S&P Global
Market Intelligence

W. R. Berkley Corporation NYSE:WRB

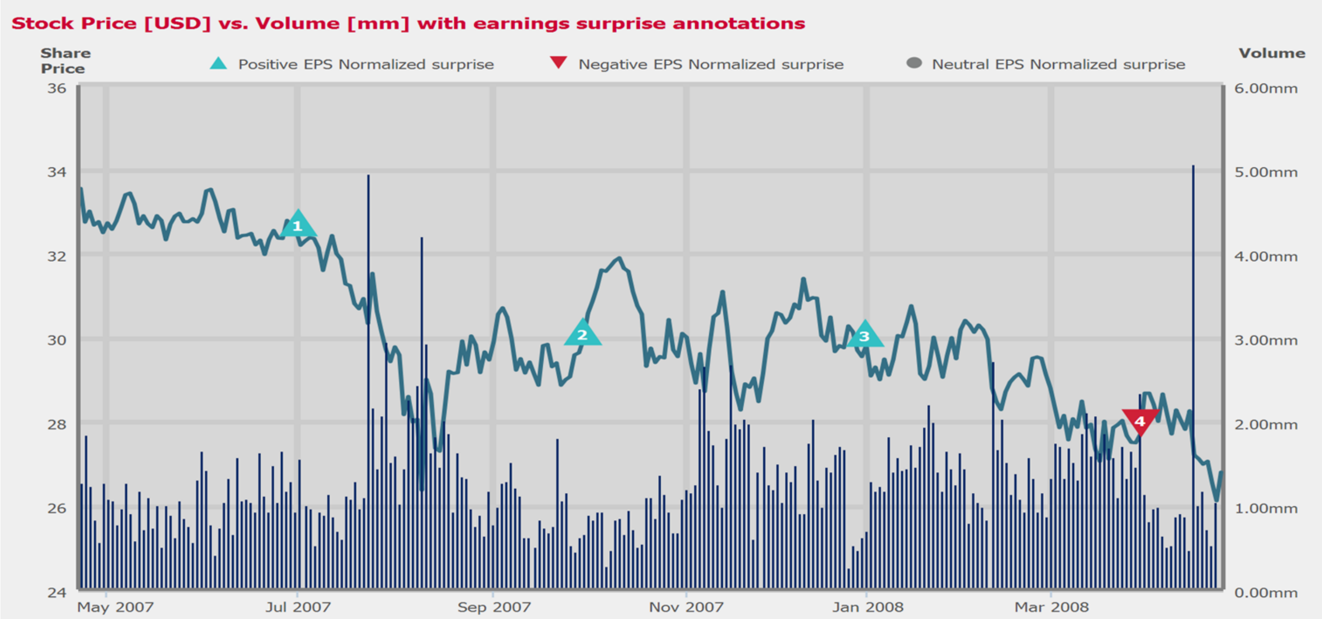
FQ2 2008 Earnings Call Transcripts

Thursday, July 24, 2008 12:30 PM GMT

S&P Global Market Intelligence Estimates

	-FQ2 2008-			-FQ3 2008-	-FY 2008-	-FY 2009-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.84	0.77	▲(8.33 %)	0.87	3.42	3.44
Revenue	-	-	▲(9.78 %)	-	-	-
Revenue (mm)	1329.12	1199.14	-	1324.48	5321.10	5251.48

Currency: USD
Consensus as of Jul-24-2008 2:18 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ2 2007	0.91	0.92	▲1 1.10 %
FQ3 2007	0.91	0.93	▲2 2.20 %
FQ4 2007	0.94	0.97	▲3 3.19 %
FQ1 2008	0.91	0.83	▼4 (8.79 %)

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EXECUTIVES

Gene Ballard

William Berkley

ANALYSTS

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Mike Grasher
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Scott Heleniak
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Presentation

Operator

Good day and welcome to the W.R. Berkley Corporation second quarter 2008 earnings conference call. Today's conference is being recorded. Before we begin, we would like to note that the speaker's remarks may contain forward-looking statements. Some of the forward-looking statements can be identified by the use of the forward-looking words including without limitation believes, expects or estimates. We caution you that the forward-looking statements should not be regarded as a representation by us as to future plans, estimates or expectations, contemplated by us will in fact be achieved. Please refer to our annual report on Form 10-K for the year ended December 31st 2007 and our other filings made with the SEC for a description of the business environment in which we operate and the important factors that may materially affect our results. W.R. Berkley Corporation is not under any obligation and expressly disclaims any such obligation to update or alter its forward-looking statements whether as a result of new information future events or otherwise.

At this time, I'd like to turn the conference over to William Berkley. Please go ahead, sir.

William Berkley

Thanks, Steve. Welcome to our call. We had an all right second quarter. We were pleased with our underwriting results. Our storm losses, given the magnitude of the storms, were certainly well within reason. Across the board, the competitive environment continues to be difficult. We see pricing levels basically continuing to be down roughly 5%, 5.5% year-over-year. It's been at that level for most of the year. We test not only our renewable, we're now testing new business, which is approximately in that same area. I think that from our perspective what that really means is pricing, adjusting for inflation, is probably down between 9% and 10%. We're trying to offset that by being more selective in our underwriting results and we think we're able to do that somewhat and moving out of the most competitive areas of the business.

We think our business is still operating at a very comfortable underwriting margin, and if you take away the storm activity, we would expect that we're probably running in the area of a 90 today, maybe slightly better than that. So, we're satisfied with our business. It's not as wonderful as it was two years ago, but such things can't continue. I'm going to talk about various segments of the business and how we're doing in a little more detail and answer questions, but right now I'm going to let Gene Ballard go through our financials.

Gene Ballard

Okay. Thank you, Bill. To begin with the second quarter operating income was $134 million or $0.77 per share and that compares with $187 million or $0.92 per share in the second quarter of '07. While our operating income was down almost 29% compared with a year ago, income per share was down much less by just 16% as the per share earnings are reflecting increasing benefits from the share repurchase program. We repurchased another 7.1 million shares in the second quarter for an aggregate cost of $190 million, and with that the average shares outstanding during the quarter were down $30 million or 15% from a year ago.

On a pre-tax basis our operating income decreased by $87 million when compared with the prior year quarter. Underwriting profits were down by $70 million, investment income was down by $15 million and all other income expense items combined were up by $2 million.

Looking first at the underwriting profits, there are four main differences in the year-over-year underwriting results. First, as Bill mentioned storm losses, primarily storms in the Midwest were $31 million in the second quarter, which is $15 million more than they were in last year's second quarter. Storm losses added 2.9 percentage points to our overall combined ratio.

Second, the decline in earned premium resulted in a decrease in underwriting profits compared with last year's quarter of about $12 million. Third and most significantly, the profit margins for the current accident year, disregarding the impact of storms, were down about six points from last year. That's due to the general price declines that Bill referred to as well as lost cost trans in inflation and that represents a decrease in underwriting profits compared with the prior year of $63 million.

And finally, the fourth item which partially offsets the other three is that we had $20 million more in prior year reserve releases this year than we did a year ago. Reserve releases were $52 million in the quarter, up from $32 million a year ago. So that gives us a total underwriting profit of $73 million and a combined ratio of 93.2%, which is up 5.3 points from the prior year quarter.

Net premiums written declined by 13% to $992 million, primarily due to declines in the reinsurance and excess and surplus business lines, which were down by 38% and 22% respectively in the quarter.

Our loss reserves increased to $112 million in the quarter to approximately $8.1 billion at June 30th. Our pay loss ratio increased to 52.8% due in part to the decline in earned premiums and our pay-to-incurred loss ratio was 83.5%.

Investment income was $154 million, down about $15 million from a year ago. The decrease was primarily due to lower returns from one of our limited partnership investments. Although, returns for the arbitrage account were much improved from the first quarter of '08, they were slightly behind in exceptionally strong quarter in the second quarter of '07.

Arbitrage earnings were $15 million this year compared to $23 million a year ago and that gives us an annualized yield of 7.3% this year compared with 11.1% in the prior period.

Investment income for the rest of the portfolio continued to grow even after the use of about $800 million in cash for share repurchases. The average annualized yield on the fixed income portfolio was up to 5.0% for the quarter compared with 4.7% in the second quarter of '07.

During the quarter, we wrote-down investments in preferred stocks issued by Fannie Mae and Freddie Mac and several large banks by a total of $82 million. These investments were considered to be other than temporary impairments primarily because of the amount and time that their market values were below cost. As you may know under FAS 115 and related accounting guidance, write-downs of preferred stocks are based on how much and how long market is below cost even if the investments are highly rated and even if you expect the issuer to honor all of its obligations, which is the case here for our preferred stocks.

So, that's what we did. All those investments, by the way, are classified as available for sale so the changes in market would already be reflected in the balance sheet and the book value per share. So, the real effect of the impairment charges is just to move those market value changes over to the income statement. I think Bill might have some comments of his own on this later.

At June 30, 2008, the total investments were $13 billion and the net unrealized losses were $13 million. As we showed on Page 8 of the earnings release our holdings of Fanny and Freddie-related assets were $1.3 billion at June 30 and that consisted mostly of mortgage backed securities and you'll also see there that in the aggregate these investments have a net unrealized gain of about $8 million.

So, that gives us an operating ROE of 15% and a book value per share at June 30th of $20, up from $19.80 at the beginning of the year. That ending book value reflects the impact of share repurchases during the period at prices above stated book value. So the effect of those repurchases in the first six months would be to reduce book value by $0.73. Thank you.

William Berkley

Well, let me just talk about a couple of things and then I'll talk about each of our operations. First of all, in anticipation of a question, our reserves overall went up by just shy of $250 million. It's an interesting thing with our earned premium down and written premium down that our reserves still went up.

And in fact, if you go back in 2005, same quarter we had roughly the same reserves, same written premium and earned premium, rather. So, one would think with that matching our duration, our reserves wouldn't have gone up at all, they would have roughly been unchanged with the duration of loss reserves and the unearned premium adjusting for inflation, you might have expected things go up by $30 million or $40 million, maybe $50 million.

It really is our conservative nature that still is in place which is anticipating higher levels of inflation and concern with directional trends we see in loss settlements. It is a conservative posture, that while we are bringing down some past redundancies, we continue to be conservative in the reserves we establish. And the best example, I can give you is, look back same quarter three years ago, earned premium, written premium roughly the same yet our reserves are up by in round numbers $250 million. I think that tells the story about our conservatism.

A couple of other items before I talk about the operating. This impairment charge is a non-issue but a big issue. Impairments or market carrying at market value was always how we carried virtually all of our securities. Some companies in fact didn't carry everything at market value.

We now have a non-standard because the accounting rules are vague and uncertain and no one has given us any kind of defined way to account for them. We work out our own judgment in negotiating and discussing with the accountants and every insurance company will have its own set of standards plus the ability of investors and analysts to compare insurance companies will be extremely difficult.

It's unfortunate that that lack of a bright line has lack of clarity is something we all face now. And the entire test is based on market value even though the current present value of the cash flows of many of these securities is really based on the ability to pay the dividends far more than the market value or in fact the face value.

So, it's a complicated thing and for all of you who are trying to examine insurance companies and compare them, it makes the issue extremely difficult. Some companies who carry everything under Section 159 at market value, some companies who carry everything at cost, some who've taken no write-downs. It is unfortunate and it's incumbent upon the FASB and the accountants to get together and establish a standard that makes sense and is logical. It's a real problem for our industry.

Continuing now about our operating units, our Specialty business continues to be under pressure. We have a few competitors, who are aggressive and some of our business is moving back to the standard market. The business continues to be extremely profitable. We're very pleased with our operating units. They're behaving in a disciplined fashion.

There are a number of new entrants as well as people from Bermuda, who are trying to get into the business. Most people are behaving rationally but it only takes a couple to create irrationality. We're pleased with that business, we're pleased with how we're doing.

Our market position continues to be excellent. Our reasonable companies had an underwriting profit despite of the storms in the Midwest. We were pleased there. Our volume is down very slightly. We've been able to take advantage of our relationships and build on them with agents. The modest decline in pricing in that market is more than offset with service and explaining to these customers that for a 5% price differential it's not something you want to change. Continuity is a value.

Our Alternative Market business again was relatively flat. We were pleased with our service revenues in that business, under more pressure from irresponsible people trying to enter the excess workers' comp business. It's astonishing. This is the longest line of business we write and you have people who have little capital and less experience getting into the business and people trusting them and then being surprised when they don't perform. It's an astonishing thing and the sad part is some of it will never get made up by guaranteed funds even because they operate on a reinsurance basis and other people front for them.

California comp continues to be a more competitive area. There still are opportunities, but it is still quite competitive. The Reinsurance business is our most competitive business. It's the place where there's less business to be had because more companies are retaining as much business as they can to avoid declines in their own written premium levels.

In addition to that, they're not wanting to buy as much facultative business because they're letting go premiums and they don't realize they're also gaining losses. So, in this moment in the cycle, the facultative business suffers also.

Facultative business is likely to come back once people realize that they let go of the premium, they also let go of the losses. So, we would expect by the end of this year, early next year the facultative business will start to return because people will realize they don't want that extreme volatility that large retentions result in when you keep that. But in the meantime we have basically stepped out of and not seen a number of our treaty accounts and that business continues and we are no longer in participation with Kiln. So, our reinsurance volume is down.

International business still doing well. We're pleased with how everyone is doing. Our Latin American business continues to do well. We have outstanding leadership in both South America and Europe. We're extremely pleased with how they're doing. It is a constant battle in Latin America to maintain that discipline and we're pleased with that.

In Europe, it is as competitive as here and our people and leadership there have done great. We've also now expanded in our International business, which accounts for a significant part of our growth.

In Australia, we've got just first class people who have taken advantage of our establishment of our Australian operation there, and we're very pleased with their start and how well they're doing. Our office in Hong Kong continues to write a small amount of Asian reinsurance business.

So overall, we're pleased with where we're going. Disciplined and not writing business is always hard. The cornerstone of our view is, have all the power you need when you come out of this.

Two other items I wanted to be sure to mention. We continue to believe that we will use our earnings we generate to repurchase stock. That means we would expect to continue to buy 5 million to 10 million, maybe slightly more or slightly less shares on a quarterly basis, which is basically using our new earnings to repurchase stock.

The second thing is I want to further my complaint about the existing accounting issues. And that is, to give you an example of the absurd accounting rules, we own a building in Washington, D.C. We were going to sell that building. It would have been roughly a $75 million profit. We own 80% of it. Instead, we refinanced the building and took out $54 million of cash tax-free, non-recourse. So, we got $54 million in cash plus all our costs out on a non-recourse basis. Yet we recorded no gain on that transaction even though for all intents and purposes on an economic basis it's a gain. There's no way we have to give that money back, but instead we had $54 million in a suspense account. Now, we have the economic benefit of reinvesting the money. But it is not in fact a gain.

Another case of accounting rules not reflecting the reality of the business situation. We have an additional several hundred million dollars, probably an additional $200 million or $300 million of unrealized gains in investment real estate and we're working on other avenues to convert those gains to be reflected on our financial statements.

We may well get the cash to use but it's silly to pay tax when there are avenues we can use to get the cash and not pay tax and have a free ride in the potential future upside in some particularly choice pieces of real estate.

So, we have many issues with the current accounting treatment of a lot of these things and they create a lot of complexity in allowing people to compare various financial statements of different insurance companies. Some like ours being quite conservative, others creating gains that are only artificial, buying leases on their own real estate and then selling the buildings based on over priced leases.
So with Steven, we will take questions.

Question and Answer

Operator

Thank you. (Operator Instructions) We'll go to Michael Phillips with Stifel Nicolaus.

Michael Phillips
Stifel Nicolaus

Hi, thanks. Good morning, everybody. Two questions, Bill. First, on the International segment, a lot of growth there, I guess just trying to have a hard time understanding the expense ratio increase and kind of what's driving that and how would you think about that going forward?

William Berkley

Two things. The growth was mainly from Australia and the expenses were mainly the startup expenses of our new operation in Australia.

Michael Phillips
Stifel Nicolaus

Okay. So I mean, over the next couple of quarters we should expect to see that come down a bit then, I assume?

William Berkley

Yes, I would expect so. But we basically had six months of expenses plus special expenses and starting up which involved a lot of stuff, but yes, that ought to come down.

Michael Phillips
Stifel Nicolaus

Okay, great. Thanks. And second question kind of centers around I guess this -- the overall topic of growth and then your comments on a $250 million increase in reserves. With, I think, Gene said reserve development was about $53 million, so your accident period results are just under 100%, about 98% now. I guess, the question kind of is, your increase in reserves being conservative at a time when growth is tough, your margins are just under 100% here on combined ratio basis accident year. How much business do you think that's still profitable that you probably don't get a chance to see it because you're being sort of conservative on the reserves here?

William Berkley

Well, we go through, first of all, we don't tell our Company's reserve set and we are on the side of what I think are the gods telling everybody you're too conservative. So, you should understand that we tell every one of our operating units when we think they're redundant, we tell them they're redundant, they ought to be writing more business. And every one of the Senior Vice Presidents here pounded the table and said, it's great to be conservative, but if you're conservative and missing good, profitable business, it's a bad decision.

On the other hand, having been through the bad parts of the cycle, everyone here is experienced. If you ever get with one of them and you ask to take their shirts off, you'll see all the scars from this. So, they're cautious because you don't direct people to be more aggressive at this moment in the cycle.

I have to tell you intuitively, I agree with you. I think you're right. I think we are not getting all the business we ought to get and I tell the people in the field that we need to be out there. But my guess is this, at this exact moment we probably shouldn't push too hard. And I think if you look at our more cautious reserving, it's probably also a reflection of what happens in the business climate when business is moving into a recession and pricing is going down, you tend to lose those audit premiums, you lose the kind of extra volume you get from operations. Your premiums which are based on the scale of a business are really covering larger scale businesses because you're covering things they did a year ago when they were bigger businesses.

So, I think that at this moment in time it's probably frustrating as it is in your comment and it is a lot more frustrating to me. I think that that's a painful issue that we face all the time. And I think that we are being a little more conservative than we should be, but I think this is the moment in the cycle where you don't want to push them too hard.

Michael Phillips
Stifel Nicolaus

Okay, great. I appreciate it. Thanks.

Operator

And we'll go next to Marc Serafin with Citadel Investment Group.

Marc Serafin
Citadel Investment Group

Thanks. One quick one and then a follow-up. How much reinsurance business did you do with Kiln?

William Berkley

We just had -- basically we had a consortium of about $35 million. But most of our decline in reinsurance premium was not from Kiln.

Marc Serafin
Citadel Investment Group

And $35 million was a full year '07 number?

William Berkley

Yes.

Marc Serafin
Citadel Investment Group

And then, could you talk a little bit more about the workers' comp loss cost inflation trends that you're seeing and what you're assuming in your pricing or your reserving at this point?

William Berkley

I don't think, I would get specific in workers' comp. I would simply say that our general view is medical cost, inflation is sort of between 7% and 9% and base rate inflation that we're using is 4.5%. So, I think what we're sort of saying for our own purposes, we think that based on premium mix, we're seeing effective cost deterioration between 9% and 11%. But it depends on the state, it depends on coverage changes. It's very, very specific by state, by tax we employed by retention. There's lot of things you try and do to compete, not just on our loss cost estimates and so forth but detachment point. It's coverage, it's our own preferred provider network which we think in some places reduces our medical cost by as much as 12%. So, I think we're putting a lot of effort on things like that. So for example, we have a preferred fire network now almost every place.

Marc Serafin
Citadel Investment Group

Thank you.

Operator

We'll go next to Josh Shanker with Citi.

Josh Shanker
Citi

Good morning to you all.

William Berkley

Good morning, Josh.

Josh Shanker
Citi

The first question I had regards some comments you made during the last conference call and just how this conference call fits in. Where's the velocity of the rate trend going? If things worsened in pricing, (inaudible) able to talk?

William Berkley

No, I don't think things have worsened, but in fact I was really surprised when I got our last loss cost trend. They're astonishingly flat, i.e. the rate of loss cost trend continues roughly at exactly the same thing. I think what I see happening that I'm interested, I think the decline in business activity is causing a few things to happen.

I'll give you an example, Josh. Construction, people have exposures on past operations when they're aggressively writing contractors business. You're really picking up exposures when businesses were much more active, so you're cutting your prices, in this case contractors go up more than 5%, I might add, a lot more. But not only are you cutting your prices, you're getting an exposure of insurance exposure that's far greater than the current rate of business operations, thus, the rate base that's used to calculate your premium.

So, I think that you're seeing in certain lines of business people not, not experienced enough to understand that their risks are greater than the rate calculation generates in premium. So, we think that that is creating a greater adverse impact on some of the most aggressive carriers, but I think that we've had no change…

Josh Shanker
Citi

Okay.

William Berkley

We've had no change at this point in time, but it continues. So, I think the consequential results are that the combined ratio for the industry will get worse. I would think the combined ratio for the industry on the average in 2009 will be certainly well over 108 on an actual year basis, could well, could be 110.

Josh Shanker
Citi

You're getting more sour than me, I think…

William Berkley

No. That's an actual year basis. I think the reported combined ratio will be a lot better than that.

Josh Shanker
Citi

Certainly, certainly.

William Berkley

By the way, I think that's great because I think the end is going to come with difficult investment results and that combined ratio, I think that that's going to mean the cycle turns in the first quarter, maybe the second quarter of 2010. So, from my point of view, that's how -- I'm much more optimistic about the turn in the cycle than I was six months ago.

Josh Shanker
Citi

Okay, very good. The second question is, I'm not seeing too many headlines in the newspapers and I'm wondering if you have any comments about your tax status lobbying efforts in Washington, whether you think either of the preferable candidates will have any impact on offshoring premiums to avoid taxation?

William Berkley

Well, I think both presidential candidates would like to have people who don't vote pay taxes and these are companies that are offshore that they ought to pay taxes and if they do pay taxes, that would be good and if they vote here, then they certainly should pay taxes because they should have to pay for the freedoms they get just as they structured their lives offshore.

So, if they complain that they do vote here then they should pay taxes for that reason. So I'm optimistic. I think we're making headway but as I said before, this is not something that's going to be won or lost on the public stage. It's going to be won or lost in Congress and we've had excellent responses from people. But as everyone had seen with getting things done in Congress, Congress is not anxious to get anything done at the moment, they're busy fighting with each other.

Josh Shanker
Citi

Okay. And finally, on your real estate problems, I just want to make a comment…

William Berkley

We have not a real estate problems.

Josh Shanker
Citi

I understand, I understand.

William Berkley

But the…

Josh Shanker
Citi

Conundrum, I guess we're seeing, why you can't realize these profits.

William Berkley

Well, we realized cash but not profits.

Josh Shanker
Citi

Right. Now, I'm fairly certain that you as well as most of your peers company have significant real estate gains that are not appreciated on your balance sheets. And I understand that you don't intend to tell people look there's obviously the balance sheet is understated but it tends to me, when companies are selling their real estate in the insurance category, it tends to me either they're trying to beef up their balance sheet in terms of appearances, they need cash or they're afraid real estate prices are going to come down in valuation. I'm trying to see your motivation for desiring to show those profits. I know you have them but why do you need to show them?

William Berkley

The difference is most of my property casualty competitors don't own whole buildings in their investment account. Their real estate is their operating real estate. We bought buildings as investments, just part of our portfolio. We were the developers. We bought them to sell. So, I don't think it's like most of our competitors. I don't think…

Josh Shanker
Citi

I understand the difference. And as you desire to sell right now, are you concerned about real estate pricing?

William Berkley

No. This has been going on for a year and a half. We refinanced this building with non-recourse at the peak of the market, we worked it. I mean on an economic basis it worked out fine. It's just that I'm trying to point out the absurd, I'm not complaining other than to say the absurdity of the accounting that if we had sold the business it would have reflected one way. We on an economic basis sold the business although not on a financial statement basis. What I'm really raising the issue is the inconsistency of the rules which make various transactions appear different ways on different company's financial statements. I'm talking less about the real estate than I am about the accounting rules.

Josh Shanker
Citi

I understand. When we're done with W.R. Berkley, then you can come and do our jobs and show us our accounting rules too.

William Berkley

Yeah. It's the most aggravating part of my job is fighting with the accountants.

Josh Shanker
Citi

I can imagine. Take care and thank you, Bill. Thank you.

Operator

And we will go next to Jay Cohen with Merrill Lynch.

William Berkley

Boy Jay, you've gotten older, your fingers are much slower than usual.

Jay Cohen
Merrill Lynch

That is true actually. In the last, I guess, month or so we've had two Specialty insurance companies sell themselves at pretty high multiples, two times book, 2.8 times book. You guys are treading at 1.2 times book. It seems that the private market is putting a higher value on this Company, a much higher value than the public market. Any thought of finding some sort of partnership where the value of your Company can be recognized more quickly than in the public market?

William Berkley

We've talked to people. We've had discussions with people. And if somebody wanted to buy this Company, I'm sure they could find management who would run it without myself and my son. But we are not in any mode to work for anybody else and we have talked to people about doing things in partnership and we continue to buy back stock. So, if the environment and the pricing of our stock continues low enough, we'll be private because everybody will sell but me.

We've bought back about 22% of the Company so far and I think we'll buy back basically 10% every six months. So, if we continue to do that, we're going to -- for those shareholders who remain, they'll be part of a elite group who get to own this Company at a much lower value than we think the intrinsic value. But we're certainly willing to talk to anybody about anything that creates shareholder value. I own right now in round numbers 19% of the Company and the only caveat is I'm not prepared to work for anybody else. But other than that, I'll do anything that helps create value for the shareholders at any point in time. So, if somebody out there wants to call me and have a discussion about it, it's okay with me.

Jay Cohen
Merrill Lynch

All right. Thanks.

Operator

(Operator Instructions) We'll go next to [Scott Heleniak] with RBC Capital Markets.

Scott Heleniak
RBC Capital Markets

Hi, good morning. Just two quick questions. First you cited excess workers' comp is an area where people were being pretty irresponsible. Can you think of-- is there any others that sort of stick out? I know you kind of went out of your way to mention that one. Any others that come to mind, especially longer tail?

William Berkley

I think that's really the most egregious. And I tell the reason it's the most egregious is because it's such a very long tail line and people ought to have more sense than that. You ought to be selective in who you do business with. But I think that's the most egregious that stands out above all else. I mean, there are people who are charging less than 50% of the appropriate rate. But the good news is that makes the long tail line a short tail line.

Scott Heleniak
RBC Capital Markets

Okay. And so, how does that 50% compare to some of the other weaker categories? Is there anything even close?

William Berkley

No, not that I can offhand think about, no.

Scott Heleniak
RBC Capital Markets

Okay.

William Berkley

I mean I think California standard workers' comp has come down by more than 50% rate, but it's come down because the benefits have come down [incompetently]. So I think that that's not a comparable thing. So, I think that that's probably the greatest. I think there are other areas that are starting to come down, but excess workers' comp is the place. And by and large most people are still being responsible and the financially secure dependent, dependable companies still are pricing appropriately. It's people who write with these new fly by nights or people who have no capital that are getting this theoretical bargain. Most excess workers' comp is still being done rationally.

Scott Heleniak
RBC Capital Markets

The only other question I had was last conference call you talked about sort of mid-market carriers getting into ENS. It really started about a year or so ago, and then they started getting out in the first quarter. Are you seeing any of that at all where the loss trends are starting to build and they're starting to get out or is this more coming in force and it's not really…?

William Berkley

I think it's a mixture still. So, I think that some are getting in, some are not. I think that, I would say that there is not the overall disregard of pricing that you saw the last soft market where people said how would it, whatever price it takes. I think there is in most lines of business there may be a disconnect as to what it takes to write at a profitable level but people aren't just saying whatever it takes to write the business. The most aggressive companies in most lines are only being modestly irrational.

Scott Heleniak
RBC Capital Markets

But is it in your forecast that that will happen in 2009?

William Berkley

I think that what's going to happen in 2009 is the cumulative effect of a 5% and a 5% rate decline and inflation. You get to the third year where that's the case and you have still a modest decline, just starts to have a huge effect. You can't hide from that. So, the reality of loss costs starts to hit. So, when you're in the ENS business with the duration of three, four, five years, six years, you start to see those losses, so you no longer can hide from the reality of your inadequate pricing.

Scott Heleniak
RBC Capital Markets

Okay, thanks.

Operator

And we'll go next to Mike Grasher with Piper Jaffray.

Mike Grasher
Piper Jaffray

Hi, good morning, gentlemen. Bill just trying to tie your comments, your verbal comments with those in your press release in terms of your own expectations on returns over the course of the next 18 months. Do you feel like the balance sheet and the reserve position is strong enough that you can maintain at least the 15% including your outlook for the marketplace?

William Berkley

Yeah, at this point I still feel that way and there's nothing that has changed about that. But I think that you -- the farther you get into a difficult cycle, the more worry you have that greater levels of irrationality are there. I still am pretty confident we'll be able to deliver that 15% plus returns.

Mike Grasher
Piper Jaffray

And does that make you apprehensive about looking at other properties that maybe out there in the market looking more attractive? And I guess, I'm speaking more to the public entities that we see trading at discounts to book, maybe a young balance sheet, smaller company that maybe is a tuck-in for you.

William Berkley

No. We're always looking at other opportunities. I mean, part of the problem, and we're trying to think what do we want to do and then as part of the problem is, we don't want to get something that isn't complimentary to what we have. So lots of the things we see today aren't particularly complimentary to what we have. We're thinking of, in fact, maybe making minority investments in some of these things that we see out there. But at the moment, no, we think there are great opportunities and we're looking at them on an everyday basis.

Mike Grasher
Piper Jaffray

Okay. And then, final question would be just in terms of the elections coming up, the political landscape. Anything have you concerned or not?

William Berkley

I think that, I think that we actually have maybe lots to be concerned about. I think it's less about the candidates than it is about the state of our economy and where we are and the uncertainty about that. But I do think it just means that not much is going to get resolved to give people confidence until after the election. So, I think, we're going to continue being an uncertainty I think until after the election and I think that '09 will end up being a year of transition and a year where our industry certainly will be painful in its suffering.

Mike Grasher
Piper Jaffray

Thank you.

Operator

And we have a follow-up question, Marc Serafin with Citadel Investment Group.

Marc Serafin
Citadel Investment Group

Thanks. Quick one on the International. How much of the growth was FX?

William Berkley

Hardly any.

Marc Serafin
Citadel Investment Group

And then, when you guys look at your cost base, I mean, what component -- how should we think about fixed versus variable components?

William Berkley

How do you mean?

Marc Serafin
Citadel Investment Group

Acquisition costs versus fixed salary and benefit type expenses.

Gene Ballard

We have a 30 point expense ratio. It's roughly $320 million a quarter and I think you could look at 20 points of that as being variable commissions and premium taxes and…

William Berkley

I think it's probably, it's just under $200 million is probably variable and probably $110 million, $120 million is fixed.

Marc Serafin
Citadel Investment Group

Thank you.

Operator

Having no further questions, I'd like to turn the conference back over to Mr. William Berkley for any additional or closing comments.

William Berkley

Okay. Well, I thank you all for being on the call. As I say, we think the end gets closer as the pain gets greater and we think the pain is going to get much more substantial as we get towards the end of the year. So, we're a lot more optimistic and we have done a lot of things to invest so we're well positioned, so our percentage increases in growth in the next upswing and the fact that it'll be at least as great if not greater than it was in the last. Thank you very much.

Operator

This does conclude today's conference. Thank you for your participation. You may now disconnect.