S&P Capital IQ

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W. R. Berkley Corporation NYSE:WRB

FQ1 2011 Earnings Call Transcripts

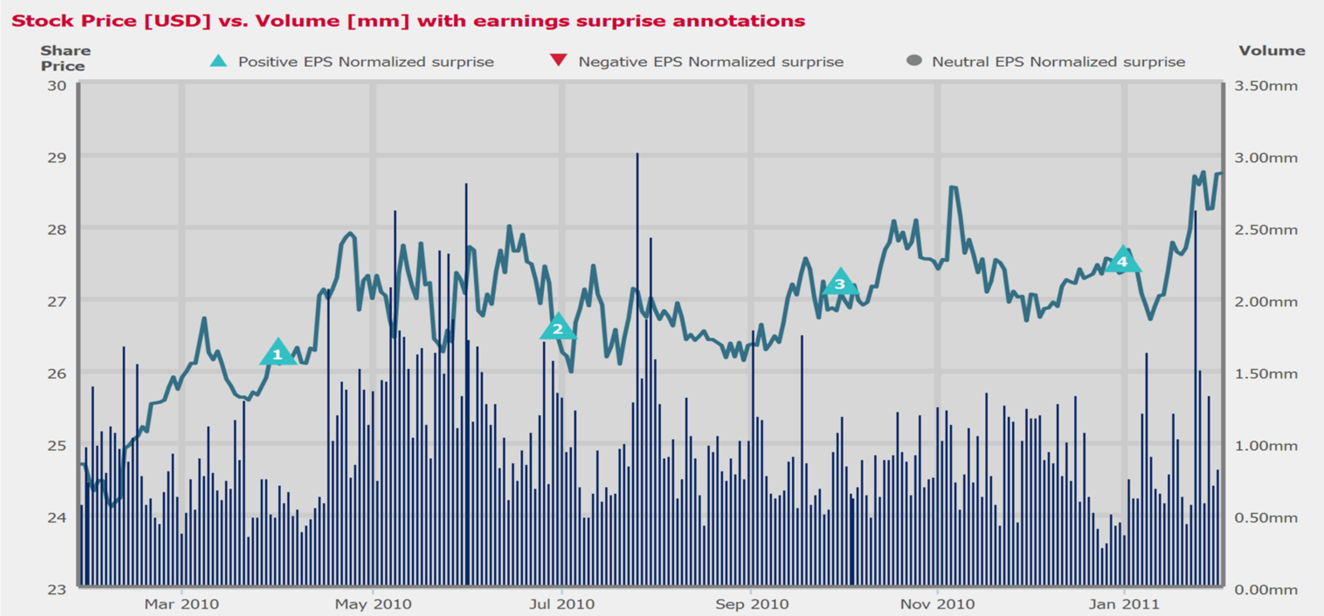
Tuesday, April 26, 2011 1:00 PM GMT

S&P Capital IQ Estimates

	-FQ1 2011-			-FQ2 2011-	-FY 2011-	-FY 2012-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.65	0.66	▲1.54	0.67	2.69	2.51
Revenue (mm)	1157.57	1234.35	▲6.63	1174.40	4718.86	4952.61

Currency: USD

Consensus as of Apr-26-2011 1:45 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ1 2010	0.65	0.70	▲1 7.69 %
FQ2 2010	0.62	0.65	▲2 4.84 %
FQ3 2010	0.66	0.66	▲3 1.52 %
FQ4 2010	0.67	0.68	▲4 1.49 %

Call Participants

EXECUTIVES

Eugene G. Ballard
Executive Vice President of Finance

Robert Berkley Jr.

William Robert Berkley
Founder and Executive Chairman

ANALYSTS

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Presentation

Operator

Good day, and welcome to W.R. Berkley Corporation's First Quarter 2011 Earnings Conference Call. Today's conference is being recorded.

The speakers' remarks may contain forward-looking statements. Some of the forward-looking statements can be identified by the use of forward-looking words, including without limitation, "believes," "expects" or "estimates." We caution you that such forward-looking statements should not be regarded as a representation by us that future plans, estimates, or expectations contemplated by us will in fact be achieved. Please refer to our annual report on Form 10K for the year ended December 31, 2010 and other filings made with the SEC for a description of the business environment in which we can operate the important factors that may materially affect our results. W. R. Berkley Corporation is not under any obligation and expressly disclaims any such obligation to update or alter its forward-looking statements whether as a result of new information, future events, or otherwise.

I'd now like to turn the call over to Mr. William R. Berkley. Please go ahead, sir.

William Robert Berkley
Founder and Executive Chairman

Thank you. Well it was a good quarter. We were pleased with the results. We continue to see the beginnings of the market turn. Because of how everyone perceives a market turn, this doesn't look like the market turn for lots of people and that's because when we think in terms of a market turn, we think of October of 2000 when Reliance and Frontier went out of business and there was some dramatic changes on 9/11 or other particular periods or events when something dramatic happens. But in fact, market turns happen gradually. Things slowly change and we think we're seeing it now.

But before I sort of go on and talk about the market and some other things, we're going to let Rob Berkley talk about our operations a bit, and then Gene talk about our financials, and then I'll join. Rob?

Robert Berkley Jr.

Thank you. Good morning. The first quarter could be described as a mixed bag. While market conditions continue to offer significant challenges, there is an ever-increasing number of data points that would indicate change is near. The industry continues to grapple with the realities that stem from a lack of underwriting discipline over the past several years. This has been compounded by the period in loss trends, as well as ongoing modest investment returns. Additionally, the recent shock losses in the global property market have applied further pressure to the situation. While this may sound like a grim picture, it in fact is just what is needed in this current circumstance, which is serving as a catalyst in changing behavior.

The company's debt written premium for the quarter was just shy of $1.1 billion. This is an increase of approximately 10% over the same period in 2010. The growth came primarily from our International and Specialty segments. International writings continue to benefit from both further development of our younger operations, as well as the general lift from doing business in select international economies that are enjoying significant growth.

Our Specialty business growth was equally noteworthy. The growth in this segment was primarily driven from our businesses serving the energy industry, as well as the environmental insurance market. Additionally, there are select parts of the professional liability market that remain attractive.

Furthermore, on the topic of growth, it is worth noting the group overall continued to benefit from an improving U.S. economy, which is reflected on many fronts including our improved audit premium activity. Having said this, we are clearly not yet in the throes of a hard market. Many lines remain quite competitive, including but not limited to, public P&L [ph], large workers' comp and excess transportation, to name a few.

Additionally, the construction classes remain challenged, as this part of the economy continues to struggle. Our price monitoring for the quarter suggested an improvement in rate, approaching 1%. On the surface this may not seem like a meaningful number, however, this is the first time in 17 quarters rate in the aggregate has increased for the group. Obviously, rates across various product lines do not move in perfect loss step. However, the overall momentum is becoming more visible. Additionally, renewal retention ratios continues to harbor around 80%. While it may be premature to declare this a trend, it certainly can be interpreted as early as it is that pricing leverage is increasing.

The loss ratio for the quarter was at 61.8%. This includes 2.5 points for storms. Of the 2.5 points, 1.5 is associated from losses from exposure to New Zealand, Australia and Japan.

Gene will be giving further detail on this a little bit later. The expense ratio was at 34.5 for the quarter, which reflects 0.5 point improvement from the corresponding period in 2010. This represents continued progress as our growth in written premium begins to materialize in our earned premium.

When one puts all the pieces together, we reported a 96.3 combined ratio. However, when one adjusts for reserve changes in cat, the accident year combined remains just shy of 100.

With each passing day, there is growing evidence that the industry is going through a time of transition. While the fate of this change will become more evident with time, it is unlikely the industry's course, headed towards a hard market, will be derailed.

Okay, Gene, do you want to pick up now?

Eugene G. Ballard
Executive Vice President of Finance

Okay. Thanks, Bill. Well Rob covered the growth in premiums for the quarter, I'll just start my comments with the underwriting results.

Our overall combined ratio was 96.3. That's up 2.2 percentage points from the first quarter of 2011. As Rob said, the combined ratio includes 2.5 points or $24 million for catastrophe losses. Regional storm losses were $9 million, and our estimate for potential losses from major catastrophes was $15 million. That's $12 million for the earthquake in Japan, $2 million for the earthquake in New Zealand and $1 million for the floods in Australia. The loss estimates for these major catastrophes is all IB and R [ph]. We actually had no known losses at this time. Catastrophe losses by segment were $9 million for Regional, $10 million for International and $5 million for the Reinsurance segment.

Prior reserve releases were $51 million or 5.2 loss ratio points in 2011, down from $62 million or 6.7 points in 2010. The development in 2011 was mostly related to the Specialty segment where we continued to see growing reserve margins, especially for the EMS business. We also experience favorable reserve development for the Regional, Reinsurance and International segment in the quarter.

The underlying accident year loss ratio was up 1.3 points to 64.6 in 2011 from 63.3 in 2010, and I'll just go through the changes by segment. The specialty accident year loss ratio was essentially flat compared with a year ago, as the impact of significant favorable reserve development in the prior years has flowed through to the current year loss pick. We raised the regional and alternative market accident year loss ratio approximately 3 points each to reflect the impact of pricing and potential lost cost trends.

The reinsurance accident year loss ratio is up almost 7 points due in part to differences in contract structures as an offsetting decrease of about 4.5 points in the reinsurance commission ratio, so the overall actual year combined ratio for that segment is up just 2.5 points.

And finally, the international accident year loss ratio is down 7 points due to growth in the earned premiums and improving profitability for our new Lloyd's Syndicate, as well as our business in Australia. So that gives us an overall combined ratio -- accident year base combined ratio of 99, excluding cats at 101.5, if you include the catastrophe losses. The pay loss ratio was 59.1, down from 60.4 a year ago, and net loss reserves increased by $42 million from the beginning of the quarter.

One last comment on underwriting is with respect to ceded reinsurance. You'll see in the segment results that the ratio of our ceded to gross premiums actually increased to 15% in 2011 from around 13% in the first quarter of last year. That's because we experienced significant growth in the International segment, which had a relatively higher percentage of ceded premiums. And also because our signed risk premiums, which are 100% ceded, were up $11 million, which is an increase of 40% over the prior year.

With respect to investments, our investment income was $132 million in 2011, down 5% from $139 million in 2010. Merger arbitrage earned $7 million in 2011 with an annualized result return of 7.2%. That compares with $11 million and an annualized return of 10.2% in 2010.

The annualized return on the rest of the portfolio was 4.0 in 2011 and 4.1 a year ago. At March 31, unrealized gains were $479 million, and the average duration of the fixed income securities was 3.6 years.

We also reported realized gains on investment sales of $29 million and income from investment funds of $15 million. You'll notice that we modified our definition of operating income to include income from investment funds. We had started excluding income from investment funds from operating income during the financial crisis in early 2009, in part because the fair value march for those funds became more uncertain and hard to determine under the volatile market conditions at that time. Those conditions stabilized and our investment funds have reported profit in 5 of the last 6 quarters. Also including these results in operating income is consistent with the way that the income from funds is reported by most other public companies. So for the first quarter, income from funds was $15 million or $0.06 per share and that compares with $5 million or $0.02 per share in the first quarter of 2010.

So that gives us net income for the quarter of $116 million and income per share up 7% to $0.79, and operating return on equity of 12.6% and an increase in book value per share of 2% to $20.78. Thank you.

William Robert Berkley
Founder and Executive Chairman

$26 [indiscernible], big difference. There was a problem giving numbers. So, let's try and look at what's going on from 40,000 feet.

Fundamentally for large risks business is still competitive. For certain lines of business, you still have more competition. You should probably -- excess comp is a good example where people are making assumptions. A number of our competitors are making assumptions of higher interest rates, so they're willing to pay or accept much lower premiums. Because the leverage on our excess comp policy goes out a duration of, let's just say, 17 years, the difference in assumption of our current interest rate of, let's just say, 3.5% versus 5.5% is enormous in the assumption of pricing. So you make the assumption of 5.5%, which many of our competitors are doing. You can price the business at a much more competitive rate. So that kind of line handles only very large risks. You have a number of competitors who are still quite aggressive.

Across the board, however, you're seeing changes. Workers' comp, definitely prices are up. We see it really, virtually every place. The prices aren't up enormously, but I would say on average, it's probably close to 5%. And more importantly, you're seeing a change in attitude where people are recognizing this is an area where you have to respond, you have to do things.

We're starting to see some improvement, not in large-scale construction, but in the home improvement industry and other things. Again, improving economy, overall, as Rob mentioned, the order premiums have gone from negative to positive. Lots of those things are starting to impact business overall. And those signs are letting us get prices back to adequate levels or, in fact, improving margins.

There are signs that this is happening every place. When you look at the assigned risk number, our assigned risk premiums are up substantially. That's a sign that for the worse quality business, the standard markets are no longer fighting to right that business. It's just early sign, it doesn't necessarily mean the market has turned. But it's an early sign that there's a bit more underwriting discipline and it can be sporadic. So a quarter doesn't mean that's changed. But again, it's a waypoint. It's a directional indication.

Obviously, when you say prices have increased something less than 1% for the quarter, we have not planned a party. However, above -- prices being up for the quarter where we haven't seen it for 17 quarters in a row is a view of change directionally. And in some of our markets, it's been a lot more than 17 quarters. We believe that the aggregation of losses to the reinsurance marketplace in Australia, New Zealand, Japan, can't ignore Chile, are so significant that many markets haven't fully reflected all of these issues. And we think that's going to have a major impact on the reinsurance marketplace. That combined with RMS 11, which is a new modeling basis. We're not great believers in modeling as a way of life. But certainly, the world seems to have a different view. RMS 11 has got a very conservative stance, especially on the range in land of cat-exposed business based on several recent hurricanes in the U.S. And that's going to increase people's exposures. It will be especially difficult for regional companies who suddenly will find their need for cat covers are much greater. And the capacity for companies to buy were just a pain. Catastrophe protection may be quite different. We think that's going to lead to people reconsidering the world.

Markets don't change because of capital. I've been pounding the table about this for a long time, but the only thing I have that's in my favor are the facts. No one seems to want to believe the facts, but you can go back to 1974 and the fact that what we said, there's always been plenty of capital. What's changed is people's state of mind, and that is the fear that the capital will erode. The losses are unexplainable, unfathomable. And when that starts to happen, people start to behave in a different way.

We believe that while the direct financial impact of the catastrophe exposures will be the first thing to hit people, we think it's going to start impact people's state of mind. So that alone with the very poor results, underwriting loss, the low investment income because unlike 1985, '86 when investment returns were a lot higher, or in fact, in 2000, investment returns are low. So you have poor underwriting results combined with low investment results gives you lower operating profit.

So the lack of operating profit combined with the current level of risk, we think will get people to reconsider. Behavioral economics has been able to generate Nobel Prizes, but it still hasn't gotten most businessmen and investors to understand that it is, in fact, a driving force for how people act. We think we're building the basis for that change. It's going to be slow. It's not going to happen at 10% and 20% price increases tomorrow. What's going to drive that is something that brings about fear. Fear will replace greed and when that happens, you'll see the dramatic price increases. For now, again, 5%, 7%, 8% that's what we would expect this year. We had expected that to start at the fourth quarter of last year. We were wrong. Actually, I was wrong. But in fact, those changes are beginning to happen now, slower than I would have liked, but they're definitively happening.
So with that, Jeron, do you want to take -- we'll take questions.

Question and Answer

Operator

[Operator Instructions] And our first question comes from Mike Grasher with Piper Jaffray.

Michael Fitzgerald Grasher
Piper Jaffray Companies, Research Division

Robert, Bill, just wanted to ask about the regional markets. Can you remind us really of those markets, the lines of business that are included in that segment, and then sort of the competitive behavior right now?

William Robert Berkley
Founder and Executive Chairman

Rob is going to take that question.

Robert Berkley Jr.

It's really a combination. It's packaged business, both the property, the liability, the comp as well. There's going to be some auto in there, in addition to that. And really the focus is providing, if you will, a whole list of solution to small and middle market commercial lines where your [indiscernible]. Competition wise, the competition is certainly still significant at this time. I don't think that the competition is increasing further or going deeper. It would appear as though pricing, so to speak, for the marketplace has bottomed out. And one is, on occasion, opportunistically able to squeak out some additional rates. But certainly things have not turned all together.

William Robert Berkley
Founder and Executive Chairman

Our statistics say that, that section had again the same modest price increases that we've seen. But again, not dramatic.

Michael Fitzgerald Grasher
Piper Jaffray Companies, Research Division

Okay, appreciate that color. And then the Alternative Markets business, the growth there that you showed in the quarter, is that driven by rate or the number or the amount of exposures?

William Robert Berkley
Founder and Executive Chairman

Really the significant growth that we have there was coming from our alternatives -- our Alternative Markets segment. You're talking -- I'm sorry -- you're talking about our gross written premiums, yes? I want to make sure that I understood the question?

Michael Fitzgerald Grasher
Piper Jaffray Companies, Research Division

Yes.

William Robert Berkley
Founder and Executive Chairman

Yes, on the gross written premium, we really have to do the [indiscernible] plan and the other areas of growth that we have in the segment have to do with our Accidents and Health business, in particular.

Eugene G. Ballard
Executive Vice President of Finance

On a net basis, it's actually down $10 million. These are the gross results that net premiums are down from 210 to 200.

William Robert Berkley
Founder and Executive Chairman

That was the -- when I pointed out the assigned risk plan.

Michael Fitzgerald Grasher
Piper Jaffray Companies, Research Division

Yes.

William Robert Berkley
Founder and Executive Chairman

That was where the gross was up mainly because the assigned risk plan was up, I think, what $11 million or $12 million?

Eugene G. Ballard
Executive Vice President of Finance

In total for the company it was $11 million, but we also have more of the [indiscernible] premium going into the alternative market than less going to the Regional segment. So it's even up more for that particular segment.

William Robert Berkley
Founder and Executive Chairman

Right. And also, in addition to that, our actions in the Health business is in there, so that was up and there's more reinsurance with that.

Michael Fitzgerald Grasher
Piper Jaffray Companies, Research Division

Okay. And then final question, just around the excess comp, piece of it, where are the attachment points currently?

William Robert Berkley
Founder and Executive Chairman

Typically, approximately about $1 million. And then that will vary depending on individual account, so that's not a bad -- a little sum, if you will.

Michael Fitzgerald Grasher
Piper Jaffray Companies, Research Division

And has that moved much over the past, I guess, year?

William Robert Berkley
Founder and Executive Chairman

Not for us, it has for others.

Michael Fitzgerald Grasher
Piper Jaffray Companies, Research Division

All right. Thanks very much.

Operator

Our next question comes from the line of Josh Shanker with Deutsche Bank.

Joshua David Shanker

Deutsche Bank AG, Research Division

My first question, I wonder if you can elaborate a little bit on what you're seeing going on at workers' comp, both in terms of just the price for various kinds of business. And not by name, but who are the key competitor types who are writing this business right now?

Eugene G. Ballard
Executive Vice President of Finance

First of all, I would say prices are in general up, say, 5%. We think in some places it is more or less competitive. But in general, we think most people are recognizing the line of business needs rate, and I think most people are responding to that. I think that in the excess comp area, as I said, I think there are a few people who are entering the business pretty aggressively or in the business and being quite aggressive because of the interest rates they're using as a discount because excess comp and comp reinsurance, you generally discount the reserves of those people are using quite high rates. Today, when we price those things, we price at the marginal treasury rate. And that -- I'm not sure if you're looking for something specific, Josh.

Joshua David Shanker
Deutsche Bank AG, Research Division

I'm just trying to get better information. You said that workers' comp is about 5%. And Rob said on the conference call certainly it's not as if all rates are moving in lockstep. I'm just trying to reconcile that with the statement that everything more or less seems up, but with an average of less than 1%. That feels to me that some things are up, some things are down with an average of 1%. How does that...

William Robert Berkley
Founder and Executive Chairman

But my response to that comp is a snapshot as of the moment, not where we were as the average for the quarter. We have apples and oranges. Do you understand what I mean?

Joshua David Shanker
Deutsche Bank AG, Research Division

Okay, yeah.

William Robert Berkley
Founder and Executive Chairman

I'm talking about where our pricing is at this moment as opposed to -- and in fact, pricing has changed over the quarter. So especially in comp, pricing's been improving for the quarter. And I think Rob talked about the number of prices -- the pricing were softer, a lot soft. But I think comp is one of the places that prices are better today than they were in January.

Joshua David Shanker
Deutsche Bank AG, Research Division

And could you bifurcate it all, the ROE -- or at least expected ROE on new business lines opposed to legacy business lines?

Robert Berkley Jr.

We have targeted returns that we find are acceptable based on different product and the characteristic for these products. We don't necessarily look or target a lower return for new business versus renewal business or vice versa.

William Robert Berkley
Founder and Executive Chairman

I think I would add that we're probably patient with our -- every time we have a new venture, we sort of have a 3-year time horizon, 4-year time horizon to get to our targeted return. We don't want anyone to ever feel they have to right business. So our target is return though -- we don't go into a business without targeted return of better than 15% after tax.

Joshua David Shanker
Deutsche Bank AG, Research Division

Okay. Thank you very much.

Operator

Our next question comes from the line of Michael Nannizzi with Goldman Sachs.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Thanks. Just a quick question on the Specialty segment. What actual years drove favorable development there? Can you talk about that a little bit?

Eugene G. Ballard
Executive Vice President of Finance

Yes, it's the hard market years, 2005 right through to 2009, and '10 even had some modest development.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

So if reserved development is favorable in those lines, in more recent lines, I'm just trying to understand what is the catalyst then for price changes in those lines and maybe the answer is, not right now, or maybe it is. I'm just curious.

William Robert Berkley
Founder and Executive Chairman

I think, first of all, even with those price changes we're not at the kind of returns that we'd like to have gotten from them. We didn't have lots of improvement and positive developments early on in all those years in all those companies. We had much more modest positive developments than many of our competitors because we were more cautious. I think that fundamentally, you're going to get price increases because the returns for those years are going to have to get better because interest rates are down and your aggregate returns and capital are going to be lower, even if your combined ratios are in the 90s. It used to be when you could have a treasury return of, let's just say, 5% on a 10-year treasury, out of 93, you'd have a great return on capital. You don't get a 5% return. You're not nearly there, and that is your benchmark, such that you need a better return. So I think there's lots of moving pieces in the puzzle, Mike. And I think that overall we don't price by company, we price by individual, underwrite risk, by line, by exposure, by anticipated inflation and all those things with it. And we don't need 30% rate increases. We just need some rate increases. We wouldn't be happy with 1%, but if we could see 10% or 12% rate increase, we wouldn't be terribly unhappy.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Got it. And just on that -- the price increases of average 1%. How does that compare to loss trend for those on an apples-to-apples basis?

William Robert Berkley
Founder and Executive Chairman

Well, this time, it's relatively flat. I would say that when you take in frequency and severity at this point, it's a push. There's no adverse stuff on the loss trends at this point in time, so it's a real benefit for having price increases at this time period. There's a lot of talk about inflation, but we're not seeing a lot. And in fact, there seems currently to be a bit more pressure on medical costs at the moment.

Michael Steven Nannizzi

Goldman Sachs Group Inc., Research Division

Great. Thank you very much.

Operator

Our next question comes from the line of Greg Locraft of Morgan Stanley.

Gregory Locraft
Morgan Stanley, Research Division

Just wanted to get your sense as to how we should be thinking about buybacks going forward. Obviously, gross returning, you didn't buy back any stock in the quarter. What's your appetite at these levels for buybacks, and how should we think about it?

William Robert Berkley
Founder and Executive Chairman

I think that we looked at -- we're constantly evaluating opportunities. We're looking at where things are going, and what we can do with our capital. And I think that we continue to look at buying back stock as one of the options due to our capital. Dividends are another option. And growth rate and expansion and acquisitions are others. And we're constantly trying to make those alternative decisions, and we certainly have not put aside buybacks, and the stock is selling within the range that is certainly on our list.

Gregory Locraft
Morgan Stanley, Research Division

All right. So I guess, is there a level -- I mean your stocks have done very well. Is there a level at which it gets more -- I mean, obviously there's a level which it gets more attractive. But do you pay attention to the valuation in the market, or is it more just a capital management tool, I guess, that you're using?

William Robert Berkley
Founder and Executive Chairman

The answer is both. At some price, you think it's better to pay a dividend to shareholders than buyback stock and it's too high a premium. That's -- I think, how do you return value to your shareholders? We are focused on using our money to grow our earnings, using our money to return it to our shareholders, return it to our shareholders in 2 ways: buying back stock or paying dividends.

Gregory Locraft
Morgan Stanley, Research Division

Okay, great. And then the other question, Bill, is just on -- I want to think about -- I mean you guys, growth's really coming back strongly for you and yet rates are only up 100 basis points. So in a way, how good -- how high could premiums go for you? How do you think about the level...

William Robert Berkley
Founder and Executive Chairman

We're not pushing growth at all. We ask -- I shouldn't say we. Rob, more than I, but we ask each of our companies exactly that question in much harsher terms, and that is we don't want to grow just to grow. We want to grow in places where prices are getting better, where opportunities are better, and we think there are such places. And we're trying to emphasize that. That's the places we want to grow. You want to that, Rob?

Robert Berkley Jr.

I would just add that the rate we tracked our ticker earlier. The growth is not across-the-board. And it would be a mistake for anyone to operate under the assumption that it is. The growth is coming from specific or select pockets of the organization. And quite frankly, when we see that significant growth as you would expect, we dig a little bit deeper along within management team to make sure that we're able to reconcile in our own minds the growth and the rate that we are charging. This is not a stock loan [ph] play.

William Robert Berkley
Founder and Executive Chairman

And I will tell you that if we -- even if we see just 1 month increase in a consequential way, the first discussion we have is with the actuaries about the pricing. What's going on with pricing? We clearly don't want growth without pricing increases. So if we see one of our operating units growing and pricing is not getting stronger, they'll hear from us about our unhappiness about that.

Gregory Locraft
Morgan Stanley, Research Division

Okay. And then last is just, if we play out -- you've seen the first meaningful change in price in 17 quarters. When do you think, in your experience, we would see a turn in the accident year margins from a year-over-year perspective? When should we begin to...

William Robert Berkley
Founder and Executive Chairman

It's going to have to be at least 3 quarters. So the first time you'll see the accident year in numbers is going to be in the third quarter or fourth quarter.

Gregory Locraft
Morgan Stanley, Research Division

3Q, 4Q of this year. Okay, great.

William Robert Berkley
Founder and Executive Chairman

That's the first time. But recognize it will be a very modest change, unless we start to see an acceleration of pricing.

Gregory Locraft
Morgan Stanley, Research Division

Okay, great. Thanks for taking my questions.

Operator

And our next question comes from the line of Jay Cohen with Bank of America Merrill Lynch.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Thank you. 2 questions: The first is, Gene, you had mentioned when you were talking about the loss reserves. I think you had used the expression a growing reserve margin. And I'm wondering what exactly you mean by that?

Eugene G. Ballard
Executive Vice President of Finance

[indiscernible] I was referring to the redundancies that have been growing in that segment within specialty.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

So it's not necessarily a comment on the reserve adequacy as it stands today. In other words, you don't feel as if your reserves are more adequate or more redundant.

Eugene G. Ballard
Executive Vice President of Finance

No, I was just referring to over the last few years we've seen the reserve redundancy and reserve releases in that segment become larger and a bigger part of the total reserve releases.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Got it. Got it. And the other question was you mentioned the renewal retention was around 80%. I guess it's been hovering around there. Where did it go down to several years ago? I'm wondering what the progression is of that number.

William Robert Berkley
Founder and Executive Chairman

Jay, it went down into the mid- to low-70s and in the, what I would call the good years of 2004, '05, '06, we were in the high-80s. So we probably went down by 10 or 12 points. So it went from, let's just say, 77, 78 down to -- I mean, 87, 88 in 2005, down to probably let's just say 73, 74. And now it's across 80 and it's continuing to move upward.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Got it. And then last question, do you see an opportunity in the Reinsurance business, given some of the strain as you rightly point out, among the reinsurance companies? What's your plans for that business?

William Robert Berkley
Founder and Executive Chairman

The answer is, yes, we do. And as we explained from the beginning, we're constantly are talking to people. We have lots of people who we're visiting with all the time. And we think there's some good opportunities in the Reinsurance business that will give us really excellent rewards.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

I assume that the cat business still is not a huge interest for you?

William Robert Berkley
Founder and Executive Chairman

The fundamental problem with the property catastrophe business is it gives you the same kinds of returns, has much less volatile business and you have to deal with the volatility. So because you're required to have so much capital, the returns look great in many years, but then are negative or terrible in other years. We don't think people like those extremely volatile years. And we think a company like Berkshire Hathaway, who it doesn't interfere with their business because they have so much capital, can be in this business just like an ordinary course event, because it doesn't change their business plan. But other people who don't have so large a capital pool have to constantly manage their capital base for a chicken today, feathers tomorrow business and it's a problem. So we think unless the returns on Catastrophe business change, it's just not an attractive business for someone like us.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Got it. Thanks a lot.

Operator

And our next session comes from the line of Vincent DeAugustino with Stifel, Nicolaus.

Vincent M. DeAugustino

Stifel, Nicolaus & Company, Incorporated, Research Division

Thanks for taking my questions. I guess we've heard with the exposure estimates with insureds, they're probably sandbagging those estimates a little bit with better-to-be-expected exposures likely to be picked up in the audit. Are you getting that sense?

William Robert Berkley
Founder and Executive Chairman

I'm sorry, could you -- for what is this?

Vincent M. DeAugustino
Stifel, Nicolaus & Company, Incorporated, Research Division

Oh, I was just asking if you're getting the sense that insureds are sandbagging their estimates on exposures and whether or not there'd be better-than-expected exposures to be picked up in the audit item.

William Robert Berkley
Founder and Executive Chairman

You're talking about order premiums?

Vincent M. DeAugustino
Stifel, Nicolaus & Company, Incorporated, Research Division

Yes.

William Robert Berkley
Founder and Executive Chairman

The answer is, I think there's a combination of people who are -- first of all, I don't know that I would suggest people are sandbagging. I would suggest that people were pessimistic. And the end result may be exactly the same as you're suggesting. But I think that if you think about people's state of mind, 18 months ago, a year ago, people were a lot more pessimistic about the world. So they gave you low-ball estimates because they were afraid of the world and they were pessimistic. And I think your conclusion is correct. I think we're likely to pick a lot of positive order premiums in the next 12 months by a good margin, both because of that and because business has really gotten better. So I think your conclusion is completely correct. But I really don't think many people try to sandbag you, there certainly were some of those. I think the world was a lot more pessimistic.

Vincent M. DeAugustino
Stifel, Nicolaus & Company, Incorporated, Research Division

And just to change gears and a question for Gene. Looking back at 4Q '09, 1Q '10, 4Q '10 and now 1Q '11, it looks like there's some seasonality with the higher tax rate for fourth quarter and first quarter. Is that accurate or is there something that I'm missing there?

Eugene G. Ballard
Executive Vice President of Finance

The variability in the tax rate has a lot more to do with just the size of the pretax income. Because our tax-exempt income has been fairly stable, so it really has more to do with how much we make on a pretax basis that affects the relative portion of tax exempted taxable income than anything else. It's been pretty stable when you adjust for that.

:p id="76389799" name="Vincent DeAugustino" />

Thanks. That's all I have.

William Robert Berkley
Founder and Executive Chairman

Thank you.

Operator

Our next question comes from Douglas Miehm with RBC Capital.

Douglas Miehm
RBC Capital Markets, LLC, Research Division

2 quick questions. First, Gene, if you could just refresh my memory, the investment fund income, what asset base is that off of? Is that just that one -- the $548 million of investment funds? Or is there any of the arbitrage funds that gets turned into there as well.

Eugene G. Ballard
Executive Vice President of Finance

No. The arbitrate funds are separate from that, so it's exactly what you said. It's the 548, what we call investment fund. Those are externally managed investment funds.

William Robert Berkley
Founder and Executive Chairman

And one of the problems is because interest rates are so low, we're putting more money into those investment funds into other kinds of investment fund vehicles. And that also was going to compound the problem. As we put more and more money into those funds, it will be excluded for our investment. So that was going to become a worse and worse problem.

Douglas Miehm
RBC Capital Markets, LLC, Research Division

Okay. Thanks for that. Second question is Bill, you mentioned just sort of throwing around speculation about possible price increases this year and you were saying things like 5%, 7%, 8%. Given that you're 1% off the board -- across-the-board, notwithstanding your sort of bullish workers' comp commentary, it seems like a little bit of a stretch to get there by third or fourth quarter, considering how slow and gradual the market seems to be turning.

William Robert Berkley
Founder and Executive Chairman

I think that, first of all, I think it's the rate of the prices, not prices will have gone up by. It's -- by the end of the year, I think prices will be increasing by that rate. So I think that you should -- I'm not suggesting that for the year prices will be up 5% or 8%. I'm suggesting that if you look at prices in the fourth quarter, they'll be 5% to 8% higher than they were in the fourth quarter of 2010.

Douglas Miehm
RBC Capital Markets, LLC, Research Division

Okay. But it's not going to happen until the end of the year.

William Robert Berkley
Founder and Executive Chairman

But not that our earned premiums for the year will be 5% to 8% higher than the earned premium prices for the prior year. Mathematically, it would be very hard to get there. So what I'm suggesting is that price levels by the end of the year will be 5% to 8% higher than they were in the fourth quarter of the prior year. And I think that's going to happen, because you're going to see things like workers' compensation that is going to be, in fact, up next quarter, a higher level and the number of other lines are going to be up. So I would expect that our price increase levels for the second quarter won't be 1%, but will be 2.5% or 3%.

Douglas Miehm
RBC Capital Markets, LLC, Research Division

Okay, thanks. That's all of my questions.

Operator

Our next question comes from the line of Amit Kumar with Macquarie.

Amit Kumar
Macquarie Research

Thanks. Just going back to the discussion on premiums and talking about reinsurance and international segment. I'm just wondering, looking at the growth from '06 to 2011 in these units, based on your comments, is it fair to say that international premiums will exit at meaningful growth going forward? Or do you think you're at that level where it sort of plateaus from this point on?

William Robert Berkley
Founder and Executive Chairman

No, I think it's just likely to have meaningful growth from this point going forward.

Amit Kumar
Macquarie Research

Okay. That's helpful. And the only other question I have is on the tax modeling when you talked about RMS 11. Some of the companies have, in fact, remarked that that's not the only model they use. They have internal models and they use all 3 models. And my sense is that if I'm a company and if I come up with a range of numbers, why would I be in fact picking the highest number based on the current returns? I mean, could there be a scenario where the impact could end up being much more muted than what we thought initially?

William Robert Berkley
Founder and Executive Chairman

Well first of all, Amit, I don't think I said that everybody's going to use RMS 11. I think -- or at least if I did, that was not what I meant. What I meant to suggest is that with all the catastrophe losses that have taken place, and we haven't really gotten into what's historically the big cat loss season which is approaching, it's likely to be quite a disastrous cat year. In fact, losses taken in the aggregate for Australia, New Zealand and Chile, Japan are likely for the reinsurance marketplace to be certainly well in excess of $50 billion. So when you take all those losses, the Catastrophe Reinsurance business is going to be under a lot of pressure. I then was trying to express the view that, that pressure will be exacerbated by the fact that RMS 11 is going to close the rating agencies having just seen these cats, which are much worse than anyone anticipated, to look at a conservative model. And I think RMS 11 is overly conservative and is not the only model we use either. But when rating agencies see losses far in excess of what they imagined, which is what they saw clearly in New Zealand and Japan, they're going to look at conservative models, not aggressive models. And it's not what a company says they want to use. It is just undeniably it's the rating agencies that are going to set that, too. And I think the rating agencies are going to certainly at least want to look at RMS 11 as one of the key stones. So I'm not suggesting it's going to be the beat all end all and heaven forbid I think we'd be in a terrible state if we relied on 1 rating model. And I don't believe in 1 rating model. Actually, I don't believe in any of them. But the fact is that I just think that it's going to be taken together that there'll be a lot of pressure on catastrophe coverages, availability and exposure. That's all.

Amit Kumar
Macquarie Research

Got it. Thanks for the color.

Operator

Our next question comes from [indiscernible] with Eagle Capital.

Unknown Analyst

Quick question to follow up on your talk about inflation. I know you guys have been thoughtful in the past about baking in some conservative inflation expectations in the different lines and I realize it depends where inflation shows up, but curious if any of the current spreads, actions in Q2 and potential further actions are worrying you at all and if you're going to do anything differently now or the same old playbook?

Eugene G. Ballard
Executive Vice President of Finance

I think that our general view would be reflective of the following: Number one, we think that just as we got benefits for a long time from the low production cost and low cost of goods being provided by China and much of the rest of the world, we're going to suffer as they have an increasing middle class and demand for food, energy and raw materials. So we think food, energy and raw materials are going to create inflation here. And that's going to cause inflation all across the board. What's maybe even worse is, it's unlikely that the Fed tightening is going to have add any impact on that because it's not within their control. So that inflation is likely to be much more dependent on how the Chinese and some of the other powers that we trade with are going to act. So we're continuing to be a bit more cautious about inflation. And a number of people, we think inflation is down around the corner. We don't think it's going to be terrible runaway inflation, so we continue to bake in inflationary expectations and what's more concerning us is because we don't think it's within the Fed's capacity to manage that inflation. So we've lost the Chinese and some of the other foreign countries that are going to drive this inflation. This one world is really true when it comes to managing raw materials.

Eugene G. Ballard
Executive Vice President of Finance

It continues to deplete into our numbers.

Unknown Analyst

Okay, great. Thanks, guys.

Operator

Our next question comes from Vinay Misquith with Credit Suisse.

Vinay Gerard Misquith
Crédit Suisse AG, Research Division

Question on -- you mentioned that fear was the big factor that drives cycles and you also mentioned that there's not much inflation yet and you can see most companies having strong reserves.

Eugene G. Ballard
Executive Vice President of Finance

I don't think I said most companies have strong reserves.

Vinay Gerard Misquith
Crédit Suisse AG, Research Division

Yes, yes. You didn't say that. But most companies have reported so far -- have shown pretty strong favorable reserve leaders and at least they're looking at the industry trying, but it doesn't seem that they're usually under reserve like they were back in '99. So what do you see that will really drive here? I mean, is it the cash flows within the industry?

William Robert Berkley
Founder and Executive Chairman

First of all, I think that we're going to start to see investment income start to decline as cash flows hasn't been significant and yields are going down. I think No. 2, you're likely to see some adverse development from some of the aggressive competitors starting to have to pay the price for that aggressive behavior.

There are lots of companies that are doing a fine job and are going to do just fine. And they may have a hiccup or a bump, but they're all the guys that are talking about raising prices. When you hear people talk about they don't need to raise prices, those are the people who are in denial. All you have to do is -- you could look at the most conservative people who do pricing measure. And the fact is, prices are down significantly. And there is some inflation, especially medical inflation, and that tells you the industry is running as a whole at 110 or 115. And given where investment income is, that means a certain proportion of the industry is having a major operating loss. The sum of the parts has to equal the whole. You can't have everyone doing okay when we know what pricing has done and we know that investment income has done and when you add up the industry, it's quite at odds with those numbers. I just think eventually you run out of redundancies from that. Eventually you have to say wait a minute, isn't it everybody, but there certainly are places.

Vinay Gerard Misquith
Crédit Suisse AG, Research Division

Fair enough. And in terms of this cycle versus the last cycle that was in '99, how is this cycle different from the last cycle? Do you think the rate increases will be slower than it was back in '99, 2000?

William Robert Berkley
Founder and Executive Chairman

I think that -- first of all, the one place where you're quite right is reserves were much, much shorter in '99, 2000 than they are now. I mean, reserves were just a disaster at that period of time for everybody. I don't think there was anybody adequately reserved then. I think everybody -- a lot of people thought they were, but they were wrong. Now keep in mind what I said just then. A lot of people thought they were, they were wrong. A lot of people think they're redundant and my guess is they're wrong now, too. So we have better numbers, better statistics, the business is going to be modestly less cyclical, but it's still cyclical. The numbers are the numbers. People who say it's a less cyclical business just -- they want to say that price declines aren't the case. Well, I think there are people who exaggerate price declines because they get hearsay evidence from brokers, from whatever, that aren't statistically driven. But the fact is, prices are down and they're down substantially. Terms and conditions are less good. If you look at our existing businesses, business that we did in since 2000, our volume is down more than 25% for most of them and some as much as 40%. It's down because prices are down and the number of units we insure are down and we don't do that because we like getting smaller. It's reality. So I just think that in '99, everybody thought in '98 -- if you talked to everybody in '98, they'd tell you the reserves were fine, too.

Vinay Gerard Misquith
Crédit Suisse AG, Research Division

All right. Thank you so much.

Operator

Our next question comes from Mike Nannizzi with Goldman Sachs.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

I just have a quick follow-up. If we were to back out the new business, the new platforms, I guess, in Specialty and Media and International, what is the trend on top line of that legacy book and exposure -- from the exposure prospective?

William Robert Berkley
Founder and Executive Chairman

I'm guessing -- for the quarter, it was probably flat. For the past couple of years, it's down probably -- what would you say? 15% or 20%?

Eugene G. Ballard

Executive Vice President of Finance

For the quarter, the -- for the mature? On the start-up line, I think 10%.

William Robert Berkley
Founder and Executive Chairman

It's down 10% to 15%.

Eugene G. Ballard
Executive Vice President of Finance

Obviously, Mike, that's going to be skewed depending on the part of the business, for example, the regional business has historically been a lot more sticky when you go to the EMS or you go to the insurance world. The retention ratios are very different.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Got it. Got it. And in terms of new business, if you were to isolate that, if we were to look at new business, again excluding the new platforms, new business on the old legacy book relative to what you wrote, new business wise, first quarter '10.

William Robert Berkley
Founder and Executive Chairman

You mean new business versus renewal?

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Yes, it's new business versus renewal, but on that legacy book. So again, excluding the startups.

William Robert Berkley
Founder and Executive Chairman

I don't have the number that I can give you off the top of my head. It's just not -- it's not in my head and it's not on the pieces of paper in front of me. And I don't want to give you a number that I don't -- it's a good question, but I don't know the answer to that, but we'll try and get back to you with it.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

No problem. I mean, I guess maybe from the other side, Gene, I know you did the last few quarters, I think it was last quarter you had talked about the new business trends in the startups or the premium percentage of starters versus the legacy book. Maybe we could -- do you have that?

Eugene G. Ballard
Executive Vice President of Finance

Yes. We can get that for you. One of the reasons we aren't discussing as much is because some of those startups were started in 2000...

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Right now, they're old. They're effectively legacy book at this point.

Eugene G. Ballard
Executive Vice President of Finance

At some point, we've got to sort of start calling startups.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Right. That's fair enough. That's fine. Okay. All righty. Thanks again. Sorry for the follow-up.

Operator

Our next question comes from Ron Bachman [ph] with Capital Return.

Unknown Analyst

Thanks a lot. I had a question, it sort of reminds me of Charlie Gates type of question. And it's sort of simply, how do rates go up? And I'm sort of curios about the interplay at the underwriter's desk at the agent and I guess at the insured or the prospective insured, that back and forth that sort of begins the increase in rates. Is it simply underwriters getting less pushback as they propose a higher rate and they sense it from the agent and the insured that it's less of a competitive environment and the retention rate they can just see sort of ticking up and that fuels the confidence to do more of that?

William Robert Berkley
Founder and Executive Chairman

Ultimately, rates go up -- they start to go up because you spend enough time with the broker and the broker is particularly concerned that they have good markets. We heard from one of our EMS competitors that their prices are down substantially. And we looked in the mirror because our EMS people said for the first time they're seeing the ability to raise prices. So what's interesting is that what's going on at this point is there's a differentiation. People saw Japan, they saw the catastrophe. They're beginning to recognize that there's a value to insurance and it matters who you do business with. So you ask -- you reiterate that to your brokers. You make the point and you don't go in and ask for a 10% or 20% rate increase. You ask for 1%, 3%, 5%. As long as you keep it under 5%, brokers understand there's inflation. Everybody's talking about inflation. And in those cases, you're able to get a modest rate increase. Not every place and in some cases the customer wants to fight and compete. You've got to sell the idea that the uniqueness of this product that people fail to understand, if you're really lucky, you brought a product that you get nothing for. There aren't many products that are like that. But when you buy property casualty insurance, you hope you wasted your premium. That you bought something that you'll never use. But you really don't want to buy something that you need to use and it's not there. And that's the message we spend a lot of time talking to our customers about.

Unknown Analyst

Bill or Rob, will the more passive companies, with respect to rate increases, increase their confidence and ability to propose and I guess ultimately get rate increases as they hear the likes of Berkley and as they hear the likes of Travelers and Chubb talk about their, in effect, successes in getting rates and that will sort of reinforce and fuel further and maybe even greater rate increases for the market as a whole?

William Robert Berkley
Founder and Executive Chairman

Without a doubt, but they're also going to be the same companies. The smaller companies are the ones that are going to have the most pressure for cats and reinsurance, so they're going to also all find out they've got a lot reinsurance cost pressure going against them at the same time. So they're going to have to raise prices so they're going to have that pressure, see other companies raising prices and they're going to have even more impotence to do it. So yes, I think that's going to happen.

Unknown Analyst

Okay. Thanks a lot. Best of luck.

Operator

Our next question comes from Ken Billingsley with BGB Securities.

Kenneth G. Billingsley
BGB Securities, Inc., Research Division

I just have kind of a follow-up to some of the comments you just made regarding Vaughn's [ph] questions. Can you just -- can you talk a little bit more maybe about the competition about your new business versus renewal business? You're saying that the brokers understand when you're trying to ask for 3% and 5% rate increases. Just a few quarters ago competition may have come in and -- been able to come in and steal that with me -- I'm assuming 10% or 15% rate declines. Can you talk about the shift and what's going on where there's terms and conditions and your ability to price your renewal business versus the ability to price the new business that you're looking at?

William Robert Berkley
Founder and Executive Chairman

I think that it's a gradual process. We talk to every agent and every broker. We talk to them, but because brokers are afraid, agents are afraid they're going to lose the business. On the other hand, many of them also know that it's important to them to have a solvent insurance and pay claims. There are companies that are in business and they want -- they need to stay in business. They need competitive marketplaces, they need viable companies. The worst thing for a broker or agent is a company that doesn't pay its claims. So they need viable companies and I think you talk candidly about them and you talk to them about the reality. I'm going at the end of the week to talk to a group of our agents and its reality. They will see companies go out of business and they know it and what brings that issue to their attention are things like Japan, where they say what the heck's going to happen. What companies are going to survive? And there'll be articles everywhere soon New Zealand, that there is not enough premium in New Zealand to pay for the earthquake exposure in New Zealand. And the government is going to have to subsidize the premiums or people won't be able to afford the risks. And as those kinds of things start to become pervasive, people are going to start to understand. So I think that brokers are afraid they are going to lose the customer to the broker next door, but more importantly, they're afraid that they're going to have a customer who's going to have a claim that's not going to get paid. And I think that's the evolution of change from greed to fear. And think when that fear starts to take over, they're not going to be afraid enough to raise prices 20%, because they don't have that much fear. The World Trade Center gave them that much fear. But today, they're going to get a little bit of fear.

Kenneth G. Billingsley
BGB Securities, Inc., Research Division

And I believe -- does that relate to the comments you made earlier about obviously reserves and the industry today are not as weak as they were going into the last cycle at the end of the 90s?

William Robert Berkley
Founder and Executive Chairman

They were not as weak, but they're much weaker than people perceive at the moment. A lot of people -- if you don't establish your case reserves, your cases -- where they need to be and if you don't understand that your pricing is inadequate, until that loss level gets to where it's supposed to be, you don't realize your reserves are inadequate. So there are a lot of people who don't understand that their reserves are inadequate at this moment in time. But they'll be finding out soon, because when you cut prices enough, even a long-tail lion becomes short tailed.

Kenneth G. Billingsley
BGB Securities, Inc., Research Division

Thank you.

Operator

Our next question comes from the line of Bob Farnam of KBW.

Robert Edward Farnam
Keefe, Bruyette, & Woods, Inc., Research Division

Thanks and good morning. So it looks like you're selectively increasing your non-casualty business mix. I mean, I take that to mean property, but it also sounds like you're not looking for property catastrophe business, so I'm just curious, one, is that an opportunity that you see just because of improving rates and 2, what types of risks are we looking for and in what segments are they going in?

William Robert Berkley
Founder and Executive Chairman

Okay, you want to talk about them?

Eugene G. Ballard
Executive Vice President of Finance

Sure. The answer is it's not that we move as we suggested, solely into the property. We certainly have increased our property exposure a bit, but pure property as we define it remains give or take around 10% of the portfolio. It's really been the expansion into some other specialty lines such as energy, agriculture, other things of that nature that we've discussed in capped calls. It's this expansion that has not necessarily taken it deeper into some of the traditional cash, those lines that we have had a significant presence in. Not pure property, but shorter-term lines.

Robert Edward Farnam
Keefe, Bruyette, & Woods, Inc., Research Division

All right. So this is mostly coming in the EMS segment and...

Eugene G. Ballard
Executive Vice President of Finance

It's mostly coming in the specialty lines and once again, it's not a true shift to property, but it's more of a shift to specialty lines especially lines that are shorter tail in nature and as I had mentioned earlier in the call, also our presence in the A&H space, if you will, is growing as well, which is obviously a shorter tail than most of our historic portfolios.

William Robert Berkley
Founder and Executive Chairman

[indiscernible] just various things.

Robert Edward Farnam
Keefe, Bruyette, & Woods, Inc., Research Division

Okay. Very good. Thanks.

Operator

Our next question comes from Josh Shanker with Deutsche Bank.

Joshua David Shanker
Deutsche Bank AG, Research Division

Thank you. I just want to clarify when you say $14.5 million of investment gains from funds that only includes the investment funds, not the arbitrage portfolio?

William Robert Berkley
Founder and Executive Chairman

That's correct. Our income from arbitrage funds is and has always been investment income.

Joshua David Shanker
Deutsche Bank AG, Research Division

Okay. And that's never been broken out separately?

William Robert Berkley
Founder and Executive Chairman

Right. We described it separately, but it's an operating income.

Joshua David Shanker
Deutsche Bank AG, Research Division

Fantastic. Thank you.

Operator

I'm showing no further questions in the queue.

William Robert Berkley
Founder and Executive Chairman

All right. Thank you all very much. Have a great day.

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