S&P Capital IQ

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The Travelers Companies, Inc. NYSE:TRV

FQ2 2010 Earnings Call Transcripts

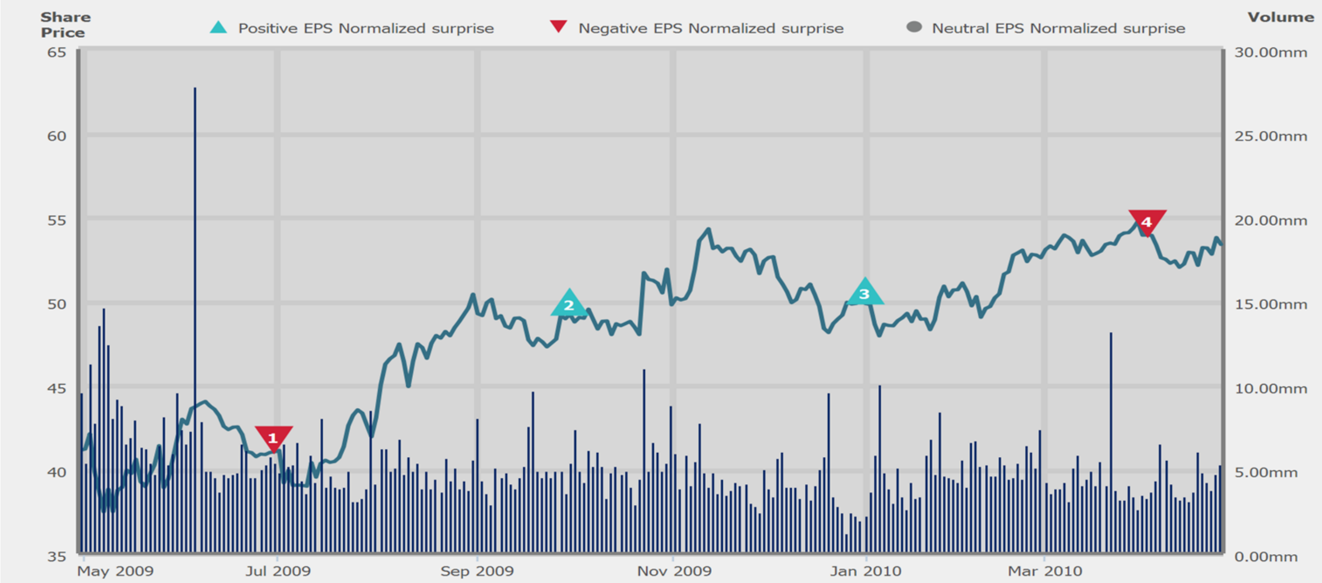
Thursday, July 22, 2010 1:00 PM GMT

S&P Capital IQ Estimates

	-FQ2 2010-			-FQ3 2010-	-FY 2010-	-FY 2011-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	1.50	1.39	(7.33 %)	1.36	5.64	5.88
Revenue (mm)	5397.70	5340.00	(1.07 %)	5459.74	22102.29	22318.48

Currency: USD

Consensus as of Jul-22-2010 1:14 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ2 2009	1.27	1.25	1 (1.57 %)
FQ3 2009	1.32	1.61	2 21.97 %
FQ4 2009	1.49	2.12	3 42.28 %
FQ1 2010	1.37	1.22	4 (10.95 %)

Call Participants

EXECUTIVES

Brian W. MacLean
President and Chief Operating Officer

Gabriella Nawi
Senior Vice President of Investor Relations

Gregory Cheshire Toczydlowski
Executive Vice President and President of Business Insurance

Jay S. Fishman
Former Executive Chairman

Jay Steven Benet
Vice Chairman and Chief Financial Officer

William H. Heyman
Vice Chairman and Chief Investment Officer

ANALYSTS

Brian Robert Meredith
UBS Investment Bank, Research Division

Clifford Henry Gallant
Keefe, Bruyette, & Woods, Inc., Research Division

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Jay H. Gelb
Barclays PLC, Research Division

Keith F. Walsh
Citigroup Inc, Research Division

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

Michael Steven Nannizzi
Oppenheimer & Co. Inc., Research Division

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

Presentation

Operator

Good morning, ladies and gentlemen, and welcome to the Second Quarter Earnings Review for Travelers. [Operator Instructions] At this time, I would like to turn the call over to Ms. Gabriella Nawi, Senior Vice President of Investor Relations. Ms. Nawi, you may now begin.

Gabriella Nawi
Senior Vice President of Investor Relations

Thank you, Frank. Good morning, and welcome to Travelers' discussion of our second quarter 2010 results. Hopefully, all of you have seen our press release, financial supplement and webcast presentation released earlier this morning. All of these materials can be found on our website at www.travelers.com under the Investors section.

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

Before I turn it over to Jay, I would like to draw your attention to the explanatory note on Page 1 of the webcast. Our presentation today includes forward-looking statements. The company cautions investors that any forward-looking statement involves risks and uncertainties and is not a guarantee of future performance. Actual results may differ materially from those projected in the forward-looking statements due to a variety of factors. These factors are described in our earnings press release and in our most recent 10-Q and 10-K filed with the SEC. We do not undertake any obligation to update forward-looking statements.

Also in our remarks or responses to questions, we may mention some non-GAAP financial measures. Reconciliations are included in our recent earnings press release, financial supplement and other materials that are available on the Investors section of our website, travelers.com.

With that, here is Jay Fishman.

Jay S. Fishman
Former Executive Chairman

Thank you, Gabby. Good morning, everyone, and thank you for joining us today. Given the very substantial second quarter weather losses for the entire property/casualty industry and, of course, for us, we were pleased with our performance this quarter reporting net income of $1.35 per diluted share, an increase of 6% from last year's quarter and a return on equity of 10.1%.

Recognizing that our operating income of $1.39 per diluted share is about $0.11 below consensus estimates, I'd like to make the following observations. First, the $0.11 differential equates to approximately $50 million after-tax. I'd point out that for the first six months of the year, we've earned an excess of $1.3 billion.

Secondly, the shortfall was attributable to second quarter weather losses, which aggregated $285 million after-tax or $0.58 per diluted share. To put that cost in context, the estimate for catastrophes for the second quarter included in our previously provided guidance was $92 million after-tax or $0.19 per diluted share. As best as we can tell, consensus estimates included $0.22 per diluted share for second quarter catastrophe losses.

To put the first half weather losses in context, we've already recorded $597 million of after-tax catastrophe losses or $1.19 per diluted share. The methods used to estimate our expected annual catastrophe losses indicate an expected annual loss of $390 million after-tax or $0.80 per diluted share for the entire 2010 year. So even after just six months, we are now well in excess of our expected annual loss estimate for the full year.

Recognizing that we don't control the timing of weather, we just take these events in stride. There have been periods where catastrophe losses have been exceptionally low such as in 2006 and '07, and there were times where they run abnormally high. We price our product for the long term, and weather will occur when it does. We don't believe this high level of catastrophe loss is in anyway a result of changed underwriting standards or reinsurance practices, and Brian is going to have more to say about our cat losses later.

Third, the quarter also benefited from $251 million or $0.51 per diluted share of favorable reserve development. Again, as best as we can tell, consensus estimates for the quarter included $0.23 per diluted share of favorable reserve development. And just a reminder, because development is so unpredictable, we don't include it in any of our guidance.

In terms of the operating environment for the second quarter, we remain quite pleased with our performance in our Personal Insurance segment, both Auto and Homeowners. Given the amount of discussion this time last year on our Agency Auto business, we're particularly pleased with the improving rate of change of policies enforced in Personal Insurance. Profitability in the first half improved versus last year, and we're pleased that the actions taken to improve profitability, which we spoke to about this time last year, are coming through in the results.

In our Commercial businesses, the operating environment really remained very similar to last quarter. Retention rates remained quite strong, and rate on renewal business remained positive but it was at a lower level than in the first quarter. The negative impact of the economy on net written premiums has moderated somewhat from recent quarters, and we're hopeful that this bodes well for future economic growth.

We repurchased $1.4 billion of our common stock in the quarter. And since the second quarter of 2006, we've now repurchased over $12 billion of our common stock. As these actions demonstrate, we continue to execute successfully in the marketplace, generate solid earnings and return excess capital to our shareholders.

Given that municipal bonds have been receiving a lot of attention lately, we felt we'd take a few minutes this morning to have Bill Heyman to take you through the strategy and the tactical positioning behind our muni portfolio and demonstrate why we're comfortable with what we own. Our investment team has applied to our municipal portfolio the same very thoughtful approach to risk and reward that served us exceptionally well during the capital market crises over the last several years. I'm sure you'll find it helpful.

And with that, let me turn it over to Jay

Jay Steven Benet
Vice Chairman and Chief Financial Officer

Thanks, Jay. There are few points based on the data contained on Pages 4 through 7 of the webcast that I'd like to highlight this quarter.

First is our strong balance sheet. All capital leverage and liquidity measures remained at or better than target levels. Second is the repurchase of $1.4 billion of our common shares this quarter and the payment of $173 million in common stock dividends. This brings the total cash we returned to our shareholders to almost $3.1 billion in the first half of this year.

Holding company liquidity of $2.4 billion at the end of the quarter, down as planned from the $3 billion we held at the beginning of the quarter due to our share repurchase activity and the timing of dividends from our operating companies to our holding company. Another quarter in which we increased book value per share. Operating performance, x cats [catastrophes] and favorable prior year reserve development, but including net investment income, that was in line with our expectations.

Another quarter of net favorable reserve development in each of our segments, mostly driven by Business Insurance, where we are now seeing better-than-expected loss results for property, workers' comp and commercial auto product lines in recent accident years and where we have re-estimated unallocated loss adjustment expense reserves given recent loss results. And finally, a double-digit ROE and operating ROE despite the record second quarter cat losses.

I'd also like to point out that we successfully renewed our cat treaties this quarter, keeping essentially the same structure but at a modestly lower cost. The new treaties are outlined on several pages in the webcast, and it's the described more fully in our second quarter 10-Q, which has been filed earlier today.

So let's have Brian now discuss our operating performance.

Brian W. MacLean
President and Chief Operating Officer

Thanks, Jay. Before I go into the business-specific results, a few comments on this quarter's catastrophe losses. As Jay mentioned, this was the highest level of second quarter catastrophe losses in our history. So obviously a difficult weather quarter, and it's on the heels of high first quarter catastrophe losses. In this quarter, the activity was not of the national headline variety, but it was a very active quarter with numerous significant events.

Page 8 lists out the 14 industry-designated cat for the second quarter of 2010 with initial Property Claim Services, or PCS, estimates. Although 14 second quarter events is not unusually high for the industry, the severity of a number of these events is clearly out of pattern. The initial industry estimates of $3.6 billion is very preliminary and based on reported activity to date. This will obviously develop up, and we are confident that once fully developed, this will be one of the largest industry catastrophe second quarters. As we look at our level of losses, we're confident that they are not a result of changes in our mix of business, selection process, geographic footprint or coverage grant and we don't see anything that would indicate a fundamental change in weather patterns.

Slide 9 displays our first and second quarter catastrophe loss ratios for the last six years, or since our first full year post-merger. It shows that for 2010, both quarters were significantly above average level. Within the previous five years, with the exception of the second quarter of 2008, catastrophe weather losses were relatively mild. Accordingly, we don't see 2010 as a trend but just another data point, which we will factor into our assessment of risk and reward. So we're going to stay in the weather business, and we'll continue to actively manage our exposure.

Now let me shift to discussing the segment results, and I'll start with Business Insurance. When excluding catastrophe unpredictability, underwriting income was very strong driven by continued favorable prior-year reserve development. In the current year, loss trend continued to be fairly benign and consistent with our expectations. The renewal rate change on premium for the first half of the year has been slightly positive but is below loss trend and less than expected. So the impact on margins is slightly more than we anticipated.

Overall, net written payments were down slightly in the quarter, but not down as much as earlier in the year. The negative impacts of the economy on our insureds, which we see in lower exposures and reduced audit premium continued but have moderated from earlier levels. So now I'll turn to pricing, and if unpredictability has been the message with the weather, stability is the message in our aggregate domestic Commercial Insurance pricing.

Slide 11 grasps our renewal premium change and splits out the pure rate and exposure change components. The short story here is that nothing is really changing. Overall, renewal premium change on guaranteed cost business was essentially flat with a modest improvement in exposure change offsetting the modest decline in rate change. These overall trends are fairly consistent on an individual business basis. But as always, there are differences, and I'd like to highlight a few things.

Starting with Slide 12 in Select Accounts. We've been getting some good premium increases and retentions have been consistent but a few points below where we historically have been. New business has been mixed with strong results in smaller accounts. But in the fourth quarter 2009 and the first quarter

2010, lower new business levels in Express Plus. In the second quarter, we moderated our pricing strategy and believe this helped boost our Express Plus new business in the quarter. On the renewal book, we typically work 90 days in advance so any impact on retention will start in the third quarter. Overall, we continue to feel very good about our Select Express platform and how we are positioned in this market.

In Commercial Accounts, retentions have remained very strong and the renewal premium change has improved modestly going from a slight negative to a slight positive. If you look at the Commercial Accounts chart at the bottom of Page 13, you can see that this essentially flat premium change is the result of improving exposure changes and slightly lower rate changes. When negotiating a renewal, we are negotiating both the pure rate and total premium with the account. As the impact of the economy on our customers' exposures has become less negative, it has become increasingly more difficult to negotiate a rate increase especially when it would result in an overall premium increase.

New business results for Commercial Accounts were down compared to the prior-year quarter. In the second quarter of last year, our new business writings benefited from the marketplace disruption caused by the financial distress of several of our competitors. Absent this impact, the results reflect the normal seasonality of our business. Our new business flow has stabilized at record levels, with quote rates up slightly and close rates down slightly. Given these dynamics, we continue to be very pleased with our new business performance.

In Other Business Insurance, retentions have remained very strong, while the price change for both the rate and exposure have moved more significantly than the overall Commercial business. These pricing impacts are primarily driven by our large property business, with some significant softening in rate but improvement in exposure. As competitive pressures in this class of business increased in the current quarter driven by ample reinsurance capacity and a benign 2009 hurricane season, we made a conscious decision to maximize our retention on this business and not push rate on large property accounts. Similarly, large property new business became increasingly more competitive with aggressive concessions to expiring terms and conditions frequently required to motivate accounts to leave their current carrier, and we are not willing to make these concessions.

In summary, we continue to prudently manage each of our businesses and adjust our actions to the unique needs. But in the aggregate, the results are not different than our recent experience, that is solid retention, relatively stable pricing and a strong flow of new business opportunities.

In the Financial, Professional & International Insurance segment, the core underwriting margins were generally stable in the quarter as the marginal rate gains essentially offset slightly increasing loss trends. Additionally, the underwriting margin benefited from a reduction in surety reinsurance costs associated with prior-year reinsurance treaties.

Net written premiums after adjusting for the impact of changes in foreign exchange rates were down for the quarter. In some of our Management Liability lines of business and in some of our International lines, we believe pricing is not consistent with our profitability targets, so our writings in those lines are down.

Turning to the production statistics on Page 16. Although renewal premium change is slightly negative in both Management Liability and International, for most of the businesses contained here, we've achieved positive rate gains.

Turning to Personal Insurance. In Agency Auto, our underwriting margins after adjusting for the impact of tax and prior-year development improved quarter-over-quarter as rate gains once again outpaced the loss cost trends. Within Agency Property, we have been speaking to you for some time regarding the slight margin compression driven by year-over-year increases in the cost of materials, primarily asphalt shingles. As the rate gains we achieved in recent quarters continue to earn through our Property business, we have crossed an inflection point where, in the second quarter, our rate improvement outpaced lost cost trends.

Agency Auto new business improved in the second quarter, as we reintroduced our 12-month policy. As we become more confident in our new business products and are consistently within target returns, we felt it was appropriate to re-introduce a longer-term policy. The aggregate timing impact of this additional six months of written premium was about $30 million in the quarter.

As the rollout of this product is completed, the impact on our new business written premiums will increase throughout 2010. More significantly, we are pleased with the improving rate of change in policies enforced. We believe the PIF change is a result of our improved competitive position compared to third and fourth quarter of 2009.

Agency Property production was, also for the quarter, continued to be strong in spite of the difficult housing market. Quarter-over-quarter PIF growth was at the highest level since third quarter 2007. Retention improved two points, and new business is up 15% compared to the same quarter last year. Given the expansion in core underwriting margins and the strong top line trends in these products, we are very pleased with both our current and going forward marketplace position in Personal Insurance.

So let me sum it up. Weather's been bad, but it's a big part of our business, and the one thing we know for sure is that it will change. The commercial marketplace, both domestic and international, is fairly stable. We obviously wish it was improving, but we feel great about our position and are confident we will maximize the opportunity. And in Personal Insurance, we are encouraged by the trends, both for us and the industry.

With that, let me now turn it over to Bill Heyman to discuss our tax-exempt portfolio.

William H. Heyman
Vice Chairman and Chief Investment Officer

Thanks, Brian. Since municipal securities have received considerable attention in the press, I thought I would spend a few minutes assessing this sector in general and our portfolio in particular.

As you know, we have a tax-exempt portfolio of about $41 billion. You may not know that of that, about $7 billion consists of bonds which have been pre-refunded, which means they have been defease to maturity with their first call date usually with U.S. Treasury securities. So the $34 billion remaining constitutes about half of our fixed income portfolio.

The first observation I'd make is that we have, fortunately, always starting long before credit quality became an issue, viewed tax exempt credits as credits first without regard to any advantages their tax exempt stated at first. While optimization of the alternative minimum tax provides a target allocation, it is not a bucket we feel we must fill regardless of policy and a general obligation of the school district competes with the corporate bond or mortgage-backed security for our investment dollars.

We scrutinize closely not only the credit worthiness of the issuer but the nature of the obligation. For example, in some cases, revenue bonds could be stronger than GOs and vice versa. Furthermore, where issuers have enhanced their creditworthiness with bond insurance, we have always ignored it. The result was that several years ago, when the bond insurers more or less simultaneously lost their AAA ratings, we did not make portfolio changes.

The result of high credit underwriting standards means that our portfolio does not closely resemble the broad market. For example, we own about $23 million of municipal healthcare revenue bonds or about one-tenth of 1% of our portfolio. Such bonds represent roughly 7% of the broad market and since 1970, 39% of all municipal defaults had been in the healthcare sector.

Conversely, we are overweighted in pre-refunded bonds, states and local general obligation bonds and water and sewer bonds. Recent focus on general obligation bonds relates to the potential for these bonds to be treated like senior unsecured debt, with bondholders becoming general creditors alongside employees, retirees and vendors. The general creditor construct is most descriptive of general obligation bonds issued by state, as the general funds act like pools collecting revenues from a wide range of taxes fees and paying salaries making pension contributions, paying vendors as well as servicing their general obligation debt.

In contrast, this construct is probably not descriptive of many local general obligation bond. We expect that in extremis, holders of many local GOs will be treated as secured creditors based upon legal precedents and the provisions of Chapter 9 of the Bankruptcy Code, which provides that the security interest in special revenues remain valid and enforceable in bankruptcy.

As you know, most school district general obligation bonds are specifically authorized by voters in a ballot initiative. This authorization allows the pledge of ad valorem taxes to be levied on all taxable property within the school district without limitation as to rate or amount. The collection of these taxes is generally segregated in the debt service bond outside of the general fund, and these funds can only be used to service the authorized debt and are not available to finance the general purposes of the school. The unlimited nature and segregation of this debt service tax revenue contrast sharply with the school district's other property tax revenues, which are statutorily limited and commingled with its state for per-pupil funding and use for operations.

In addition to assembling the portfolio selectively, we managed it actively. The portfolio contains approximately 8,000 discrete securities, but have only 925 issuers. There are over 50,000 issuers in the municipal market. We have general obligation bonds of a mere 75 cities. There are 5,300 in the Bloomberg database. So we feel we know our cities well. We monitor closely the financial condition and operations of our credits. While it is true that we are basically buying to hold investors, we have in the past year reduced, often substantially, positions and issuers whose creditworthiness has, in our view, deteriorated. So I would add we believe that even those issues we sold are overwhelmingly likely to pay every dollar on time.

As we demonstrated two years ago with our mortgage portfolio, we do not blindly rely on ratings. But it is nonetheless worth noting that roughly 50% of our municipal portfolio holdings, which are not pre-refunded, carry an average AAA rating from Moody's, S&P and Fitch compared to only 17% of the broad market. Almost 96% are rated Aa3 or higher. Only 4%, 4.3% are rated A or lower compared to 33% in the index.

Rating agencies are looking at the same challenging economic budget and spending dynamics affecting state and local governments that all of us are, yet the ratings of our holdings remain very strong. A recent publication by Moody's points out that over the entire period 1970 to 2009, the riskiest 20% of municipal issuers, measured by ratings, accounted for 86% of all the defaulters.

Our portfolio contains approximately $7.2 billion in state general obligations, with only about $330 million in the headline states of California, Illinois and New York. The table in the webcast contains the aggregate holdings and the average ratings of our the top 16 states. With the exception of our holdings in California, which averaged Aa2, the average rating for each state is double Aa1 or higher. The general obligation bonds at the top five states totaled $1.4 billion.

All that said, we have purchased very few big state GOs in recent years and have sold a few recently. The other slide of the webcast presents the runoff of our stage GOs. Based on current market yields for those borrowers and the coupon structure of our holdings, nearly 70% of our state GOs will mature or be called by 2015.

For local general obligation bonds from the top five states totaled $6.4 billion, and the revenue bonds from these states totaled $3.6 billion. Our general obligation bonds and issuers other than states consist largely of school district exposures with a moderate number of counties, cities, community college districts and other special districts. As we just discussed, the nature of these obligations is such that most could be considered as obligations secured by a pledge of revenues from ad valorem property taxes levied without limitation as to rate or amount.

As we have discussed previously, our fixed income portfolio exists, first and foremost, to ensure our commitment to our policy holders. We underwrite the investment risks assumed in our portfolios with careful consideration of the trade-off between risk and return. Just as in the other fixed income assets, we do not reach for yield in our municipal portfolio in attempt to outperform our benchmark, lose investment managers' compensation or for any other reason. We expect our fixed income assets, including our municipal portfolio, to provide adequate risk-adjusted returns and support our insurance operations in pursuit of maximizing wealth for shareholders over the long term.

Obviously, history may not be indicative of the future, and ratings cannot be relied upon with certainty. But we believe our portfolio was strong, and we wouldn't trade it for anyone else's. We could certainly have losses in our municipal portfolio, maybe even material losses. But even viewed through the prism of recent events, we feel very comfortable with what we own.

Let me turn it over now to Jay Benet.

Jay Steven Benet
Vice Chairman and Chief Financial Officer

Thanks, Bill. Well, let's discuss updated guidance for the full year. We've got information on Page 22 for full year 2010, fully diluted operating income per share, which has now been refined from the previous range of $5.20 to $5.55 to a new range of $5.20 to $5.45, which is a $0.10 reduction of the upper end of the range that primarily resulted from commercial renewal premium increases in 2010, not meeting our original expectations, which we believe is attributable to the impact of the continuing difficult economic environment. In round numbers, this range for operating income should still translate into an operating return on equity of approximately 11% as we've said before.

We continue to anticipate some accident year-loss ratio deterioration on a consolidated basis for full year 2010, x cats, as we expect loss cost increases to modestly outpace projected earned rate increases in our commercial businesses for the full year. So in your modeling, please remember that the second half of last year included favorable re-estimations of current year loss ratios for first half 2009 losses. So quarterly loss ratio comparison for 2010 versus 2009 must take this into consideration.

We're now assuming cat losses of $835 million after-tax or $1.71 per diluted share, which incorporates our actual cat losses for the first half and our original estimates for the second half of the year; no further estimates of prior-year reserve development, either favorable or unfavorable; below single digit decrease in average invested assets, x unrealized gains and losses, resulting from a reduction of holding company liquidity due to the share repurchases; full year share repurchases of $4 billion; and a weighted average diluted share count, after share repurchases and employee equity awards, of approximately 487 million shares.
So with that, why don't we open it up for Q&A?

Question and Answer

Operator

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

Jay H. Gelb
Barclays PLC, Research Division

My first question is on the pace of the share buybacks. Travelers repurchased $3 billion of stock in the first half of this year. I believe the guidance is for $4 billion for the first year, yet there's still almost $4 billion left in the existing authorization. I was just trying to get a sense of why the pace may slow or might that just be a conservative outlook. And my second question has to do with the economy. It appears that we're lapping some of the more challenging comparisons. So I'm trying to get a sense of how much of a benefit the stabilizing economy could be and why does Travelers feels it can still raise prices as exposures increase?

Jay S. Fishman
Former Executive Chairman

First, on the share buyback, we have historically scaled back in the third quarter pending, obviously, cat season, of course it seems to us like we've already endured two quarters of cat season already. My recollection was that the original estimates of share buyback included in the guidance was $3 billion to $4 billion, $3.5 billion to $4 billion. And essentially, we are still largely on that target for the moment. We may alter that as we go into the quarter depending upon second half of the year, that is depending upon earnings, depending upon weather, reserve development to the extent it occurs and all that. But nonetheless, it's a plan that we embraced the beginning of the year, and for the moment, we're sticking to it. Your second question, and maybe Brian and I will ham and egg this a little bit. We certainly can't approve this to you. It's largely anecdotal. It's been sitting with conversations with our field folks and I'm speaking now about your question regarding the commercial insurance environment. Our sense is, is that there isn't anything that has particularly changed competitively. You all seemed to be fixated all the time, have some company or companies change their pricing strategy or tactics. We certainly don't see that and have no evidence of it. What we are hearing from our field folks is that as exposure is leveling out, and it was a comment I made earlier is that it looks as though exposure is trying to get back to zero, broadly speaking, in the Commercial Lines businesses, is that it's getting more challenging to get rate increases. If you're a customer, you really don't focus on the granular dynamics that make up your price, your premium. You're really not all that worried about how much is exposure and how much is rate change and all that nonsense. What you as a customer tend to look at is my premium going up or down in its simplest form. And as exposure flattens out to the extent that you're try and get rate gains, you're asking for a premium increase. In this economic environment, our sense is, is that it's getting just more challenging to pass that rate increase on. There's a little more resistance, both from the intermediaries, the agency brokers, as well as the customers to accepting meaningful rate increases. Now it's interesting. We didn't present the data, but we certainly do look at the distribution of rate gains in our middle market business each and every quarter. We've shared that with you previously, and to the extent there are loss dynamics at work, to the extent that the account has loss experience that's different, more problematic than what it had originally been expected, we do get rate gain. There are still significant accounts where we will see a plus five or even a plus 10 rate gain, but it largely is loss-driven. It's not in effect margin or profitability driven. So I'd love to hear if Brian has any comment, but our sense is, is that the margin picture broadly in our commercial businesses is modestly deteriorating, and that is that our ability to get rate in the aggregate is a little bit less than what you're experiencing broadly speaking in loss trends. So that's the way that we would -- I think I'd answer.

Brian W. MacLean
President and Chief Operating Officer

I mean, one of the phrases that I'd emphasize that Jay just used is this economic environment. So we certainly wouldn't want to make the statement that as long as exposures are coming up, you can never get rate changes. If you think of where the psyche of our typical commercial customer is today, they saw the economy take a big dip. They saw their businesses, by and large, take a big dip. The good news is if we look at our total portfolio, they're kind of back to not dipping any more. They're not yet back to growing or anything close to robustly growing. And in that mindset, they're saying they're going -- again, loss experience being neutral, we're going to struggle with premium increases. So that's the dynamic we're seeing today and...

Jay S. Fishman
Former Executive Chairman

And in the context of returns in our business, you always got to go back to where are we from a profit margin perspective. When we went back -- we go back to the guidance that we gave at the beginning of the year which obviously contemplated normal tax and normal reserve development, the return on lean equity that we were projecting for the year was about 11%. And in the context of the environment we're in, both the investment environment -- it's important to remember, the investment environment combined with the economic environment, that's a pretty good return. It's difficult for us to plead that probability measures in our business are inadequate and as a consequence we need to improve margins in this investment and economic environment, to the extent that we're capable of producing an 11% return on equity, we feel pretty good. So we continue to try and seek rates where -- and most importantly, where the loss experience demonstrates that we should and to the extent that we can improve our profitability dynamic. As we move forward, will continue to do that. But it's not as if we're starting from a point of impaired profitability in any way. It's a pretty strong franchise and a pretty strong profit picture in the context of that environment.

Operator

Our next question comes from the line of Matt Heimermann from JPMorgan.

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

One, I was just curious if you could comment on the performance of the other investment income line this quarter and what drove that? I'm just a little surprised in given what macro is happening in the investment environment. And then second, just with respect to the municipal portfolio, I guess if someone wanted to play devil's advocate, a lot of the defenses of the municipal, the securities market around rating average, credit quality, things like that, were things that were made for the mortgage market. So I guess if you had to be realistically bearish on your portfolio or the market broadly, what would you point to as kind of the bigger risk?

William H. Heyman
Vice Chairman and Chief Investment Officer

Let's take it in order. In terms of the other assets, the results of the quarter were attributable to strong distributions in private equity. Cash flows from the portfolio for the first six months was about even, that means distribution equal capital contributions which is better than we would've expected. And there was a lot of net investment income gained in the results that we saw. Hedge funds made money but not very much, maybe a couple of points better than the broad index. Our hedge fund portfolio was only about $470 million, it was $1.6 billion at the time of our merger. And frankly, we find it difficult to predict de facto, which managers will do well and which won't. So we have a handful of relationships of long-standing. In real estate, a lot of our funds had marked-down properties probably excessively, and the first half of the year were affected the balance in valuations. Let's go to municipal. I agree with you. One can argue both sides of the equation forcefully. We think about this issue everyday. But I would add, we're not talking our book because we can't get out of where we are. If we decided that instead of $34 billion -- forget the pre-refundeds for the moment, instead of $34 billion, it ought to be $20 billion or $25 billion. But the quality of our holdings would permit us to make that adjustment. And the market is very firm, thankfully it's very firm, even credits -- it's very firm, even in credits we wouldn't buy. In terms of the risks in the sector, and I think I alluded to this at Investor Day in May, I think the risks are less of economic default. But even some states with big budget problems are, when you analyze them, it's not very heavily taxed. The risks are that some jurisdictions will seek, if a court allows them but may not, to repudiate their debt simply because they choose not to increase taxes and such budgets. I think with respect to larger jurisdictions, the possibility of this is pretty remote. It is one thing to only have access to the capital markets at a high price. And frankly, most jurisdictions haven't even paid debt penalty yet. It is another to lose access to the capital market altogether, which is what would happen in a political repudiation. So I agree, the issue is not free from doubt, and our take on it can be disputed but it's not all that likely.

Operator

Our next question comes from the line of Keith Walsh from Citigroup.

Keith F. Walsh
Citigroup Inc, Research Division

Just to follow up on the exposures, the trend looks better. How do we reconcile that with sort of a negative data that we've been seeing coming out of small businesses, whether it's lending, business optimism, new business startups? And then if you could also touch on the trend you're seeing within audit premiums?

Jay S. Fishman
Former Executive Chairman

I'll take the first and I'll ask Greg to take on the second. First, I think our exposure data is actually largely in sync with what we see as to GDP changes broadly. We're not seeing growth. What we're actually seeing is a leveling out. And I think that there are some measures that would suggest that the economy is actually expanding modestly. There are some that would suggest that -- there are some that would suggest that it is flattened and that's largely at this point what our aggregate data says. There will be some pluses and some minus in various businesses but the exposure change that we saw in the second quarter across all of our commercial businesses in the aggregate was getting close to zero. And I think if you asked anyone from the economic perspective what do they see, they would largely say that at the very least, we flattened out. So we don't see it as inconsistent. Maybe there's something else we do see but that's kind of our take on it.

Brian W. MacLean
President and Chief Operating Officer

Keith, on the second piece, did you ask about auto or audit?

Keith F. Walsh
Citigroup Inc, Research Division

Audit.

Brian W. MacLean
President and Chief Operating Officer

This is Brian. On the audit premium side, we've talked about the numbers before. At the depths of -- in the normal environment, we're going to see something like 3 to 5 points of positive on the audit premium side. Around the end of last year, the very beginning of this year, we were running about 1 point negative, and we are close to back to zero. So we're at a really modest negative number, so pretty consistent with that same view on the exposure change numbers. So still negative but close to back to a plus number. Now, again in a normal world, we'd look for a plus 3 to 5.

Jay S. Fishman
Former Executive Chairman

And that's less about -- it will speak to that point about it being less about the economy and the way our policies work.

Brian W. MacLean
President and Chief Operating Officer

Yes, there's obviously -- the audit premium has a lot to do with the psychology of the buyer and how the product is even sold. And the natural course is that the buyer is going to understate exposure slightly and we pick it up on the back end on the exposure, so we're always playing that game. So that leads to the normal 3 to 5.

Jay S. Fishman
Former Executive Chairman

And so that one makes snap back somewhat unpredictable because we're dealing with the psychology of our buyers and their willingness, in effect, to have us carry for a period of time, premium relative to exposure change because we factor that into our pricing. It's not a surprise to us. But that one makes snap back faster because it is predominantly psychologically-driven more than the overall genuine exposure which really is an economic dynamic.

Keith F. Walsh
Citigroup Inc, Research Division

Bill, you started to touch on this on the munis but what I really want to know is who holds the senior position here? Is it the bondholders or is it muni workers, pension payments and healthcare benefits? Where is that dollar going to go to if it has to, if we come down to that?

William H. Heyman
Vice Chairman and Chief Investment Officer

Well, we think in issuers below the state level, bondholders. At the state level, less clear.

Operator

Our next question comes from the line of Michael Nannizzi from Oppenheimer.

Michael Steven Nannizzi
Oppenheimer & Co. Inc., Research Division

Just had a question about the FPII segment and reserve development there. Can you talk about that development relative to your Management Liability business, in particular, the depository institutions?

Jay Steven Benet
Vice Chairman and Chief Financial Officer

Sure, and I guess I'd direct you back to the conversations we've had previously about the credit crunch analysis and I'd say that probably the way that we're looking at it is stable. So haven't been a lot of change. The release probably comes from six or eight years from '01 to '08 and that the actuaries goes through the data every quarter, and they are making lots of estimates and judgments based on a lot of cases that are still really in a state of infancy. So I would say broadly speaking, no change.

Michael Steven Nannizzi
Oppenheimer & Co. Inc., Research Division

And then I know from that disclosure last year, you had mentioned 26 institutions that had been closed. Can you update a little on the exposure there? And any changes or any new institutions?

Jay Steven Benet
Vice Chairman and Chief Financial Officer

You mean, specifically on the institutions that have been taken over?

Michael Steven Nannizzi
Oppenheimer & Co. Inc., Research Division

Yes.

Jay Steven Benet

Vice Chairman and Chief Financial Officer

So far this year, I think we've got probably close to 100 institutions that have been taking over about 96, we've got 33 of those. There's been 96 institutions the FDIC has taken over, but we are on about 33 of those. Our average exposed limits to those are about $4.5 million. So broadly speaking, it's developed since last year as we would've expected it to.

Michael Steven Nannizzi
Oppenheimer & Co. Inc., Research Division

On personal lines. Brian, you had mentioned on that side, $3.6 billion, I think, in cat expectations for the second quarter. And Travelers number in the second quarter was up $440 million. Am I looking at that right? And if it's about 10%, I just want to understand is it just different estimate base or how should we think about that?

Brian W. MacLean
President and Chief Operating Officer

The $3.6 million on the industry slide comes out PCS, property claims services, and that is purely the kind of initial data that they've gotten from carriers. And in some cases, for some events that happened literally three or four weeks ago. So very, very immature data. That will develop up fairly dramatically.

Jay S. Fishman
Former Executive Chairman

History would suggest.

Brian W. MacLean
President and Chief Operating Officer

History would suggest and just the way the claim process works.

Jay S. Fishman
Former Executive Chairman

I'd like to make a very important point. We don't utilize PCS, and it's to make our estimates of losses from those of then. Our losses are based upon what you were clearly are based upon, claim notices, claims filed and our people on the ground. So the important point here is that while we believe that history again suggest PCS data will develop negatively, historically, our estimates have actually been pretty good relative to catastrophe claims.

Brian W. MacLean
President and Chief Operating Officer

Because obviously, what we're try to do is quickly as possible, take our claim data and make an actuarial estimate of what the ultimate will be and PCS does that over time, but it takes them longer. So it's really tough to do any kind of industry relativity right now. And then obviously, you got geographic distribution underneath that, that you got to look at. So we will scrutinize that as the data becomes available. But all we know is that it's a big industry event and it was a big, big quarter for us, too.

Operator

Our next question comes from Jay Cohen, Bank of America Merrill Lynch.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

First, maybe big picture on the reserve development. I guess if you looked at your accuracy, you'd almost think you guys aren't that good at setting reserves given how redundant things have been. If you can talk more specifically about what's happening -- and I know its going to vary by line and by segment but is it more of a frequency issue or a severity issue? That's the first question. And then secondly, maybe for Bill, on the other investments. It looks like the return this quarter annualizes around 12%. And I've probably asked this before, but what would you consider the normalized return on those investments?

Jay S. Fishman
Former Executive Chairman

Jay, Brian's going to answer your question on the reserve development. But I'd just make an observation that we really try hard to get it right because the issue is actually with how we price our product. To the extent that we end up overstating our loss costs going into a product offering, then we're pricing it higher than we otherwise would have to and we'd become less competitive relative to someone who takes a different view. So it always feels good when it happens, of course. It feels terrific when your results are impacted this way. And certainly, it's a whole lot better than underestimating your loss cost, which means you're underpricing your product, and that's really a disaster. But we really try hard to get it right because in the end, what we're about is trying to grow our business and getting it right is what's going to help us do that the best. Now, your point's relevant, we've had a long stretch year significant development, and Brian or Jay have...

Jay Steven Benet
Vice Chairman and Chief Financial Officer

I can start. I think when you look at the components that make up the reserve development, frequency continues to be behaving in a way that when you go through the reserve setting process, you come up with estimates on what frequency it's going to be and it's behaving better than that. And that's been a trend that's been going on for a while. When actuaries and finance people are looking at what the reserve process should be as it relates to favorable frequency and work with their business partners in terms of pricing and everything. If you look at what the current trends are, you wonder if things are going to get better than they are when you're in a favorable position. And sometimes, you just look at it and say "Well, they're pretty good and I can't imagine them getting better," and sometimes, they do. So that's been a part of it. We are in a very low inflationary environment today. And looking out several years as to what the severity is going to be, just a little bit of a change in the inflationary outlook is going to have an impact as well. So you'd have to go back to what's the base upon which all of this is being done. And on a gross basis, all reserves, they're in excess of $50 billion. So that's the absolute level of these changes, in terms of percentage points, are very, very low. But given the nature of their reserve base, they impact the income statement as you've seen. But as Jay said, each one of these quarters, we're doing best estimates of what we see out there using all the information and as it changes, we'll just update the reserves.

Brian W. MacLean
President and Chief Operating Officer

Jay, this is Brian. So two other points -- because if you look at where the development has come from, not just in this quarter but over a good period of time, I'd say two things. First, on the liability side, where we've had a lot of favorable reserve development, one of the toughest things to guesstimate at over time is where the current environment is selling and what the sustainable impact of that is. And so that's been a big variable driving our improvement. And at the same time, over and again, this is a 5 to 6 year kind of statement. We've done a lot in our liability claim process that we think has helped the way we do business and service our customers, and we think that's had a pretty strong impact there. But it takes time to see the impact of those things coming through the lost data. And so that's been driving it. And then the other area is workers comp, which has continued -- again, I always say this with comp, very much a state-by-state gain. But in the aggregate where we play, we've continued to see some favorable moves there and frequency dynamics that Jay Benet talked about. But comp would be an area where that's really been true, as trying to look at those frequency trends and project forward whether we think they're going to be in the future.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

And then the other investment return?

Jay Steven Benet

Vice Chairman and Chief Financial Officer

Yes, I think that one has to speak to various sectors rather than generalize for other investments. I think from owned real estate unleveraged one hopes to make, we made the high single digits, leveraged real estate. Leveraged real estate that is funds, low double-digit hedge funds, low double-digits -- private equity, maybe a little more. And therefore, our blended returns depends on our allocation of those asset classes. Obviously, one has to rethink all those returns. If we are in a protracted period at very low interest rates, we may or all of us will still be stuck in the mindset of what these assets sense ought to make in the world before our 2008, but those are horse back numbers.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

So based on what you just said, the returns in this quarter weren't terribly overstated at all?

William H. Heyman
Vice Chairman and Chief Investment Officer

They are -- generalizing, it's a blended number there, what we would hope to make over a statistically significant time period, which unfortunately is more than a quarter.

Operator

Our next question comes from the line of Cliff Gallant from KBW.

Clifford Henry Gallant
Keefe, Bruyette, & Woods, Inc., Research Division

In terms of loss cost trends. I'm just wondering about to what degree are you seeing favorable loss cost trends, whether it be from deflation or even falling frequency? And Jay, in such stage that you are, how confident would you be to really act upon that in terms of your foreign pricing? I think of the personal auto industry and 10 years ago where you're about to experience several years of rapidly falling frequency, and I think somebody more aggressive companies like Progressive had wished that they had been able to fully anticipate that to really grow their book. And I'm curious how you would take that in terms of going forward?

Jay S. Fishman
Former Executive Chairman

Well, first I'd observed that this is very much line by line specific. There are long tail lines where you take a deep breath, obviously, before you embrace an emerging trend. And I'd make an example, in workers comp, we are still contemplating meaningful medical inflation. We're not pricing our product. We talk all the time about benign loss cost and inflation. We should always be excluding medical work and medical portion of workers comp when we assume a robust inflation rate and we'll obviously see how that works out. Generally speaking, I think a couple of individual exceptions Brian talked about as a chingle [ph] which a number of carriers have highlighted because it's a by-product price of oil, that loss cost trends severity have, broadly speaking, been awfully benign. That doesn't mean zero. It doesn't mean that we don't see some embedded inflation in lines of business. And the shorter the tail of that business is, the more we're willing to embrace it and incorporate it into our pricing because before long, it doesn't take long before we can reprice the product. The same thing holds true for the frequency. In many lines of business, there has been a long-term systemic decline in frequency. And I would actually say that it's gotten where we've been chasing it. You ask the question all the time, as frequency comes down, is it making a new level? Is it going to return back to previous levels, not only from a pricing perspective, but all of also from a reserving perspective as well. I think the same thing holds true to the extent that these are shorter tail lines of business, we're pretty aggressive in embracing it. And to the extent that they're longer tail, we're a little more reluctant to move in that direction. I think one of the things that's affected workers compensation -- I can't prove this, but just in data that we look at, is that as our economy has moved increasingly to a service-based environment, frequency and workers comp has come down. It don't naturally surprise to people and so that sort of he dynamic, that element, that we feel more comfortable embracing. So it's very line-specific and I think it's difficult to generalize it. There's a line that you're particularly interested in we can't attempt to answer.

Brian W. MacLean
President and Chief Operating Officer

Cliff, you're really getting to the core of the puzzle we're trying to solve each and every day in the marketplace. Can we understand why loss trends are trained changing? First of all, can we see as granular as possible where they're changing and breaking out and then the real trick is understanding why. The generality would be the better we feel about our ability to understand why something's changing, the more confident we're going to be factoring it into our pricing. Where you get in trouble is you see a pattern and you don't understand why and you just started extending the pattern. When we can talk, it is as Jay said, it's very much a line by line.

Jay S. Fishman
Former Executive Chairman

And I do think, though, culturally as a matter of the institution and the way actuaries think in this organization, you would characterize us as not pushing the edge. And again, particularly in longer tail lines, you take a great risk when you make an assumption as to changing trends, embrace it, praise your product, reserve forward and find on the hold that you -- not only underpriced, but under reserved both. So I just think culturally, we're not an organization that instinctively pushes the edge.

Operator

Our next question comes from the line of Brian Meredith from UBS.

Brian Robert Meredith
UBS Investment Bank, Research Division

Looking at the Business Insurance action here combined ratios x the underlying, particularly on loss ratio side, it looks like when you adjust for the current period development last year, it's up about 200 basis points year-over-year. Is that pretty consistent with what we should expect here going forward given your comments about continued action near the deterioration year-over-year?

Brian W. MacLean
President and Chief Operating Officer

Brian, I'm trying to do the math in my head...

Brian Robert Meredith
UBS Investment Bank, Research Division

Because I think you said it was about 62 last year in the second quarter x the current period.

Brian W. MacLean
President and Chief Operating Officer

Yes, I would say pretty close to that.

Jay Steven Benet
Vice Chairman and Chief Financial Officer

This is Jay Benet. The thing I would urge you to do or urge everyone to do, is look at last year's combined ratio, look at last year's loss ratio component of that and its totality for the year. Because of the re-estimation that took place in the third and fourth quarter so the best proxy for a what the loss ratio was for coming into 2010 would be the full year 2009 loss ratio. And then we said we would expect some margin compression from that. And so far, what you've seen is the first six months. That would be the mechanical comparison that you'd want to do. Recognizing that in any period, non-cash related weather is also going to bounce around and there's going to be some noise from other large loss activity or whatever. But that would be the base information you should be taken a look at.

Brian Robert Meredith
UBS Investment Bank, Research Division

And then also the Business Insurance, your G&A expenses, even if you add back the benefit you had, let's say, quarter last year down fairly substantially year-over-year, anything unusual going on there? Or is there some expense initiatives going on?

Jay S. Fishman
Former Executive Chairman

Well, we're always closely managing expenses. And there is the timing of some expenses that will take place in various quarters, one year versus the next. So I wouldn't say there's anything in particularly going on there, other than we're always watchful of our expenses.

Brian Robert Meredith
UBS Investment Bank, Research Division

Jay, you talked about pricing and how you want to adjust it for obviously what's going on with loss cost, et cetera. But what about interest rates right now? It seems like interest rates are going to be low here for a while longer. How can you adjust pricing for interest rates or can you in the current marketplace?

Jay S. Fishman
Former Executive Chairman

If you had gone back a year ago, our view was, is that the investment environment that we were in was shorter rather than longer. And then it was likely that the combination of stimulus dollars and whatever royalty is there, ultimately backing away from support of the financial institutions, that rates would rise to more normal historical levels. Bill and I spent a lot of time talking about the environment and it's very possible now that what we are in is an extended period of time of where we are. And as a consequence, we are beginning to think meaningfully about what the implication of that is for our business. And that not only gets to pricing of our product but return expectations, capital embedded in our business, ways in which capital is used. It's a broad question that gets well beyond are you pricing adequately. Again, in this environment, with this interest rate, we're able to generate round numbers and 11% return on equity. Now you begin to ask yourself the question, if riskless rates are where they are and spreads are where they are, then what are reasonable returns and what do they expected and how do we deploy our capital appropriately in that very different environment? We're at the, I would say, the early stages of those discussions but they are serious discussions that were taking place here regularly.

Operator

Our next question comes from the line of Paul Newsome from Sandler O'Neill.

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

I think I accurately heard that you are issuing annual policies for your personal lines. And if that's the case, I'm a little bit curious as to the strategic -- historically, I think of that as certainly top-of-the-market kind of strategy to hold on to your business as opposed to a bottom-of-the-market strategy. Given that on the upside, you would typically want to be able to reprice your product as fast as you can. Am I just wrong on that or is there a different subtlety here to that strategy that I'm missing?

Gregory Cheshire Toczydlowski
Executive Vice President and President of Business Insurance

Paul, this is Greg Toczydlowski. To answer that question, you got to kind of start off where we began. And we started driving our sophisticated product out in the marketplace about five years ago. And underneath that was our first foray in the predictive modeling. So as we needed to stay nimble and adjust that product, we kept the shorter-term contracts as we move forward and become very confident in that new business pricing. And that, in combination with the demand base from our agents and customers based on the profile that we're trying to attract, we think it was prudent to issue the annual policy at this point in time. And again as Jay talked about some of the underlying dynamics of the Personal Insurance business, we feel terrific about that position right now.

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

My second question is back to the current returns, and I agree that 11% ROE, especially relative to your peers is a good result. The question I have is that does this in your mind suggest that essentially, the property casualty market largely ignores interest rates than where they are today in their profitability? Or is this in your view a view that essentially, the hurdle rate has fallen for the industry? Because I would imagine that the hurdle rate, if anything, has gone up, given volatility uncertainty, the cat losses and the stock market seems to be behaving that way. The stock market looks like it's behaving as the hurdle rate for the industry has risen over the cycle. Any thoughts?

Jay S. Fishman
Former Executive Chairman

I understand the question, I think, anyway. First, I certainly don't think that the insurance industry ignores investment returns. As we price our product, we are driven by available investment returns in the marketplace. Shortly, after the crisis when the world sort of settled backed down and we were confronted with a different kind of fixed income environment and it existed grievously, the real question was would you go into knee-jerk react to a changing interest rate environment, causing disruption to agencies, brokers, customers and all of your distribution. We really wanted to take a deep breath and see what would happen to investment returns over time. I've spoken about this earlier. It was a hard decision to take this in the longer view and not to knee-jerk now 18 months ago and attempt to drive pricing up in a very dramatic fashion. I think that would've been not only highly disruptive but candidly not very successful. That would've been a strategy that I think would have failed. Now I think, and again this is how we perceive it, you can certainly ask other companies what their view is, it may very well be that this economic malaise such as it is, is longer rather than shorter. And it may very well be that this investment environment is, as a consequence, longer rather than shorter. And we are, as I said, in the early stages of really thinking through the implications of that. It's a long view. We speak about returns over time. We try hard not to get tangled up, and candidly, this quarter, next quarter that we manage this business to generate returns over time. And one of the questions that we're going to ask ourselves is in the investment environment that's available and given other investments, we recognize that we compete against other investments including investments that are fixed income. We have round numbers of 3% yield at the moment. What are the implications of that? How do we think about our company and what do we strive to produce for investors in a very different investment environment that existed even a couple years ago? And it's a very legitimate question and we're ankle-deep in it at the moment as we try and wade our way through it. It's complex. Obviously, no one company can adopt the strategy that's disruptive in the marketplace and thinks somehow that it will be successful. We operate in a very competitive environment. So we have to balance all of those factors. More to follow. I just have no immediate clear answers about that issue, but a very relevant question.

Operator

Ms. Nawi, I will now turn the call back to you. Please continue with your presentation or closing remarks.

Gabriella Nawi
Senior Vice President of Investor Relations

Thank you very much for joining us this morning. If anybody has any additional questions, you can reach either myself or Andrew Hersom in the Investor Relations department. Thank you, and have a good day.

Operator
Ladies and gentlemen, that does conclude the conference call for today. We thank you for your participation and ask that you please disconnect your lines. Have a great day, everybody.