S&P Global
Market Intelligence

American Financial Group, Inc. NYSE:AFG

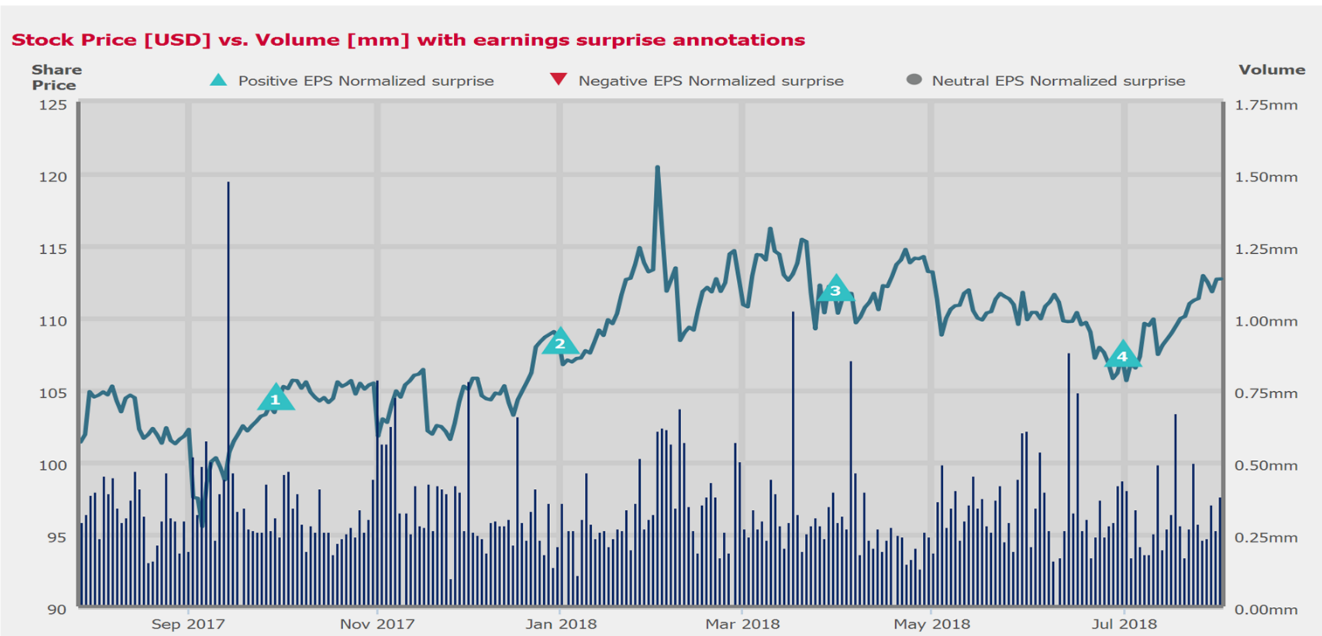
FQ3 2018 Earnings Call Transcripts

Wednesday, October 31, 2018 3:30 PM GMT

S&P Global Market Intelligence Estimates

	-FQ3 2018-			-FQ4 2018-	-FY 2018-	-FY 2019-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	1.87	2.19	▲17.11	2.22	8.58	8.68
Revenue (mm)	1294.00	1327.00	▲2.55	1280.50	4842.50	5214.33

Currency: USD
Consensus as of Oct-31-2018 12:54 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2017	0.84	1.06	▲24.71 %
FQ4 2017	1.64	2.20	▲34.15 %
FQ1 2018	1.92	2.42	▲26.04 %
FQ2 2018	1.91	2.04	▲6.81 %

Table of Contents

Call Participants

EXECUTIVES

Carl Henry Lindner
Co-President, Co-CEO & Director

Diane P. Weidner
Assistant Vice President of Investors Relations

Joseph E. Consolino
Executive VP, CFO, Principal Accounting Officer & Director

Stephen Craig Lindner
Co-President, Co-CEO & Director

ANALYSTS

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

DeForest R. Hinman
Walthausen & Co., LLC

Jon Paul Newsome
Sandler O'Neill + Partners, L.P., Research Division

Lawrence David Greenberg
Janney Montgomery Scott LLC, Research Division

Presentation

Operator

Good day, ladies and gentlemen, and welcome to the American Financial Group 2018 Third Quarter Results. [Operator Instructions] As a reminder, this conference is being recorded. I would now like to introduce your host for today's conference, Diane Weidner, assistant Vice President Investor Relations. Ma'am, you may begin.

Diane P. Weidner
Assistant Vice President of Investors Relations

Good morning, and welcome to American Financial Group's Third Quarter 2018 Earnings Results Conference Call. I'm joined this morning by Carl Lindner III, and Craig Linder, Co-CEOs of American Financial Group; and Jeff Consolino AFG's CFO. Our press release, investor supplement and webcast presentation are posted on AFG's website. These materials will be referenced during portions of today's call. Before I turn the discussion over to Carl, I would like to draw your attention to the notes on Slide 2 of our webcast. Certain statements made during this call may be considered forward-looking statements as defined under the Private Securities Litigation Reform Act of 1995. These statements are not guarantees of future performance. Investors should consider the risks and uncertainties that could cause actual results and/or financial condition to differ materially from these statements.

A detailed description of these risks and uncertainties can be found in AFG's filings with the Securities and Exchange Commission, which are also available on our website. We may include references to core net operating earnings and non-GAAP financial measure in our remarks or in responses to questions. A reconciliation of net earnings attributable to shareholders to core net operating earnings is included in our earnings release. And finally, if you're reading a transcript of this call, please note that it may not be authorized or reviewed for accuracy, plus it may contain factual or transcription errors that could materially alter with the intent or meaning of our statement. Now I am pleased to turn the call over to Carl Lindner III to discuss our results.

Carl Henry Lindner
Co-President, Co-CEO & Director

Good morning. We released our 2018 third quarter results yesterday afternoon. If you'd turn to Slide 3 of the webcast slides for an overview. Craig and I are very pleased to report a new third quarter record for AFG's core operating earnings at $2.19 per share, up 107% from last year's third quarter, which was impacted by significant cat losses. Our results include strong profitability in our Property and Casualty operations and excellent results in our Annuity segment. Third quarter 2018 annualized core operating return on equity was 15.8%. Net earnings per diluted share were $2.26 and included $0.31 per share in realized gains on securities and a $0.24 adjustment to our A&E reserves. Craig and I thank God, our talented management team and our great employees for helping to achieve these results. Based on results through September 30, we're increasing our 2018 core operating earnings guidance for AFG to be in the range of $8.35 to $8.65 per share, up from our previous estimate of $8.10 to $8.60 per share, and an increase of $0.15 per share at the midpoint. Our guidance does include a preliminary estimate of approximately $30 million for pretax losses associated with Hurricane Michael, and the estimated impact of stock market declines in the fourth quarter to date on Annuity segment earnings. Craig and I will discuss our guidance for each segment of our business in more detail later in the call. Now I'd like to turn our focus to Property and Casualty operations. Earlier this month, we announced that we reached a definitive agreement to acquire ABA Insurance Services.

ABA Insurance Services is a market-leading provider of D&O and other complementary insurance solutions for banks, small businesses and nonprofit organizations with a long track record of underwriting success and profitability. We expect the transaction to close later this year. And we look forward to welcoming John Wells and his team as our 34th Specialty Property and Casualty business. We're already a leading specialty rider at D&O with attractive niches and nonprofits, private companies and small accounts. ABA

Insurance Services adds another specialized niche within our Specialty Casualty Group. Now if you'd please turn to Slides 4 and 5 of the webcast, which include an overview of third quarter results. As you'll see on Slide 4, gross written premiums in our Specialty Property and Casualty insurance operations were flat year-over-year and net written premiums grew by 2%. A change in the timing of the renewal of 2 large transportation accounts from the third to fourth quarter impacted reported growth in the quarter. Excluding the timing of these policy renewals, overall, Specialty Property and Casualty gross and net written premiums grew by 2% and 5%, respectively, from the year ago quarter. Property and Casualty operating earnings in the third quarter were significantly higher year-over-year. Higher Property and Casualty underwriting profit principally due to lower catastrophe losses and higher Property and Casualty net investment income primarily the result of higher earnings, unlimited partnerships and similar investments both contributed to the year-over-year improvement. The strong performance of these investments shouldn't necessarily be expected to repeat in future periods. Specialty Property and Casualty combined ratio of 95.7% included 3.7 points in favorable prior year reserve development, catastrophe losses added 2.6 points. Overall, renewal pricing in our Specialty Property and Casualty Group was up 2% during the third quarter, that's the highest that we've seen in 17 quarters in above our overall loss ratio trend, which is about 1.5%. Loss cost trends remain stable, and we're keeping our eye on inflation and interest rates. Excluding our Workers' Comp business, overall renewal pricing was up about 3% during the quarter. I am pleased that we're seeing broader price movement and achieving renewal rate increases in the majority of our Specialty Property and Casualty businesses. In our Workers' Comp businesses, overall, we continue to see pricing pressure associated with strong industry profitability. Despite the rate decreases, we believe we're making appropriate returns in these businesses in the current policy year.

Now I'd like to turn to Slide 5 to review a few highlights from each of our Specialty Property and Casualty Groups. Our Property and Transportation Group reported breakeven underwriting results in the third quarter of '18 compared to an underwriting profit of $6 million in the prior year period. Improved underwriting results in our Ocean Marine operations and higher underwriting profit in National Interstate were offset by lower accident year profitability in several other businesses in this group. Overall, results include 0.8 points of favorable prior year reserve development in the third quarter of '18 compared to 1.5 points in the year ago period. Catastrophe losses for this group were $13 million in the third quarter of '18 compared to $25 million in the comparable prior year period. Gross and net written premiums for the third quarter of 2018 were 11% and 10% lower, respectively than the year ago 2017 period. Again, the decrease was largely the result of a change in the timing of the renewal of 2 large accounts in one of our transportation businesses from the third to the fourth quarter, as I noted earlier. As well as the lower year-over-year premiums in our crop insurance business as we had expected. Gross and net written premium in the other businesses in this group for the third quarter grew by 6% and 4%, respectively, year-over-year.

Overall, renewal rates in this group increased 3% on average for the third quarter of 2018 with nearly all the business in this group achieving renewal rate increases. Today, marks the closing of the 23-day harvest price discovery averaging period for corn and soybean contracts. Based on pricing, as of yesterday, corn will finish down 7%, and soybeans will finish down 15% from the spring discovery pricing. National corn and soybean yields are expected to be at record levels. While we're generally comfortable with pricing, crop results are dependent on a state-by-state basis results. But certain states falling below-expected profitability. Overall, we anticipate slightly above-average crop profitability this year following last year's very strong results. Specialty Casualty Group reported third quarter underwriting profit of $49 million compared to $2 million in the third quarter of '17. The year-over-year improvement was primarily attributable to lower third quarter 2018 catastrophe losses within Neon, as well as higher underwriting profit in our executive liability business. The negative impact of catastrophe losses for this group were $12 million and $56 million, respectively in the third quarters of '18 and 2017. Gross and net written premiums increased 12% and 11%, respectively, for the third quarter of 2018, when compared to the same prior year period. Growth within Neon was the primary driver of the higher premiums. To a lesser extent, our workers' compensation and excess and surplus lines businesses also reported higher year-over-year premiums. Renewal pricing for this group was up about 1% in the third quarter. And we continue to see pricing momentum in our social services, excess liability and D&O businesses. Excluding our Worker's Comp businesses, renewal rates in this group were up approximately 2%.

Our Specialty Financial Group reported an underwriting profit of $9 million in the third quarter compared to an underwriting loss of $3 million in the third quarter last year. Lower year-over-year catastrophe losses in the lender-placed mortgage property book within our financial institutions business and higher underwriting profitability in our surety business were the primary drivers of this growth. The negative impact of catastrophe losses for this group were $13 million and $31 million in the third quarters of 2018 and 2017, respectively.

Gross and net written premiums increased by 8% and 2%, respectively in the third -- 2018 third quarter when compared to the same 2017 period primarily as a result of higher premiums in our financial institutions business. Renewal pricing in this group increased by 6% for the quarter. Now if you please turn to Slide 6 for a summary view of our 2018 outlook for Specialty Property and Casualty operations. Based on the results for the first 9 months of the year, we now expect a 2018 combined ratio for the Specialty Property and Casualty Group overall between 93% and 94%. We've narrowed our range from our prior estimate of 92% to 94%.

Specialty Property and Casualty Group's calendar year GAAP combined ratio has been between 92% and 94% each of the 5 preceding years. Our guidance for growth and net written premiums is now in the range of 5% to 7%, also, narrowed from the 4% to 8%, estimated previously. Looking at each segment, we now estimate a combined ratio in the range of 94% to 96% in our Property and Transportation Group, up from the range of 91% to 95% estimated previously. Net written premiums in this group were estimated to be down 1% to up 2% for the year, revised from our previous estimate of flat to up 4%. We now expect our Specialty Casualty Group to produce a combined ratio in the range of 93% to 95%, narrowed a bit from the previous range of 92% to 96%. We revised our estimate for growth in net written premiums to be between 9% and 12%, up from our previous estimate of growth of 6% to 10%. And we've revised our expectations for the combined ratio and Specialty Financial Group to be in the range of 89% to 91%, up from the range of 86% to 90%, estimated previously. Our projection for growth in net written premiums is now in the range of 3% to 6%, narrowed slightly from our previous estimate of 3% to 7%. We continue to expect overall Property and Casualty renewal pricing this year to be up 1% to 2%. Given the strong performance of certain investments, including limited partnerships and similar investments during the first 9 months of the year, net investment income is now expected to grow between 15% and 18% year-over-year, a change from the 10% to 13% growth estimated previously. I'll now turn the discussion over to Craig to review the results in our Annuity segment and AFG's investment performance. Thank you.

Stephen Craig Lindner
Co-President, Co-CEO & Director

Thank you, Carl. I'll start with a review of our annuity results for the third quarter beginning on Slide 7. Statutory Annuity premiums were $1.38 billion in the third quarter of 2018, an increase of 57% from the prior year period. Sales of traditional fixed and indexed annuities in 2018 by AFG and the industry continue to be significantly higher than sales in 2017.

We are pleased with our premium growth and we continue to earn our targeted returns despite a competitive market. While we have seen third quarter sales growth in all of our channels, production in the retail and broker-dealer mortgage continues to be particularly strong due to the launch of several new products and our efforts to expand our penetration of these markets. Rising interest rates as well as the favorable impact of tax reform allowed us to selectively raise credited rates on new business this year.

By comparison, looking back in 2017, the annuity industry faced uncertainty related to the proposed Department of Labor rule, which was later vacated in 2018.

Furthermore, interest rates fell in 2017. And in response, AFG implemented several decreases in credited rates in 2017 to maintain appropriate returns on new sales. The rate decreases resulted in a negative impact on premiums in the second half of 2017.

Turning to earnings results. Pretax annuity earnings were $117 million in the third quarter of 2018 compared to $102 million in the third quarter of 2017, an increase of 15%.

The components of fair value accounting are shown on this slide. Under GAAP rules, a portion of the reserves for fixed indexed annuities is considered to be an embedded derivative and is recorded at fair value based on the estimated present value of certain expected future cash flows.

Assumptions used in calculating this fair value include: projected interest rates, option costs, surrenders, withdrawals and mortality.

Variances from these assumptions as well as changes in the stock market will generally result in a change in fair value. Some of these adjustments are not economic in nature for the current reporting period but rather impact the timing of reported results. The impact of fair value accounting for fixed indexed annuities includes an ongoing expense for annuity interest accreted on the FIA embedded derivative reserve. The amount of interest accreted at any period is generally based on the size of the embedded derivative and current interest rates.

We expect both the size of the embedded derivative and interest rates to rise, resulting in continued increases in interest on the embedded derivative liability. In the third quarter of 2018, the stock market increased 7%. This increase exceeded our expectation of a 1% increase and resulted in a significant favorable impact of $12 million for the quarter.

For an analysis of fair value accounting, see our quarterly investor supplement, which is posted on AFG's website. Annuity earnings before fair value accounting for fixed indexed annuities were $119 million in the third quarter of 2018, up 12% from the prior year period.

Turning to Slide 8, you'll see that AFG's quarterly average annuity investments and reserves grew by approximately 10% year-over-year. In addition, as shown in AFG's Quarterly Investor Supplement, AFG's Annuity segment results were, again, favorably impacted by exceptionally high returns on certain investments required to be mark-to-market, including very strong earnings from limited partnerships and similar investments.

These high returns should not necessarily be expected to repeat in future periods. The benefit of these items was partially offset by the runoff of higher-yielding investments.

Please turn to Slide 9 for a summary of the 2018 outlook for the Annuity segment. Due to significantly stronger-than-expected earnings in the third quarter of 2018, we're increasing our guidance for annuity earnings before the impact of fair value accounting for FIAs and unlocking. We now estimate that these earnings will be in the range of $440 million to $450 million compared to our previous guidance of $430 million to $450 million. However, as a result of the decrease of 9% in the S&P 500 since September 30, 2018, we now estimate that pretax annuity earnings, including fair value accounting and the second quarter unlocking charge, will be in the range of $385 million to $425 million, which is lower than our most recent guidance but equal to our original 2018 guidance. As you'll see on Slide 10, this guidance indicates fourth quarter earnings of between $44 million and $84 million. This range is significantly lower than recent quarterly results for 2 primary reasons. First, and primarily, interest rates and stock market can have significant positive or negative impacts on the Annuity segment's results.

Due to the -- due to increases in stock market and interest rates in the first 9 months of 2018, the impact of fair value accounting has generally been positive, resulting in a total of $14 million of earnings in the first 9 months of 2018. However, as of yesterday morning, the S&P 500 had decreased by 9% in the fourth quarter. This decrease assuming no recovery in stock markets before year-end will have a negative impact on AFG's earnings. This negative impact is included in our updated guidance. The majority of this negative impact is noneconomic in nature and is expected to reverse over time. Much of the remaining impact is economic but would reverse over time if the stock market recovers.

Second, and to a lesser extent, as can be seen in our investor supplement, income from the Annuity segment's equity and investees, primarily limited partnerships that are required to be mark-to-market, were $25 million in the third quarter of 2018, and $77 million in the first 9 months of 2018, reflecting year-to-date returns of approximately 15%. We are not forecasting such high returns to continue in the fourth quarter of 2018.

These earnings expectations do not reflect any potential earnings impact from our annual fourth quarter review or unlocking of major actuarial assumptions in our fixed annuity business. Finally, we continue to emphasize earning the appropriate returns on new sales regardless of the competitive environment. Based on our strong sales year-to-date, we now expect that our 2018 full year annuity premiums will be up 17% to 20% from the $4.3 billion reported in 2017. This is an increase from our previous estimate of growth of between 10% and 15%.

The resolution of the Department of Labor Fiduciary Rule has provided lift for the retail market, and a current demand for shorter surrender charge period products fits well with our product strategy. Our guidance reflects the introduction of new products and opportunities to grow our business in the registered investment adviser and broker-dealer markets. Our recently launched Landmark 5 product targeted for these markets has been particularly successful due to its short duration and simple design.

Please note that fluctuations in the returns on investments, large changes in interest rates and/or the stock market and higher or lower FIA option costs as compared to our expectations could lead to significant positive or negative impacts on the Annuity segment's results.

Additional information on the Annuity segment's earnings, premiums, investments and reserves can be found in AFG's Quarterly Investor Supplement posted on our website.

Please turn to Slide 11 for a few highlights regarding our $48 billion investment portfolio.

AFG reported third quarter 2018 net realized gains on securities of $27 million aftertax and after deferred acquisition costs. This compares a net realized losses on securities of $8 million in the third quarter of 2017.

As of September 30, 2018, unrealized gains on fixed maturities were $93 million aftertax and after DAC. As you'll see on Slide 12, our portfolio continues to be high-quality with 90% of our fixed maturity portfolio rated investment-grade and 98% with an NAIC designation of 1 or 2, its highest 2 categories. We provided additional detailed information on the various segments of our investment portfolio in the Quarterly Investor Supplement on our website. I will now turn the discussion over to Jeff, who will wrap up our comments with an overview of our consolidated third quarter 2018 results and share a few comments about capital and liquidity.

Joseph E. Consolino
Executive VP, CFO, Principal Accounting Officer & Director

Thank you, Craig. Slide 13 summarizes AFG's core operating earnings results on a consolidated basis. The $2.19 of core EPS is based on core net operating earnings in the quarter of $198 million. The year-over-year increase in core earnings in the 2018 third quarter was primarily the result of strong operating earnings in our insurance businesses. Property and Casualty pretax operating earnings were 66% higher year-over-year, specialty P&C underwriting profit was $46 million higher in the 2018 third quarter, primarily due to lower catastrophe losses.

P&C net investment income grew $14 million or 15% year-over-year, primarily the result of unusually high returns on certain investments, including limited partnerships and similar investments.

2018 P&C other expenses were $6 million, which was roughly in line with the 2017 third quarter. Pretax earnings for our Annuity segment increased 15% year-over-year. Interest and other corporate expenses decreased by $2 million. Parent company interest expense decreased by $6 million year-over-year, as a result of our 2017 debt refinancings. Starting in Q1 this year, this line item includes income and expenses related to AFG's previously reported runoff lines of business.

Slide 14 provides a reconciliation of core net operating earnings to net earnings. Recall, AFG adopted ASU 2016-01 effective January 1, 2018, which requires holding gains or losses and equity securities to be recognized in net earnings.

The impact to our income statement will vary each quarter depending on the performance of the securities held in our equity portfolio. In the third quarter of 2018, AFG recognized $27 million or $0.31 per share in net aftertax realized gains. Realized gains increased net earnings in the quarter. Net earnings were reduced by an A&E reserve adjustment of $21 million or $0.24 per share. According to data provided by S&P Global Market Intelligence, industry 3-year survival ratios for asbestos and environmental reserves were 6.7x paid losses as of year-end 2017. In contrast, the 3-year survival ratio for AFG's P&C insurance businesses now stands at 15x paid losses.

As indicated on Slide 15, AFG's adjusted book value per share was $57.22 as of September 30, 2018. Annualized growth in book value per share plus dividends was a very strong 15.6% for the first 9 months of 2018. We returned $31 million to our shareholders with the payment of our regular quarterly dividend during the third quarter. Recall, in August 21, we announced an increase in our regular annual dividend by 14%, from $1.40 to $1.60 per share on an annual basis.

AFG has increased its dividend in each of the last 13 years. This increased dividend was paid on October 25. Parent cash at the end of the third quarter was $250 million. We maintained sufficient capital on our insurance businesses to meet our commitments to the ratings agencies.

Our excess capital stood at approximately $865 million at September 30, 2018. Remember, we plan to hold approximately $200 million to $300 million as dry powder to maintain flexibility for opportunities as they may arise. Our management team reviews all opportunities for the deployment of capital on a regular basis. Wrapping up, on page 16, we show a single page presentation of our updated 2018 core earnings guidance, the midpoint of which has moved up by $0.15 per share.
Our guidance assumes an effective tax rate of approximately 19% on core pretax operating earnings. AFG's expected 2018 core operating results exclude noncore items, such as realized gains and losses, and other significant items that may not be indicative of ongoing operations. Thank you. Now we'd like to open the lines for any questions.

Question and Answer

Operator

[Operator Instructions] Our first question comes from Greg Peters with Raymond James.

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

I wanted to just focus on, as far as the Property, Casualty operations are concerned, I was looking at your supplement. And on Pages 8, 9 and 10, you provide details on each segment. And there was one line item in -- on each of those pages that caught my attention and that would have been the combined ratio line, excluding catastrophes and prior year development. And I noted that in all 3 lines, all 3 segments, the combined ratio, excluding catastrophe and prior year reserve development was not only up on a quarter-over-quarter basis but also, on a 9-month-over-9-month basis. So I was wondering if you could help reconcile the moving parts in each of the segments which are causing this upward trend?

Joseph E. Consolino
Executive VP, CFO, Principal Accounting Officer & Director

Greg, this is Jeff Consolino. First, thank you for studying our investor supplement. We are pleased when people make use of the information that we provide them with.

In past quarters, when we talked about trends here, we've always started by saying you've got to look at each of the subsegments individually, and I think that each one has a different dynamic at play.

Overall, though, just a reminder that we're aware of these trends, and we certainly look at these trends when we provide our guidance for the year. So whatever you're seeing here on those pages has been fully reflected in our expectations for our earnings results in 2018.

If you'll indulge me for a second, let me just go through each of the pages. And I'm going to focus on the quarter rather than year-to-date, if you don't mind. So for Property and Transportation, it is correct, we've moved up on that ratio. If you split it between the movement and the underlying loss ratio and the expense ratio, it's 1.2 points higher for the current accident year loss in L&E ratio, excluding cat losses.

We talked on our last quarter call about some elevated loss activity in our aviation group and our equine group was in this. That plus some of our international business account for that 1.2 point rise. On the expense ratio, that is 1.3 points higher. Now our 2 biggest business units in Property and Transportation are crop and National Interstate. As Carl talked earlier about crop being slightly smaller year-over-year in terms of premium, and crop also has the lowest expense ratio in the group. So a lower balance of crop business will necessarily elevate the expense ratio a little bit as the other lines of business in P&C take a bigger share.

In addition to that National Interstate, which is better than 1 quarter of our earned premium in this segment, had an increase in its expense ratio for, what I would term to be, internal accounting purposes. We've had them under our ownership for 2 full years and brought them into our expense allocation architecture. And so that rose by allocating some of our corporate expenses down into National Interstate and artificially inflated the expense ratio in this segment.

For Specialty Casualty, this is a big chunk of our overall business. It's about half of our written premium. Here, our current accident year loss and L&E ratio, excluding cat, has actually declined by 1.7 points. The reason for that is that we've had an improvement in the loss ratio for Neon, excluding cats. Neon is a relatively large unit here. So that's being driven by better performance in Neon's Underwriting. On the expense side, that rose by 4 points. I talked about Neon being a relatively big share. Neon's gone from being about 1/10 of the earned premium in the segment to about 1/7, and operating always carries a higher expense ratio. So that increase the expense ratio in this subsegment with Neon being a bigger piece. Another piece of that is Summit, which is another large business unit for us here. They represent nearly a quarter of the earned premium base. Summit pays policyholder dividends, which we include in expenses. And since Summit's operating results and loss ratio have been very good, the policyholder dividend ratio has risen, which contributed to a rise in the expense ratio.

In addition, Summit receives fees for managing some third-party mutual entities and those entities have declined in size and Summit has grown. So the offsetting expense benefit of managing those has relatively decreased in the quarter. So those are the more significant items I would point to for the expense ratio change there. I can go more quickly on Specialty Financial, which is the last of the 3 subsegments. What you're seeing there is driven by our financial institutions business and the lender-placed mortgage property business. We said in past quarters, we look at the combined ratio with the expense ratio and the loss ratio moving in opposite countervailing directions. We had an improvement in the loss in L&E ratio, excluding cats for the current accident year of 1.5. All else equal, that would raise the expense ratio because of profit commission components, the one last factor that really contributes to the 8 point increase. And this will carry across more broadly, spread across our whole business. With very high cats in 2017, we had a reduction in that commission expense that was effectively caught back in the third quarter of 2017, that was meaningful, but not present in the third quarter of this year. If you go back for this subsegment, in the last 10 quarters, the expense ratio has only been under 50% for 1 quarter, which was a year ago. So this really is a return to a more normal expense ratio for the subsegment rather than indicative of an ongoing elevationary difference. So again, thank you for studying the supplement and asking the question. I hope that wasn't too much detail but that's how we'd analyze the 3 pages you referred to.

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

Well, that's excellent color and it's almost like you were prepared for the question, Jeff. So I'll stop on that point. Two other topics to discuss. Your investment income guidance and results clearly are tracking ahead of expectations. And I'm curious, if you have a view on how, call it, sustained levels of market volatility might affect this line as we think about 2019?

Stephen Craig Lindner
Co-President, Co-CEO & Director

Greg, this is Craig. What I would say is the returns on mark-to-market assets have been exceptionally strong year-to-date through the first 9 months, and we don't expect that to continue. We would project a more normal rate of something in the neighborhood of 10% or so on a go-forward basis. It can be somewhat lumpy, as you know. Our expectation on the lifetime returns would be higher than that. It'd probably be, I don't know, what 12% to 15% or some number like that. But in the first year or 2, when you make investments in private equity or some of the assets that are mark-to-market, you don't have earnings. So it weighs the overall returns down a bit. So from a reported earnings standpoint, or investment income standpoint, I would think something more in line with a 10% type number would be a good number to use for projections.

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

Craig, I did -- I don't want to steal your thunder, but I did have a question for you in 2 parts. First of all, can you talk about the competitive environment in the retail side of your business? It looks like you're continuing to do a lot better this year than last year. And then secondly, in your guidance, the pretax Annuity guidance, and this is Slide 9 of your conference call presentation. The range that you updated has been expanded. So -- and I'm just -- and you lowered it, but you also increased the size of the range, and I'm just curious about the mechanics behind that.

Stephen Craig Lindner
Co-President, Co-CEO & Director

Sure. First of all, on the competitive environment, it is a competitive environment, generally always is a competitive environment. Having said that, the industry premiums are growing at a very strong rate. As you know, we just raised the guidance for our premiums to -- overall premiums to up 17% to 20%. We think that the industry will probably be a little bit stronger than that. So here for a number of reasons, sales -- and when I say industry sales, I'm talking specifically about traditional fixed and indexed annuities.

For a number of reasons, including the elimination of the noise over the Department of Labor fiduciary rule, higher interest rates, volatility of the stock market, just a number of things are really driving the industry premiums to very healthy picture there, even though, it is a competitive environment.

On the reason for the wide range at this point of the year, it just boils down to the volatility of the stock market, Greg. The earnings are very sensitive to movements in the stock market. So I've tried to -- this may help you understand kind of the real underlying fundamentals of the Annuity business and what we're projecting in the quarter. We put out a midpoint of guidance yesterday. We got to finalize that number in the middle of the day. Since then, we've had a nice recovery in the stock market. But we put out a midpoint of the guidance of $64 million. At that moment in time, the impact of the 9% stock market decline was a little over $32 million. So if you kind of normalize the projection that we put out, it takes you up to the mid-90s. We view -- in a normal environment, we view kind of a normal run rate for Annuity earnings as being $95 million to $100 million. Certainly, that can change with fixed wins and interest rates or the stock market.

But that gives you an idea of the sensitivity or the impact of the really major decline in the stock market since September 30. I'll also tell you that before this conference call, I ran numbers based upon the current level of interest rates and the current level of the stock market and right before I came into the conference call, it took our best guess from a $64 million midpoint to a high 70s midpoint. So that gives you some idea of the sensitivity. This is just a 1-day difference and it's because of the sensitivity of interest rates and stock market.

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

That's an interesting answer. Just as a follow-up, I think you said the 9% decline cost $32 million. So is it fair to say that we can think going forward that in any given quarter, with the market moves for very 1% up or down, we can pick up $3.5 million of incremental earnings or lose $3.5 million of incremental earnings, just on your existing block?

Stephen Craig Lindner
Co-President, Co-CEO & Director

There are a lot of items that go into, especially, fair value accounting. But let me give you a couple of rules of thumb, and they are just that, they are rules of thumb. But in a rising stock market, every 1% change has an impact of $0.5 million to $1 million on both pre-fair value and fair value earnings. For a -- at a decreasing stock market environment, each 1% change -- I'm sorry, each 1% decline has an impact of $1 million to $2 million on both pre-fair value and fair value accounting earnings. So total of $2 million to $4 million. It isn't linear, but that is the impact from a decreasing stock market. So obviously, pretty sensitive.

Joseph E. Consolino
Executive VP, CFO, Principal Accounting Officer & Director

Greg, this is Jeff. I just wanted to pile on for one moment here. You rightly noted that the range of guidance had extended for the reasons that Craig then explained. You just go forward 1 page in that slide deck to Slide 10, which is the new slide for us. I think that this is a helpful tool to see really the range of earnings, that Craig has presented before fair value accounting, is quite tight, reflecting our ability to see with great clarity how the business is going before these noneconomic and possibly, ephemeral effects of fair value accounting would drive the wide range that's line item on Slide 10 impact of fair value accounting, which you can see, not only the range for that, then also the assumption with respect to the change in S&P 500, which in this case is down 5 to down 12. So this is in addition to our slide deck to help you get more grip -- more of a grip around the phenomenon you identified of the wide range.

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

I appreciate that slide and actually noted that for the fourth quarter based on what's going on with impact to fair value, that and just the market that the year-over-year guidance looks to be down. I guess, I can't help myself just as we're talking about how the changes in market affect your earnings for the life block. Maybe, you can finish up with just how the change in market conditions might affect the sales as well? And I promise, that's my last question.

Stephen Craig Lindner
Co-President, Co-CEO & Director

Sure. Greg, this is Craig again. What I would say is market volatility is very good for, say, it was whenever we see a lot of volatility in the stock market or in particular declines in the stock market, we see more people wanting to reduce risk and that's very good for the sales of fixed annuities and indexed annuities where in any given year, you can't lose money.

Operator

Our next question comes from Paul Newsome with Sandler O'Neill.

Jon Paul Newsome
Sandler O'Neill + Partners, L.P., Research Division

Just a few here. Small ones, I think. First, I want to ask the timing of the 2 transportation deals, do we assume that, that premium shows up in the fourth quarter so there's sort of an extra benefit there from a revenue perspective?

Joseph E. Consolino
Executive VP, CFO, Principal Accounting Officer & Director

Paul, this is Jeff. Yes, those shifted to the fourth quarter. And as a consequence, our premium guidance incorporates them coming through in the fourth quarter. Obviously, for full year '18, it washes out Q3 versus Q4 you would see the impact when you look at Q4's reported results this year versus last year once we report fourth quarter earnings.

Jon Paul Newsome
Sandler O'Neill + Partners, L.P., Research Division

Okay. Should we expect any update of kind of where your capital positioned? And what you would be interested in doing from a capital management before the year-end? Or do -- or should we wait -- would it be normal for you to wait till you report the fourth quarter earnings in I guess February?

Carl Henry Lindner
Co-President, Co-CEO & Director

This is Carl. Yes, I think you can expect an update on capital management between now and year-end. In the past year or really in the past conference calls, we've mentioned that as we see what's on our plate, as we -- and we get into our finalizing our business plans for next year, we'll review the potential for special dividend sometime over the next 30 to 60 days or so.

Jon Paul Newsome
Sandler O'Neill + Partners, L.P., Research Division

And then, could you give us a little bit of an update on what's going on with Neon? There've been some pressure reports that there might be some changes there?

Carl Henry Lindner
Co-President, Co-CEO & Director

I'll let Jeff talk about that since he was in London here just recently.

Joseph E. Consolino
Executive VP, CFO, Principal Accounting Officer & Director

I'm not sure exactly, Paul, what press reports you're referring to. But obviously, we would not want to comment on any kind of market rumors surrounding Neon's status. We would say though that if you follow the Trade Press closely, which I'm sure you do, that the environment always is changing. The performance management directorate is taking a very harsh lens and training it on all of the syndicates with their goal towards improving the overall voyage-to-combined ratio as a result, many industry observers say there's never been more challenge and more push back on business plans in the market than there is today. That will affect 2019, but that's an ongoing situation that affects Neon similarly affects all the syndicates in the market. And from us, from a big-picture perspective in the last couple of quarters, Carl's commented that Neon's made improvement, but still not at the level we'd like it to be at. We did rebrand and fundamentally change the business starting in 2016 under the leadership of the new management team and have cleaned up the balance sheet by taking off the legacy liabilities through reinsurance to close transaction, and redone the business plan. And each and every year since then, inclusive of '16, we've really hit all the benchmarks we've wanted to hit. This new level of scrutiny from Lloyd's I think does call into question whether that kind of growth strategy is really going to be feasible in the new environment. So time will tell whether this is a point-in-time thing or a change in Lloyd's overall philosophy.

Operator

[Operator Instructions] Our next question comes from Larry Greenberg with Janney Montgomery Scott.

Lawrence David Greenberg
Janney Montgomery Scott LLC, Research Division

A couple of questions. I'm just wondering first whether you would share what your range of expectations is for partnership income in the Annuity segment for the fourth quarter.

Stephen Craig Lindner
Co-President, Co-CEO & Director

It would be a more normalized number. Time will tell. We don't get the works for a while, but it would be a more normalized number, something in the neighborhood of 10%.

Lawrence David Greenberg
Janney Montgomery Scott LLC, Research Division

Okay. So you would expect a positive partnership return even given what the stock market has done?

Stephen Craig Lindner
Co-President, Co-CEO & Director

We would. As I've said, we're going to get marks here for some period of time, typically get them the ones that we'll book in the fourth quarter. They're -- it's based upon marks at the end of the third quarter, and those are just tray now. So we don't have a real good handle on what a precise number might look like, but we certainly would expect it to be positive.

Lawrence David Greenberg
Janney Montgomery Scott LLC, Research Division

Okay. And then, on Slide 10, Jeff, I think you were talking about it. So I'm a little bit curious. Your implied guidance has a range for the S&P of down 5 to down 12 and the commensurate fair value accounting is minus $12 million to minus $42 million. And given that you have kind of $10 million to $12 million kind of built-in of interest on the embedded derivative, I would've thought that the negative mark could be a little bit worse. And I'm wondering -- so is that just interest rates offsetting the negative impact of the S&P?

Joseph E. Consolino
Executive VP, CFO, Principal Accounting Officer & Director

Larry, thank you for being a student of fair value accounting. I've never seen Slide 10.

Lawrence David Greenberg

Janney Montgomery Scott LLC, Research Division

My head is spinning, but I'm trying.

Joseph E. Consolino
Executive VP, CFO, Principal Accounting Officer & Director

On that same Slide 10, at the bottom of the slide, we have also our expectation for the change in the average 5-year and 15-year corporate A2 rates. That's the rate at which the embedded derivative discounted to present value. And as rates rise, that is a benefit. Flipping to the supplement on Page 13, you picked off the interest on the embedded derivative, you picked off the change in markets, and there's another line item for impact of changes in interest rates higher or lower than expected. And with rising rates, expected in the quarter, that would be an offset to the interest component and the change in markets component.

Lawrence David Greenberg
Janney Montgomery Scott LLC, Research Division

Okay. And then, just the last one, for this kind of built-in headwind for the impact of the embedded derivative. I mean, is there an offset in terms of pricing on the business or crediting rates that you kind of built -- build into the model?

Stephen Craig Lindner
Co-President, Co-CEO & Director

Larry, we are absolutely including that in the pricing analysis and determining what kind of credit rates we can pay.

Operator

Our next question comes from DeForest Hinman with Walthausen & Company.

DeForest R. Hinman
Walthausen & Co., LLC

Just to focus a little bit more on the Property and Transportation business. You cited 3 areas, Aviation, Equine and International. Can you walk us through any type of issues there? Is it a continuation of a trend? Onetime item? And anything we're doing to kind of address those? I don't know if I want to use the word unsatisfactory, but not that great results there on the earning side.

Carl Henry Lindner
Co-President, Co-CEO & Director

Yes, this is Carl. I can give a little bit of color. The aviation market, that's a relatively small business for us. One we just started a couple of years ago. And as others have been seeing some severity and volatility and not enough pricing to go along with the business. So we've seen some of the same thing. I guess the good news, bad news is there have been a number of competitors that have left the market, which provides opportunities. And our pricing actually -- we're beginning to see double-digit increases in pricing there in the quarter. So right or wrong or otherwise, we're going to see just how firm this part of the cycle in that business becomes and both pricing and terms or changing. We're tightening our underwriting guidelines, and we're attempting to improve that business. In the Equine Mortality, you can get quarters and years where total losses and horse mortality can be a little bit lumpy in that. So we'll continue to make the adjustments we need to make in that business. In our International, we started -- there are some start up costs that go along with starting a business in Singapore a number of years ago. And some early mistakes on a few accounts or types of business that we wrote that we pretty much worked through at this point. But that would be the color around those 3 businesses. We're optimistic that we can -- we've been making the changes in those businesses to see a bright 2019 or a much brighter 2019, so...

DeForest R. Hinman
Walthausen & Co., LLC

And the comfort level with the fourth quarter CAT losses, as they relate to the hurricanes, is that based on feet-on-the-ground numbers coming in or is that more estimate based on some previous results or third-party services?

Joseph E. Consolino
Executive VP, CFO, Principal Accounting Officer & Director

This is Jeff. This is not based on modeled output. Sometimes people disclose numbers that just take their portfolio and run it through a commercial model and report that. So this is based on reporting back to us from our business units. And what they expect their gross exposures will be. And then, it reflects the application of our Catastrophe Reinsurance program. So we have a lot of confidence around the number in part, because we are a consistent buyer of catastrophe reinsurance. We've indicated in past investor meetings and calls that we've got 2 towers or pillars of catastrophe reinsurance, one that covers our U.S. property and casualty group and one that covers Neon. Each one has a $15 million per event net retention. And so a large growth loss that would affect both pillars would result in $15 million to each in net retention or a sum of $30 million. And it's pretty hard to drive that number up since we buy a large amount of recurrence production vertically. So the number of $30 million for, Michael and then Carl talked about earlier, would reflect a full retention loss for each of those 2 pillars and that would pretty much cap us out.

Operator

And we do have a follow-up question from Paul Newsome with Sandler O'Neill.

Jon Paul Newsome
Sandler O'Neill + Partners, L.P., Research Division

I thought maybe just you can weigh in on the Workers' Comp Frequency trends issues that seem to be hitting other insurers. And it doesn't sound like you're having some of the same issues, but maybe you could give us some of your thoughts based upon your own experience.

Joseph E. Consolino
Executive VP, CFO, Principal Accounting Officer & Director

Happy to. We're not really seeing the same elevated frequency trends as maybe some others are. Republic actually is -- remains negative in our California business. Summit we really consider Summit relatively flat. The one thing we're watching closely is a year-to-date frequency through the third quarter's up 0.5% year-over-year for lost time claims in all of our Summit states combined. Again, we consider that trend relatively flat, but it's a little bit of a departure from the negative frequency actually that Summit has had over the past couple of years. So I think -- we think that maybe that little tick up is partially attributable to a higher percent of lesser-experienced workers out there in this economy. But again, except for you or others asking the question, we wouldn't consider that trend in Summit. We consider that relatively flat trend in that.

Operator

This concludes today's Q&A session. I would now like to turn the call back over to Diane Weidner for closing remarks.

Diane P. Weidner
Assistant Vice President of Investors Relations

Thank you all for joining us this morning, and we look forward to talking to you again when we share our results for the fourth quarter.

Operator
Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program. You may all disconnect. Everyone, have a great day.