind and flood and Japanese wind and quake, we have seen rate improvements in those two territories. For us though at least for now, it is not yet enough to increase our PML aggregates in those two zones. Rates in offshore energy for Gulf of Mexico exposures have grown significantly, triple digits in many cases which allows us to continue to commit PMLs through that zone.

On the insurance side, the rate stabilization and improvements we saw in the fourth quarter of '08 continue in the first quarter of '09. This trend is spreading to more lines of business. However, with the effect of the credit crisis on claims inflation and the impact of available risk-free rates on available certain lines of business, additional rate improvement is required in some lines of business to achieve adequate returns. Despite the improvement in the rate environment, current economic conditions will also have a negative effect on our customers. Rate improvements, while we'll produce better risk adjusted returns will not necessarily translate into more premium revenue as exposure basis are negatively affected by reduced payroll sales and insured values. We have begun to see this manifest itself as certain insurers are purchasing less limits and retaining more risks themselves.

Before I turn it over to John for more commentary on our financials, let me update you on our PML aggregates. As of April 1, 2009, our one in 250-year PML from a single event expresses a percentage of common equity was 23%, slightly below December 31 levels and our 25% common equity self-imposed limitation. The reduction was more attributable to our increase in shareholder's equity, not a reduction in the overall aggregate PML.

Our capital position remains excellent under various measures, and we'll remain well positioned to benefit from opportunities we'll see in either the insurance on reinsurance market. With that, let me turn it over to John for a more detailed financial discussion on our results. And then after John, we'll come back and take your questions. John?

John C. R. Hele
Former Chief Financial Officer, Principal Accounting Officer, Executive Vice President and Treasurer

Thank you, Dinos. It is a great pleasure for me to be here on my first Arch Capital earnings call especially with the good results of the first quarter of 2009. Before I start though, I would like to recognize the excellent financial organization and company that my predecessor, John Vollaro built with Dinos. It is a great benefit to have John continue on as a senior advisor to the company and it makes for a smooth transition.

I will briefly cover the financials and provide some insight into some key items that may be of interest to you. Dinos has already covered the trends and solid results of our premiums and overall business. I might add that the mix between the shorter tail of lines and the longer lines remains constant at approximately 50, 50 in both quarters. The net to gross ratio was 80% in the first quarter of 2009, compared to 77% in 2008, primarily due to changes in insurance mix of business and reinsurance usage along with the reduction in the ceded business to Flatiron Re, the high card treaty that expired in December 31, 2007.

Now let me give you a little color on the ratios. The loss ratio reflects 7.3% or 51 million, a favorable development in the first quarter of 2009 compared to 8% or 57 million of favorable development in the first quarter of 2008. Approximately, 70% of this development came from medium and long tail lines and primarily resulted from better than expected claims emerging in older underwriting years. The first quarter of 2009 reflects 1.1% or eight million of losses related to current year catastrophic events while the first quarter of 2008 reflected 3.7% or 26 million of cat activity which primarily related to Australian floods. Incurred losses related to the major 2008 cat events, Hurricanes Ike and Gustav, were relatively unchanged from the 2008 fourth quarter estimates. 71% of the company's net reserves is six billion were incurred but not reported which was substantially unchanged from year end.

Of the 1.8% increase in the acquisition expense ratio, two-thirds related to lower commission income from the Flatiron treaty, one point two points with the remainder is only from favorable prior year reserve development. The 1.4% decrease in other operating expense ratio was primarily driven by the insurance segment due to nonrecurring adjustments in incentive compensation and the benefits of the insurance segment's expense management plan implemented in the 2008. The largest change this quarter compared to a year ago was in the net investment income with decrease of 96 million or $1.53 per share compared to 112 million or $1.79 per share in the 2008 fourth quarter and 122 million or $1.80 per share in the 2008 first quarter. The pretax investment yield was 3.82% for the 2009 quarter compared to 4.5% last quarter and 4.88 in the first quarter of 2008. The 4.88 excludes 3.4 million of arbitration proceeds. Before I delve into the details in net investment income, it is important to put the net investment income into perspective as their total return of Arch's 10.3 billion investment portfolio had a positive total return of 1.23% in the regional currency in the quarter, 1.09% take into account currency fluctuations. Arch manages its investment portfolio on a total return basis as this is the core element to increase book value per share.

In these volatile markets, we have found opportunities during the quarter that created some interesting and noteworthy results in the net investment income line but still delivered a positive total return. In comparing net investment income from the fourth quarter of 2008 to this quarter, the decline in the embedded book yield of 38 basis points from 4.55 at year end of 4.17 at the end of March was the largest contributor as the company lowered the average effective duration from 3.6 years to three years and maintained the portfolio's AA+ credit quality. As an example of the interesting and noteworthy result in net investment income, we had an investment in TIPS [treasury inflation protected securities], which are action-industry [ph] anomaly for the credit crisis. TIPS are inflation adjusted treasury notes where the principle adjust to inflation, up when there is inflation and down when there is deflation. The investment income under the accounting rules includes interest plus the amortization of the principle adjustment. Now there's a quarter lag in the adjustment of the TIPS.

In the fourth quarter of last year, we experienced deflation. And that created negative investment income in the first quarter of this year. One would think that the total returns of the security then would also decrease over the quarter. But no, we bought TIPS in the fourth quarter of '08 at a discounted par and experienced a gain during the quarter as they are trading above par at the end of March 2009. This was we believe due to the desecrated markets in the fourth quarter of last year, which improved in the first quarter as well as the fact as there was a small inflation in the first quarter of '09 that will positively adjust TIPS in the second quarter. So TIPS had a positive total return and we have now sold most of the exposure in the first quarter.

As I mentioned earlier, Arch manages on a total return basis and this is just one of the examples where the accounting on the book value basis did not match the actual results on a market value basis. The net investment income for TIPS was 12 with a negative 12 basis points over the quarter, and this is not expected to continue in the same magnitude in future quarters. The remainder of the net investment income change can be explained by two less days in the first quarter which is about 10 basis points, less income on securities lending due to lower interest rates which is another 10 basis points and lower yields on cash and higher investment expenses which is a five basis points. Before summarizing the return of the investment portfolio, it performed quite well in the first quarter. The dominance of treasuries, munis, agency backed, mortgage backed securities and older years CMBSs, and an increase in percentage of government-backed corporates provided stability and an increase in market values in the quarter.

Our bank loan funds totaled 331 million in market value at the end of the quarter, of which 211 million is held under the equity method through P&L and 121 million held as available for sale, where the changes in market value flow through equity. The total bank loan portfolio experienced a 3% decline in market values of 10 million, substantially, all of which was directly reflected in the P&L. We have provided further details on this portfolio in the press release in supplement, including sector allocations and the overall credit quality of B1 [ph].

Now last quarter, John Vollaro spoke about the accounting rules and how they were punitive for securities that were determined to be other than temporarily impaired, as the full difference in market value and amortized costs has slowed through realized losses in the P&L. Even though one may expect to have an ultimate credit loss far less than this amount. The FASB must have been listening, and the new standards FAS 115-2 corrects this issue. Arch adopted both FAS 115-2 and FAS 157-4 as of January 1, 2009 which is in the early adoption date. These standards will become mandatory as of April 1, 2009. FAS 157-4, which is the fair value standard has had no impact on our fair values. But FAS 115-2 has had an impact on both our balance sheet and the income statement in the first quarter of 2009.

To dock [ph] the standard we had to first reclassify all OTTI provisions taken on the security still on our portfolio as of January 1, 2009 into two components. Our credit loss component that stays on retained earnings and an other factor component that reflects interest rates, market conditions, et cetera that is reclassified into accumulated other comprehensive income, AOCI from retained earnings. Of the 171 million OTTI subject to review on the 1st of January, 109 million was deemed to be credit related and 62 million was related to all other factors, which increased the amortized cost of impaired securities by 62 million. We recorded a cumulative effect reclassification net of tax from retained earnings to AOCI in shareholders equity. It is quite important to note that there is no restatement to prior year earnings under the standard, even though on theory, one may think you might do so and equally as important there is no impact on book value per share as a result of this adjustment.

In the first quarter applying the same credit process now an up-to-date assumptions in credit reports, we booked 36 million of credit related impairments which were reflected in the P&L and 57 million of all other factors which were reflected in other comprehensive income. The first quarter impairments were related to deterioration of recovery values in mortgage-backed securities as well as the winding down of the euro denominated bank fund during the period.

Our financial condition became even stronger in the quarter with 3.6 billion of shareholders equity, a 5.8% from 3.4 at the end of last year which we believe is well above wherein agency requirements. Total capital including our perpetual preferred securities and debt totaled 4 billion at the end of March with the revolving credit facility of 100 million maturing in August 2011 and a long-term debt of 300 million maturing in 2034. Portfolio liquidity has remained very healthy with cash, short-term investments in treasuries and agencies representing 25% of our investable assets.

Finally, the two most important measures for our operating ROE which came in at 21.1% on an annualized basis, and the increase in book value per share which is up 6.3% to 54.61 which demonstrates the discipline and shareholder focus of the entire organization and would have been challenged insurance and financial markets.

That concludes our prepared remarks and we're pleased to take questions.

Constantine P. Iordanou
Chairman and Chief Executive Officer
Francine [ph], we're ready for questions.

Question and Answer

Operator

[Operator Instructions] Our first question comes from the line of Matthew Heimermann of JPMorgan.

Matthew G. Heimermann
JP Morgan Chase & Co, Research Division

Dinos, could you talk a little bit about -- with some of the changes in the different lines of business in the reinsurance segment kind of how growth looks like, what year-to-date growth looks like three two year basis?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Let me give you a little flavor. If you exclude that one single transaction which was the substandard auto facility we didn't renew actually our reinsurance group would had a slight growth even in the first quarter. This is a much-improved picture from my commentary in the fourth and third quarter when I was projecting that probably reinsurance business will be shrinking somewhere between 10, 20%. That's an indication that we've seen more opportunities, and we have enough aggregate capacity and PML capacity for where we believe the pricing is the strongest, which is cat area and we believe our prospects today on the reinsurance side of our business the better than what we saw maybe two quarters ago or even last quarter. So that gives you a little flavor. At the end of the day though, markets have an ability to change quickly. Right now, I think I called it as the step-recovery last quarter that things that moving both on insurance and reinsurance in a positive direction are more optimistic than I was a quarter ago.

Matthew G. Heimermann
JP Morgan Chase & Co, Research Division

With respect to just how you're using your cat aggregate now, in the quarter cash view was down property catastrophe is up. I don't know if there is some FX in those numbers but is that reflects -- holding back capacity for later in the year. Does that reflect the fact guys may be using a little bit more capacity than they have in the past? Is it some combination of the two or some other factor?

Constantine P. Iordanou
Chairman and Chief Executive Officer

It's two factors. One, you remember we've talked about a transaction when you compare year-over-year you have a little bit of dislocation because one customer we moved from January 1 to December 31. So in essence, it makes the comparison of year-over-year a little bit confusing because that contract was booked in the fourth quarter of '08. And in essence, when you look at the '09 numbers you're missing that component. If you adjust for that, basically we're using approximately the same PML capacity and as our balance sheet is growing I said it were a 23% of common equity right now as of April 1, we still got a little more rule and whatever opportunities we see in June, July we will take advantage of up to the risk management level that we have set ourselves. We don't want to go beyond that 25% because it doesn't, it's not prudent from the risk managements' point of view. In dependent on how good the rates are.

Operator

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

Vinay Gerard Misquith
Crédit Suisse AG, Research Division

Just a follow up of Matt's question. I remember last quarter you had a large contract that renewed. My understanding was that some of that aggregate were grown off by the middle of the year so that you could drive more cat premiums. Is that true? And would you be able to actually write more premiums in the middle of the year on the cat because of that contract?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Some of it will run. That contract is a quarter share contract. So you're earning over the year so some policies come off and some come on. But I think a more capacity is going to come because our capital is growing. I will attribute more to that in our ability to write more in June and July.

Operator

Our next question comes from the line of Josh Shanker of Citigroup.

Joshua David Shanker
Citigroup Inc, Research Division

A couple of housekeeping questions and then a meaty one. What is the IBNR and ACR numbers for the quarter?

Constantine P. Iordanou
Chairman and Chief Executive Officer

The ratio I think between IBNR ratio together is 71%. I think the ACR is 2% and the IBNR is 69, I believe. I can get you the specifics at all but that sounds right to me. I do the closing at weekend, I'm getting older so I don't remember exactly the decimals. But 71 I know is the actual number for the combination of the two.

Joshua David Shanker
Citigroup Inc, Research Division

What is the average liability duration of the reserves?

Constantine P. Iordanou
Chairman and Chief Executive Officer

The duration of our reserves they are about 3.3 to 3.5. Don't forget, we have shifted the boogaloo [ph] to beat two more property. It moved a little bit of the duration closer, that's where we are. As you can see, we're moving the investment portfolio lower than that so that tells you that the capital account is going to have a much shorter duration than the liability. Assets that we're holding for our reserves, we usually match to the duration of those liabilities. And we move depending how we view the investment environment, the shareholders equity from zero duration to all the way up to five-year duration. So right now, we're getting closer to the zero than to the five. John, do want to add something to that or?

John C. R. Hele
Former Chief Financial Officer, Principal Accounting Officer, Executive Vice President and Treasurer

Yes. I think that it all depends upon the outlook as they would think what's going to happen and as Dinos mentioned, we do expect some data has the inflation coming. So you don't want to be too long because you need to re-adjust your portfolio as inflation pulls in. It's very hard to predict when that may be. But also, we're not out of the woods yet probably in terms of the global economic downturn and you have to be cautious from a credit point of view. So we're doing both shortening generally overall as well as continue to be very cautious on the credit side.

Operator

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

Ian Gutterman
Adage Capital Management, L.P.

Firstly on the insurance side, it looks like you took up your retentions. Can you just talk about was that just a mix in the quarter? Is that a counter strategy that you want to retain more right now?

Constantine P. Iordanou

Chairman and Chief Executive Officer

It's neither. I think we have less quota share more access of loss. So we found a little bit of a change in how we bought reinsurance rather than the increasing our per risk net retentions. So we move to a little more extra, extra wealth. We found that to be more attractive purchases than quarter share.

Ian Gutterman
Adage Capital Management, L.P.

And that was a pricing decision? Or was that out of view of -- concern about lost cost in the future?

Constantine P. Iordanou
Chairman and Chief Executive Officer

It was a pricing decision.

Ian Gutterman
Adage Capital Management, L.P.

My other question is on the impairments. I just want to make sure I'm understanding the FASB changes accurately, John. So basically out of -- you classify 62 million from prior to this year as non-credit out of the 171, so about a third of it roughly. And then this quarter, you classified 57 out of 93 which is like 70% of it. Why was this so much more non-credit Q1 than what you've had cumulatively up until now?

John C. R. Hele
Former Chief Financial Officer, Principal Accounting Officer, Executive Vice President and Treasurer

Well, we go through security by security and analyze the credit piece of it. In the older book or the starting book, we had things like Lehman in there and some things that are better obviously credit related. But in the new quarter, we saw both the prices on some of the mortgage backed continue to be challenged in the quarter which we believe is still quite a bit due to supply. We do extensive analysis with our investment advisers as well as us in analyzing how much of that ultimate loss we expect to be credit and that's how we come about the split.

Constantine P. Iordanou
Chairman and Chief Executive Officer

We have not changed the process. Our evaluation in the third quarter, fourth quarter, first quarter is being the same. We use the same methodology et cetera. Now under the new rule which we had to adopt either in the first quarter or mandatory in the second quarter, you bifurcate your decision, but the process has been exactly the same. And as John said, we're very, very detailed, we go security by security. We have a committee, I'm part of it. John Vollaro, in his part-time assignment, he's part of that committee; John Hele, we have a whole bunch of us looking at that and we go security by security every single quarter.

John C. R. Hele
Former Chief Financial Officer, Principal Accounting Officer, Executive Vice President and Treasurer

We have to repeat this with the latest credit analysis at then end of the quarter each and every quarter. So we will go through the whole -- everything has been impaired and we do this calculation each and every quarter.

Ian Gutterman
Adage Capital Management, L.P.

So some of that 57 million from this quarter could move into the credit backed at next quarter, if you see the environment getting worse?

John C. R. Hele
Former Chief Financial Officer, Principal Accounting Officer, Executive Vice President and Treasurer

Yes or some of the credit could come back again...

Ian Gutterman
Adage Capital Management, L.P.

Exactly, could come back that way. And I think Dinos said just to make sure, it doesn't sound like then you had a migration to level three?

John C. R. Hele
Former Chief Financial Officer, Principal Accounting Officer, Executive Vice President and Treasurer

No. As we've said we haven't had any migration to level three and the level three we have didn't changed by adopting 157-4.

Constantine P. Iordanou
Chairman and Chief Executive Officer

And one more point, Ian, you have to understand that even with this change, it doesn't affect book value per share. We mark everything to market and it's just -- you're rebucketing some of these to two buckets instead of one. At the end of the day, our balance sheet is marked to market, from book value per share basis when you look at it. That's the true picture as to what we believe, the healthiness of the company.

Operator

[Operator Instructions] Our next question comes from the line of John Shanker of Citigroup.

Joshua David Shanker
Citigroup Inc, Research Division

Of course you guys seen that I'm so much skeptical of all this hard market chatter out there, and maybe I'm the only one. But is this really that much different from where we were in 2006 this time of year? Can you guys compare and contrast 2009 and 2006?

Constantine P. Iordanou
Chairman and Chief Executive Officer

You're talking the absolute environment today or trajectory where we're going? I can tell you 2006, it was a better year than '09 is going to be. You don't have to think very, very hard. On the other hand, you know that we do extensive monitoring of rates. Everything is improving even -- let me go over quickly to give you some of the movements this way you can -- this is on our book of business and I'm talking about effective rate change that includes everything in the effective rate change. In our E&X casualty and excess in umbrella, we went from a minus 4.7 in the fourth quarter of '08 to a plus 1.4 that's a movement and it's a positive movement. Our executive assurance which is the D&O has 7.9 positive in the quarter. Healthcare, you saw my prepared remarks, it's still negative at minus eight and about the same that we saw in the fourth quarter of '08, but better then the third and second quarter of '08. So slight improvement but not where we -- trajectory I'm talking about. Property business is up. It went from negative in the fourth quarter of 6.8 to positive 5.4. Professional liability is flat. Construction, we had minus five in the fourth quarter, it became minus 0.4 or four-tenths of 1% in the first quarter. In our special risk, it went to plus 9.2. So everywhere I look, I see either rate reductions easing, meaning the reduction is less than the quarter and more and more lines getting into positive territory. Now, some lines we feel very good about because we think on an absolute basis they give us the north of 15% ROE. Some other lines are improving but still they're not giving us the double-digit ROE, so we're a lot more cautious. But we made those judgments through a profit census both on insurance and reinsurance on a quarterly basis. One thing that I love about Arch, we are small and nimble. So the messages from me and John and our senior team to our operating units, they're easily understood and implemented. And also they have feed back to us as to what's happening in the marketplace is pretty instantaneous. That allows us the ability to shift focus where we believe we can find the best returns. But I'm not going pound on our chairs and say this is a terrific market like '06 but the trajectory where we're going, if it continues we like. It's improving and it's a slight improvement, and there is many reasons for it. You've got companies that they have financial difficulty. They're starting to lose some business, new money invested and people, when they price their business and we price all our business assuming risk-free rate of return is nothing to write home about even when we find to invest in very secure things like government-guarantee issuance that sometimes we can get 150, 170 bps above treasuries. It still gets us in the three to three and a half maybe we get lucky 3.7% for the kind of durations the business you're underwriting. So underwriting profits have to increase and you're not going to increase the component of your return coming from underwriting profits unless rates go up. And we see that in the marketplace, so we're cautiously optimistic.

Joshua David Shanker
Citigroup Inc, Research Division

Aviation. You haven't surprised me. You said aviation's down, I thought aviation was starting to work back in November?

Constantine P. Iordanou
Chairman and Chief Executive Officer

We don't like the absolute. Yes, aviation is part of our special risk and I said we're plus 9.2%, but from an absolute rate point of view, two classes we don't like. I don't think you're getting the adequate returns. It's aviation and we're cutting back quite a bit on that and Onshore Energy, both of them have positive rate movement. But don't confuse positive rate movement and profitability. It's moving in the right direction but it hasn't got to the point yet that gets us excited.

Operator

Our next question comes from the line of Jay Gelb of Barclays Capital.

Jay H. Gelb
Barclays PLC, Research Division

I do want to ask you about Arch's ability to take market share from some of the stress competitors out there. How is it going versus your expectations?

Constantine P. Iordanou
Chairman and Chief Executive Officer

We've seen some movement on credit-related business. More people calling us for surety and more people calling us for D&O, E&O [ph]. I think we're responding to D&O, E&O [ph], we're cautious on surety because of the general economic environment. And we're getting a lot more opportunities, what I would call the loss sensitive plans, the national accounts that in essence, the predominance of the risk is taken by the insured and you're managing of course their claims, their money and they're getting credit sensitive so we've seen some of the business come our way. We're not a huge player in national accounts yet, but you've seen we had a significant first quarter growth and it's all related to what's happening to some of our competitors and how the market views the strength of the Arch balance sheet. That's the only two areas we have tangible evidence that there is movement from -- the rest of it is competitive. You've got to compete for it, even in the lines that you're getting better rates, you're still competitive. But some of these I think you're seeing some shift.

Jay H. Gelb
Barclays PLC, Research Division

Separately on the reinsurance segment, I just want to make sure I understand, are you saying now that Arch can generate positive [Audio Gap] and premium growth in the reinsurance segment over the remainder of 2009?

Constantine P. Iordanou
Chairman and Chief Executive Officer

No, what I'm saying is -- we don't give guidance because I don't know where the market is going to go. It might get competitive overnight. I've been in this business long enough to know that it behaves schizophrenically sometimes, so I don't know. What I'm saying is that, if you would have asked me that question a quarter or two ago, I would have said highly unlikely. But now I don't rule it out of the question. Based on what we saw in the first quarter, the activity, the opportunities we see the more like I said, we would renewed one big contract, you would have seen positive in the first quarter, it might or might not continue. I know you guys got to beat models and you got to have projections. I don't worry about that. I let you guys worry about that. All I worry is our guys, the pricing business for a return and they're having margins in the business. If we see a lot of business with margins, I will assure you, we're not going to fall asleep. We're going to write it. If we don't, we also have the ability, the willingness and the desire to cut the book back if the pricing is not there. And you've seen that behavior with us in the last three years we were reducing top line because we weren't finding the opportunities. But when we find the opportunities as we did in '02, '03, '04, we were writing a lot of business and I think we know how to do that.

Operator

Our next question comes from the line of Michael Paisan of Stifel Nicolaus.

Michael George Paisan
Stifel, Nicolaus & Company, Incorporated, Research Division

You've mentioned that you see more opportunities on the reinsurance side and I was wondering if you could just kind of drill down a little bit and explain where those opportunities are coming from, whether it's strictly just from the weaker competitors or had the buying patterns change from your customers? Or it just simply that pricing is better today versus what you saw a quarter ago? It seems like a pretty quick fast change in judgment on that business from last quarter to this quarter.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Without mentioning names, I'll give you an example. This is an example that you can see. See the insurance business is a lumpy business. We had a client that is a very good client of ours that would have been on their program for five years and we started with a 10% participation on that program. And we were coming down and we were down to six and probably would've went down to 3% participation because we didn't like the trajectory where the business was going based on run the writing audits. We always have very good dialogue with our customers and this customer. When we went for the renewal of this piece of business in the reinsurance sector, to our pleasant surprise, we found out that they have instituted significant, not only rate increases, but underwriting guidelines changes that we like. So instead of budgeting that we're going to go from 6% participation down to three, we went the other way and we have a 10% participation with a client that we like and we've been with. Things in reinsurance can change on a dine [ph] that's why it's very hard to predict how much revenue you're going to get. It's treaty by treaty. If we saw a substandard order rates they were going up and we can have results that transaction is $60 million for us. The other opportunities we see is related to balance sheet pressures that somehow and their willingness to reinsure more of what otherwise they would have retained on their books of business. And we've seen some of that also, so it's a combination of the two. Some cases the underlying business, the rate environment is improving and we are increasing our share on programs that we might otherwise would have decrease our share and new opportunities because people they want to buy more because their balance sheet might not allow them to retain all the businesses that they were otherwise retained. But in a business that's very lumpy, you write one treaty or you don't, it can change your quarter from a plus 10 to minus 10. It's hard to predict where premium goes. Hopefully we can predict where our profits go and that's more important to us.

Michael George Paisan
Stifel, Nicolaus & Company, Incorporated, Research Division

If you could talk a little bit about what your assumptions are for inflation as it applies to your loss picks on your reserve. I think John had mentioned that there's certainly some inflation that's probably coming down the pipe at some point, and I think most people will agree with that. And we're just wondering if you've changed your reserve, your loss pick assumptions accordingly and if so what kind of inflationary measure are you using?

Constantine P. Iordanou

Chairman and Chief Executive Officer

Don't forget, trend in both insurance and reinsurance is slightly different than inflation. Inflation is only a component of what the trend is. And I can tell you we do that study. We do a trend study by our actuarial department. Let me run some numbers and tell you where we think they are. For casualty lines we're using about 5.5%, for D&O we're about 8%, for Healthcare we're using a little over 6%, for property about 2.5, for construction about two, for professional liability about 6%. So it goes by line of business and as the socio economic inflation that comes with looking at a lot of data and where it's going. How big is medical component as part of your loss? And where label labor costs is going? Where material goes, et cetera. It's not a very simple calculation. Our comments it was more relating to our asset base and how getting a little bit more conservative, both on credit and duration because even though we cannot predict when inflation is going to come. We believe that with budget deficits, we're going to have the stimulus. And it's not just in the U.S. but globally, eventually we're going to invite inflation and we might be the exception of the rule here. But we felt, for our investment portfolio we need to be a bit more conservative than and go the other way around.

Operator

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

Vinay Gerard Misquith
Crédit Suisse AG, Research Division

Just a numbers question. In terms of the yield, 12 basis points of that was later took TIPS, which had not recur in the next few quarters. Do you think that you would increase your investments and risk your assets? Or do you think extra TIPS number would stay flattish for the next few quarters?

John C. R. Hele
Former Chief Financial Officer, Principal Accounting Officer, Executive Vice President and Treasurer

Let me just clarify something. First, that the reduction net of investment income was 12 basis points due to TIPS, but the yield is a moment in time calculation on the data March 31 and we've sold some of the TIPS since then. So the yield is less impacted by it. The yield on the portfolio was investment income has other impacts on it. So there's a little difference there. And no, I think we're trying to be clear here about our investment outlook. We just don't think at this moment time is the right time to be increasing risk or increasing duration until we see how things proceed through the course of this year and maybe even earlier next year. We'll have to wait and see.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Our embedded yield now is what? 4.17 that might move a little but I don't think you're going to see the same movement you saw from the fourth quarter to the first quarter that we gave up about 40 basis points. You might see a few basis points. We're finding some good opportunities to invest in government-guaranteed securities. Somewhere between 150 and 170 basis points above treasuries. That gets us into the 3.5% yield. And don't forget, not the entire portfolio is turning over. So the movement downwards, it's going to be slow and if we find opportunities that we believe fits our credit profile. For example, if we find CMBSs of the bondage [ph] that we have. Unfortunately, we can't find them that they yield eight, nine, 10% we will buy them. But we're not finding those kind of securities that give us the credit comfort that comes with the yield.

Vinay Gerard Misquith
Crédit Suisse AG, Research Division

The second point was on the expense ratio and the like and the primary insurance segments. That was down this quarter because of some one-time issue. Do you think that the operating expenses will stay in the 70 million ratio for the rest of the year? Within that segment?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Expense ratio is a function of activity. It was steady as we go that's a good assumption. The reduction expense ratio was most of it, it was because of permanent restructuring. Don't forget, we made the move from downtown Manhattan to Jersey City in '08. You didn't get a lot of that benefit because you unwind some of the furniture, but eventually that is starting to come in their end course is going down. And second, we're readjusting our incentive compensation a bit because as you know we pay for performance at Arch and at the end of the day, the '06, '05, '04 underwriting years and we have a time delay as when we pay that will be better years from an incentive compensation than the '07 and '08. So those adjustments get made as we accrue for all these things into a balance sheet. So if volume doesn't grow, I don't think expenses will grow and if volume shrinks, we'll probably have to be cutting expenses. But usually you don't cut expenses as quickly as volumes shrinks. Right now, I'm pretty comfortable where we are.

Operator

Ladies and gentlemen that concludes the Q&A portion of the presentation. I would now like to turn the call back over to Mr. Dinos Iordanou.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, thank you all for joining us. John again welcome to Arch, it's a pleasure to have you here and we're looking forward to talking to you next quarter. Have a good day.

Operator
Thank you for your participation in today's conference. This concludes the presentation. You may now disconnect. Have a good day.