S&P Global
Market Intelligence

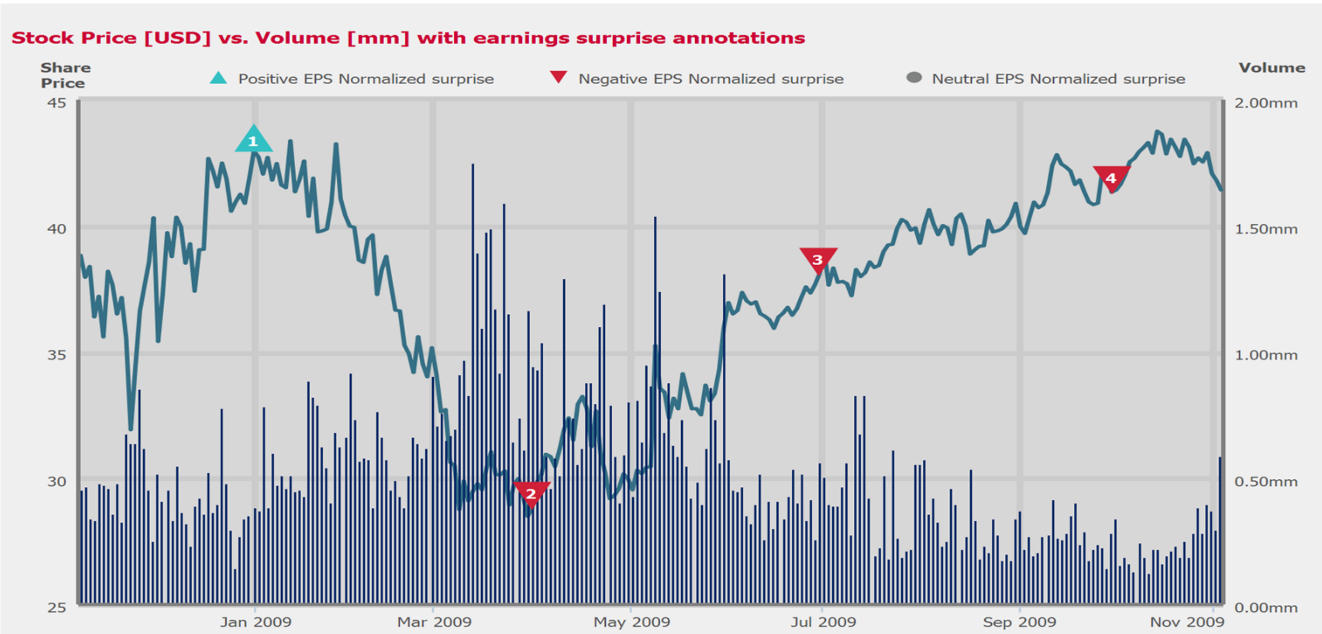
The Hanover Insurance Group, Inc. NYSE:THG
FQ3 2009 Earnings Call Transcripts

Tuesday, November 03, 2009 3:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ3 2009-			-FQ4 2009-	-FY 2009-	-FY 2010-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.98	0.89	(9.18 %)	1.08	3.40	NA
Revenue (mm)	669.85	688.80	2.83	623.50	2588.50	NA

Currency: USD
Consensus as of Nov-04-2009 2:58 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ4 2008	1.13	1.16	1 2.65 %
FQ1 2009	0.44	0.39	2 (11.36 %)
FQ2 2009	1.01	0.86	3 (14.85 %)
FQ3 2009	0.98	0.89	4 (9.18 %)

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Call Participants

EXECUTIVES

Eugene Martin Bullis

Frederick Henry Eppinger

Marita Zuraitis

Robert Patrick Myron

ANALYSTS

Clifford Henry Gallant

Dan Farrell

Jay H. Gelb

Michael Wayne Phillips

Samuel Hoffman
Lincoln Square Capital Management

Presentation

Operator

Hello, and welcome to The Hanover Insurance Group 2009 Third Quarter Earnings Conference Call. [Operator Instructions] I would now like to turn the call over to Bob Myron, Senior Vice President of Finance. Please go ahead, sir.

Robert Patrick Myron

Thank you, operator. Good morning, and thank you for joining us for our third quarter conference call. Participating in today's call are Fred Eppinger, our President and Chief Executive Officer; Marita Zuraitis, President of our Property and Casualty Companies; and Gene Bullis, our Executive Vice President and CFO. Before I turn the call over to Fred for a discussion of our results, let me note that our earnings press release, statistical supplement and a complete slide presentation for today's call are available in the Investor Section of our website at www.hanover.com. After the presentation, we will answer questions in the Q&A session.

Our prepared remarks and responses to your questions today other than statements of historical facts include forward-looking statements. These include statements regarding expectations of segment earnings, pricing, accident year results, premiums, expenses, development of loss and LAE reserves, returns on equity and other projections for 2009. There are certain factors that could cause actual results to differ materially from those anticipated by this press release, slide presentation and conference call. We caution you with respect to reliance on forward-looking statements and in this respect, refer you to the forward-looking statements section in our press release, Slide 2 of the presentation deck and our filings with the SEC.

Today's discussion will also reference certain non-GAAP financial measures such as total segment income, segment results excluding the impact of catastrophes, ex-cat loss ratios, book value excluding accumulated and other comprehensive income and accident year loss ratios among others. A reconciliation of these non-GAAP financial measures to the closest GAAP measure on a historical basis can be found in the press release or the statistical supplement which are posted on our website as I mentioned earlier. With those comments, I will turn the call over to Fred.

Frederick Henry Eppinger

Good morning, everyone, and thank you for joining us. As usual, I will take a few minutes to talk briefly about our results, I'll review some of the initiatives we have underway and put our third quarter results and our competitive position into context. Marita and Gene will provide additional insight into our performance and trends in our business.

With respect to our earnings in the quarter, the fundamentals of our core business remain very strong. In addition, our strategic initiatives have good traction, which makes us very positive about the current mix of our overall book of business. We're growing partnership with winning agents and are expanding product offerings. Our business momentum and our financial strength position us very well for the continued disruption we see in the marketplace. We also feel very good about the strength of our investment portfolio, our capital and liquidity position and the resulting flexibility it gives us with respect to the capital actions that we are taking to drive shareholder value.

With respect to the results for the quarter as noted on Slide 4, we generated net income of approximately $50 million or $0.97 per share for the quarter compared to a net loss of about $62 million or $1.21 per share in the third quarter of last year. We generated segment income of approximately $45 million or $0.89 per share compared to about $3 million or $0.07 per share quarter-over-quarter. Putting catastrophes aside, our combined ratio was approximately two points higher than the prior year quarter, driven by higher-than-expected accident year losses and higher expenses.

On a loss side, earnings for the quarter were impacted by continuing weather-related losses. The impact of the economy and the state of the insurance market. In particular, in Personal Lines, the largest driver of our performance sharp fall was above historical average losses for non-CAT weather. While this trend has put pressure on our short-term earnings, it has made significant rate increases much more achievable, particularly in many of our markets that are dominated by regional competitors.

In Commercial Lines, we had higher-than-expected losses in some lines that were driven by increased loss incidence as well as a more cautious approach towards setting our accident year loss picks. We think this is a prudent approach given where we are in the market cycle as well as in the state of the economy and its potential impact on industry loss trends.

We don't expect this to have a long-term impact on our results because the improving quality and mix of our business and the rate increases we are now achieving.

On the expense side, earnings were impacted by ongoing investments we are making in product, distribution and infrastructure, principally in Commercial Lines as well as an increased pension-related expenses across our business. From a top line perspective, we continue to be pleased with the growth trend and the progress we are making in our overall book of business. We are maintaining a disciplined underwriting approach both in terms of pricing and terms and conditions. Net written premium growth for Personal and Commercial Lines combined was 5.7% for the quarter and 3.2% year-to-date. The growth we're achieving is a result of the positive actions we are taking and the momentum we have established in many areas of our business.

In Personal Lines, we continue to thoughtfully improve our product offerings and at the same time, improve our mix, writing an increasing amount of attractive account business. In fact, as of September 30, 2009, over 2/3 of our business is now on account. We continue to manage our core states for margin while growing in states targeted for growth. While overall, our net written premium in Personal Lines was flat for the quarter, we grew 6.2% in the growth state. We have strengthened our field teams in these states over the past 18 months and we are working hard to develop and build on partnerships with the best winning agents in these states in order to continue the positive momentum we have already established.

In Personal Lines, our overall rates were 4.4% above the prior year. And based on filed and approved rates, we expect this trend of pricing to increase in the fourth quarter and into 2010. We believe these increases will keep us ahead of loss cost inflation also taking to account the ongoing trend of heightened weather-related losses, all with the view toward increased profitability in future periods.

In Commercial Lines, we achieved 15% growth, driven by our more specialized businesses such as niches, Professional Liability, Marine and AIX, as well as our increased segmentation of our core commercial offering. We also continue to expand our specialty offerings with a long-term view toward improving our overall mix and margin of our Commercial Lines business.

Our outlook for all our strategic investments in the specialty and niche areas is very bullish for the remainder of 2009 and 2010. Separately, we continue to push ahead with our launch into the Western part of the country, leading with middle market niches and industry segment along with a full breadth of our specialty offerings, all of which we feel aligned well with business opportunities in the region.

Obviously, a significant portion of the agents we consider winning agents reside in this part of the country, as well as over 30% of the specialty niche businesses we target. Ultimately, this expansion will improve our geographic diversification, leverage our product investments and build on our partnership strategy.

We already have a significant transparency to attract these new business opportunities with our selected partner agents, and expect to see some meaningful impact on our 2010 results. For our westward expansion as well as generally across all our Commercial Lines platform, we are bringing on highly-talented individuals, as well as teams of people that we feel strongly will help us continue to drive growth in our Commercial Lines business. We have never been in a better position to acquire terrific talent in our business.

While we're excited about the profitable growth and improvements in our mix of business we expect from the investments we are making, we are also keenly aware of the pressure these investments place on our expense ratio. However, they represent a critical component of our long-term strategy and enable us to capitalize on the opportunities we see in the marketplace.

While expense ratio for the year will be at the high end of our previously issued guidance, we are pleased with the progress that is being made on all our strategic investments and confident that we are on track over the next five quarters to meet our investment hurdles and achieve the ROE improvement discussed during our Investor Day. In terms of our core Commercial Lines pricing, we continue to have pricing increases on our small commercial and middle market businesses in the low single digit.

Moving on to our balance sheet and capital. We consider prudent management of our investment portfolio and our capital to be core tenets of our operating strategy. In particular, capital management is an important lever to increase shareholder returns. With capital market continuing to normalize and our capital position continuing to strengthen, we made several important capital management decisions during the quarter.

First, we successfully completed the process of restructuring a portion of our debt through drawing a $125 million, 20-year loan from the Federal Home Loan Bank of Boston at a cost of 5.5%. This served to lower our overall cost of capital and decreased our interest expense on a post-tax basis by approximately $2 million per year. Second, we continue to buy back stock during the quarter, in October, at prices below our book value, which is immediately accretive to book value and earnings per share. Third, we increased our existing share buyback authorization by $100 million and expect to continue to opportunistically utilize the program. And lastly, we increased our annual dividend by 67% to $0.75 a share, and announced our intention to move to a quarterly dividend in 2010.

All of these items represent tangible steps to increase shareholder returns, and the buybacks and increased dividends demonstrate confidence we have in our company's overall financial condition and our ability to generate strong profitable growth going forward.

As shown on Slide 4, our book value per share increased by 10% in the quarter and 30% for the year-to-date, driven by increases in the value of our investment portfolio, as well as our operating earnings. At $48.06 per share, our book value per share is now the highest it has been in any point in the company's history.

In summary, we produced solid results in a very difficult economic and market environment. And while we anticipate some negative trends to persist through the end of the year and into 2010, we are very optimistic about our company's ability to manage through it and create significant shareholder value. Although the insurance cycle has not fully turned, I am pleased with our ability to achieve price increases in both Personal and Commercial Lines, and I am very pleased with the quality and the mix of our new business coming from our new product investments.

Our ex-cat combined ratio of 93.7% is very solid compared to many of our regional competitors, but it does not meet our expectations. However, given mix improvements, our pricing actions, increased expense leverage, we are confident that we will see meaningful improvement in 2010.

Without question, the past year has been characterized by more change and challenge than I have seen at any time in our business. But with disruption comes real opportunity. I am very pleased with the way our company has performed over the course of the year, and I am more confident than ever that we are positioned to capitalize on the opportunities that will unfold over the next several quarters. With that, I will turn the call over to Marita for a review of our business.

Marita Zuraitis

Thanks, Fred. Good morning, everyone, and thanks for joining us today. Fred gave you a broad overview of our operations, and I'll review our business specific trends. Starting with the discussion of our overall P&C results on Slide 7.

Our third quarter produced $74 million of pretax segment income compared to $14 million in the prior year quarter. Segment earnings were up from last year, primarily driven by lower catastrophe activity. Excluding cat, the combined ratio in the current quarter was 93.7%, compared to 92% in the prior year quarter. This moderate margin compression is reflective of a number of factors, including increases in expenses, driven by investments in our operating model and our product breadth and higher losses in some business lines, driven by weather and economic conditions.

Net written premiums were $689 million in the quarter. This represents a 5.7% increase over the third quarter of 2008. Our more specialized businesses such as niches, Professional Lines, marine and AIX as well as increased segmentation of our core commercial offerings, fueled our year-over-year premium growth. I'd like to discuss the drivers underlying these results in more detail starting with Personal Lines.

Turning to Slide 8. Our Personal Lines segment reported pretax earnings of $27 million in the current quarter compared to $18 million in the prior year quarter. Earnings in the current quarter were impacted by lower cat losses, higher underwriting expenses and higher ex-cat accident year losses in our Homeowners line, which was primarily weather-related.

At our second quarter earnings call, we shared with you plans to accelerate some technology product and ease of doing business investments in our Personal Lines in the third and fourth quarters of 2009. We can now see these expenses running through our numbers in the current quarter. These initiatives gathered under the umbrella of Think Hanover campaign, leveraged and emphasized our total account products suite, allowing us to support our growth initiative in our newer states, and to more effectively preserve margin and market share in our core states.

We expect these higher expenses to continue in the fourth quarter. But starting in 2010, our cash spending on these projects will decrease significantly. As we've discussed in the past, expenses in the current quarter were also impacted by increased pension costs compared to the prior year.

And finally, the year-over-year expense comparison also was affected by a reduction of variable compensation expenses made in the third quarter of 2008, which was related to the first three quarters of 2008. The variable compensation reduction was a consequence of decreased profitability in 2008, due to heavy cat losses in the third quarter. Higher ex-cat accident year losses in Personal Lines were driven by ongoing higher than usual weather-related losses in our Homeowners line.

While weather had a more limited effect on profitability in this quarter compared to the first and second quarters of this year, the fact that the trend is continuing makes it an ongoing area of focus and a main driver of continuing rate increases in our Homeowners line. Overall, the combination of increased rate to address these weather-related losses, along with our prudent risk appetite and underwriting practices, makes us comfortable with the expected profitability of this business.

Our business mix also continues to improve, driven by successful initiatives implemented last year to write more account business, to move away from higher risk drivers and to carefully manage our coastal property exposures.

Turning to Slide 9 to discuss our Personal Lines growth for the quarter. Net written premiums decreased 2/10 of a point compared to the prior year quarter. Our growth strategies in Personal Lines, as well as our top line results, remained similar to prior year quarter trends. We are striving to preserve our market share and margin in Michigan, Massachusetts, New York and New Jersey, while increasing exposure in states targeted for growth. Written premiums decreased 2% in our big four states combined in the quarter. With respect to states targeted for growth, however, net written premium increased 6% and PIF grew 5%, with impressive momentum in states like Ohio, Illinois and Wisconsin.

Overall, we continue to grow Personal Lines business that's associated with a lower risk profile and higher retention. We attribute our retention improvement in personal Lines into successful past mixed management actions in Homeowners and in Connections Auto, and our focus on writing more multi-car and multi-account business that's consistent with our strategy.

As I just mentioned, the investments that we're making in our Think Hanover program are intended to make writing account business more convenient and beneficial to our agent. As Fred mentioned, 66% of the new business we write in Personal Lines is now coming from full accounts, which means we underwrite the customer's home, auto and other lines.

The portion of our Account business has grown 4% since the end of 2008 and 9% since the end of 2007. As a result of this whole account strategy, our PIF counts in Homeowners business grew 5% in the quarter, primarily coming from our newer growth states like Ohio and Wisconsin.

In Personal Lines, overall, we continue to see sequential and year-over-year improvement in the growth of policy counts, which comes from states targeted for growth. We expect to sustain this upward momentum going forward as we anticipate better retention of this business due to our improved profile. At the same time, we remain disciplined in our approach to pricing, pushing enough rate to get ahead of lost cost inflation as well as pricing our Homeowners line to address the higher weather. Our Auto rates increased 4% in the quarter, while Homeowners rates were up 5%, and we have larger increases in both Auto and Home in the pipeline.

As we look into the future, we have visibility into growth and profitability improvements in Personal Lines, which are supported by investments in product and the ease of doing business enhancements, as well as our commitment to the independent agency channel, which we know is very important to our partners.

Now moving on to Commercial Lines on Slide 10. Pretax segment income for the quarter was $39 million compared to a $7 million loss in the third quarter of 2008. Catastrophes were $9 million in the current quarter compared to $59 million in the third quarter of last year. On an ex-cat basis, the current quarter combined ratio was a 94% or 2.5 points higher than the prior year quarter.

Our Commercial Lines underwriting expenses were higher in the current quarter compared to the prior year quarter, reflective of continued investments in product, distribution and infrastructure in new and existing lines of business and geographies, which are critical to our future success.

In contrast with across-the-board technology and basic infrastructure investments in the beginning of our journey six years ago, we are now making more targeted and discrete investments in specific areas of business, which we believe have the best growth and profitability potential. This investment strategy has been very effective. Over the last two years, we have actively invested in several of our specialty Commercial Lines products and platforms, which are now driving significant growth.

Our total specialty growth, even excluding AIX, was 15% in the current quarter. We are also seeing growth from our investments in selected industry segments in commercial middle market. Lastly, we expect that cost we incur ahead of premium in our Westward Expansion initiative will be beneficial to our top and bottom line in future periods.

Clearly, these investments have put additional pressure on our expense ratio. However, we consider these investments to be critically important to position us well for profitable growth in the future. We are willing to take this expense risk in order to take advantage of the market opportunities that are in front of us.

They not only makes sense on a stand-alone basis, but they also allow us to grow our share with partner agents across multiple lines of business as we become more meaningful to each of them. As in Personal Lines, higher pension costs and a reduction of variable compensation expenses in the third quarter of 2008 negatively impacted the year-over-year expense comparison. Our ex-cat accident year losses were lower overall in the current quarter when compared to the prior year quarter. This is due to better results in CMP large losses when compared to unusually high incidence of large losses in this line in the prior year quarter. Partially offsetting the lower CMP large losses in the third quarter this year was a moderate severity increase in some of the other commercial businesses.

Our bond portfolio, which is principally contract and commercial surety, historically has had very limited level of losses. Given the state of the economy and the level of activity we are now seeing, we have adopted a more conservative approach to establishing loss picks, reflective of a higher incidence of losses, which is quite typical in this recessionary economic environment.

This more cautious approach to loss picks also drove us to increase current accident year loss expectations for our workers compensation line and commercial auto lines, which were driven by a combination of negative audit premiums as well as higher severity assumption.

Now turning to growth on Slide 11. Our 15% net written premium increase in Commercial Lines for the quarter reflected the impact of our AIX acquisition as well as growth in our niche, professional liability, marine and segmented middle-market products. We are positioning our current Commercial Lines growth strategy to minimize the impact of the recession. And at the same time, we continue to emphasize specialization and deeper industry segmentations, which allows us to get an edge in pricing, thus maintaining an improving margins. So far, we have been relatively successful in this regard and I'd like to discuss our thought process related to each of our Commercial Lines businesses starting with our core lines.

In our flow, small and middle-market businesses, we try to explicitly avoid recession-sensitive industry classes like contractors and building owners, which are prone to retail and office vacancies. We have minimized those classes in our new business writings to a negligible level. We also continue to tighten underwriting on all slow businesses and to hold firm on pricing, which reduced our new business flow, which decreased 8% in the third quarter of 2009 compared to the prior year quarter. At the same time, our retention rate on renewal business is holding relatively well. Rate increases flattened a bit on a sequential quarter basis. However, our rates were still up 2.5% in small commercial and 1% in middle-market in the quarter. We did experience exposure decreases in the quarter, clearly driven by the economy.

To mitigate this, we continue to segment our middle market businesses by the packaging of coverages and terms for specific segments. We believe this will allow us to continue to grow our segment and middle market business, and more importantly, will help us preserve margins.

Our segment at new business grew 6%, including such segments as Hospitality and Assisted Living. Our middle market niches continue to grow at a significant pace despite the slowdown in the economy and the difficult market conditions. Recently, we've concentrated our product development efforts in more recession-resistant business classes like education, human and professional services. Some of our best people and most experienced underwriters have been tasked to service these products. As a result, all of our niche offerings combined, produced net written premium growth of 35% on a year-to-date basis.

Our Inland Marine line grew 20% during the quarter and stands at 8% year-to-date. Our Marine book is a highly diversified and profitable book of business and we're very pleased with the growth. We're also extremely pleased with the substantial traction that AIX has achieved in the first half of the year, validating the synergies gain by combining our businesses.

Hanover's retail distribution and our A rating contributed to AIX's top line in the quarter. Our Hanover Professionals unit, which grew 49% in the quarter, continues to give us high quality business from a limited number of committed agents, with lawyer's professional liability capability. We have recently added an employment practices liability insurance program to the Hanover Professional portfolio to address the unique risks of small and mid-sized businesses and organization, and allows us to be more distinctive to our agent's local markets. This program offers protection for employers wrongful acts, including coverage for discrimination, constructive discharge, termination, failure to hire and negligent supervision and temporary workers.

With respect to our outlook on the market, the overall state of the economy and the pricing climate in the insurance industry makes us cautious about near-term pricing. However, we're confident with our partner agent support and continued product innovation and industry segmentation, we'll be able to continue to grow profitably across our Commercial Lines businesses.

So in conclusion, while continuing weather, a slow recovery in pricing and the recession put some pressure on third quarter results, we remain satisfied with our strong fundamentals and above industry average top line growth. We expect the improvements that we're making in our mix and product offering to be fully reflected in our bottom line results in future periods as we continue to implement our strategy. And with that, I'll turn the call over to Gene.

Eugene Martin Bullis

Thank you, Marita, and good morning, everyone. As you just heard, our third quarter operating income was $45 million after tax or $0.89 a share. Both weather and the difficult economy played a role in our results for the quarter. Based on our year-to-date results and a more cautious outlook for the remainder of the year, we are adjusting our full year 2009 pretax segment earnings outlook to a range of $280 million to $290 million. Pretax segment earnings exclude interest on corporate debt and realized investment gains and losses. This revised outlook is based on an assumption of a modestly higher ex-catastrophe current accident year loss ratio when compared to the full year of 2008, reflective of higher weather in the first three quarters of the current year as well as a stronger than expected negative impact of the economy on our accident year fix.

All other assumptions remain unchanged. Combined Personal Lines and Commercial Lines, we expect to achieve mid single-digit net written premium growth. We assume full year catastrophes of 4.2% of net written premium. We continue to expect lower prior year development as compared to actual amounts in 2008. We expect our full year total expense ratio to be on the higher end of our current guidance of one to 1.5 point increase, driven by higher pension costs and other investments in our business, and we expect an effective tax rate of 33%.

I'd like to touch on a couple of other items not covered yet on this call on our income statement for the third quarter before I move on to discussing our balance sheet. Net income this quarter was higher than operating income by about $4 million, driven by a federal income tax benefit of non-segment income. This benefit was related to a release of a deferred tax valuation allowance associated with realized investment losses recorded earlier in 2009.

In the third quarter of 2009, operating results reported in our Other P&C segment were $7.5 million and included the effect of favorable reserve development of $10.5 million from our run-off voluntary pools business. The reserved development relates to pools that are in run-off, with Excess and Casualty Reinsurance Association or ECRA being the largest. Every four years, the association has a third-party actuarial firm perform an actuarial study on pool reserves. The $6.4 million favorable adjustment of our ECRA reserves was based on the results of this periodic study, which was completed in the third quarter.

Additionally, during the quarter, we lowered our estimates on a large pool claim by $3.1 million. This higher favorable development in our Other P&C Insurance segment was partially offset by higher pension expenses and lower net investment income in the segment, due to a lower level of holding company investment assets.

Now I'd like to move on to a discussion of our balance sheet, starting with a quick overview of the company's investment portfolio. And I'm now on Slide 13. At the end of September, we held $5.3 billion in cash in invested assets, including assets in our discontinued accident and health business. Cash and fixed maturities with a carrying value of $5.2 billion, represent 97% of our portfolio. Nearly all, or roughly 93% of our fixed income securities, are investment grade. The composition of our portfolio remains largely unchanged from the prior quarter. The average duration of the portfolio is 4.1 years.

Net investment income from continuing operations in the third quarter was $62.1 million compared to $65.5 million in the prior year quarter. This decrease is primarily due to our utilization of fixed maturities to fund the 2009 repurchase of our corporate debt at the end of the second quarter of 2009. While this lower level of investment assets produced lower net investment income, it also lowered our pretax interest expense by $3.7 million in the third quarter of 2009. The decrease in net investment income this quarter also reflects lower net new money yields. The year-end yield on our fixed income portfolio has remained relatively flat at 556 through the nine months of 2009, compared to 560 for the same period last year. New money yields were 492 in the third quarter of 2009 and 466 for the nine months.

I'd like to draw your attention to our CMBS information to Slide 15. In the third quarter, we added $63 million of CMBS to our portfolio from targeted active purchases. The market value of our CMBS portfolio at the end of September was $338 million, which still represents only 7% of our overall fixed income holdings. Approximately 20% of our CMBS is fully defeased, and approximately 77% of the company's CMBS holdings are pre-2005 vintages, with 8% now coming from 2007, and 7% from 2006, and 8% from 2005.

Although we've added some asset risks from more recent vintages, we feel very good about these selections as they are very well protected, predominantly, first cash flow AAA paper. We have very strong CMBS expertise, which we have clearly demonstrated through this market cycle. Notably, as of the end of September, our CMBS portfolio was in a net unrealized gain position.

Moving on to our discussion of our unrealized position for the quarter on Slide 16, the total market value of our investment portfolio, excluding cash, increased to $5 billion at the end of the third quarter. This quarter, we saw a significant improvement in our net unrealized position, which moved from a $72 million pretax loss at the end of the second quarter of 2009 to $118 million pretax gain at September 30. Improving credit spreads combined with relatively stable treasury rates helped boost market values within the portfolio.

Turning to Page 17 for a discussion of our recent capital management actions, our strong capital position and normalization of capital markets allowed us to undertake several notable capital actions in the third quarter. At the end of the quarter, we successfully completed the process of restructuring a portion of our debt, through drawing $125 million, 20-year loan from the Federal Home Loan Bank of Boston at the cost of 5.5%. This served to lower our overall cost of capital and decreased our interest expense on an after-tax basis by approximately $2 million a year.

As of September 30, 2009, we are carrying $434 million of debt, which is made up of $122 million of senior debt, $166 million of subordinated debentures, $125 million of Federal Home Loan Bank loans and $21 million of miscellaneous debt inherited from recently acquired subsidiaries. Our debt total capital ratio is now at 15%, giving no equity credit to the subordinated securities and including the full Federal Home Loan Bank loan as debt in the financial leverage calculations.

During the third quarter of 2009, we've repurchased approximately 725,000 common shares for $29 million. At the end of the quarter, we had $104 million of capacity remaining under our recently expanded $200 million stock repurchase program. During October, we've also repurchased approximately 239,000 common shares for $10.2 million through our 10b5-1 program, leaving $94 million remaining under our current share repurchase authorization. Finally, we recently declared an annual dividend of $0.75 a share, which represents an increase of $0.30 or 67% from the dividend paid last year. As Fred mentioned, capital management is an important part of our overall operating strategy and we will use this lever over time, along with earnings growth, to achieve our targeted returns.

On Slide 18, we've displayed changes in our book value, which improved by 10% in the third quarter of 2009 and 30% on a year-to-date basis. The improvement was primarily driven by increases in the fair value of our investment portfolio of $159 million after tax for the quarter or $3.18 a share, as well as earnings.

On Slide 19, we have some key metrics that highlight the strength of our balance sheet. Our GAAP equity grew 8.4% in the quarter to $2.4 billion. The growth was higher on a per share basis, reflecting the $29 million of share repurchases. Our insurance company statutory capital stood at $1.7 billion at September 30. At 1.5:1, our premium to surplus ratio remains more than acceptable for our current ratings and mix of business.

In the liability side of the balance sheet, our loss and LAE reserves remain strong. We believe our loss picks are appropriately conservative given the economy, and we also continue to have a margin of about 5% between carried reserves and our actuarial indications. Holding company cash and investment securities were $311 million at September 30.

In summary, our goal is to use our capital as effectively as possible to strengthen our organization, take advantage of growth opportunities and assure that we are positioned to win in the long term. With this, I'll turn the call back to Bob.

Robert Patrick Myron
Thank you, Gene. Operator, that concludes our prepared remarks. Could you please open the line to questions?

Question and Answer

Operator

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

Jay H. Gelb

In terms of the guidance outlook for 2009 being taken down just a bit, what are the implications that -- are there for that for 2010, especially looking in terms of the expense ratio, as well as capital management, with the stock trading well into book value?

Frederick Henry Eppinger

I actually feel like, for 2010, the conversation we had at Investor Day still holds. I mean, obviously, the company has three levers, Jay, that are pretty clear and for our improvement of our returns. We have the capital lever, expense lever and the mix of margin lever. And there is no question that the economy and kind of the uncertainty around this kind of non-CAT weather has made us feel a little bit more conservative in the fourth quarter. But if you look at the rate we're achieving and frankly, what's already been approved, we feel very, very good about the increasing margin in personal lines as some uncertainty around how the weather unfolds, but we have assumed that this significant above-average weather continues.

And so I feel like while there's some short-term issues there, I feel like the vast majority of that we have transparency to overcome. So I look at our action here and I say, we will see improvement next year. I feel good about the mix in commercial and what we're achieving. Obviously, the economy and the return premium like in places like comp put a little pressure on that but we are achieving rate increase and our mix is improving a lot. So I feel pretty good about 2010 about how that will unfold.

On the capital side, obviously as I said, one of the things that I'm watching is the particular opportunity that present itself to us, both organically and inorganic. We are seeing some interesting opportunities present themselves to us in the marketplace, partly because of our upgrade, partly because of this West Coast expansion. We obviously have started doing some capital actions that give capital back as I could cap transparency to the excess, if you will.

We will continue to move in that direction if it's appropriate. If there's opportunities to increase shareholder value, I'll do it but we're obviously not shy about moving in the direction of giving capital back to shareholders if we feel that it's excess. And again, I think we've signaled, we've shown what we're doing and as these opportunities either come about or don't, we will react appropriately. And that's why I feel confident that the run rate by the end of next year, I think I have some transparency, there's significant improvement in our return.

The final lever is this expense thing. And as I look at the IRR of every single thing we invested, I'm really not disappointed in anything. Do I wish that pricing and commercial was a little bit robust faster? Sure. The IRR is still on almost everything I can get my hands on as far as early results, I feel very, very good about. So I see a real leverage of expense opportunity next year. It probably won't unfold in the first quarter but as this stuff comes in as I watch the West Coast expansion, you will see our improvement on our expense ratio.

So if I take together all those three levers, I am still focused on and relatively confident that by the end of next year, we'll do as we said at the Investor Day. There's a little drag on the fourth quarter, maybe in the first quarter, sure, but again, if you look at these rate increases, I mean, we're still significantly a personal lines company. And if you think about where we are in our state, that we are in some big states where it's dominated by regional company. We outperform them by multiple points. And what this weather gives us is an opportunity to continue to take our price increases as we do but up them a little bit.

And just think about our competitors having to take 12% or 14% rate because they were behind. That creates massive disruption for them. So not only will we get away with this 5%, 6%, 7%, 8% rate increases that we're going to earn our way through. My view is, we have a chance to actually grow because the disruption of what they're having to do to catch up creates some real opportunity for us. And so I actually think that helps us in those -- kind of throughout next year, so I feel good about all of them. And so I'd say, yes we're being conservative about the fourth quarter as we give new guidance, we'll probably do it at the next quarter call for next year. We will try to talk about how the sequences through the year. But I feel still that what we've said in the Investor Day is very doable as we had the year unfold.

Jay H. Gelb

What does that translate into a return on equity for 2010, Fred?

Frederick Henry Eppinger

Well, we haven't guided that, the average for the year. But what I said is, that I'd like to see us get to that or target by a run rate by six quarters, which is actually the fourth quarter of next year and I believe we can get there. But we will, as I said, we haven't given all the guidance on the average numbers and all that for the year, which we will at the next earnings call.

Jay H. Gelb

Is that consistent with the Investor Day, the 12%?

Frederick Henry Eppinger

Yes, absolutely. Because when I talked about it, getting to the 12% in a six-quarter period because of two -- the big thing, right? As I've got about a point and a half of excess expense that we're kind of putting into the model here to take advantage, and I have a lot of excess capital, right? And I still have excess capital, even after the actions I've taken because I'm looking for, is there going to be opportunities unfold for us. And in both cases, those are going to get better through the year, right?

On the capital, I'm going to make a decision as soon we've come which transparent debt is excess, right? If we can't use it to increase shareholder, we'll give it back. And on the expense side, that'll go down. In essence, the investments are coming full for us. And again, if they're not, I will ratchet back to what we're spending. So with a 12% kind of fixed-quarter run rate is what we talked about in the Investor Day.

Jay H. Gelb

Can you quantify the excess capital at this point?

Frederick Henry Eppinger

Still, again, we've done a little bit, so if you look at -- as we look out next year, it's in that 300 to 400 range still. I mean, we've done a lot of interesting, good things but we are also earning in the money, so I would say it's still in that range as we look for the full year next year.

Operator

Our next question comes from Dan Farrell of FPK.

Dan Farrell

Fred, can you just comment on what you're seeing currently in the environment for M&A activity?

Frederick Henry Eppinger

Yes. I mean, it's a fascinating, again, I would tell people this is the quietest storm I've ever seen but it's a storm. What do I mean by that? Clearly, the spreads and investment grades have come back, so everybody's kind of heaved a sigh of relief that's visible. But underneath all of this, what we see is continued turmoil particularly for the small companies. I mean, and again, what we're seeing in particularly the geographies we compete in, a lot of these regional companies are getting killed. I mean, there's a lot of 115s, 120s out there and they're under a lot of stress.

And so we see both kind of organic opportunities because of that as they have to shrink and hunker down. But I would also say that for some of these small capitalized specialty companies, there are more and more meaningful conversation about should they get out because of the capital they have to carry and the uncertainty with the economy. I mean, it's the first time in 50 years. I mean, we could talk about the capital thing that's coming back and all that but the reality is, it's the first time in 50 years that the cycle has coincided with an economic downturn.

Those two things put tremendous pressure on folks that are heavy into some of the specialty areas that are most affected by the economy. So our view, as you're going to see it out, is there's still some higher-than-should-be expectations about pricing for some of these? Sure. But what we see is lots of meaningful conversations going on out there with some of these smaller, especially companies and frankly, in some of the other companies that are subscale in some line thinking about capital preservation and protection.

So I would see that we're getting to that stage of the market, that if you're going to see renewal rights, you'll start seeing them on the next 12 to 18 months as people kind of rejigger their portfolio. And again, I don't think it's -- our business, everything happens slower than people expect, but it's going to happen. You can see the strains out there. You can see some of the opportunities that are presenting. Our philosophy is I don't need them. I don't need any transactions to do what we're trying to do but we are constantly having conversations because there are some wonderful teams out there that are contemplating their future and I still think it is some real opportunity.

The other interesting thing that's happening and the thing is this tale of two cities that I'm sure you guys see even better than I do as you talk to the company, is this -- that all these additional capacity or new capacity, if you will, coming from Bermuda and overseas to the big brokers for large accounts has created a bloodbath in some of these segments at the high end and that's going to put continued earning pressure on some of these guys. Luckily, those folks don't have the distribution, the retail distribution and the operating model to get the small face value stuff.

But that puts pressure on the people we compete with that live up there, that live in the wholesale market, the program equivalent companies that compete against AIX that almost all go through wholesalers of large accounts, which helps us, because we are well protected by that and their overall economics will be challenged by that. So I remain bullish on what you're going to see. I don't think it's going to be easy. I don't think you're going to have the big transactions per se but I think you're going to see the continued consolidations of smaller companies and the share shift in the retail channel with small companies.

Operator

Our next question is from the balance of Cliff Gallant of Keefe, Brunette (sic) [Bruyette], & Woods.

Clifford Henry Gallant

Just wanted to talk a little bit more about the expense lever, you're talking about...

Frederick Henry Eppinger

Sure.

Clifford Henry Gallant

And for the expense ratio to go down, you really just needed to leverage existing platforms and I was wondering if there was anything you could do more proactively? Are you considering any reductions in any...

Frederick Henry Eppinger

No. I think, Cliff, it's both. I mean, I talk about -- you've heard me talk about this a lot but it's a third, a third, a third [ph] for us almost. If you look at -- Marita mentioned one of our big capital investments in discretionary expenditures this year, which was "Think Hanover". We believe that there was a wide open opportunity as some of our personal lines prepares went direct and some of the other guys were commoditizing by appointing all the agents to go to fewer agents with an account offering in tow [ph].

We put a significant amount of effort on this over the last 15 months and spending an above run rate in IT product investments in personal line. The way it works, about half of that is expensed and half of it is capitalized. Well, you will see us this year take our discretionary investment and technology will go down, so that is very proactive. And if you remember, two years ago, we put a lot of work in variablizing our IT cost. So we can take our IT cost down very quickly and it's very, very -- mostly the partners, outside parters, so we have that ability to do it. So we proactively can move there.

Second, a big part of our expense this year was our pension ratchet up because of the way the timing of the capital market collapsed in the fourth quarter, first quarter. Some of that comes back for us as well, so you will see that as a more quicker expense lever as well. So yes, it is growth grow, but there is this discretionary spend stuff that you will see us manage.

The other thing I would tell you is that we don't, because if it's in the wash, our throughput efficiency has gone up every quarter we've had this journey, so we worked hard on variablizing a lot of different cost like data entry and stuff, so some of this is very proactive. And again, that's why I will get some of it next year. I'm not -- as we give guidance next year, we'll be a little bit clear about it but it's not hard to imagine us getting more leverage on our expense base.

Now the one warning I would give you is that, I will also be very open about whether we see opportunities, because what I'm seeing is lots of action. Not a lot of decisions yet on transactions and things, but we will always be very transparent. And if I see something that creates a significant IRR and future shareholder return, we obviously will jump on it. Like this West Coast expansion, our upgrade and the disruption we're seeing with some of the major players we compete with has created our transparency in a comfort level and my ability to see an IRR very clearly and get commitments before we started.

And if we didn't see this disruption, would have I waited probably six more months because of the ramp down of personal lines? Absolutely. But I saw the opportunity and I doubled down a little bit doing both at the same time. So we believe the expense leverage is absolutely there. We will take some proactive actions to get at it, but I will also be very transparent, particularly over the next two quarters. If I see anything else where I feel that there's a real opportunity to take a lower risk of opportunity to capitalize on it, which we believe is an expense risk versus a loss risk, but again, we're getting completely open to that.

Operator

Our next question comes from Michael Phillips of Stifel, Nicolaus.

Michael Wayne Phillips

Kind of following up on Fred's that we're still largely a personal line company, couple of questions on that segment. Fred, you mentioned in your opening comments 6.2% increase in your growth states and I think Marita said that the core four were down two, what was the number for the non-core four? Is that what you mean by the growth states?

Frederick Henry Eppinger

Yes.

Marita Zuraitis

Yes.

Michael Wayne Phillips

Is that every thing else?

Marita Zuraitis

Yes.

Frederick Henry Eppinger

Yes. Yes, that's basically everything.

Eugene Martin Bullis

I'm trying to get the dollar amount of this discretionary IT spending in personal lines, then impact in the third quarter?

Frederick Henry Eppinger

Well, in total, the discretionary, you've looked at what we've done over the last five or six years, the run rate of our company -- I believe a normal run rate for us is going to be in the $45 million discretionary run rate at that level. This year, and again, I can't give you the exact numbers of the expense versus amortization, that number got into the low 60s, right? So because we accelerated a budget development. And so it's real money to take it back down to that normal run rate.

Now again, some of that's capitalized, some of that is expensed. It typically runs 50/50 but it's -- it's why I guided to this additional investments. What I saw was an ability to take some teams and I really did believe to accelerate some of our niche, niches, personal lines, we increased our segmentation. We brought in the technology team and we're building this technology product that's being launched in January. All of that also has filing that you have to do and adjust in our technology because of the filing of all of those products and that's why the discretionary went up.

In addition, there were some personnel attached that to that. And again, I won't -- that's why I guided up because in the first quarter, I saw this opportunity and I started accelerating this staff like it hit the ground in the third and fourth quarter, that's what -- we start from the beginning, the momentum was coming in the third and fourth quarter because a lot of these stuff was coming to fruition.

The "Think Hanover", especially businesses were being filed and all the states being improved. We we're getting kind of hit little bit more on all cylinders, on some of the earlier niches that the distribution was receiving these product. And in January, we're able to hit the West Coast expansion in most of those states with our full complement of specialty and niches. All of that required an acceleration of discretionary spend to the tune of, again, just the IT portion, you're talking a $20 million acceleration.

And again, so it is very deliberate, there is nothing -- none of this is ad hoc, none of this is backing into expense problem and what's ironic guys, I mean, people talk about our expense ratio but because everybody else we compete against is shrinking at rates 6% or 8%, their expense ratio is getting pretty damn close to ours and what I'm proud about is that most of ours is completely discretionary towards these IRRs that I'm comfortable with and will be able to be managed.

So again, I am -- would I rather not have to do it? Sure. I'd rather have all these products done, but it feels relatively good for us as we look into next year. And again, there's none of these that we're not seeing the kind of mix and product lift that we wanted and the agent's reception has been excellent. I mean, there's a couple of states like New York and California that have dragged on approval, that we've kicked in ahead a little bit but what we expect to get it passed but other than that, the reception has been excellent.

Marita Zuraitis

And specifically on personal lines because we packaged the product enhancement doing business enhancements in this "Think Hanover" campaign. The buzz and the traction and the impact that we're getting is much more substantial than if we have stretched it out so clearly, the acceleration of these IT investments and products investments in the third and fourth quarter bode well for the traction that we'll get in personal lines in 2010, which is why we talked about our cash spend in that area being less than 2010 because it really was an acceleration and a packaging of all those things together so we could have market impact with the "Think Hanover" offering.

Michael Wayne Phillips

In personalized lines, you said 45% auto and home rate increases that's probably going to get even better, I can see the confidence in current actual year improving next year there. In the specialty side, I can also see it there. But how confident are you with that you can do that, maintain or improve the current actual year margins on the core commercial lines?

Marita Zuraitis

In the core commercial, as we mentioned in the script, that's exactly why you saw new business at a lower level in the third quarter than had been prior. You see price holding two and a half in small and one in middle market is not significant but it's certainly better than the average that we're seeing out there in the industry. We're very careful about what the take in. We're very careful on how we price it.

I would say we're holding our own but I completely agree with you, I think it's an excellent question and we have intense focus on that segment and that's a segment the growth will be what the growth is. We underwrite it prudently. We priced it appropriately and if it's fixed, it's fixed. And if it doesn't, we're okay with that because we're seeing growth in higher...

Frederick Henry Eppinger

One of the things to remember about us, the non-segment at middle market we have. We have most of our businesses quite small, right? So that's majority and so while two and a half in some of the lines aren't complete inflation, it's pretty damn close and what we're doing is reunderwriting. So we actually feel pretty good but it is the challenge. That to me, is the heart of what we need to focus on for our momentum. It's making sure that all our middle market is segmented and achieving the right rate and our mix continues to improve.

But again, one of the benefits we have is most of our business is small. We got out of most all of our large account and frankly, like monoline comp, we don't have it. So for the most part, our issue is kind of the small, what Marita likes to call schmiddle [ph], which is the low end the middle, the unsegmented portion of that and making sure that our underwriters are absolutely disciplined in achieving rate.

Now again, we have gotten rate, most of our competitors will talk about middle market not being positive. We've been positive in middle market now for a full quarter and we've been positive obviously, since April on most of our business. So I feel good but it is the right question, it is the place we need to zero in and make sure that we're managing our business properly.

Operator

Our next question comes from the Sam Hoffman of Lincoln Square Capital.

Samuel Hoffman
Lincoln Square Capital Management

On the other Commercial Lines, your loss ratio, which had been in the 35% to 40% trends are pretty consistently since 2006 and even into the beginning of this year is now kind of in the mid-40s. And I think last quarter, you had described kind of an increase in severity as the cause of the increase from the loss victim [ph] now it's, I think, more it's kind of the permanent increase at least for the time being.

And so I guess my question is, can you give a bit more color as to what specifically is causing it? Is it just a surety business or are there other classes of business that you're being more conservative on? And then also, are there other lines that are giving you concern where you potentially might need to increase the action [ph] of your pick in the future?

Frederick Henry Eppinger

Sure. I mean, the other obviously makes money good money for us. So let me just, now -- the other has changed the nature of what in other has changed dramatically since the dates you've described. We didn't own AIX before. Obviously, also in there is a lot of the other specialty lines and bonds is obviously in there too.

So what we have done, again, when you look at what we've looked at, it's particularly around a surety business. It's not a big amount, but we did take the accident year up because of where we are in the cycle. We still doing great on making money at the line but I just feel that given where we are in the cycle and given the activity we're seeing in contractors in general in the industry, that it was appropriate for us to do it. It obviously, at the same time, we are thinking about pricing as going forward and I feel very good about what pricing we're achieving in those lines.

On AIX, we did have some severity but it was on programs. If you recall what I said before at the last call and I feel very good about this, when we bought AIX, there was some programs because of their rating was not programs that we would've written. And so we have discontinued all those programs but there was some severity that came out of those programs as we run them off so that we feel good that, that is gone, so I do think that was a permanent thing, it was just, it was one of those things where they, as a lower-rated company, did a little bit of stuff that was a little bit more volatile that we wanted to drive off.

That's what it -- again, so you're absolutely right. We did take it up. We are being conservative. I feel like the earnings of that business has been outstanding for us and we'll be fine but we did take it up.

Samuel Hoffman
Lincoln Square Capital Management

And are there other lines that you think might acquire an increase in the loss pick [ph] going forward?

Frederick Henry Eppinger

Obviously, this year and our numbers, as Marita talked about it in our script, with the return premium in comp, there is an impact. Now what's interesting about us is we don't payout much comp in total and we don't have a lot of monoline comp and we don't have a lot of large comps. So the smaller comp is performing very well for us but we did have a movement in that line, which is almost directly attributable to the increase in return premium. Again, it's peanut in total but it is the other place that we looked.

The auto, while over time, that has come down a little bit. It's still very attractive to us, our commercial auto and we see actually stabilize. So the question for us is not this huge fear about our commercial results. Okay, our commercial results is really, it's two-ish. One is, earning in the additional expense we have in commercial, which changes our combined ratio dramatically.

And then the other issue is just making sure as we go forward in our flow businesses, as was asked earlier, that we are achieving the kind of rate in pricing and mix that we're comfortable with so that we don't have a slow decrease in margin. But again, I don't see that happening yet, and so I feel very good about what's coming in and as Marita said, we'll slow the growth there because we have plenty of growth and stuff where we believe we have adequate margins, so there's no real need to push it. So net-net I feel kind of we're in pretty good shape.

Samuel Hoffman
Lincoln Square Capital Management

And when does the AIX business that is not the quality that you're looking to have?

Frederick Henry Eppinger

Pretty much go on. I would say with this quarter, because again, the nice thing about them is they have a contract where they can -- the way those programs work, you could just stop, right? So it is no remnant, it just goes away. So we would've closed on December of last year, I guess. So it might be a little bit in the first quarter but the vast majority of that stuff's all behind us.

So I feel very, very good by the way about the AIX stuff. Our rating increased, them coming on board, using our retail distribution, the quality and what I call age of that business, most of the business were picking up with AIG, that's where the AIX is tough, that was with the people we're getting it from for years, if not decades. So it is tough, it's stable, transparent and good margins, so I'm pretty excited about it.

Samuel Hoffman
Lincoln Square Capital Management

My other question is for 2008 and 2009. You've experienced pretty consistent higher non-cat and cat losses in homeowners and Commercial Lines than you would have expected and because of that, you're probably going to be getting some good price increases going forward.

And so my question is, what, in your statistical analysis, makes you believe that this is actually good business? Meaning, in the states that you are located in, at the pricing that you're going to be getting, is this in fact good business? Or has it been underpriced, given the higher cats that are expected currently in the marketplace and given the companies have really been competing aggressively, moving their business to the Midwest from places like Florida and California and so forth?

Frederick Henry Eppinger

So again, when we look at it, you got to remember, the entire industry destroys economic value, right? So on average, it's not just homeowners. The entire industry doesn't earn cost of capital through the cycle, so homeowners is not a unique thing about our industry. So when you look at some of those analysis that homeowners is underpriced, we outperform in our core states against regional companies. In a lot of cases, 5 to 10 growth points.

So there's no question that homeowners had underperformed through the cycle and there isn't also any question that the Midwest, part of the Midwest, has chronically had some problems probably in the last three, four or five years that's been exaggerated as people have gone to those markets, so both of those things are true.

Now if you look at our business through the cycle, they break. So yes, for seven quarters, we have had above average non-cat weather and I wish I was smart enough to know if it was permanent. I'm not. But what I am smart enough to know is to assume it is and take rate that essentially gets us the cost to capital, assuming that it's permanent. Now our data would tell us that this is a relatively cyclical thing and over the last couple of decades, the last two years had been the worst two years as far as non-cat weather and it is spiky, it is somewhat cyclical. But that's just better for us if it goes back to normal so we have assumed a higher.

But the question you asked is the right one. We believe very, very strongly this account focus, near of fluent focus that we have, that our full account and our homeowners on a stand-alone basis in the account will earn cost of capital through the cycle. We believe that. We believe we can achieve excess return in that business and in the account through the cycle.

Now again, I would tell you that you're absolutely right about this non-cat weather. It's been -- there's 26 states in the last two years that have had their single worst storm ever and it's all occurred in the last couple of years, which is a remarkable thing, right? So again, I do think that it's important for us to stay on top of rate. It's important to make sure that we're not doing monoline home and if you've seen us get out of Florida home, you've seen us get out of Rhode Island home, you've seen us decrease our exposures in the Southeast dramatically, where we thought there was chronic problems with pricing. But I think where we are, we are very confident that we have set it up to get our targeted returns through the cycle.

Operator

That does conclude our question-and-answer session. Gentlemen, do you have any closing remarks today?

Robert Patrick Myron

We don't, other than to thank everyone for their participation on the call and we look forward to speaking with you again in a quarter's time. Thanks very much.

Operator

Thank you for joining us today. At this time, the conference has ended. You may now disconnect your lines.