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Market Intelligence

The Travelers Companies, Inc. NYSE:TRV

FQ4 2007 Earnings Call Transcripts

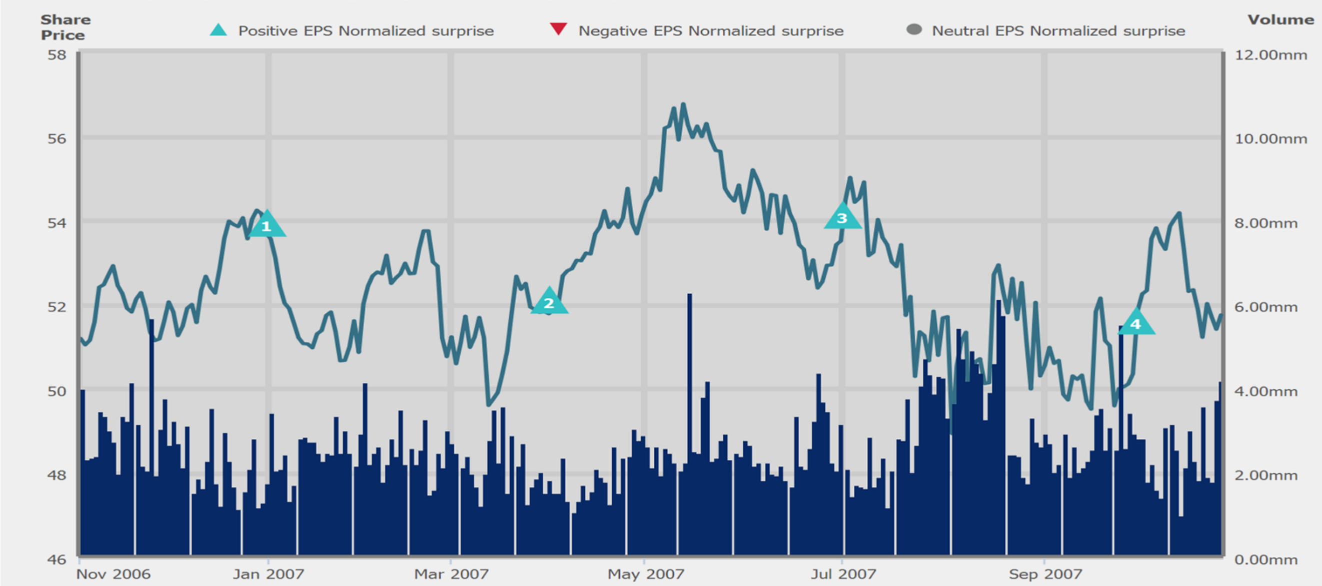
Tuesday, January 29, 2008 2:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ4 2007-			-FQ1 2008-	-FY 2007-	
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	ACTUAL
EPS Normalized	1.60	1.63	▲1.88	1.54	6.66	6.71
Revenue	-	-	▲(0.51 %)	-	-	-
Revenue (mm)	5459.59	5432.00	-	5450.33	21537.74	21470.00

Currency: USD
Consensus as of Jan-29-2008 12:44 PM GMT

Stock Price [USD] vs. Volume [mm] with earnings surprise annotations



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ4 2006	1.42	1.54	▲1 8.45 %
FQ1 2007	1.45	1.50	▲2 3.45 %
FQ2 2007	1.49	1.73	▲3 16.11 %
FQ3 2007	1.49	1.81	▲4 21.48 %

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Presentation

Operator

Good morning ladies and gentlemen and welcome to the fourth quarter and full year earnings review for Travelers. (Operator Instructions) At this time I'd like to turn the call over to Mr. Michael Connelly, Vice President of Investor Relations.

Michael Connelly

Morning and welcome to The Travelers discussion of fourth quarter and full year 2007 results. Hopefully all of you have seen our press release, financial supplement and webcast presentation released earlier this morning. All of these materials can be found on our website at www.travelers.com under the Investor section. Today with me is Jay Fishman, CEO, Jay Benet, CFO, Brian McLean, Chief Operating Officer, Joseph Lacher, head of our Personal and Select businesses and Tom Kunkel, President of Bond and Financial Products, as well as other members of senior management.

They will discuss the financial results of our business in the current market environment and they will refer to the webcast presentation as they go through their prepared remarks and then we'll open it up for questions. Due to the number of topics we plan to cover in our prepared remarks we will run past our normal one hour but will still leave 30 minutes for Q&A.

Before I turn it over to Jay, I'd like to draw your attention to the following on page one of the webcast. Our presentation today includes certain forward-looking information as defined in the Private Securities Litigation Reform Act of 1995. All statements other than statements of historical fact may be forward-looking statements specifically earnings guidance is forward-looking and we may make other forward-looking statements about the company's results of operations, financial condition and liquidity, the sufficiency of the company's reserves and other topics. The company cautions investors that any forward-looking statement involves risks and uncertainties and is not a guarantee of future performance. Actual results may differ materially from our current expectation due to a variety of factors. These factors are described in our earnings press release and in our most recent 10-Q and 10-K filed with the Securities and Exchange Commission. We do not undertake any obligation to update forward-looking statements. Also in our remarks or responses to questions we may mention Travelers operating income which we use as a measure of profit and other measures that may be non-GAAP financial measures. Reconciliations are included in our recent earnings press release, financial supplements and other materials that are available in the Investor section of our website, www.travelers.com. With that I'm going to turn it over to Jay.

Jay Fishman

Thank you Mike and good morning everyone and thank you for joining us today. We're very pleased with our company's performance in the fourth quarter and for the entire year. On the bottom line for the full year we posted operating income of $4.5 billion or $6.71 per diluted share with a strong operating return on equity of nearly 18%. Operating income per share increased nearly 14% over 2006. On the top line net written premiums increased 3% adjusted for the sales of Afianzadora Insurgentes and Mendota. We are pleased with this result particularly given the somewhat more competitive marketplace we faced this year. With disciplined underwriting we've been able to grow our business profitably and that's what we will strive for again in 2008. Each of our business segments contributed to the $1.1 billion of operating income that we earned in the fourth quarter. Retentions remain and are at historically high levels and margins continue to remain strong as evidenced by our fourth quarter and full year overall combined ratios of 88.4% and 87.4% respectively.

In keeping with our commitment to active capital management in the fourth quarter we repurchased $1 billion of our company's stock to bring the total amount we purchased to $4.1 billion since inception of the program in the second quarter of 2006. The Board of Directors has approved an additional $5 billion of common share repurchases bring the total remaining authorization to just under $6 billion. The company remains very well capitalized and highly liquid and our balance sheet is strong. We're well positioned for the marketplace ahead.

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This morning we're broadening our call to provide insight and transparency into a number of issues that may be of investor interest particularly given recent events. We've covered our residential sub-prime exposure previously and we will update that but we're also going to provide insight into our commercial mortgage-backed securities position and our real estate owned portfolio. We're going to discuss our Directors and Officers and errors and omissions exposure to the sub-prime environment generally as this has received some attention in the press over the last few weeks. We're also going to cover our subdivision surety bond position and update you on that portfolio. In all of these areas we are pleased and comfortable with our position and will share with you our analysis of these various exposures. We think you'll be pleased with the transparency and candor of the analysis as well as the conclusions we've reached. To make sure we cover everything Jay, Brian and Joe are going to go through the customary materials somewhat more quickly than we have in the past. From an underwriting perspective the fourth quarter was not much different from the third and we don't anticipate a meaningful change in our marketplace strategy for 2008. We do expect that the investment environment will be somewhat more challenging. Nonetheless that is all factored into the 2008 guidance we provided in our press release and Jay will have more to say about that later. With that let me turn it over to Jay.

Jay Benet

Thanks Jay. Page three of the webcast summarizes our fourth quarter and full year financial performance, net earned premiums increased by 2% quarter over quarter and by 3% year over year. Fourth quarter operating income exceeded $1 billion for the sixth quarter in a row and full year operating income climbed to $4.5 billion, an increase of 7% from an already highly profitable 2006. Importantly notwithstanding the very challenging investment environment that has recently hurt many banks and other large financial institutions our investment portfolio performed very well for both the quarter and the full year and it remains very healthy and well positioned. I'll speak to NII and certain components of our investment portfolio in a few minutes but I wanted to specifically point out the $6 million of after tax net realized investment gains for the quarter and the $101 million after tax net realized investment gains for the full year. These net realized investment gains include impairments of only $38 million pre tax for the fourth quarter and $70 million pre tax for the entire year. These low levels of impairments truly speak to the high quality of our portfolio.

Our weighted average diluted share count of 649 million has dropped significantly due to our share repurchase activity. We repurchased 19 million common shares in the fourth quarter at a total cost of $1 billion bringing full year share repurchases to 8.3% of outstanding shares as of the beginning of the year. And since the second quarter 2006 inception of this program we've purchased 78.8 million shares at a total cost of $4.1 billion representing 11.3% of the outstanding shares as of the beginning of that period. Given our strong operating performance and financial position we expect to complete the current $5 billion share repurchase program near the end of the first quarter of 2008 although as always we will modify our repurchase activity based upon current market conditions. And as Jay already mentioned our Board has approved an additional $5 billion multi year program under which share repurchases are expected to begin immediately after completing the current program.

The information on page four speaks to many of the reasons why we feel so good about our company. Let me start by saying that our balance sheet is in terrific shape. We ended the year with almost $26 billion of common equity ex FAS 115 up 5% since the beginning of the year and book value per share ex FAS 115 up $41.23 up 14% since the beginning of the year each after $2.9 billion of share repurchases and $738 million of common stock dividends. Our capital is at or above target levels for our regulators and rating agencies and we have no current need to add to our capital base other than for normal growth which we are self-funding. We are currently under review for possible upgrade from Moody's, from whom our claim spending rating is already at an AA3 and we continue to generate significant amounts of excess capital.

Our debt to capital ratio of 19.4$ favorably compares to its 20% target and with a very low level of debt maturing in 2008 and 2009 coupled with our very strong liquidity we have the ability to self-fund all of these maturities placing us in the enviable position of being able to refinance debt in the capital markets if and when we believe market conditions are favorable. Our holding company liquidity of $1.6 billion significantly exceeds our target of one year's worth of interest and dividends by $500 million and we are not reliant on commercial paper for funding or liquidity needs. Our investment portfolio had a pre tax on

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realized gain of $937 million at year end 2007 and we have determined that we have immaterial exposure to ratings changes from municipal bonds insurers. We've closely examined our exposures to sub-prime Alt-A mortgages as well as to commercial mortgage-back securities and SIV related assets and found each of them to be negligible and the rest of our real estate portfolio is well diversified and appropriately valued.

Lastly while not on this slide, I'd also like to point out that our insurance reserves have continued to develop favorably as we have had net favorable prior year reserve development in each of the last eight quarters. The data provided on page five highlights several items that are contained within our consolidated operating income and GAAP combined ratios. I will make just a few comments here. Net favorable prior year reserve development was $83 million after tax in the current quarter and we made no adjustments to our asbestos or environmental reserves other than for payment activity. Current quarter catastrophe losses of $45 million mostly resulted from wild fires in California and we also experienced a favorable revision to our loss ratio estimates for the current accident year resulting in a $35 million after tax benefit in the current quarter. With that I'd like to now turn the microphone over to Brian McLean.

Brian McLean

Thanks Jay. I'll start on slide six and talk a little about the marketplace, go through the segment results for our commercial businesses and then offer some specific comments on our sub-prime exposure generally.

Our commercial businesses performed very well this quarter and for that matter throughout 2007. The fundamentals of our business are very strong; margins remain strong and are consistently solid across all our markets. The renewal book has performed exceptionally well with very high retention and in general modest price declines. The new business environment has been somewhat more competitive particularly in the fourth quarter so even though we saw some softening our performance was extremely favorable. Looking at the details on slide seven you can see that retentions are very high across all the businesses, they've been consistently strong and we had improved retentions across the board in the quarter. These levels reflect our strategy to leverage our excellent margins and keep the profitable business we have on our books. We believe these high retentions clearly reflect the value of our franchise to our agents and our customers and have not been attained at the expense of meaningful rate accommodations. This is clear from the pure rate change on the renewal book which shows a modest decline. Comparing rate change in the fourth quarter 2007 with fourth quarter 2006 you see that Select, our small commercial business has experience only a 2 point rate change. In addition commercial accounts has seen a 2 point rate change and remained consistent with last quarter.

In our international and financial products businesses pure rate has come down but gradually. In all you can see a gradual decline in pure rate change over the past several quarters with the biggest declines being in larger account markets.

On slide eight we show total renewal price change which reflects both the rate and exposure change. RPC can be more erratic due to these exposure movements but as you see our experience over the past eight quarters has been generally consistent with the pure rate trends. New business dollars are also shown on slide eight and you can see that overall 2007 was a very strong year. In almost all markets new business submissions were up dramatically from 2006, a result of the initiatives we've discussed in previous calls including express and express plus and select and the new products offered to our industry edge initiatives. In the fourth quarter we were still seeing good flow but the number of new accounts we actually wrote as a percentage of quotes, our hit ratio, while steady through 2006 and 2007 moved down slightly in the quarter. This decline in hit ratio indicates a more competitive marketplace for new business with pricing some times at levels lower than we are willing to go. Even with this competitive environment new business pricing on the deals we did write, remain at acceptable levels and for the full year 2007 showed strong performance, with a total of $2.8 billion written in these markets.

Turning to slide nine, business insurance turns in a great performance with a 4% increase in operating income in the quarter and a 15% increase for the full year. The combined ratios for both the quarter and full year were 87.8, an improvement of 3.1 points from 2006. Severity was benign this quarter again in the lower single-digits continuing the trend seen in previous quarters. As we outlined in last quarter's call frequency while continuing to decline slightly is leveling off. This quarter's results have demonstrated a

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continuation of that moderate trend again still within a favorable range. When we adjust our combined ratio for net favorable prior year development business insurance had a terrific full year result at 91.1 consistent with 2006.

Turning to slide 10 you see that net written premium is down 2% in business insurance this quarter due to our disciplined underwriting in the new business environment we discussed. If you look at the full year most of the markets were up year over year resulting in a 2% improvement again driven largely by the strong retention and the impact of our initiatives in products and analytics.

Looking at slide 11 the financial, professional and international insurance segment continued to produce positive results with operating income of 5% from the same quarter last year, full year results showed an 11% increase. The combined ratio improved 5.1 points quarter over quarter and for the full year it was 87.6 a strong result again improved over 2006. The lower portion of the slide shows net written premiums up 2% for the quarter and 4% for the full year. In bond and financial products growth in our surety business was offset by declines in management liability products. Underlying the growth in surety is our high retention of existing accounts, solid flow of new business and a credit profile that continues to get stronger. The international operations premium increase was favorably impacted by foreign exchange rates as well as solid growth in our Lloyds and Canadian businesses. We are pleased that even after adjusting for net favorable prior year development the FPII segment combined ratio for 2007 was 90.6 versus 89.4 in ’06. In a minute I will provide comments specific to our management liability book and sub-prime environment but want to emphasize here that even after taking into account the impact of any losses or all the losses from these issues, this business continues to perform at very profitable levels.

Overall in this quarter our commercial insurance businesses produced great results. The fundamentals of our business are solid, retention of our profitable book is strong and margins remain excellent. We recognize and increasingly competitive marketplace and certain underlying economic pressures however we’re maintaining our focus on growth albeit in a disciplined manner and that discipline produced another terrific quarter.

Now I’m going to take a few minutes to talk about our management liability book of business and how we evaluate potential exposure to the sub-prime environment. On slide 12 we’ve shown our management liability premium for 2007 and broken out the portion of this book by product that we estimate is exposed to this issue. You can see that we have $1.6 billion of management liability premium and have separated it into four product groups; directors and officers, fiduciary, errors and omissions and all other products. The other category contains a variety of products that are footnoted at the bottom of the page and would not directly respond to the issues created by sub-prime. In the three exposed product groups the percentage of our book that we estimate is exposed to sub-prime is relatively small primarily due to the diverse nature of the book. For example, approximately 4% of the total book is with private and non-profit accounts with negligible exposure to this issue. Additionally, we have a very industry diverse book and specifically our market position in the financial services industry is led by our community bank portfolio. These are smaller banks which so far have not been associated with the sub-prime issues and we don’t currently anticipate that as a class they will. Our portfolio is not heavily weighted to larger, public company financial institutions or money center and investment banks. Overall our total exposed management liability products are less than 1% of our total company premium.

Turning to slide 13 it’s important to consider specific characteristics of these products and our approach to underwriting. D&O, E&O and fiduciary products are issued on claims made policies which dramatically reduce the latency tail on the business and the ability to stack limits. Very importantly policy limits are low, between $5 million and $25 million and are weighted more heavily towards excess coverage than primary with relatively high attachment points. Specifically for the exposed D&O policies our average limit is about $8 million and 70% of the premium is excess. On these excess accounts we typically attach it over $50 million which is very important when you consider the defense costs due to this issue could be considerable. We also have a reinsurance program that further limits our exposure. On a policy level basis we see it approximately two-thirds above a $5 million retention which reduces our net exposure per loss to $12 million up to an annual aggregate of approximately $375 million. In addition we’ve been proactively taking into account the sub-prime pressures throughout much of 2007 incorporating the environment into our underwriting. So considering our diverse book and the way we’ve approached the market you can see

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that we have acted to restrict our exposure and we expect that any potential issue would be a frequency not a severity one.

If you turn to slide 14 I'd like to walk you through the detailed analysis we performed to determine our potential exposure to sub-prime claims. For starters we conducted an individual account analysis on all accounts that we felt had an elevated level of exposure. The definition of what was elevated obviously began with accounts that had current reported claims or notices and I'll speak directly to them in a moment. Second we identified and individually analyzed accounts for which we had not received a claim or notice but which we determined to have a heightened risk of loss. This group was broad and included large financial institutions, sub-prime lenders, bond insurers, home builders and suppliers, as well as related accounts we saw mentioned in major financial press. For this analysis we reviewed each individual account from an actuarial claim and underwriting point of view. Our team factored in relevant circumstances of each account with particular attention to the structure of the coverage including limits and attachment points, as well as reinsurance. The result is an account by account estimate of ultimate gross and net liability. Third we performed an aggregate analysis to estimate losses not identified in the individual account analysis. In this portion of our portfolio which included accounts such as community banks, we conducted an actuarially based frequency and severity reserve analysis to understand our level of exposure. The net result of this entire process was a robust review of loss pertaining to sub-prime events for this market.

On slide 15 we provide some data from this analysis specifically regarding claims and notices as of December 31, 2007. As of the close of '07 we had 30 sub-prime related management liability claims. You can see in the charts that we were primary on five and excess on 25 of these policies which again is typical of our approach within the large financial institutions marketplace. As I mentioned, in general limits ranged between $5 million and $25 million and you see the average related to these claims is $11 million. Limits management is an active part of our liability underwriting strategy. So overall a limited number of claims and consistent with our overall profile. We have fully recognized these claims in our 2007 earnings results and the overall provisions in the 2007 financial statements and the 2008 guidance incorporates the results of the analysis we conducted. The estimate for sub-prime losses in 2008 guidance is not materially different from the estimated losses for 2007. After considering all of the above actions our management liability business continues to meet our return thresholds.

Our project is based on what we believe to be a realistic assessment of our exposure to the sub-prime environment but you could obviously ask could it be worse. Given that we view this as fundamentally a frequency issue, we think a material variance from our assessment would require systemic changes to the insured litigation environment expanding our exposure to segments that currently appear to have low correlation to the sub-prime environment.

Finally let me round out the conversation on our bond and management liability business by touching on our surety segment, specifically about potential exposure to residential real estate developers. Slide 16 and 17 speak to subdivision bonds which as you know provide coverage to real estate developers in the event of a financial or operational failure prevents the developer from installing improvements guaranteed by the bond. These typically include sewer, roads and sidewalks. We generally do not provide performance bonds guaranteeing the construction of individual homes. Our construction surety business is comprised largely of infrastructure and public work projects and importantly only 1% of our construction surety accounts are subdivision programs. During the past quarter we took a very close look at the potential for subdivision exposures. We have scrutinized the portfolio and evaluated the financial condition of many of our insured's, the extent to which the credits are secured and the general progress towards completion of the obligations. We then applied a series of stress scenarios assuming market conditions worse than we currently anticipate. This analysis which is outlined on slide 17 concludes that under scenarios worse than we currently anticipate we wouldn't expect losses over time to exceed approximately $100 million.

In summary we have thought in a comprehensive fashion about the evolving implications of financial sector stress on our management liability and surety industry exposures. The net conclusion of our in depth exposure analysis at year end 2007 are that the issues are very manageable for us and we're comfortable by both our diversity and profitability of business in the management liability and surety lines.

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Now before I turn it over to Joe for personal lines, I'd like to address one more topic relating to this. Recently we've gotten the question about how a recession would impact our security book so I'd like to turn it over to Tom Kunkel who runs our bond and financial professional liability businesses to give you our response.

Tom Kunkel

Thank you Brian. That is a legitimate question so here's some perspective on our surety portfolio. Seventy-five percent of our surety premium is actually in our construction surety business. Within that construction surety industry we are seeing some slow down in the amount of privately funded construction projects. But it's important to realize that we estimate that 90% of our construction portfolio is driven by public work spending, for example, Federal, state and local funding for building and infrastructure projects. The level of public work funding is currently historically robust. We write some of the best capitalized contractors in their class and the condition of their balance sheets as well as the condition of the back log of uncompleted work continues to look very strong. And lastly it's important to realize that in the event of a contractor default, we typically do have the right to the owner's unpaid contract balance, thus mitigating our exposure under the bond. For these reasons we feel very good about the profitability in this construction surety book. We feel equally strongly about our commercial surety portfolio. Commercial surety makes up approximately 25% of our overall surety premium. Again the credit quality and underlying financial strength of this portfolio is very strong. This book is well secured and where appropriate it is collateralized. It's a very diverse portfolio and we pay very close attention to managing the underlying makeup of the individual obligations that we assume. So again, while these are very legitimate questions we feel very good about the profitability of our surety portfolio. Joe?

Joseph Lacher

Thanks Tom. Looking at slide 18 personal insurance segment had another terrific quarter with a combined ratio of 91% in $201 million in operating earnings. It continued to deliver strong retention, renewal pricing and year over year PIP growth, both the auto and homeowners line. As you look at profitability there are several items affecting the comparability of results I'd like to discuss to make the underlying results are clear. Our reported combined ratio was 12.7 points worse than the fourth quarter 2006. Adjusting for lower levels of favorable prior year reserve development and current year loss ratio re-estimation and for higher levels of catastrophe losses the difference was only a modest deterioration of 1.4 points of combined ratio.

Looking to production results on page 19 let me talk first about homeowners business. Here we continue to produce strong results despite the declines in housing sales. We've maintained a stable retention rate of 86%, renewal price change at 8% was in line with what we've seen in the last four quarters. Policies in force increased by 3% versus the prior year quarter. We've been pleased with the reception and the early sales of Quantum Home in the market. Quantum Home offers industry leading product sophistication enabling us to continue to deliver profitable growth. Over the last quarter the program was implemented in six additional markets bringing our total to date to 31 states plus the District of Columbia. We're on track to roll out the remaining targeted states during 2008. We're also very pleased with the production results of our auto business. Excluding the impact of the Mendota sale net written premium and policies in force both grew 1% over the prior year quarter. Retention remained strong and stable at 83% and RPC was plus 2%. Quantum Auto now represents over a third of our country wide annualized written premium. This was the first full quarter in which Quantum Auto was available in New York which represents the final planned launch in our Quantum Auto roll out.

Page 20 shows our combined ratios for auto and homeowners. As I mentioned before several items impacting comparability need to be considered when looking at results across periods. There are three principal items. First combined ratios in the fourth quarter 2006 benefited from significantly greater favorable prior year reserve development and the re-estimation of the current year loss ratios. Second results in 2007 had significantly greater catastrophe losses than in 2006. Third there is typically a quarterly seasonality impact in auto loss ratios with the fourth quarter being the highest quarter. This results largely from weather and usage differentials. When looking at the seasonality impact the fourth quarter 2006 results were somewhat better than typical and the fourth quarter 2007 were somewhat

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worse. Thus when comparing the results, the bulk of the difference in combined ratios between fourth quarter 2006 and 2007 were attributable to these three items. When comparing the auto combined ratio for sequential quarters, the bulk of the difference is attributable to the seasonality issue.

Please recall that renewal price changes were plus 2% for auto and plus 8% for homeowners. Clearly price reductions were not driving combined ratio changes. Let me try to wrap this all together. Although not displayed here as you look at the full year 2007 result excluding the impact of prior year reserve development and catastrophes the combined ratios for both auto and homeowners were within half a point of the prior year. This underscores that underlying results were generally consistent period over period.

Turning to page 21 I'd like to spend a few moments on auto loss trends. On the far right side you can see that we're seeing total loss trend in the low to mid single-digit range excluding the impact of the Quantum Auto introduction. Looking underneath this result, frequency trend drives the total loss trend. Severity is down slightly overall, this is a combination of a modest increase in physical damage severity trends and a decrease in bodily injury severity trend. I know that our bodily injury results are counter to what a number of our competitors have been disclosing; we attribute this to the continued impact of our claim initiatives on these coverages. As we flip to page 22 I'd like to spend a moment on Quantum Auto's anticipated impact on our frequency.

The product's broader reach to more standard drivers anticipated an increase in overall absolute frequency. Our pricing appropriately reflects this change. When we look at the chart on the left the red line shows the expected impact on the overall books frequency from Quantum. The blue line shows the actual results are generally in line with our expectations. Again we remain pleased with our results from Quantum Auto and the overall program is performing consistently with our expectations.

Wrapping it all together, we've had another great quarter and year and look forward to carrying our success into 2008. With that I'll turn it back over to Jay.

Jay Benet

Thanks Joe, the chart on page 23 average invested assets grew to $75.2 billion in the quarter increasing over 3% when compared to the prior year quarter. Operating cash flows were approximately $1.4 billion in the current quarter and over $5.3 billion year to date. The average quality rating of our fixed maturity investment portfolio remains very strong at AA1 or AA+. The low investment grade securities comprise only 2.5% of the portfolio and the duration of the portfolio remained at 4. Our fourth quarter net investment income is shown on page 24 with $696 million after tax reflecting lower yields on non fixed income investments than in recent quarters. NII for the affixed income portfolio benefited from the increased invested asset basis as well as higher reinvestment rates. Overall our after tax yield was 3.7% for the quarter. In our continuing effort to be highly transparent and responsive to our investors and the analyst community we're providing detailed information about certain portions of our investment portfolio. Last week we provided detailed information about our municipal bond holdings in a Form 8-K filing and as the data indicated we estimated that the average credit rating of the portfolio would be AA+ without any of the benefits from the insurance [wrappers] as compared to an approximate AAA- including the [wrappers] due to the very strong underlying ratings of the issuers of these bonds.

We've concluded that we have immaterial exposure to ratings changes for municipal bond insurers and for your convenience, we've reproduced the schedules contained in that 8-K as an appendix to this webcast.

Page 25 provides an update to our exposure to sub-prime and Alt-A mortgages while pages 26 and 27 which are new, provide information about all other of our real estate related holdings. Our exposure to sub-prime Alt-A mortgages remains negligible, the only change of any consequence in the quarter was that we selectively took advantage of favorable pricing to add modestly to our position increasing our total sub-prime Alt-A mortgages to $286 million or .4% of the fixed maturity portfolio at the end of the fourth quarter from $192 million or .3% at the end of the third quarter.

Our exposure to commercial mortgage-back securities is also negligible. As the data on page 26 indicates we held only $607 million of non-agency US CMBSs at year end representing less than 1% of our fixed

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maturity portfolio and having an average credit rating of AAA and all of these investments were acquired in 2004 and prior, well before recent increases in commercial real estate values.

On page 27 we show certain information for our remaining real estate related holdings. This is a highly diverse portfolio and recent appraisals for holding on properties and joint ventures are well in excess of current carrying value. Here too we feel very comfortable with our investments and their carrying values.

The common theme in all of this is a highly disciplined approach to investing. Recognizing that as a company we take most of our risk on the liability side of the balance sheet and making sure that on the investment side we are appropriately compensated for the risks that we do take.

Pages 28 and 29 provide information about our guidance for full year 2008. We expect fully diluted operating income per share to be in the range of $5.40 to $5.75 generating an operating return on equity of approximately 13% to 14%. Based upon expected market conditions we are anticipation somewhat lower NII due to a more challenging investment environment particularly for non fixed income investments and a 1% increase in our underlying combined ratio due to a continuation of the somewhat more competitive underwriting environment. Our guidance assumes full year catastrophe losses of $525 million pre tax and $340 million after tax or $0.55 per share after tax which represents the average annual loss expectancy as indicated by our [cat] modeling. No prior year reserve development either favorable or unfavorable, growth in average invested assets in the low single-digits after approximately $2.7 billion of share repurchases and weighted average diluted shares of approximately $618 million after share repurchases and employee equity awards.

Finally on page 29 we have provided certain information that should help you understand the major differences between actual operating income per diluted share in 2007 and our 2008 guidance. With that let me turn the microphone back to Jay for his closing remarks before we do Q&A.

Jay Fishman

Thank you Jay. First we apologize for the length this morning but thought it was very important to go through these various topics and before we open it up for questions let me just make a couple of closing observations.
First we've got very good positive momentum as we head into 2008 and we're optimistic about our performance. Second we're pleased with the results of the analysis that we shared with you this morning and believe that it speaks well to our size, the diversity of our business and the smart, disciplined approach that we take to underwriting and to investing. We plan on running our business with that same focus as we look to the future and with that we'll open it up for questions.

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Question and Answer

Operator

Your first question comes from Jay Gelb - Lehman Brothers

Jay Gelb
Lehman Brothers

Thanks and good morning and I just wanted to say thanks again for all the increased disclosure on the sub-prime and the surety I think that helps. If I could come at that issue from another angle based on your current expectations for the sub-prime D&O and E&O and surety related components if you look back to where say we were in 2001, 2002 with the melt down in the NASDAC and [Rona WorldCom] what were your initial expectations in terms D&O and E&O related losses then versus the ultimate result. I'm trying to get a sense of how bad it could get relative to your expectations and then in addition to that if you could give us a sense of how high your surety combined ratio can go in a recession-type environment. I think that would be helpful for a historical perspective.

Jay Fishman

Well Jay let me start with making an observation about our expectations with respect to D&O and E&O, the management liability losses. You've been in this industry long enough to understand that we actually write insurance and expect to have claims. And that we anticipate a level of claims in the business and we price the business accordingly. One way to think about the management liability exposure anticipated losses that we see, or anticipate at the moment, is that it's envisioned, incorporated, accommodated by if you like, the loss ratio that we would ordinarily peg against this business. We don't make an assumption that any business that we write is going to be loss-free. We make an ongoing assumption that there will be claims and there will be losses and at least there isn't anything yet in the management liability arena that would cause us to believe that there would be a dramatic difference between the ongoing expected loss performance and what we see coming out of this which is why we make the comment that says that we continue to view these businesses as operating within the return thresholds that we set. We've spoken earlier on Investor Days about having return thresholds in our business of from 13% to 18% depending upon the business itself and even after giving affect to expected losses in this business we continue to view the returns in the business being in those ranges. So I've got to start with the premise that says after a detailed account by account analysis it looks to us as though the expected losses will fall within the expected range of losses that we would have for this business. That may change. It may be different because of a systemic difference in the kinds of losses that come at us, but again as Brian mentioned before, it's frequency not severity.

I'm looking at Tom, I don't know how to go back to 2001 and comment on expectations versus actually kind of on-the-run here.

Tom Kunkel

Yeah, on the run it's a very difficult question to answer Jay. I share you sentiments on that.

Jay Fishman

The second question I think Jay that you asked was about the surety business and I think you asked about…and I'm not sure whether your question is specific to the subdivision environment or the surety business more generally. First in the subdivision environment the stress test that we provided in this webcast does I think exactly as you asked us to do which is we've assumed only those accounts that are of the strongest quality either because of their strength or their collateral position, would in affect be money good, and we've assumed that 33% of all of the remaining accounts default and have zero recovery associated with them. That would be an awfully bad environment. Yeah I'm assuming it could probably we worse but in our experience that would be, I suspect on precedence in terms of loss experience in that book, and even in that highly remote scenario we're talking about cumulative net

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losses which would evolve over obviously a number of years of less than $100 million and in the context of the business that's just reporting $4.5 billion in earnings, I just don't see that as anything particularly problematic when you view it as a stress case scenario.

If you look more broadly at the surety business and again going back to Tom's comments, 75% of the surety business is construction-based, 90% of it in public works projects. Importantly look at the customers that we've been engaged with in that business and remember in the end that we have rights to the remaining contract proceeds in the unlikely event that a contractor defaults. That has happened, it certainly has happened in our book and to others as well, but fundamentally the project is collateralized by the remaining proceeds due from the municipality or the state government. So our view of looking at the construction side of the business remains pretty confident and wouldn't envision a dramatic change in losses from sort of historical experience. The commercial side is carefully underwritten. We focus on collateral and security and yeah, you know you tell me the economic environment or the level of distress that you want to place at it and sure I think losses would tick up, but again in the context of a company our size I don't think that they would become problematic. I know I'm not answering your question with a level of specificity that you'd like but it's virtually impossible to do so. Anything Tom that you want to add?

Tom Kunkel

I would just add that our experience in this business shows us that recessions in and of them selves don't necessarily cause surety losses. But they do tend to expose the underwriting that took place when times were good, when the economy goes into a recession and I think our position on that is that even in robust economic times our underwriting has not changed and so in a recession it's not necessarily going to follow that our losses will increase.

Jay Gelb
Lehman Brothers

I appreciate that and then just a separate one for Jay Benet, on the investment portfolio, for the other investments, I know I've asked this question before but what do you think is the right run rate or right investment yields for the other investments so we can model that?

Jay Benet

Yeah in the past what I've said you know given some steadiness in the marketplace, the quarterly analysis show ups and downs but we would generally advise averaging the quarters. I would say at this point in time, given the way the markets are at least for our planning purposes, we think the fourth quarter of '07 is more indicative again for planning purposes, of what we would look for going forward into '08.

Jay Gelb
Lehman Brothers

Do you tend to get an up tick on that in the first quarter though seasonally?

Jay Benet

I'm sorry could you repeat that?

Jay Gelb
Lehman Brothers

Is there seasonality in that result, in the quarterly result, does the first quarter tend to be stronger than say the fourth?

William Heyman

In typical times there some seasonality in distributions by private equity funds. I think we're in a climate right now in which that is not the case and not likely to be the case for a while. Also in December private equity funds often make distributions before year end.

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That was not the case this December. So I think for the moment we have to take a somewhat longer term view of the portfolio, which we think as a matter of risk thresholds ought to perform over time much as public equities perform, possibly plus or minus a few points.

Jay Fishman

I think the other point, Jay, that I would add and Jay Benet did mention this but simply to reiterate it is that our guidance for 2008 assumes a somewhat lower level of net investment income than we actually realized in 2007, driven really uniquely by what we perceive to be the potential for a more challenging realization environment in the investment arena.

It's not attributable to cash flows or anything else. It's purely an issue of perceiving the realization environment to be somewhat more challenging and then the rest of the guidance is accounted for by about 100 basis points change in the ongoing run rate of the combined ratio simply to incorporate the continuation of the more competitive environment that we've been witnessing.

We are assuming for '08 that that environment will continue to look very much like the change in '07 looked; that it will get increasingly somewhat more competitive as '08 moves along.

Operator

Your next question comes from Bill Wilt - Morgan Stanley.

Bill Wilt
Morgan Stanley

Back to management liability; Brian, in your prepared remarks you rhetorically questioned, how could it be worse? You mentioned that it would be more likely frequency driven than severity. Then you went on -- and I think Jay Fishman, you also used the word systemic, there would have to be a systemic change in the litigation environment, presumably entities that you're not currently contemplating brought into this mess. Could you expand on that some?

Jay Fishman

I think your characterization is actually quite right. We, for example, do not currently see -- this isn't a conclusion that we're reaching, these are facts -- we don't currently see the small local community bank being dragged into the sub-prime issue.

Again, there are a couple that have and in our account-by-account analysis we've incorporated that into the work. When we refer to a systemic change, we're really talking about a class of risk not currently identified in any way, not currently associated with it in some way being dragged into it.

Brian's comment about frequency versus severity is driven by our limits profile. We have low limits, relatively small limits I think compared to other people who underwrite the business, and so an individual account won't change much of anything. It would actually take a systemic change in the class of business that was associated with this and for there to be litigation which our policies would respond to.

Ultimately, there has to be litigation to the insured for our policies to respond. So that's what we think could trigger a worst case scenario, but so far there's no evidence of that.

Bill Wilt
Morgan Stanley

Are you currently contemplating defense coverage that would obviate some of these claims or policies vis-a-vis the nature of the claims you've seen so far, are there issues or questions as to coverage?

Jay Fishman

It's very important first to remember that in claims made policies defense costs are contained inside the limits unlike traditional occurrence policies where the obligation to defend run outside the limits and so the obligation to defend can simply run on, in effect forever, at least theoretically.

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With claims made policies the defense costs fall inside the limits so they are very much quantifiable. To the extent that defense costs emerge, they emerge first at the primary level. Those who have the primary policy will provide defense. Of course, they will assuming that there's an indemnification obligation. Eventually it will run up the policy to where if it continues to go excess riders eventually get dragged into the defense obligation sequentially.

I think one of the things that we take some comfort in -- and it's in the analysis of the 30 claims and notice of claims that we've got -- is that only five of them are primary, 25 of them are excess so at the moment you see the average attachment points there. One can make an assumption as to the litigation costs and all the rest. It sure feels good in this case to be an excess provider rather than a primary provider.

The limits are there and obviously if either the defense or the indemnification obligation extends through the policy then those limits will be tapped as well. But it is important to note that defense costs are inside the limits.

Bill Wilt
Morgan Stanley

The last quick one for me is if you could offer just a quick reminder of the nature of the coverages in commercial surety.

Tom Conkel

Commercial surety entails a variety of what typically used to be called miscellaneous surety bonds. They can entail anything from small mom-and-pop compliance bonds to bonds which may guarantee appeals of court judgments for larger, better secured companies.

So in the class, there are obviously a wide variety of obligations. In our underwriting we consider the nature of each of those underlying obligations and we tailor our underwriting approach to the risk of that obligation and then the financial solvency of our customer.

Jay Fishman

The larger end, and this is real time, so correct me if I'm wrong, but in all likelihood you've got permit bonds, sales tax bonds and tobacco bonds and all that would be small on an individual basis. At the larger end, there might be a commercial surety bond issue for a self-insurer of workers' compensation obligations. That would be toward the larger end on a size scale of a commercial security obligation.

Tom Conkel

That would be one of the obligations, yes, Jay, that we would write only for our larger and most financially secure accounts and one that also receives the greatest degree of underwriting.

Operator

Your next question comes from Alain Karaoglan - Banc of America Securities.

Alain Karaoglan
Banc of America Securities

I want to thank you also for the additional disclosure. That was very helpful and very thorough. I just want to confirm that I heard correctly in terms of the share buyback, Jay. You said $900 million in the first quarter or second quarter of the whole program?

Jay Fishman

Given our cash position, our expectation is that we would do about $2.7 billion for the year. That's what we included in the guidance. We would expect to finish the first program which is that $900 million somewhere near the end of the first quarter. It could be a little into the second quarter or just before. But that's the target.

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Alain Karaoglan
Banc of America Securities

International business, I realize it's a small percentage of your overall business, had 10% growth rate this quarter, 9% for the year. You mentioned foreign exchange was helpful to the top line. Could you quantify that?

If the growth rate is still above the other areas, what are you seeing there that you're comfortable growing or why is it attractive and we shouldn't be concerned about growing in a softening market?

Jay Benet

First of all on the FX it's about 2 points overall in that business. That gives you a sense of that.

We see a variety of opportunities there in the international marketplace. As I said in my comments, the Lloyd's business is something where on a very selective basis -- and again at Lloyd's we are fundamentally not a long tail player -- so we're doing property-type of coverages out of Lloyd's and feel very good at what we're seeing there. So we've seen some selected opportunities to grow there.

Jay Fishman

It's important to mention, to reinforce this, that we are not a long tail casualty writer at Lloyd's. That our appetite at Lloyd's is virtually exclusive to property, to marine, to aviation, to other short tail coverage. So don't perceive in this that we've gone out and begun writing long tail coverages in Lloyd's. Not the case.

Jay Benet

So our opportunities in Lloyd's have been heavily focused in the marine industry, for example, some in the power generation area. The other place where we've had a decent amount of growth and think we've got opportunities in our Canadian franchise which historically had been very focused on a couple of products and we think we've got an opportunity there to expand both geographically in Canada and expanding some of our product profile that we've got in the U.S. into our Canadian operations.

Alain Karaoglan
Banc of America Securities

The next question relates to the market environment. I'm sure anecdotally there's an unreasonable competitor, but any broad unreasonableness by product line? Is there any product line or segment that you're concerned that's already not meeting your hurdle rate or concerned that in 2008 is unlikely to meet the hurdle rates?

Jay Fishman

It's certainly the case that the largest end of the insurance business, largest accounts, is clearly the most competitive. The thing I think that's often misunderstood about our franchise is that that's not where we live. We are a small and middle market company. Our large account business is largely, largely a loss responsive business. There will be other companies that do guaranteed costs in the largest account segments. The commentary that you'll hear from them in the aggregate of their business is I think different from the commentary you'll hear from us.

The small and middle market segments have not nearly been as competitive as the largest guaranteed cost segments are. Again, that's not where we do business. But in terms of size, that would be the breadth.

One of the interesting dynamics, and this is highly anecdotal, is that we actually still see some softness overall in the D&O market, which actually is quite interesting given all of the questions that are coming at us this morning about management liability. That's true both on the reinsured side as well as on the primary side. The market as of yet is not, from a pricing standpoint, reacting as though there's some insurmountable crisis here that needs to have an immediately reaction in the pricing dynamic. Those would be the two I'm closest to.

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Jay Benet

That would be it. One quick correction because I misspoke. The 2% was on a broader portfolio. For the international business alone it was about 4 points of the growth.

Brian MacLean

If I could just help to clarify.

Jay Benet

Because I was thinking of the total segment number.

Brian MacLean

In international, you'll see in the supplement, 9% adjusted for FX will be about 4%.

Operator

Your next question comes from Larry Greenberg - Langen Mcalenney.

Larry Greenberg
Langen McAlenney

I was just wondering if Joe might elaborate a little bit more on the personal auto market conditions? We heard from some companies that they are now trying to push rate up and just wondering if Joe is seeing any sort of bifurcation in the marketplace?

Joe Lacher

Larry, we hear the same kind of comments and what we're doing is watching it. It becomes very much a local market and a local environment issue and you get a couple of companies in any one environment might move up and down a little bit. We're not seeing anything that's fundamentally causing big swings either way. We're watching it. We hear the same reports and are looking for those impacts and are anxiously awaiting to see them in the market.

Larry Greenberg
Langen McAlenney

Jay, as aggressively as you guys are returning capital to shareholders, you're building capital even more quickly. Has anything changed in your view or your opinion on whether you would like to be acquisitive?

Jay Fishman

That sounds a little bit like "have you stopped beating your wife?" Let me try and answer the question my way.

Larry Greenberg
Langen McAlenney

It wasn't intended that way.

Jay Fishman

I think it would be irresponsible for a management team to say in the broadest sense that it would never consider an acquisition. I think we have a responsibility to be thoughtful, to see how we can create shareholder value and to use all of the tools that are available to us to do that.

Having said that, our instinct about it is really no different than it was which is that the risk of any transaction is very high. There's culture risk and balance sheet risk, reserve risk, people risk, financial risk; it's significant and we recognize it. We're experienced at it and we recognize that those risks are real. Any transaction that we might evaluate will inevitably be compared to the very high hurdle of the risk assessment that we put into any transaction.

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So then I go back to, can we create shareholder value? Can we complete our mission with the tools and skills and the assets that we have? The answer is we're absolutely convinced we can. So you take a transaction, you evaluate it in the context to accelerate the growth of shareholder value, again evaluating against the risk.

So I think it's all on the table, Larry. I don't think that's any different than it was three months ago or six months ago. Risks are high. They are difficult to do. We have a lot of experience doing them so we feel pretty good about it but the risks are nonetheless high.

There's nothing in our capital profile that's driven towards accumulating capital in anticipation of a transaction. We are returning capital as aggressively as we think prudent in the marketplace that we're in. To the extent that we feel comfortable doing more we will do more.

I think it would be nice to be AA straight with both agencies. We are on watch on upgrade from Moody's from AA3 to AA2. I don't know if that will occur or when. We're currently rated AA minus with Standard & Poor's I think it would be nice to be AA rated and the financial targets that Jay sets and the ways in which we measure our business are geared to doing that.

But we're not sitting on $0.05 of capital without a good reason and a good reason is not sitting on it to create a war chest for an acquisition. That's just really a silly way to run a business and we just don't do it.

Operator

Your next question comes from Matthew Heimermann - JP Morgan.

Matthew Heimermann
JP Morgan

You talked about in the presentation some of the declines in frequency you're seeing in auto are expected based on some of the changes you're making. Is the same also true for severity that there's some impact there because of some of the underwriting changes?

Joe Lacher

There is a little bit of a change. It's much more modest and sometimes almost counter to what you would expect as you move deeper into some parts of the standard marketplace, you might see lower limits. In some cases we're seeing different numbers of limits is probably the easiest example to see. Lower limits you'd anticipate getting some lower severities.

Again, when we described for you on page 21 loss trends, what we're doing there is describing all of those trends -- loss frequency and severity -- excluding the expected impact of the product changes. We're trying to take out that noise and the aggregate statistics so that we look at underneath is the real and appropriate numbers for financial projections, the environmental inflation that's going on and any difference between our expected numbers and the actuals.

So those two items together would roll through what you see on page 21 and give you the best set of numbers to project what our numbers or the environment were doing.

Matthew Heimermann
JP Morgan

On the claims side, what inning are we in terms of the benefit you're getting there, just from the implementation of processes, procedures, et cetera?

Joe Lacher

I think we've commented before, and it would still hold true. On the physical damage initiatives, we're most of the way through there. If we were picking an inning, maybe it's the ninth, maybe it's done. It's hard to tell exactly. But it's on the tail end. On bodily injury, it's hard to project when the end is. It's

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definitely in the last half of the inning. But until you really get closer to the end and see the shift change it's hard to project it. I guess seventh or eighth.

Jay Fishman

Just to clarify on that point, because importantly when the ball game's over, to use your example, it doesn't mean that trend goes up. What it means importantly is that the expected declines or the expected benefits from that investment -- they may actually not necessarily be declines, but the expected benefits -- have now run their course and will continue to be evident in our loss trend.

Joe Lacher

And will continue to perform at the new and improved levels.

Jay Fishman

That's exactly the point.

Joe Lacher

And we will experience whatever environmental inflation there is, whether it's up or down.

Jay Fishman

That's exactly right.

Matthew Heimermann
JP Morgan

I just wanted to get to the gravy, so to speak. The other follow-up I have is any contemplation of perhaps more aggressive dividends in your capital return program prior to the board decision for the $5 billion?

Jay Fishman

Obviously dividends are a board decision. We typically review that with them annually. If you look at our history you'll see that to the extent we've changed our dividend we've done so in connection with the annual meeting which would take place at not this board meeting but the meeting after. We'll obviously evaluate the marketplace, our capital needs and everything else and make a recommendation to the board. But it's premature at this point to speculate on anything.

Operator

Your next question comes from Brian Meredith - UBS.

Brian Meredith
UBS

Can you talk about loss costs or terms and conditions in the commercial lines environment and what you're seeing there? You mentioned the frequency is flattening out. Does that have anything to do with maybe loosening terms and conditions or just the great favorable frequency trends coming to conclusions?

Brian MacLean

We've talked about that a little bit last quarter. I'd say we're seeing continuing of the same. We have not yet been in a spot where we felt we had to move our terms and conditions significantly. It's not really affecting our frequency numbers.

We are starting to see more of that in the softening in the market as everyone would anticipate. It somewhat goes with the comments Jay made if you talked about larger property accounts. That would be the most dramatic example. At the other extreme, nothing really significantly happening in the smaller account market.

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Some movement, but it's not really driving the frequency in our book. I think it is just our frequency trends are more coming out of really an unprecedented period of, for many of our businesses, declining frequency numbers. They're really leveling out at something approximating zero trends. So not a bad place.

Brian Meredith
UBS

Actually, is there anywhere in your commercial lines book of business or business lines that you're saying you're actively just pulling back from it or trying to reduce exposures because of market concerns?

Jay Fishman

The only one where I think we have and have been for some time is in our excess standalone casualty liability business. We have a business unit that writes, in effect, umbrella liability, standalone. That business has been competitive and we've been shrinking that business. It's not a terribly big business for us, but we've been shrinking it, I'd say aggressively for the past 12 months.

Brian MacLean

Even a little longer than that.

Jay Fishman

But I don't think there's anything new in the news in the marketplace that's changing our profile. That's the only area where I can think of where we've clearly made the decision a while ago now that this is not for us.

Brian MacLean

There's no other area where we're taking significant actions.

Operator

Your next question comes from Jay Cohen - Merrill Lynch.

Jay Cohen
Merrill Lynch

There seems to be a foregone conclusion -- and this is probably the right one -- that the pricing environment will just continue to deteriorate until there is absolute stupidity like what we've seen in the past. Can you envision an environment where the pricing essentially begins to stabilize over the next two years and returns stabilize at a still reasonable level? Is that a possibility at all?

Jay Fishman

Jay, I've been talking for a couple of years now actually at some risk to my perceived sanity, that there's lots of factors that could cause one to believe that the traditional cycle that we've seen in the business may be somewhat different this time. We've talked about terrorism. We've talked about the management of various companies and how much that's changed. We've talked about the tools and analytics that are available universally in the industry now and the fact that people are not running the business by the seat of their pants but in fact the analytics are really very much improved.

We've talked a little bit about the Sarbanes Oxley process that all companies, I believe certainly as we do go through; I mean there are so many people internally here that certify the financial statements that any concern about loss trend or reserve development gets evidenced very, very early and filters up to senior levels of management. I think you can make thoughtful decisions about risk-taking.

I think it's interesting that virtually every company in the business of any size has been involved now in share buybacks or dividends. If you look back in the '90s, that was not the case. There were companies that had programs but there were precious few who were actually in the market returning capital.

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The fact that we are this long into the cycle and our guidance would translate to a 13% to 14% return on equity range, even before the impact of any development I think is an indication of the fact that we are believers that it may not necessarily be as dramatically bad as it's been before. I think there are lots of signals; and again, I've said this before. Look at the retentions. The retentions and ours are exceptionally strong but there are other companies that also have had strong retentions. That is a counter-indicative signal with respect to a highly competitive, as you say, stupidity environment.

We were looking at middle-market retentions in the '90s that were in the high 60s, and now we're talking in the mid '80s. These are very dramatic differences. Although I've worked for people who said don't ever assume it will be different this time so I think we look to next year and assume that it will continue to be somewhat more competitive than it was this year but I still think there are lots of indications out there that it may indeed be a little bit different. So we're hopeful.

Jay Cohen
Merrill Lynch

On the share repurchase, you obviously have been very aggressive in buying back your own stock. If you base success of this buyback on your stock price -- in other words, creating shareholder value -- you could conclude that it's not doing a lot for you. Does that ever disturb you? Do you ever consider, hey, what if we don't buy back stock, what would happen?

Jay Fishman

Well, sure, to answer that portion of the question.

But the share buyback has had a meaningful impact on our return on equity. We actually do measure the cumulative impact of the share buyback on our return on equity. I think it provides clarity and transparency to investors because there always seems to be the question that if we didn't buy it back what are we holding it for? So I'm personally a believer that this is absolutely the right thing to do.

The only alternative that we have is to plunk it into the bond portfolio. When I last looked this morning, the 10-year Treasury was yielding 3.6%. I'd rather that you all decide what to do with the money that comes back if you don't want to own our shares.

I continue to believe it's the right thing to do. It's sort of obvious to us, frankly. Again, I don't know what other alternatives there are. It's interesting that we get sometimes I'd say modestly criticized for growing our business too aggressively. I don't understand that criticism. I think our numbers support our growth appetite significantly. Yet we're only absorbing modest amounts of capital in doing so what would you do with the rest? I think it's sort of obvious.

To give you some sense of it, the 2007 return on equity was 1.3 points benefited by the share buyback cumulatively over time. That's 130 basis points positive. Eventually one would think that investors will take note of that. They will perceive that the return on equity in our company is better than it otherwise would have been and I believe better than many of our competitors and will ultimately choose to say that's a security we'd like to own.

The fundamental reason for doing this is to maximize shareholder value. So no, certainly it's disappointing when things like this work out, but it doesn't cause any concern about our strategy.

Operator

Your next question comes from Josh Shanker - Citigroup.

Josh Shanker
Citigroup

I was wondering if you could give us any granularity given that the 2007 year is complete on the net favorable development, could you talk about how gross development would work for certain vintages? Give us an idea about reserve releases from '06, '05 '04 and how '97 to '01 is looking and whatnot?

Jay Benet

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There really weren't any major trends that were underlying the favorable developments in this quarter. This was a lot of little changes that came about in actuarial reviews of each of the business lines.

As I've said before, we do these very thorough reviews on a quarter-by-quarter basis. So this isn't like an annual review that was different from what we've been doing in previous quarters.

I would say overall there's no great information or great trends taking place. What I would say is that we've had more data come up on recent years. I think most of what you're seeing here is related to property business and some liability business in recent years.

Josh Shanker
Citigroup

Have you seen a general freezing of development for those years that were quite painful in previous years?

Jay Benet

We haven't seen much movement in that in the earlier years, if that's what your question is.

Josh Shanker
Citigroup

So in the end could we perceive that the difference between the gross development and net favorable development is about the same for the quarter?

Jay Benet

Gross and net in this case is in the eyes of the beholder. I mean we look at things on a segment basis, each individual product line. The level of granularity we use here is very significant. I don't want to give the impression that every single reserve that we had developed favorably. The amount of movement in any of the reserves tended to be quite small.

This is not the result of some large negatives being offset by large positives.

Operator

Your next question comes from David Small - Bear Stearns.

David Small
Bear Stearns

You mentioned that you bought some ABS in the quarter that's backed by sub-prime. Could you just tell us when in the fourth quarter? Was it at the beginning of the fourth quarter, the end of the fourth quarter that you bought that?

Bill Highman

We bought them at various points; highly selectively less due to the climate of that particular day or week than due to what we have show as some of it [inaudible]. Typically to buy a $10 million piece requires two people to spend an afternoon, one doing the modeling and the other negotiating with the dealer. It's a highly labor intensive process, and each purchase is really [inaudible]. It's hard to characterize the purchases as a whole. We bought maybe $100 million consisting of 10 pieces.

David Small
Bear Stearns

In the quarter did you revise your management liability current accident year loss ratio?

Jay Fishman

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No. That goes back to my earlier comment that at least at the moment that the experience that we're both seeing and anticipating in the management liability business falls within the normal loss expectation that one would have for the business when taken as a whole.

David Small
Bear Stearns

Jay, earlier you were talking about a desire to be AA from all the rating agencies. Could you just help us understand what you think the benefits to the company are of having that rating?

Jay Fishman

It's not a big deal -- let me be very clear about this. I wouldn't pursue a lot of cost in pursuing a AA versus a AA minus. I just think as a financial services company where ratings matter that to be a AA company and afford that to your customers has some long-term value associated with it.

I've been out of the treasury business for a number of years but it used to be that AA flat also made you an A1P1 short-term issuer and the AA minus makes you an A2P2 issuer. Again, not that we're in the commercial paper business, but I do think that financial services companies should aspire to have the highest ratings. That's the only reason. Not that we would spend a lot or go through a lot of excess capital position to acquire it.

Jay Benet

There are no conversations with ratings agencies that suggest to achieve those goals we have to increase our capital base over and above what it already is.

Jay Fishman

There should be no confusion by anybody on this call about our aggressiveness with respect to returning capital to shareholders. It's not transactional, it's strategic. It is strategic. We do it consistently. It's part of our philosophy, and it is not limited or driven by any particular dynamic. It's just the right way we think to run a business.

David Small
Bear Stearns

If you think about the commercial book, I think you talked earlier about the frequency trends being flat. I'm trying to get the idea of what is the spread right now, do you think, between the loss trends and the price change? If you think about, well, frequency is flat. What's severity doing if pricing is down a few points? It seems likely you're going to get that margin compression. I'm trying to figure out how wide that would be right now.

Jay Fishman

Again, we were very upfront about that comment. We said that our guidance for 2008 envisions about a 1% increase in our combined ratio. That's being driven by the fact that we're planning for, I would call it modest loss trend and some decline in rate. That's what accounts for that 1% difference.

Jay Benet

Then you've got mix and you've got bond initiatives.

Jay Fishman

There's a lot of other things that go into it but our guidance for 2008 does envision a 1 point increase and I would characterize that as very reasonable under the circumstances reflecting the notion that pricing may continue to decline.

Operator

Your next question comes from Charlie Gates - Credit Suisse.

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Charlie Gates
Credit Suisse

On both the Markel conference call and the RLI conference call, they opined that they saw standard markets companies entering the excess and surplus lines business. To what extent do you think that the Travelers might be one of those standard markets companies?

Jay Benet

We seem to continue to get that question and we actually went back a couple of quarters and looked at our data on our middle market book of business and we are taking virtually no business and moving it from the E&S market into our standard commercial environment.

Jay Fishman

Our answer very directly would be not at all, to your question. Not at all.

Charlie Gates
Credit Suisse

I'm on slide number 22. George Joseph, out at Mercury General opined several years ago that I think he thought your company was adopting, with regard to personal auto, a take allcomers strategy. He put other companies into that same box.

That said, reading from your slide, "Quantum intentionally targeted a broader spectrum of drivers than captured by historic product reach." Is that what he's referring to?

Joe Lacher

I'm not 100% what he's referring to. You'd have to check with him. What I can tell you, Charlie, is we very clearly have talked before that back in the 2000/2001 timeframe, our product was very focused on a highly preferred segment of the marketplace. We very clearly talked about Quantum and its roll out, that we were not moving into the non-standard segment of the market which is generally described as running 20%, 25% of the marketplace but we were moving out of our niche in that highly preferred segment into more preferred and standard business.

So it is by no means a take allcomers strategy. We've demonstrated any number of times with underlying data that that's not the book of business that we're writing, but it is in fact broader than the niche we were hunkered in in 2000.

Charlie Gates
Credit Suisse

Could you give an example of the new standard market? Say the standard market before was a guy who lived in the suburbs who drives to work; what's the new standard market guy look like?

Joe Lacher

I think the standard market might be the same definition -- I'm referring to that as highly preferred preferred standard and nonstandard. What we would have done before is we might have had a book that had less youthful drivers; drivers with fewer incidents than average. That would make them a more preferred set of risk.

As we move out to drivers who might have one or two speeding tickets or a minor accident on their record or might have more presence of youthful on the policy that might be something that might move into a more standard classification.

Jay Fishman

A way to think about Quantum is that it represents or will eventually represent the broader spectrum of the American driver as opposed to the old programs which were very targeted at the highly preferred segment.

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You can think about that from an IFS score, if you like. You can think about it from an incidence. But it simply broadens out and provides a price for a broader group of customers than our product really did before. It certainly is not a take allcomers.

Operator

Your final question comes from Paul Newsome - Sandler O'Neill Partners.

Paul Newsome
Sandler O'Neill Partners

I was hoping you could spend just a little bit more time on the auto frequency results. Particularly it looks like many folks assume that the frequency trend would continue to be favorable. What's your view on that topic? Do you think at some point in time we start getting negative frequency trends and see some price increases as a result of inflation at your firm?

Joe Lacher

Well, what we've seen is that loss frequency if you look over the last ten years had a significant decline and we are near historic lows from an absolute frequency perspective. So it wouldn't surprise us if we saw those frequency numbers climb a little bit.

When you measure frequency trend, that's of course the change from period over period so ticking up a little bit to see some positive trend but still be near historic lows. We're seeing a little bit of increase in frequency in the last several quarters. It's not at alarming rates of growth. When we project forward total loss trend and project total loss trend to be in the low to mid single digits and that's what we think about through our environment over the next year, which is incorporated in our underlying guidance.

We don't usually break that apart when we're disclosing it between frequency and severity, because sometimes those move counter to each other. We feel it's really more appropriate to project them in aggregate.

Jay Fishman

Independent of the mix change which we are trying to highlight on page 22, obviously page 21 shows a modest increase in frequency. It's very difficult to look out and predict with any thoughtfulness what's going to happen. You're talking about everything from numbers of miles driven to the impact of fuel and seatbelt usage and cell phone usage and changing state laws that require hands-free.

There are so many variables that go into frequency. I don't think that we particularly have any great insight into why something would change. Again, that's independent of the mix dynamic on page 22.

Paul Newsome
Sandler O'Neill Partners

Are you pricing for low single digit claims inflation currently?

Joe Lacher

The guidance that we provided anticipates that running through the environment.

Paul Newsome
Sandler O'Neill Partners

That's not the question. The question is whether or not you're pricing for it in your policies.

Jay Fishman

Let's back up for a moment. We provide and have at our investor days given insight into the returns that we are recording in our businesses and as it relates to the personal lines business broadly and particularly it's well within the targeted returns of the business.

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If you're asking how we price a particular product in a particular market, it's a very complicated question. We look for the returns on a book of business overall and the book of business continues to meet our target thresholds. We're pricing it to do that. I'm not sure exactly how to answer the question but we're pricing the product to achieve our targeted returns.

Joe Lacher

We look at targeted returns. We look at the marketplace dynamics. We look at opportunities for growth. We look at what we expect will be the underlying loss trend and we put them all together. We don't take any one of those variables independently and solely make a price change on that. We're not trying to dodge the question. You've got to take all four, five of those things and mix them together.

Jay Fishman

Again, broadly stated, we price the product achieve our targeted returns given everything we see happening in the marketplace. So a silly assumption would be that we price it to achieve targeted returns assuming a decrease in loss trend. We are not assuming a decrease in loss trend. We are essentially assuming that loss trend will continue at low single-digits. That's how we price our product.

Paul Newsome
Sandler O'Neill Partners

I think we're all just trying to figure out if auto has bottomed out industrywide. There's certain mixed results from various companies.

Jay Fishman

I don't have a comment I can make on industrywide dynamics. Page 21 is giving you very specific insight into our book and you can see that our loss trend has been running for the last several quarters in the low single-digit and total loss trend and that's how we're pricing our product.

Paul Newsome
Sandler O'Neill Partners

Thank you for the increased disclosure. That detail is very helpful.

Operator

Gentlemen, there are no further questions at this time. I would now like to turn the call back to Mr. Connelly for closing remarks.

Michael Connelly
Thanks very much for taking the time with us today to discuss what was a terrific 2007. If anybody has comments or questions please feel free to follow up with me directly. Thanks.

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