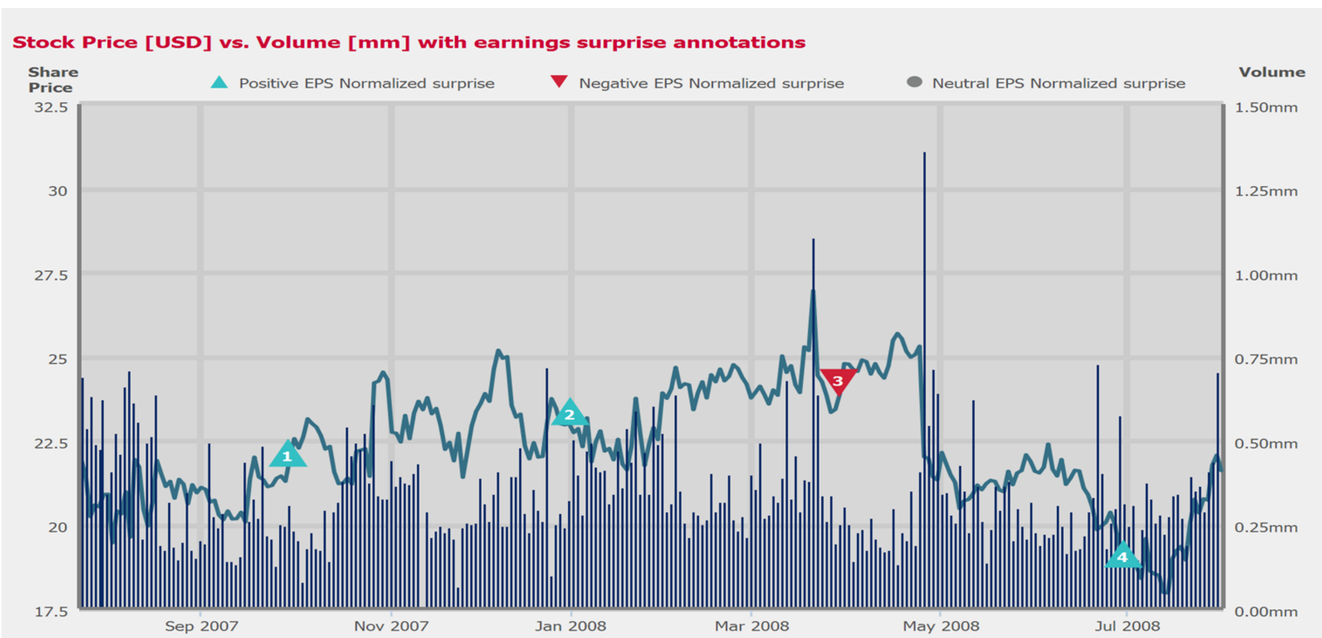
Selective Insurance Group, Inc. NasdaqGS:SIGI
FQ3 2008 Earnings Call Transcripts
Friday, October 31, 2008 12:30 PM GMT
S&P Global Market Intelligence Estimates

	-FQ3 2008-			-FQ4 2008-	-FY 2008-	-FY 2009-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.45	0.45	0.00	0.51	1.85	1.98
Revenue	-	-	(4.22 %)	-	-	-
Revenue (mm)	435.49	417.12	-	441.43	1773.20	1772.08

Currency: USD
Consensus as of Oct-31-2008 7:24 AM GMT



- EPS NORMALIZED -	CONSENSUS	ACTUAL	SURPRISE
FQ3 2007	0.54	0.63	16.67 %
FQ4 2007	0.56	0.60	7.14 %
FQ1 2008	0.50	0.43	(14.00 %)
FQ2 2008	0.51	0.52	1.96 %

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Call Participants

EXECUTIVES

Dale Allen Thatcher
Former Executive VP, Treasurer & CFO

Gregory Edward Murphy
Chairman & CEO

Jennifer DiBerardino

John Marchione

ANALYSTS

David Lewis
Raymond James

Mike Grasher
Piper Jaffray

Rohan Pai
Banc of America Securities

Scott Helenak
RBC Capital Markets

Susan Spivak
Wachovia Capital Markets, LLC

Presentation

Operator

Good day everyone and welcome to the Selective Insurance Group third quarter 2008 earnings release conference call. At this time, for opening remarks and introductions, I'd like to turn the call over to Vice President Investor Relations, Miss Jennifer DiBerardino.

Jennifer DiBerardino

Thank you. Good morning and welcome to Selective Insurance Group's third quarter 2008 conference call. This call is being simulcast on our website and replay will be available through December 1, 2008. A supplemental investor package which includes GAAP reconciliations of non-GAAP financial measures referred to on this call is available on the Investors page of our website at www.selective.com. Selective uses operating income and non-GAAP measure to analyze trends and operations.

Operating income is net income excluding the after tax impact of net realized investment gains or losses. We believe that providing this non-GAAP measure makes it easier for investors to evaluate our insured's business. As a reminder, some of the statements and projections that will be made during this call are forward-looking statements as defined by Private Securities Litigation Reform Act of 1995. Forward-looking statements are not guarantees of future performance and are subject to risks and uncertainties.

We refer you to Selective's annual report on Form 10-K filed with the U.S. Securities and Exchange Commission for a detailed discussion of these risks and uncertainties. Please note that Selective undertakes no obligation to update or revise any forward-looking statements.

Joining us today on the call are the following members of Selective's executive management team - Greg Murphy, CEO; Dale Thatcher, CFO; John Marchione - Chief Field Operations Officer; Mary Porter, Chief Claims Officer; Ron Zaleski, Chief Actuary; and Kerry Guthrie, Chief Investment Officer. With that I'll turn the call over to Dale to review the quarter results.

Dale Allen Thatcher
Former Executive VP, Treasurer & CFO

Thanks Jennifer. Good morning. Third quarter results were solid despite the financial market turmoil, higher than anticipated catastrophe losses, and the competitive insurance market. We reported a statutory combined ratio of 97.6% and a GAAP combined ratio of 101.5% for the quarter. The statutory expense ratio reflects the positive actions we have taken this year to reduce expenses including the February reduction in workforce, the targeted agency commission reductions that went into effect on July 1, and the Indiana re-domestication of two insurance subsidiaries.

These savings benefit our statutory expense ratio first since expenses related to production of business are deferred and amortized for GAAP earnings purposes. As we reported in our prerelease dated October 14, catastrophe losses in the quarter added 3.4 points to the statutory loss in the LAE ratio. Hurricane Ike had the largest impact as the storm remnants made their way through our Midwestern states. Excluding catastrophes, the statutory and GAAP combined ratios were 94.2% and 98.1% respectively.

Statutory net premium written declined a modest 2% in the quarter from a year ago. Commercial lines net premiums written declined 3%, while personal lines grew 4%. In commercial lines, pressure on new business continued unabated. However, our renewal book retention remains strong at 78%, an indication of our superior relationships with agents as they work with us to renew accounts up to 60 days in advance of the expiration date.

Renewal pricing including exposure was down only 2% for the quarter and 1.2% year-to-date while pure price declined only 3.2% in the quarter and 3.1% year-to-date. Commercial property results for the quarter posted a 98.8% combined ratio including 18.7 points of catastrophe losses. Cat losses in the quarter were 15.6 points more than 2007 and 11 points higher than our five year average.

Workers compensation continued to demonstrate underwriting improvement with a statutory combined ratio of 91%, 8.5 points better than a year ago. Results reflect the success of our multi-disciplinary improvement strategy implemented in 2006, including favorable prior year statutory reserve development of 6.4 points in the quarter versus 4.3 points a year ago.

Despite pricing pressure, general liability was profitable in the quarter with a 98.5% statutory combined ratio. Our contractors book, which represents about 45% of our commercial lines premium, is well diversified into 26 different segments. We are maintaining underwriting discipline in the contractors book, despite market pressure. In many cases competitors are relaxing their standards by not asking for loss runs and not following contractual risk transfer guidelines. We have very specific contractual risk transfer requirements for sub-contractors that require the proper hold harmless defense and indemnification provisions.

Commercial auto statutory combined ratio increased by about 12 points in the quarter to about 98.1% compared to the third quarter of 2007. Last year's results included 7.5 points of favorable prior year statutory reserve development, while this quarter included 1.3 points of adverse development. Pricing continues to put pressure on this historically very profitable line of business as the combined ratio for the quarter reflects 4.2 points of price decreases including exposure.

Overall prior year statutory loss in LAE favorable reserve development on a pretax basis for the quarter was $6.4 million or 1.7 points on the combined ratio, compared to favorable development of $4.5 million or 1.2 points in the third quarter of 2007. This quarter's favorable development was primarily driven by accident years 2005 and 2006, partially offset by accident year 2007.

The personal line statutory combined ratio excluding flood was 109.5% for the quarter, which included 4.4 points of catastrophe losses. Premium increased 4% from a year ago, due mainly to the rate increases we have taken this year and last, totaling 10.4%. New Jersey auto business, which is currently about 68,000 cars, had a statutory combined ratio of 111% for the third quarter essentially flat with a year ago.

To improve results in New Jersey auto we rolled out two rate increases in 2008, 6.8% effective in May and 6.5% effective in October. On December 1, mandated territory changes go into effect which will positively impact rate in our most unprofitable territories while allowing us to maintain our competitive position in our most profitable territories.

In August the capping effect from our matrix automated pricing system expired so that all policies can now achieve their full indicated rate level. Additionally, in October we introduced a surcharge for insureds who did not have insurance prior to coming to Selective, which was also help profitability on a go forward basis.

Personal lines results are still challenged but we believe that over time the improvement plan we have in place will yield the results we need to achieve. It's a three pronged approach. First we are aggressively getting rate wherever possible. We apply the rate increases that are in effect today to our premium base we would generate $13 million in additional premium on a pro forma basis.

Second, we continue to drive new business through matrix. As of September, 81% of in force auto premium was in matrix. The result will be better quality business due to the effectiveness of our models. Finally, we have other initiatives such as targeted agency management, straight through account processing, and claims initiatives that will further drive positive results.

High credit quality continues to be the cornerstone of our investment strategy as we maintain an average overall portfolio rating of double A plus, with nearly 100% of our fixed maturity securities being investment grade. The resiliency of this high quality, conservative investment portfolio was tested in the third quarter. Relatively speaking, it weathered these unprecedented times extremely well. For the quarter, after tax investment income was down $4.9 million or 15% from a year ago, primarily driven by losses recorded on our equity trading portfolio and a lower level of alternative investment income compared to a very strong result a year ago.

The equity trading portfolio is a portfolio of Master Limited Partnerships or MLP's which is managed externally. The market dislocation had a significant impact on MLP's in the quarter. We elected to adopt the FAS 159 accounting treatment for this portfolio in January of 2008, which requires us to record the mark to market impact of the portfolio value in investment income. Partially offsetting the reduced investment income in the quarter was a $1.4 million after tax increase in interest income on fixed maturity investments.

We have no common or preferred equity exposure to Lehman Brothers, Wachovia, Washington Mutual, AIG or Merrill Lynch. We do have a $1.8 million fixed income investment in one of AIG's subsidiaries, International Lease Finance Corp. We don't hold any Fannie Mae or Freddie Mac subordinated debt, common or preferred stock. While we cannot guarantee the ultimate performance of any security held, we are very comfortable with the high quality and conservative nature of our overall portfolio.

The pre-announced $22.7 million after tax in OTTI write downs in the quarter included

$16.4 million after tax of fixed income investments related to both structured securities and the financial services sector. On a pretax basis the write downs represent less than 1% of Selective's total investment portfolio. We continue to believe that unrealized losses on equities and certain fixed maturity securities are not necessarily predictive of the ultimate performance of the underlying collateral.

Given market liquidity issues, obtaining prices for securities that have essentially stopped trading has become a problem for companies to properly value their holdings. Until there is more clarity on how to price these securities, future write downs may be necessary for securities that are performing in line with anticipated or contractual cash flows.

In light of current market conditions, we have made adjustments to our investment strategy. We're providing for additional liquidity at the holding company and insurance subsidiary levels by increasing short term investment balances and NEIC approved and triple A rated money market funds. In addition, we have increased purchases of U.S. Treasury obligations in our fixed income portfolio.

Selective has a strong source of operating liquidity given our consistent 78% commercial lines renewal retention. In addition, we maintain allotted maturity schedule in our investment portfolio, have a conservative reinsurance program and can access a $50 million line of credit through the holding company.

We also believe we have adequate sources of funds to satisfy debt service and shareholder dividend obligations of the parent holding company. On September 30 we had approximately

$74 million in cash and short term investments at the parent company. Year-to-date we have upstreamed $77 million in dividends from the insurance subsidiaries and have a 2008 maximum dividend capacity of $141 million.

As regards our capital management strategy, we repurchased 1.8 million shares totaling

$41 million in the first half of the year but stopped repurchases after the second quarter to preserve liquidity and capital. We have no current plans to complete our share repurchase authorization in the near future.

Our debt to capitalization ratio at September 30 was 21.9% or 15.8% when adjusted for equity credit on our hybrid security. The average life of our debt outstanding is currently 36 years and we have $12 million in private placement debt maturing in May of both 2009 and 2010. As a result of the OTTI write downs, realized losses and the declining market value of our investment portfolio, book value per share declined 4% from the second quarter to $18.53.

Selective has always been committed to balance sheet strength and these uncertain times we believe we've taken the right steps to preserve liquidity, preserve capital, and provide for long term returns to shareholders. Now I'll turn the call over to Greg.

Gregory Edward Murphy
Chairman & CEO

Thank you Dale and good morning. Much has happened since I spoke to you in July. Unprecedented has become the word of the day as we've seen power houses in the financial industry declare bankruptcy, be acquired or forced to sell off significant subsidiaries. While Selective's not been immune to the market destructions, we remain financially strong as we continue to focus on writing good quality business in a competitive insurance marketplace while maintaining our conservative investment philosophy.

Service is the cornerstone of what we do at Selective and why we rank so highly in independent agent surveys. Response is everything is our brand, our 940 agents agree that we consistently respond to and proactively anticipate their business needs. We recently hosted an industry panel for our President's Club agents.

In addition to me, the panel included Bob Rusbuldt, President and CEO of the Independent Insurance Agencies and Brokers of America or the Big "I"; David Sampson, President and CEO of the Property Casualties Insurer's Association of America or PCI; B.J. Dowling, managing partner of Dowling Partners - of Dowling Securities, excuse me and Bob Hartwig, President of the Insurance Information Institute or the Triple I.

Bob Rusbuldt commented on why agents like to do business with super regionals over nationals. He said, "Super regionals like Selective are attracting the top independent agents in the country. There's going to be a flight to good companies like Selective. You're A plus rating is huge to the policyholders of my members." He also said "Why do we call Selective a super regional? You've taken on the role that national's used to play as far as loyalty and the quality of service and excellence."

Overall, I'm comfortable with the solid operating performance we delivered year-to-date, a profitable 98.2 statutory combined ratio which is much better than the A.M. Best industry expectations for 2008 of 103.2. Cat losses, depleting reserves and rising reinsurance rates are affecting industry operating results. Additionally, industry wide realized losses including OTTI write downs, unrealized losses and deferred tax limitations are lowering surplus levels.

Rating agencies are scrutinizing all these factors, revising their outlooks for the industry results in 2008 and 2009, and clearly having a rating downgrade bias. Each day I become more convinced that commercialized pricing is on the verge of moving from decreases to flat to modest increases. We have the capability through our decision support tools to drive commercialized pricing higher on a very granular basis.

One question posed to our industry panel was, "In your opinion when will commercialized pricing begin to firm?" Although there was no consensus, the following points of view were discussed - we've already reached the inflection point; the fact that fewer companies have excess reserves moves the hard market ahead one year; and lastly, property prices should rise in the first quarter of 2009 and casualty by the third quarter. This may well be driven by reinsurers.

Reflecting the current competitive market environment, new commercialized business was down 10% in the quarter and 17% year-to-date. Year-to-date new business growth by segment was as follows. One and Done automated small business, $52 million, up 11%; AMS middle market business, $132 million, down 21%; Selected Risk Managers, our large account business,

$17 million, down 41%.

Small business continues to provide the best opportunities for growth in the current market and the expansion of our capabilities in this area is clearly working. New One and Done eligible programs represented 15% of the $52 million. So far this year, the ease of doing business through our small One and Done system has led to new business written per work day of

$271,000. In addition, our ease of doing business recently garnered two new awards for our technology efforts, the 2008 Interface Partnership Award from Applied Systems and the 2008 [Asknet] Interface Award for Download Achievement.

New business opportunities in the middle market remain challenging. While our agents are working with us to proactively renew business up to 60 days in advance, new business is difficult to harvest, particularly for accounts over $25,000. Based on conversations with our regional managers, field underwriters and agents there's one particular competitor that stands out for driving middle market pricing down.

Large account new business opportunities picked up for the third quarter as we capitalized on opportunities in the specialty and contractor's classes. Our overall hit ratio improved in the quarter to 40% from 20% to the prior quarter. Industry pricing in this segment in our opinion can still be reckless but we review each account closely with our actuaries who specialize in large account business. The service we provide to clients is clearly reflected in nearly 90% large account client retention.

We are proactively working on January 1, 2009 renewals in an effort to keep the best business. Selective is ready to capitalize on the tools we have in place to drive price where we need to and outperform over the long term. We will also maintain our conservative investment philosophy to maximize after tax yield and income while balancing risks. Overall, we believe we are in a much better competitive position than most carriers to emerge on the other side of this market cycle stronger and more nimble than ever.

Based on our nine month actual results and lower expected investment income in the fourth quarter, we are adjusting our earnings guidance range to $1.75 to $1.85 from $2.00 to $2.20. Our assumptions for the full year 2008 are a statutory combined ratio under 100, a GAAP combined ratio of approximately 101, and diluted weighted average shares of approximately $53 million.

And for the quarter we're making the following assumptions - after tax catastrophe losses of $3 million or $0.06 per share, after tax investment income decrease between 10 and 15%, and diversified insurance services revenue decrease of 1% and return on revenue of approximately 10%. Now I'll turn the call back to the Operator for your questions.

Question and Answer

Operator

(Operator Instructions) Your first question comes from David Lewis - Raymond James.

David Lewis
Raymond James

Greg, from your standpoint do you think one, down the personal lines are you getting pushback from the state regulators at putting that rates in? Or are you already starting to apply for rate improvement as we kind of come into the first quarter? So that's one. And maybe why some of the brokers out there are a little less optimistic about a market hardening just from your perspective.

Gregory Edward Murphy
Chairman & CEO

Okay. Yes, let me address both of those points and then I'll let others comment as well. With respect to the personal lines, I've got to tell you that market's already moved and we filed for a number of price increases country wide and I'll tell you almost every price increase we filed with maybe some slight modification along the way has been approved. Including two in New Jersey, a 6.8 and a 6.5 and a territorial rate change so as all the commentary in New Jersey about being a pretty tight regulatory environment, we've gotten all three of those changes approved pretty quickly.

We also have a homeowners rate change in New Jersey coming through in the first part of 2009. With respect to the rest - and that's New Jersey, all right? So now let's go to the rest of the country. We filed for a number of price increases and we are very comfortable at the velocity of those rate approvals and our ability to put them forth into the marketplace. So that's really that part.

Now let's kind of talk about the commercial line sector because I've got to tell you, personal lines has been a moving story for a number of quarters. Commercial lines is more of a day to day kind of monitoring of the market and I will tell you every day, my opinion gets firmer of our ability to push price.

But let's first address your concern about the broker aspect. You know a lot of times on the broker, you're talking about large brokers. That's not the space that we're really playing in. So when you talk - and that's why when you look at like the industry results from a CIAB survey or a market scout, you're seeing price increases still of like 7, 8, 9% in some cases. And then when you look at a tilling house analysis or CLIPS, you'll see a lot lower on a pure price basis. Our pure price this quarter wasn't down but more than 2%. So we were down in the quarter on a pure price - on a renewal price basis 2%, on a year-to-date basis 1.2%. That's what most other people quote, okay, are the renewal price. No - most people are quoting the renewal prices. When you compare our numbers to Travelers, when you compare our numbers to other companies, it's renewal price. And that's only down 2 on the quarter, 1.2 year-to-date.

Now on a pure price basis, which is really what's going to drive loss costs and combined ratio movement, we were down 3% for the quarter and 3% year-to-date. And that's - I just want to make sure when you start comparing our renewal prices you're looking at a comp relative to the rest of the competition and I don't hear many companies quoting pure price. Most companies are quoting renewal prices. And I also see a lot of companies reporting their combined ratio, ex cats, ex everything else. It's just kind of amusing to me because the wind does blow and it does affect your profitability.

And I will tell you our ability to drive that price increases now through on an agency by agency basis or a line basis, we have the very granular capability to segment our business on a very fine basis. And we're going to be pushing price in different areas of the market and different areas of the country as we move through the year. So I'm going to let John Marchione maybe comment on anything else that he wants to add.

John Marchione

The only thing I'll add to that, Greg mentioned the pricing tools we have, but also the manner in which we're structured whether our renewal underwriters and the contact between our renewal underwriters and our individual agents and producers on renewal business is what allows us to really understand the point at which the market moves.

So that's managed by a line of business level, at a state level and at a class of business level. So I think we are positioned with our renewal underwriters out in the field, close to agents, to really understand when that movement in the market is happening and where very specifically it's happening.

David Lewis
Raymond James

Do you get a sense that some of the more aggressive pricers out there in the market are starting to feel some of the pain of their rating activity of the last couple years that's starting to get them to step back? Or is it a little bit early and we need a little more time for that to filter through?

Gregory Edward Murphy
Chairman & CEO

With the one that probably is the most aggressive nationwide, I've heard that message delivered. But then I've heard the message has been delivered in a very mixed way. In some cases I've heard that they're having discussions about their profitability issues on the one hand but on the other hand I've heard they've also brought in some of their regional managers and said, "Look, why aren't you growing?" So that is something that I think will continue to be refined.

And that message is really - could be as old as 60 to 75 days, which is totally, you know, today might not be of much value because I think as we continue to navigate through these difficult waters, I think everybody's opinion of balance sheet risk relative to the risk that's on the asset side's changed a lot. And therefore people's understanding of pricing and what we need to get on the returns on the liability side, i.e., on the underwriting side has obviously shifted.

And obviously put more pressure, particularly when you start to look at returns on a risk adjusted basis, they need to go higher. And so I think as more companies realize that, and as the old saying goes, "Would you rather have smart competitors or dumb competitors?", we'd rather have smart competitors that understand where the pricing great points need to be and there are still some dumb competitors out there.

David Lewis
Raymond James

Greg, do you compete much against AIG? I mean, and that may be what you're kind of referring to, I hear some mixed messages coming through the organization. Ed Libby's out there saying "We're going to continue to focus on adequate profitability", then I hear from the underwriting side "Look, we're expected to maintain market share", so those don't mesh either.

Gregory Edward Murphy
Chairman & CEO

I would say that they're not one of our big head to head. They play on the upper end of the market. We see them on some of our SRM business. That's our large account business we would run into them and we have run into them on some accounts, which I will tell you they can have a tendency to be aggressive with limits and things like that. But you've got to understand our average account size is $11,000. That's not the space that they play in.

Operator

Your next question comes from Mike Grasher - Piper Jaffray.

Mike Grasher
Piper Jaffray

I just want to follow up on Dave's discussion there around the current marketplace and I'm looking at your risk to capital somewhere around 1.6 at the end of the quarter. And just wondering what would be the ceiling that you could go to on a risk to capital basis?

Gregory Edward Murphy
Chairman & CEO

Dale, why don't you comment on the comments with [inaudible]?

Dale Allen Thatcher
Former Executive VP, Treasurer & CFO

Yes. Basically I mean we're very comfortable where we are right now. We've historically had discussions with the rating agencies about being at 1.8 to 1 premiums to surplus kind of level. But obviously as David indicated earlier, in these uncertain times capital has become somewhat sacred out there. So we're very comfortable where we are. We do feel that there's some level of excess capital, but we're certainly unwilling to commit to any specific dollar amount given the uncertainty out there in the marketplace.

Mike Grasher
Piper Jaffray

You walked through a number of the different levers you have in terms of liquidity and I'm certainly comfortable with all those, but in terms of the sort of the change that occurs going from a 1.6 to a 1.8 that would sort of be the cushion I assume? But if you get a turn in the market, how does that sort of impact some of these? How much time do you have? Do you feel comfortable with the cushion that you have, should you get a sudden change in the market?

Dale Allen Thatcher
Former Executive VP, Treasurer & CFO

You mean as far as being able to take advantage of price increases if the market changes?

Mike Grasher
Piper Jaffray

Exactly.

Dale Allen Thatcher
Former Executive VP, Treasurer & CFO

Yes. I mean obviously we're generating profitability now. As the price changes we'll generate more profitability which will enable our sustainable growth rate to accelerate. So we feel very comfortable at a 1.6 and actually even approaching 1.5 in a lot of our operating subsidiaries. Excellent condition there. As we've indicated also we've got a $50 million line of credit at the holding company level. We could easily tap into that to downstream additional capital in the event that the pricing just hugely accelerates beyond our wildest expectations, which would be a great problem to have.

And in addition to that, we're currently at a 21% debt to cap and a 15% debt to cap on adjusted basis. Obviously the capital markets aren't what I would call open at the moment, but there's certainly room there and we don't anticipate them being closed forever. So we feel very comfortable of our overall capital position in a very conservative and proper manner.

Gregory Edward Murphy
Chairman & CEO

The word I would use on that would be clean. I mean we have good clean long term capital in terms of our debt structure. As Dale mentioned to you in his prepared comments, we have about $12 million maturing in '09, another $12 million maturing in '10 and then there isn't another piece of debt maturing for probably another 23, 24 years after that.

Mike Grasher

Piper Jaffray

Just in terms of that debt to capital ratio, what is your ceiling in terms of your discussions with the regulators of the agencies?

Dale Allen Thatcher
Former Executive VP, Treasurer & CFO

We've been as high as 28 or 29%. I wouldn't say that today that that would be something that they'd be overly comfortable with, just because of what's going on out there in the marketplace. But over time we've indicated to them that around 25% was the level that we felt was appropriate to operate at and they felt very comfortable with that.

Mike Grasher
Piper Jaffray

And then just in terms of the underlying business, the workers comp line and your risk exposures there, can you sort of remind us - you went through and kind of mentioned the contractors, you spoke about those but what is it or what lines or part of the economy are you most exposed to with the workers comp line?

Gregory Edward Murphy
Chairman & CEO

I would say probably construction because it represents approximately 45% of our overall business. And let's make sure that that one because there's a sense out there that I hear from people that when the economy - unemployment goes up and the economy gets weaker, that you're workers compensation results worsen. That's not true. I mean the studies show that actually your results improve and you sit there and say, "Why is that?"

Well, why that is is because you have better workers, better quality workers, people don't want to be out of work. They're worried about their jobs and I will tell you actually the performance actually improves.

But relative to the softness in what are premiums return, return premiums and things like that, it'll probably come mostly in the contracting area where you'll see some downsizing of the contracting. And understand that our business is very well diversified and when you look at even residential or commercial GC's of our contracting book, they only represent approximately 15% of the overall contracting book. And that's probably the area of the market -

Mike Grasher
Piper Jaffray

15% is residential?

Gregory Edward Murphy
Chairman & CEO

No, 10% is residential and 5 is commercial GC. So the total, the aggregate of the two is 15% of our contracting book. So it's pretty well diversified and but that's where you'll see some softness as you move into 2009. And that's some of the issues that our agents obviously have to work through. Delivering price increases into a customer base that's feeling a lot of pain is going to be difficult on their part.

Most - many customers might be experiencing exposure declines either through less sales, less payroll or other things. But I would tell you that probably our comp book is probably more exposed on the contracting area, but theoretically as unemployment kind of takes up the performance of the book should actually improve as a result of that.

Mike Grasher
Piper Jaffray

And do you find a shift in the worker from the standpoint of okay, so they're exposed on the residential construction or that's where they've been, but then do they sort of make the transition over to another type of construction, be it municipality or some other state type of organization that's actually -

Gregory Edward Murphy
Chairman & CEO

You know, it's hard to really navigate through that. I will tell you obviously electricians and HVAC guys are clearly running on the whole green concept are improved lighting and things like that.

Tracks that they can run on where they can actually carve themselves into a market where they can sit there and deliver either a different HVAC system that will bring down their heating and cooling costs, or in the case of electricians where they may be able to migrate from doing new construction work into modification work, where they can install all new, more energy efficient lights and bring them into a place like Selective and say, "Here, we can reduce your - this has got a two year payback, you know, new lighting because it's more efficient" and that.

So there are opportunities like that, but I think what you find in the residential GC's is they'll move more into instead of doing new building, they'll work into modification work. You know, basements, additions, things like that.

Operator

Your next question comes from Susan Spivak - Wachovia Capital Markets, LLC.

Susan Spivak
Wachovia Capital Markets, LLC

I was hoping you could talk a little bit about what you've budgeted for your reinsurance costs next year and how that might change if we do have a harder reinsurance market?

Gregory Edward Murphy
Chairman & CEO

Yes, let me just comment. I mean we met with all of our large reinsurers at the CIAB conference several weeks ago. And I'll just tell you that the tone that we got from the major reinsurers at that time, which may have been modified since then and to a little firmer stance since that conversation probably happened about 20 to 25 days ago, it can be different than it what might be today. That's how fast the velocity that some of these things are moving. Generally, the tone was that they're looking for flat rate relative to what they're getting in terms of premium dollars.

What I mean by that is if our earn premium goes down, their rate's going to go up. As our exposure increases, they want the same amount of rate relative to that exposure. So they're looking for, on a relative basis, the same amount of premium dollars that they got on last year's exposure is what they're going to want on 2009 and that if you add to that exposure then they're going to want more. So that's kind of the message that was clearly delivered, and then with respects to property catastrophe rates I believe that they'll continue to migrate maybe even higher than that.

Operator

Your next question comes from Rohan Pai - Banc of America Securities.

Rohan Pai
Banc of America Securities

Are you noticing any signs of stress especially among some of your mutual and regional competitors? And I'm trying to get a sense whether the weak capital markets may have hurt them more and you might see some movement in small commercial and maybe even the middle market -

Gregory Edward Murphy
Chairman & CEO

Yes, and I've got to tell you that will be something that we'll see as we move through our - we're starting our road shows. We'll be across the country. We'll be in 15 different states starting on Monday. And I will tell you that generally what we see there from the mutuals and other small regional players is that they react to where they end up pretty much towards the end of the year. And what they sense is their rating agency meeting.

And we've run into many instances where basically the rating agencies or whatever have shut them down, say "That's it. You can't grow anymore premium based on your surplus base." And so my sense is that they're a little slower to put together all their information. And my belief is that after they put together their September numbers and move into the October decline, because a lot of these companies are top heavy in equity and their equity securities relative to their surplus is very top heavy. And they're going to get a great surplus diminishment, and that may slow their ability to grow and their ability to be aggressive in the marketplace.

So I think that's going to slow down a lot. And I've got to tell you when we look at our 22 state geo location, the Midwest has probably been the most competitive from a pricing standpoint for exactly the reasons that you mentioned. I believe that that could be the first market to turn in terms of price as a result of the Ike losses that I think hit the Midwest particularly hard. And as a result of some of these other surplus issues that you just mentioned, that you could see a real change maybe in that market, maybe before - that may actually lead to firming relative to following it.

Rohan Pai
Banc of America Securities

A question now on the construction book, the - you mentioned worker's comp results often get better in a slowing economy. What has your experience been on the GL book historically? Do you get higher maybe construction defect claims and things in a weak construction environment? Or is that not really a factor?

Gregory Edward Murphy
Chairman & CEO

No, I would think that that wouldn't really be that big of an impact relative to the economy. I think what you're looking - and I guess if you really wanted to stretch what I said before and you could sit there and say, "Maybe when you have a better quality worker on the job you don't get bad caulking around a window" that maybe generates a construction defect claim down the road in terms of new business. That's really a stretch though, but you know if you have a better quality worker on the job maybe you get a better quality product and it lessens maybe construction defect claims long term. But that's a real stretch.

Rohan Pai
Banc of America Securities

And then finally for Dale the lower investment income in the fourth quarter, if you can remind us do you report your alternative asset returns on a one month lag?

Dale Allen Thatcher
Former Executive VP, Treasurer & CFO

Most of the alternatives are on a one quarter lag. There are several of them that are on time, but a few of them end up coming in a little bit late. The other thing is that traditionally in the fourth quarter is our heaviest common stock dividend quarter and we have an anticipation that the dividends aren't going to be quite as strong from our investments in the fourth quarter. So that's why we've included that in our projections.

Gregory Edward Murphy
Chairman & CEO

And the other thing, Rohan, on that too is we're a very heavy cash position right now and the virtual collapse in the short term rates is also having an impact relative to when we look out at the fourth quarter. And that's why when you sit there and say with respects to our investment income forecast for the quarter that reflects virtually no investment income on any alternative investment and much lower returns relative to the heavy, short term position.

And the third point is just an expectation that dividend yields relative to harvesting of realized gains on mutual funds will be down just based on what's happened in the market. As much as I hate to do this, I think our investment income just reflects what we believe to be what will happen in the fourth quarter. And that's what it is.

Rohan Pai
Banc of America Securities

And the equity trading portfolio is as of the current quarter when you report the gains and losses on that one?

Dale Allen Thatcher
Former Executive VP, Treasurer & CFO

That's correct.

Gregory Edward Murphy
Chairman & CEO

And we actually have started to move some of that portfolio into an AFS so it has less volatility on our [vest] income. So we've actually moved about half of that portfolio out of trading back into available for sale and we'll look at opportunities in that for the rest of the year as well. Just to lessen the volatility on the investment income line.

Operator

Your next question comes from David Lewis - Raymond James.

David Lewis
Raymond James

Any thoughts on kind of where you see the tax rate going maybe in the fourth quarter as well as 2009? And second I know you've made a number of efforts to reduce the GAAP expense ratio that'll start to show up. How quickly do you think we start to see that flowing into 2009?

Gregory Edward Murphy
Chairman & CEO

I think you'll start to see that in the second quarter really start to catch into that run rate particularly as the commission reductions start to get amortized more into the expense ratio.

David Lewis
Raymond James

Are we talking about a half a point benefit or a point or what do you think?

Dale Allen Thatcher
Former Executive VP, Treasurer & CFO

Well you've seen the dollar amounts that we've talked about announced, it's about $8 million on the commission reduction and $8 million in terms of the run rate on the lower expenses regarding salaries. So both of those two numbers will begin to manifest themselves in a more full way in the GAAP as Greg indicated in the second quarter.

Gregory Edward Murphy
Chairman & CEO

Do you want to answer the question about effective tax rate then?

Dale Allen Thatcher

Former Executive VP, Treasurer & CFO

That's where I was headed, yes. On the tax rate front the one thing is this is fairly low where we are right now. The expectation is is that we don't have a whole lot more room, if any, in terms of adding additional municipals. So it should begin to drift a little bit upward from where it is currently. The other thing that causes it to be as low as it is is the fact that you've got the alternatives and the MLP, those chunks that are showing big negatives are 35% chunks. So they have a depressing impact on the tax rate also.

Gregory Edward Murphy
Chairman & CEO

And then as the markets start to come normalized, whenever that may be, as more product in the market is start to purchase, [these] got some opportunity to really get some yield pick up.

David Lewis
Raymond James

So if we just pick a figure, and you'll let us know when things normalize, right?

Gregory Edward Murphy
Chairman & CEO

Hey, no, I figured you'd do that.

David Lewis
Raymond James

But let's just assume the world comes a little more normal by January of 2009 and if things kind of worked in a more fluent environment should we maybe look at a 25% tax rate as a starting point?

Gregory Edward Murphy
Chairman & CEO

No, I think that's probably a little high.

Dale Allen Thatcher
Former Executive VP, Treasurer & CFO

I guess the one thing we've got to be careful about is that when I'm discussing the tax rate I'm discussing the tax rate on investment income. That has traditionally been between the current 21.5 and about a 24 kind of number. So I would anticipate it would drift upward, but 25 would be too high. The way to look at our taxes is to break apart the investment income and use a rate on that and then use 35% on everything else. Because the blended rate is wholly dependent upon the relative sizes of the components.

David Lewis
Raymond James

And Greg I'll put you a little bit on the spot. I know you probably haven't done your budgeting but just from a high level for 2009 expectations, it's going to take awhile for any rate improvement to flow through, you're going to get some expense ratio benefits as you indicated in the second quarter, with the rate decreases that we've seen over the last couple of years continuing to pressure the combined ratios but then you've got some benefits as you improve, is kind of flattish number maybe a good starting point as we look at 2009?

Gregory Edward Murphy
Chairman & CEO

We will be putting out our forecast with the year end call and obviously you know that the rate level reductions that have occurred this year need to be earned in into the 2009 numbers. But we won't be giving any prognostication on that until we are done our full budgeting process and we'll release that with our year end call.

David Lewis
Raymond James

Let me go about it maybe a different way. If we just kind of look at the loss ratio and I know you've got the matrix benefits and everything else you continue to improve that profitability, would it be fair to assume some of the potential improvements are probably all set by the rate pressure that we've seen over the last year or two?

Gregory Edward Murphy
Chairman & CEO

As I said before we'll release our year end - with the year end results we're releasing our 2009 forecast. There's a lot of moving parts in that.

Operator

Your next question comes from [Scott Helenak] - RBC Capital Markets.

Scott Helenak
RBC Capital Markets

Can you just talk about any significant changes you're seeing on either frequency, severity lines in your overall book? I know obviously workers comp has improved quite a bit but anything out of the ordinary you're seeing on the other lines besides -

Gregory Edward Murphy
Chairman & CEO

Generally frequency trends are down on the severity side that we've made a lot of modifications in our claim department that have made the statistics year to year not really comparable. So it's really difficult for us to really even talk about the severity aspect of the numbers we're seeing, but the general trends [inaudible] comment is that frequency continues to modestly improve. And I really couldn't give you any comment on severity which means I really can't give you any comment on the overall loss costs.

Scott Helenak
RBC Capital Markets

You mentioned slight [inaudible] on the agency side and I'm just wondering if you expect to increase more your agency count next year? As kind of the market stabilize you have more agencies, high quality agencies probably knocking on your door. How are you thinking about that for next year? Any impact there as I'm sure that's probably already happening [since] some of your competitors are kind of wounded?

John Marchione

I'll respond to that. In terms of agency planning, we go through a pretty in depth planning process, AMS territory by AMS territory. As you know we're at about 930 agents at the end of the third quarter, we've added about 85, 87 during the course of the year so far. We put out a long range target a couple of years back of 1,000 and I think that continues to be about where we'd expect to see it go over the next year or two.

We've obviously benefited in terms of agency growth or additions to our agency plant by the additions of Tennessee and Massachusetts. And some of what you see in that 87 this year is driven by those two states. But we still have some geographic pockets in a number of our existing footprint states, especially those newer states. The mid-America states and some of the northeastern states where we have some opportunity to add some additional agents along the way.

We've got a lot better information now in terms of where the market opportunity is across all of our business segments and what the reach of our individual agents are across those territories and our filling in those gaps. So again I think we'll take another pretty good step towards getting that 1,000 number, but that's about where we feel comfortable at this point in our 22 state footprint.

Gregory Edward Murphy
Chairman & CEO

And the only comment that I would kind of add to that in addition to bringing on new agents and bigger agency opportunities, we are also continuing to help agents hire producers which is another avenue or another source of revenue generation. And then we've obviously coupled that with a more aggressive leads program that is starting to garner a lot of traction. We've rolled out one of our newer products, out Pay Go workers compensation.

And then what we are focusing on tremendously is the development of sales and sale management tools with respects to better selling techniques at the producer level, which we've trained probably several hundred - we probably trained over 3, 400 people last year throughout our agencies. And we are actually doing even more so at the managerial level. So the goal is to find ways to increase the effectiveness of our distribution plant and then add more producers to that.

In addition like John said to selectively add more agents in our geo footprint, because as the market starts to move and our agents get more into a growth mode, because they are actually in a protection mode now.

So the protection mode is they're trying to protect their renewable inventory, which means their producers are spending less time harvesting accounts, more time protecting their inventory, and as that kind of shifts into more growth and less protection because the market stabilizes, plus all these other things that we've done should begin to help us grow. Now countering that obviously is a pretty soft economy that we prognosticate for 2009. So all those factors kind of have to be weighed together when we look at our 2009 expectations.

Scott Helenak
RBC Capital Markets

Can you just comment on - I guess you've been in Massachusetts over a year now and just got into Tennessee, can you just talk about whether those are kind of running on planned as you imagined or just any general commentary on -

Gregory Edward Murphy
Chairman & CEO

Yes. Both those states have run much better than expectation. I will tell you that the agencies that we have in Tennessee are very happy that we're there. They're giving us a lot of business opportunities. And I think the best example that I can demonstrate to you with respect to Massachusetts is we will have - our President's Club has a $2 million requirement and we're going to have an agency in Massachusetts qualify for the President's Club outright and we've only - by the conclusion of this year, we would have been in Massachusetts for 18 months.

So they are very excited up in Massachusetts about having a strong, regional carrier that underwrites business the way it used to be done many years ago. That's the comment that I hear from some of our Massachusetts agents. We have three AMS's on the ground in Massachusetts. They're still continuing to develop out their agency plant. And we are very, very comfortable with the commercial lines, regulatory environment there and our ability to grow and generate an underwriting profit.

Operator

And at this time there are no further questions.

Gregory Edward Murphy
Chairman & CEO

All right. Well thank you for participating in the call this morning. The market environment continues to be challenging but we remain optimistic about our long term success. If you have any follow up questions please call Jennifer or Dale. Thank you.

Operator

And this concludes today's conference call. You may disconnect at this time.