S&P Global
Market Intelligence

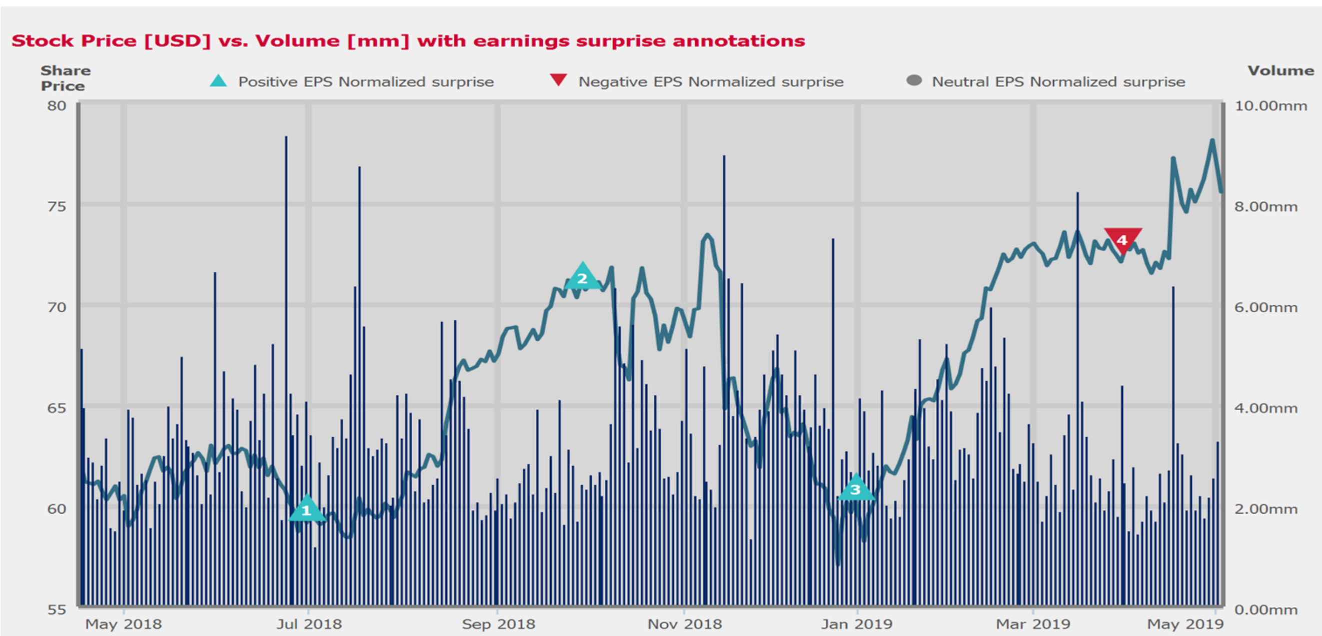
The Progressive Corporation NYSE:PGR
FQ1 2019 Earnings Call Transcripts

Thursday, May 02, 2019 5:30 PM GMT

S&P Global Market Intelligence Estimates

	-FQ1 2019-			-FQ2 2019-	-FY 2019-	-FY 2020-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	1.36	1.35	(0.74 %)	1.22	5.12	NA
Revenue (mm)	9197.24	9239.90	0.46	9209.53	37156.01	NA

Currency: USD
Consensus as of Apr-29-2019 5:10 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ2 2018	1.11	1.16	4.50 %
FQ3 2018	1.10	1.33	20.91 %
FQ4 2018	1.01	1.25	23.76 %
FQ1 2019	1.36	1.35	(0.74 %)

Table of Contents

Call Participants

EXECUTIVES

John Peter Sauerland
VP & CFO

Jonathan Bauer

Julia Hornack

Richard Madigan
Analyst

Susan Patricia Griffith
President, CEO & Director

ANALYSTS

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Wells Fargo Securities, LLC, Research Division

Jeffrey Paul Schmitt
William Blair & Company L.L.C., Research Division

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Keefe, Bruyette, & Woods, Inc., Research Division

Michael Wayne Phillips
Morgan Stanley, Research Division

Michael Zaremski

Yaron Kinar

Presentation

Operator

Welcome to the Progressive Corporation's First Quarter Investor Event.

The company will not make detailed comments related to quarterly results in addition to those provided in its annual report on Form 10-Q and the Letter to Shareholders, which have been posted to the company's website, and we use this event to respond to questions after prepared presentation by the company. This event is available via moderated conference call line and a live webcast with a brief delay. Webcast participants will be able to view the presentation slides live or download them from the webcast site.

Participants on the phone can access the slides from the Event pages at investors.progressive.com. In the event we encounter any technical difficulty with the webcast transmission, webcast participants can connect to the conference call line. The dial-in information and passcode are available on the Events page at investors.progressive.com. Acting as the moderator for the event will be Julia Hornack. At this time, I will turn the event over to Ms. Hornack.

Julia Hornack

Thank you, Joelle, and good afternoon to all. Today we will begin with the presentation by 2 senior portfolio managers: Richard Madigan and Jonathan Bauer. That presentation will be followed with -- by Q&A with our CEO, Tricia Griffith; and our CFO, John Sauerland. Our Chief Investment Officer, Bill Cody, will also join us by phone for Q&A. This event is scheduled to last 90 minutes.

As always, discussions in this event may include forward-looking statements. These statements are based on management's current expectations and are subject to the many risks and uncertainties that could cause actual events and results to differ materially from those discussed during the event. Additional information concerning those risks and uncertainties is available in our 2018 annual report on Form 10-K, where you will find discussions of the risk factors affecting our businesses, safe harbor statements related to forward-looking statements and other discussions as a challenges we face. These documents can be found via the Investors Page of our website at progressive.com.

It's now my pleasure to introduce our CEO, Tricia Griffith.

Susan Patricia Griffith
President, CEO & Director

Good afternoon, and welcome to Progressive's first quarter webcast. We are delighted with our first quarter results, growing net written premium 16% at an 88.8 combined ratio. Really great start to 2019, especially after several years of profitable growth.

Today's webcast is going to be a little bit different than what we've done in the past. We have focused the most recent webcast on our operational strategies and how they help us make investments to ultimately achieve our vision. Today, we're going to talk about the investment side of the house.

Before we get into that, I want to step back a little bit and just make sure we're all clear on our overall objective function, and that's for both the operating side of the business and the investment side of the business. We want to grow as fast as we can at or below a 96 combined ratio, as long as we can service our customers. The great news is we've been achieving that goal many times over the last several years.

2016, we grew $2.8 billion in net written premium; 2017, another $3.8 billion; last year, $5.4 billion. And comparing quarter 1 of 2019 with quarter 1 of 2018, we've already grown nearly $1.3 billion. But that has made us a huge asset under management for our investment firm to invest of about $35 billion. And, of course, premiums float is one of the inputs to our investment strategy.

Progressive capital management, or PCM as you will hear it called today, is based in Norwalk, Connecticut. It's a 13-member strong, a small, but mighty team.

Let's first talk about overarching risk. We want to balance our operating risk with the risk of financing and investment activities to have sufficient capital to support all of the insurance we can profitably underwrite and service. Within that -- that's overarching -- within that, the PCM organization has 3 mandates. Jonathan will talk about this.

Jonathan and Rich will both talk about this a little bit later in more detail. The first one, protect the balance sheet; the second, achieve a strong risk-adjusted total return; and the third one, support the operating business as we think about future endeavors. I think about horizon's rate that I shared with you before.

We tend to be more conservative on the investment side because we've chosen to lever the operating franchise because we see it as our most durable means for a really strong ROE. A comprehensive ROE is measured by business profitability and capital efficiency.

This slide gives you a sense of how we look at comprehensive income. This is a pretax basis, and it is the past 5 years plus the first quarter of 2019. In each of the bars, you will see several colors: the blue is underwriting profit; the orange is investment returns; and the small sliver of gray are interest expenses. As you can see, the investment part of our company is very important, and that's why it was important to share with you a little bit more about our philosophy today. As you can see for 2019, it's actually over 50% of our comprehensive income.

We don't have an explicit comprehensive return on equity goal, rather it's the natural outcome of our operating goals, our investment mandate and our financial policies. So again, operating goal, grow as fast as we can into the 96; investment mandate, have a strong total return on our investment; and our financial policies that we shared with you before, that is maintained at 3:1 premium-to-surplus and then have a contingency layer of capital for unforeseen things that could happen and then have no more than 30% of our total capital comprised of debt. When we have those 3 working together, which we have for many, many years, we are able to earn an attractive comprehensive return on equity in excess of our capital structure.

So now I'm going to get to the heart of the matter, and that is to introduce you to Richard and Jonathan. So they both started out many years ago at PCM. They started out as analysts and quickly moved into the portfolio roles. They both report to Bill Cody, who you've met before, so we thought it would be nice for you to meet 2 members of his strong bench. Richard Madigan has his BA in accounting from Boston College and his MBA from the University of Chicago. He currently leads our structured product portfolio, and he served on the strategy council that we developed several years ago. And so -- and works closely with Andrew as we think about the future.

But first, I'm going to introduce to you Jonathan Bauer. He has his BA in economics and political science from what we Ohioans call the school up north in Ann Arbor, and he has his MBA from Columbia. He leads our corporate bond portfolio, and he takes the initiative to think about technology strategies to make sure that PCM organization is efficient and effective.

Jonathan Bauer

Thanks, Tricia. Richard and I appreciate the opportunity to give you more detailed understanding of who Progressive Capital Management is, what our strategy is and how do we fit into the larger organization.

To start with, it's important to mention that we only manage the money of Progressive. We do not take in any outside funds, as we believe that could distract from our core mission. As of March 31, 2019, we have 13 investment professionals who managed just under $35 billion in assets. That $35 billion is composed of $32 billion in fixed income and $3 billion of equities. We manage the fixed income portfolio on an active basis, while almost the entire equity portfolio is passively indexed to the Russell 1000 Index.

If you look back over the last 10 years, you can see a sharp increase in our assets under management, especially over the last 3 years. One of the benefits of investment management is the scalability of the business. As you can see, we have only added 3 members to the team, even though our assets have more than doubled. However, that scalability does have limits, and as Progressive grows further, we will continue make sure we have adequate resources.

Before we go any further, we thought it might be useful to review what the sources of our investment funds are. Starting at the bottom of Progressive's capital stack is our shareholders' equity, which comes from the company's retained earnings. Next up is our preferred stock. Progressive issued $500 million of preferred stock in March of 2018 to support our operating growth. Above that, you can see our debt. Some of you on the call may have participated in our 2 issuances in 2018, as we came to market in both March and October.

Finally the last 2 contributors to our investment portfolio: First is the float we make on premiums; next is the reserves we have in place in our insurance business. All of these funds flow up to our fixed income and equities portfolios. I would just point out that the size of these boxes on these slides are for illustrative purposes and are not the actual size of the category.

Now that we've talked about the sources and growth of our portfolio, let's talk about our investment returns and where you can find the components of our returns in our financial statements. We manage our portfolio on a total return basis. So what encompasses that total return? First is recurring income. This flows through our operating income and comes from the interest income that we earn on our fixed income portfolio and the dividend income earned in our equity portfolio. This is 1 component of our total return.

Second on our slide is realized gains or losses on both portfolios as well as holding period gains and losses on equities. Now what does it mean for a gain to be realized or unrealized? We realize a gain when we sell a security at a price above where it was purchased. Again it's unrealized when a security is trading above the purchase price, but we have not sold it yet. As you can see, these gains and losses flow through our net income. I do want to point out that it was only last year in which holding period equity gains and losses started flowing through our income statement due to changes in accounting standards.

Moving on to the last component, which is unrealized gains and losses on fixed income. This is not something that you would see on our income statement, but instead flows through our comprehensive income. I stated earlier, we measure ourselves by our total return, which encompasses income, realized and unrealized gains on the fixed income portfolio.

I had mentioned earlier that we have 13 investment professionals. On this slide, you can see how we've structured the team. We have 4 individuals, including Richard and myself, who report up to Bill Cody, our Chief Investment Officer. The 4 individuals are broken up by corporate bonds, structured products, treasuries and short term and economics and financials. Beneath these 4 people, we have a team portfolio managers and analysts who help to drive our strong performance. It's important to note that this is the current structure of the team. But as I will speak to later in the presentation, rotation through different sectors is a core tenet of our investment philosophy.

While our team is small, that has not prevented us from achieving outperformance versus the overall market. While our compensation is not driven by outperformance of a benchmark, we thought it would be useful for demonstration purposes to compare us to the index that most closely matches our investment constraints. As you can see, there has been consistent outperformance on a 3, 5, and 10-year basis. And on the following slides, I'll provide you some of the broad hallmarks of our group that we think have helped drive that outperformance.

We think there are certain aspects of our investment team that are unique compared with other fixed-income investment managers. The first one I would want to point out is our flexible mandate. As mentioned earlier, we measure our performance based on our total return. Therefore, our purchase and sale decisions are in no way influenced by the book yield of the security. We have the ability to purchase both high-grade and high-yield securities as long as we ensure that our overall portfolio rating does not drop below A plus. While we showed our performance versus an index on the previous slide, that was purely for illustrative purposes. Our security selection and asset class allocation are in no ways meant to match in index. Further, the size of our different portfolios are whether they be corporate or mortgages are no way fixed. So we can adjust them based on the best opportunities that the market provides us.

As I mentioned earlier, a core tenet of our team is the rotation of analysts and portfolio managers through different sectors. So why do we do that? Don't we give up a lot in terms of specialization? We think the rotation adds a significant amount of value to the organization. And in fact, this rotation is something similar to what occurs on the operating side of the business. To begin with, it offers each individual a fresh look at the risk/return potential of different portfolios. Through this rotation, individuals get a better sense of relative value across different asset classes.

While there's a daunting task to get up to speed on a new portfolio every few years, we think it actually helps with both recruiting and retention as it offers a continually challenging position to highly motivated individuals. We feel this rotation not only benefits the entire organization through improved performance, but also creates a deep bench of future leaders for Progressive capital management. As Lori mentioned on the last call, part of our culture is to promote from within, and this rotation allows individuals to prepare for greater responsibility in the future.

The final component to our unique structure is our incentive system. To begin with, 1 portion of the incentive compensation is based on Progressive's overall gain share score. As I mentioned earlier, our first goal is always protect the balance sheet, and we are incented to do so with such a significant component of our incentive compensation coming from Progressive's annual performance. The other important piece of our incentive compensation comes from the group's fixed income total return on a 1- and 3-year basis versus a group of other fixed-income money managers with generally similar constraints.

We point this out for 2 reasons: One, to show that the team is encouraged to be long-term focused in their thinking and investing; and two, that all members of the PCM team are incented by the group's total return, not based on their portfolio size or their individual portfolios return. Therefore, no one is incented to purchase assets that do not benefit the overall performance, and everyone is encouraged to assist other team members because it will end up benefiting them in the end.

We feel like we have created an integrated path within the organization. Our unique strategy helps to drive outperformance, which generates more capital for the operating business. This increased capital provides a base for further operating company growth and increases our assets under management, and then the whole cycle begins again.

Now we mention on the previous slide the flexibility in our mandate. However, that is not to say we don't have strict constraints in order to manage risk in our portfolio. On this slide, I will talk about some of our more important guidelines. We have a limit of 25% of Group 1 assets in our portfolio at any time. So what does that mean?

Group 1 assets include equities, not investment-grade bonds and preferred stock. The total amount of these 3 types of securities cannot equal more than 25% of our entire portfolio. Why do these securities get put into Group 1? We view these as our most volatile assets and also the ones most likely to incur a permanent loss of capital. Therefore, it makes sense to have a limit in terms of how much they represent within our portfolio.

We mentioned earlier that we have the ability to buy both high-grade and high-yield securities within our portfolio. That flexibility has benefited our performance over the longer term. However, that capacity to invest in lower-rated securities is not infinite as the weighted average portfolio rating must be at least A plus across the portfolio.

The constraints also extend through our interest rate risk. Our duration is an indicator of how much interest rate risk we're taking in our portfolio. The allowable range for the portfolio is 1.5 to 5 years. However, for individual securities, we will invest out to 10 years. At the end of the first quarter, we had the duration of 2.6 years, as we believe there was a higher probability of rates increasing rather than decreasing over the intervening 12 months.

Finally, we feel it's important to have limits on how big any individual position could be in proportion to our shareholders' equity. The limit is 6% from municipal state obligation bonds, for investment-grade bonds, the limit is 2.5%, and 1.25% for non-investment-grade bonds and preferred stock. We believe it is imperative to prevent 1 idiosyncratic investment from impairing Progressive's capital.

We've gotten the question from investors like yourself many times regarding yields that we're seeing in the market. So we thought this chart showing yield opportunities in the U.S. fixed-income market might be useful. The y-axis of the chart shows market yields on offer, while the x-axis shows the total market size of these different asset classes, where you see the blue numbers is the post-crisis median yield for that individual asset class.

As you can see, for many sectors that they are at or above their post-crisis median yield, a big driver of that increase has been the increase in treasury rates across the curve over the last few years. We thought it would be useful to highlight a few of the market yields available on sectors where we have exposure. Starting with high-yield corporate bonds, investment-grade corporate bonds, commercial mortgage-backed securities, asset-backed securities and treasuries and municipal bonds.

We mentioned earlier in the presentation that our flexible mandate allows us to invest up and down the credit curve. So when we make the decision to invest in high-yield corporate bonds, what are the characteristics of those types of investments? We look to invest in companies that are high-grade quality. The reason that they may be high-yield is that they have more financial leverage than the rating agencies: Moody's, Standard & Poor's and Fitch might be comfortable with. This provides us with an opportunity to purchase these investments at attractive levels, and many times when the companies improve their balance sheets down the road and get upgraded, we see a strong incremental return.

Many times we also find interesting opportunities within the industries that are penalized for previous issues which no longer exists. The most recent examples in the post-crisis period have been the automotive and housing sectors. Most importantly, what we want to get across is as you look at that table at the right, we only focused on the blue boxes. We're focused on avoiding investments in businesses that we view as weak, even if the financial leverage seems relatively low.

Taking it one step further, let's look at a couple of examples of high-yield investments. First up is a BB-rated noncyclical business. The reason why this company would be high-yield is because they have high financial leverage that won't conform to rating agency high-grade standards. However, we view the leverage as sustainable. We could earn 275 basis points or 2.75% more than treasuries. This would be about 125 basis points of incremental pickup over an investment-grade company.

Potential outcomes for this type of bond is an upgrade to investment-grade. We would see about an 8% increase in the price of the bond. There's the potential for no change in price, but we would still get to earn the incremental compensation. And third would be the potential for company underperformance, driving a 4% depreciation in the bonds upon a downgrade. While possible, for the companies that we tend to invest in, we do not see a high probability of that downside outcome.

Now let's look at one more example. Instead of a noncyclical BB-rated name, let's assume we buy a more cyclical, B-rated issue. In this case the financial leverage might look optically high because the industry has just recently bottomed. Therefore, the company's EBITDA or cash flow is at a cycle low. On this type of investment, we would expect to -- in the current environment, to earn about 400 basis points or 4% over treasuries. That would be 250 basis points or 2.5% over a similar maturity investment-grade bond.

In terms of potential outcomes, we could see an upgrade in ratings to BB. This could occur just by the EBITDA or cash flow normalizing as the industry recovers. In this case, we would see both price appreciation and 400 basis points of incremental coupon. If we see no change in the business, we would still earn an incremental 4%. And then the downside scenario would see an increase in financial risk caused a depreciation in both ratings and price. I should mention that an investment like this one tends to occur earlier in the economic cycle as opposed to where we are now 10 years into the cycle.

And with that, I have the pleasure of passing it over to my teammate and partner, Richard Madigan.

Richard Madigan
Analyst

Thanks, Jonathan. So Jonathan walked you through how we're set up as a group, how we think about value, our performance over time and how we think about opportunities incorporates. Now I'm going to spend a bit of time going into more depth about how we approach portfolio construction and security selection, including one example in commercial mortgage-backed securities before wrapping up and moving to Q&A.

The most basic question that we ask ourselves on a regular basis of PCM is do we want to take more interest rate risk or credit risk? And as is the case with most questions, the answer is typically it depends. In general, we look for asymmetric risk/reward relationships, in which we believe the upside is greater than the downside. As fixed-income investors, we are particularly sensitive to downside scenarios, and we'll generally look to stay away from low probability with high-severity downside situations. We'd like to say that the upside takes care of itself if you're focused on protecting the downside.

This chart plots the path of the 5-year treasury note against Progressive's duration positioning over the last 10 years. As a reminder, duration is proxy for how much interest rate volatility we are willing to take on. As Jonathan mentioned earlier, we have a guideline of 1.5 to 5 years on our duration. 1.5 would be taking the least amount of rate risk possible, and 5 would be the most rate risk, mathematically putting our midpoint somewhere in the 3.25 range.

As you can see in the chart, we've been lower than our midpoint and, in fact, very close to our lower bound of 1.5 on taking interest rate risk for quite some time. For the very simple reason that U.S. interest rates have been historically low coming out of the financial crisis.

You can also see that our duration positioning has come up more recently as the Fed has increased rates and move toward a more neutral policy position. While we are closer to our own duration midpoint of 3.25, we're still short of that mark. Key indicators that we watch closely to inform our duration positioning include inflation, a multitude of economic indicators, rate movements themselves, and Fed commentary. As always, we will be watching these indicators closely in 2019 and beyond to inform how we position our duration for rates going forward.

In addition to interest rate risk, the other major question we ask ourselves constantly as a group is how much credit risk should we be taking on? And the answer, once again, is it depends. It depends on where we are in the economic cycle, where valuation, also known as credit spreads are, and it depends on the capital needs of the company. This slide shows our Group 1 assets as a percentage of the portfolio over the last 10 years, which is roughly the length of the current economic recovery.

As a reminder, our Group 1 assets are rough proxy for our general risk appetite because Group 1 contains our most risky assets: High-yield bonds, preferred stock and common equities. Coming out of the financial crisis, valuations were quite attractive. As you can see from the chart, we maintained the Group 1 exposure very close to our 25% constrained for a number of years. There are some wiggles in there, which were mostly related to -- into your capital planning activities like share buybacks and our dividend payment, but for the most part, we saw it as a good time to take risk from the standpoint of both valuations and the economic recovery.

As the economic recoveries continued, risk assets have performed well, as expected, and valuations are no longer as compelling as they once were. Additionally, there's the risk of a downturn at some point, during which fundamentals and valuations will both likely take a hit. We don't know exactly when that will occur, so we've taken some chips off the table in advance.

Our Group 1 assets have steadily come down over the last several years, and we're currently running at 14.3% of the portfolio as of March 31. We are defensively positioned right now. And we hope to capitalize on more attractive valuations when markets get cheap. And they always get cheap at some point often very fast and without warning. We want to be ready for those type of opportunities.

Turning now toward our portfolio in aggregate, we thought it would be helpful to show our portfolio composition against the widely followed index: The Bloomberg Barclays Intermediate US government Credit Index. There are few differences that I would point out between our portfolio and the index. The first, of course, is that our portfolio is really the output of bottom-up security selection, not the result of top-down asset allocation. While we do discuss relative valuations across asset classes frequently to inform where we should put our resources in the short term, our portfolio remains a bottom-up fundamental portfolio.

Turning now to a few examples of how our portfolio differs from an index, I will first point out the allocation to U.S. treasuries. In the index, treasuries make up 60% of the portfolio, whereas cash and treasuries made up 39% of our fixed income portfolio at March 31. Second, you can see in the highlighted orange box that we have a significant exposure at 26% of our portfolio to securitized products. Securitized products also called structured products, are bonds that are backed by common loans such as car loans, home mortgages, credit cards or commercial real estate mortgages.

I am personally biased because I oversee securitized products for Progressive, but I believe that we have great domain knowledge in this space, and it will likely continue to be an important asset class for us over time.

Finally, I'd like to point out the duration differences. The index currently has a duration of 3.9. That would be at the longer end of our duration range of 1.5 to 5, and we would be taking on higher-than-average interest rate risk if we were to map to the index. As you can see in our portfolio, our current duration is 2.6, resulting in lower than the index interest rate risk.

You can see the contrast between our portfolio and an index even more starkly in our corporate portfolio. The left pie chart shows the Bloomberg Barclays US Intermediate corporate investment-grade index, and the right pie chart shows our corporate portfolio as of March 31. The first major difference you can see is the difference in allocation to financials.

The index has 40% financials exposure, while our corporate exposure is 23%. We do broadly see value in financials, and we take targeted risk to financial institutions through both our corporate portfolio in the 23% you see here, and our preferred stock portfolio where we think there are number of attractive securities.

The second difference I would point out is our exposure to consumer noncyclicals. Consumer noncyclicals are a broad category containing things like health care and consumer packaged goods. We have spent considerable time researching both of those industry, and we feel great about our 30% portfolio waiting versus the index waiting of 15%, particularly as we get closer to the end of a long economic expansion.

The last difference I would point out is our smaller than index exposure to the energy industry. We have approximately 3% in energy versus 8% for the index. The rationale for our smaller exposure is that we're very mindful of the volatility of commodity price movements and our inability to predict those movements. As a result, within energy, we skew towards stable subsectors like pipeline assets.

While our positioning limits our upside during commodity price spikes or risk-on markets, it's substantially helped us during the big high-yield and energy sell-off in 2015 and '16. As mentioned previously, we are focused on protecting our downside, and we worry less about giving up a bit of upside in the euphoric markets. I haven't shown duration on this chart, but our duration is lower than the generic index. As a reminder, we managed our duration at the aggregate portfolio level rather than at the individual asset class level.

I thought I would spend some time describing how we think about security selection in 2 of our major portfolios, corporate bonds, which Jon overseas, and structured products which I oversee. They include things like asset-backed securities and commercial mortgage-backed securities.

If I were to summarize our corporate bond strategy, I would say that we're looking for great businesses with great management teams and stable industries. So how do we do that in a bit more detail? First, we look at the industry structure. All else equal, we prefer more mature industries with some level of consolidation, stable pricing power and no major threats from emerging technologies. When we look at management, we look for a strong track record of doing what they say they are going to do. We will not invest in companies with known questionable ethical track records. We have, in fact, sold securities after attending meetings or conferences with management teams that left us uncomfortable.

Management compensation is a powerful tool that directly drives behavior. We look to ensure that management compensation is aligned with stability and conservative debt management and not with a specific accounting metric that might encourage lender-unfriendly behavior. EPS and sales growth, those are examples of broad compensation metrics that could encourage things like large M&A activity, which is generally a negative for bondholders.

Cash flow. Cash flow is where the rubber hits the road for the credit investors. We either look for stability over an economic cycle or strong tailwinds in the cyclical recovery. Cash is king. We love the Benjamins.

Predictable capital allocation policies. Management has a number of choices in capital allocation. They can invest in the business, pay down debt, pay dividends, receive share buybacks or pursue M&A. We preferred debt pay-downs or business investment first, and we look for predictability and stability in dividends, buybacks and M&A.

Performance during the financial crisis. We have a great built-in stress test for how companies perform in a sharp downturn. If it's available, we always look at performance during the financial crisis even if the business has changed since then. It's a great data point.

Finally, as Jonathan mentioned earlier, we look for catalysts that could drive credit performance. One key catalyst that comes to mind is whether the company is a potential acquisition target. If there is a strategic target for well-capitalized competitors, that's great. That could cause our bond prices to rise potentially significantly. If they are target for a debt fueled-type private transaction, that would generally be a negative.

Another asset class that's very important to our portfolio is structured products, which I rotated on to and have overseen since 2016. Again, structured products, sometimes referred to as securitized products, are bonds that are backed by cash flows from everyday assets, things like car loans, home mortgages, commercial mortgages or credit cards, everyday stuff in the real economy. Because not everyone on this webcast may have the same level of background in structured products, I thought I would use a simple example of car loans to help visualize how these securities work and how we think about them.

Structured products typically start with a product we're all familiar with in our daily lives such as auto loans. In the case of this example, the process starts with a consumer purchasing a car and taking out a loan. Millions of buyers purchase cars every month making this an important market. Auto loans are typically extended by a bank or a consumer finance companies such as Ford Motor Credit. The banks and finance companies have a choice, do they hold these loans? Or do they sell them to free up capacity to make more loans? When they sell them, that's where structured products come into play. When enough loans are made, the bank or finance company sells those loans into a trust. The trust receives the cash flows and security on those loans, and then the finance company working with an investment bank, creates and sells bonds to institutions such as ourselves.

These bonds are typically enhanced by various forms of what is known as credit protection to shield them against defaults and losses in the loan portfolio. It sounds complicated, but these products have long track records and work well through the ups and downs of the economy. So what do we look for when we evaluate a deal? First, we look at the reputation and track record of the issuer. How long have they been in business? How have their assets performed? Do they do what they say they will do?

Next we look at the underlying asset class. Car loans to prime buyers have been a very dependable asset class. A contrast to autos might be something more esoteric like aircraft finance or shipping containers, which are considerably more difficult to analyze and predict.

Next we look at the underlying borrowers. We look for quality and reliability and statistics such as FICO score, income levels, and geographic diversity. And finally, we look at the structure of the bonds themselves. Structured products are typically issued with built-in credit protection. The most simple example is that Bond ABC example I have highlighted here. In the case of a typical deal, Bond A would be senior to Bonds B and C in case the trust started to incur losses from defaulted car loans. If you make Bonds B and C large enough, Bond A can survive even the harshest stress test, which is what we look for.

Last point I'd like to make about structured products can be summarized through a simple example. Unlike corporate bonds in which we are analyzing 1 company, structured products often contain hundreds or even thousands of underlying loans and mortgages. As a result, we have to rely more in statistical testing to underwrite the credit quality. And as Mark Twain was rumored to have once said, "facts are stubborn things, but statistics are pliable." We couldn't agree more, and we reflect that in our analysis.

This chart shows 2 illustrative, normally distributive borrower pools that might exist in a typical securitized you. Both of them have a seemingly identical credit worthiness as shown by an average FICO score of 740. If you knew nothing else you would think these are both high-quality borrower pools. However, it's not the average that we are after, but rather the dispersion of the FICO scores and the size of the left tail, which represents the lower FICO score borrowers with higher default risk. As you get below the roughly 660-or-so FICO score subprime cutoff, that default risk rises exponentially, so that's where you're exposed as a lender.

In the left chart, FICO scores have a wide range, from 580, which is considered deep subprime to 900, which is pristine. You might think that having pristine borrowers in your pool is positive, but that merely helps the average of the pool without improving the loss potential of the lower quality borrowers. Mark Twain would probably furrow his substantial borrower here.

The right chart has a much more narrow dispersion, in other words all FICO scores are closer to the average than the left chart. The pool ranges from just under 660, that rough subprime cutoff to just under 860. While this pool doesn't have any 900 FICO score borrowers, statistically speaking, a 900 FICO score borrower isn't much different from an 800 FICO score borrower in terms of probability of default. So we would strongly prefer to invest in case 2, which contains a significantly smaller left tail and probability of sustaining material credit losses.

Now I'm going to run you through a quick example in commercial mortgage-backed securities, which I will refer to as CMBS going forward. There's a lot going on in this chart, so I'll try to break it down for you. Before I describe this slide, the punchline is that we like the deal on the left and we chose not to purchase the deal on the right. CMBS is really a tale of 2 markets. The depiction on the left is an example of the single asset, single borrower market, which is a fancy way of saying each deal contains only one property, and that property is often a very high quality such as trophy New York City office building on Park Avenue.

Loans are typically also backed by large sponsors, such as publicly traded REITs or other large, well-known real estate investors. The depiction on the right is an example of a conduit. Conduits are deals that contain multiple loans, usually more in the small- to medium-sized range, properties and conduits can range from things like regional malls to suburban offices to self-storage facilities. Sponsors can range from high-quality sponsors to small local real estate investors.

If we were to stop there, it would seem to be enough to convince us that the single asset, single borrower market is of much higher quality, and it typically is. However, it gets a bit even better from there. The single asset market is also known for its lower leverage, which results in more protection against losses. By way of comparison, if you look at the skinny blue bar on each chart, known as the single A-rated tranche, you can see they're protected from losses by all of the bonds and the equity beneath them.

In the case of the single asset deal, the property's value would have to go down by a stunning 68% before the A tranche lost money. In the case of the conduit deal, the bonds are protected from a loss of value of 47%. Now both are substantial cushions, but think back to the quality and resiliency of the underlying assets.

On the left, you have that trophy New York City office building backed by a deep-pocketed sponsor. On the right, you have a set of lower quality properties with lesser-known financial backers, and therefore, more volatility and more downside.

So is this all too good to be true? Why not always just buy the quality single asset deal? Well, if you look at the number of circles on the chart, these show credit spreads that you receive as investors. And you do get paid more to hold the conduits bonds. Higher compensation for higher risk. In the case of the single asset deal, you would receive a spread of 100 basis points or 1% over LIBOR.

In the case of the conduit, you would receive treasuries plus 215 basis points or 2.15%. While you're certainly getting paid more to only conduit, we believe the better risk-adjusted returns through both economic ups and downs is in the higher-quality assets. You can either eat well by getting paid more to own a conduit bonds, or sleep well by owning the single asset deal. We prefer to sleep well at this point in the economic cycle.

So how are we positioned now? As mentioned in an earlier slide, our Group 1 risk assets are at 14.3% in the portfolio relative to our 25% constrained. That's on the low side for us as you saw from our 10-year chart. Cash and treasuries make up 36% of the total portfolio and is 39% of our fixed income portfolio. And our interest rate exposure is lower than the midpoint of our duration range. In short, we feel that we're conservatively positioned and ready to take advantage of market opportunities as they present themselves.

What will we be thinking about going forward? First and foremost, we will continue to support the company and its mission to grow as fast as possible at a 96 or better combined ratio. Second, we're watching the risks out there, things like unexpected inflation or signs of an economic downturn. And we're always mindful that what we're focused on is unlikely to be the actual problem. Black swans absolutely do exist in our experience.

And finally, valuations are fair at best right now. These things can change suddenly as they did in 2015, '16 and December of 2018. We will focus on staying nimble with the goal of going on offense and buying cheap securities when others are playing defense.

So in summary, we believe our team is rock-solid. We have significant investment experience through economic ups and downs, we have a great culture and we're tightly integrated with operating business. Our mandate is clear, support the business. We do this by focusing on protecting our balance sheet first, while pursuing the best risk-adjusted returns we see in the financial markets.

Our model is flexible. We can shift the portfolio rapidly when we see opportunity, and we're focused on generating total returns without having to worry about accounting or other metrics. And finally, our compensation plan is simple, company gain share and our performance against our peers. We'll work toward the same common goal of generating 1 aggregate portfolio return.
Thank you very much for your time. And now we will pause and transition to Q&A.

Question and Answer

Julia Hornack

[Operator Instructions] Joelle, can you please introduce our first participant from the conference call line, please.

Operator

The question comes from the line of Yaron Kinar with Goldman Sachs.

Yaron Kinar

My first question is around severity, and then I have a follow-up. So with regards to severity, we clearly saw an uptick in the BI severity in the first quarter. And physical damage severity is also continuing now. It's crept up. I guess do you have any thoughts as to what's leading these increases now of all times as opposed to over the last, I don't know, 1 year, 2 years or 3 years? And what actions can you take in order to offset some of that other than raise in price?

Susan Patricia Griffith
President, CEO & Director

Yes, on the physical damage portion of it, we're still seeing the component parts are more expensive. So that continues to be pretty clear as cars get -- as the technology gets more advanced. So we can price that pretty quickly. On the BI side, what we did is we took kind of a deep dive into that trend. Mike Sieger who is our Claims President have -- has a group of people and they did a deep dive and have narrowed down the BI severity to 7 specific states, and specifically, we look at segmentation and claims like we do in product. Specifically, soft tissue, attorney rep claims that aren't litigated. And we're actually seeing the special damages increased not the general damages. So think of general damages as pain and suffering, the specials as medicals.

So what Mike and his team are doing is they're taking another deep dive right now into those 7 states to understand and have hypotheses to prove or disprove so they can take action, is it -- are they specials, or is there more frequency of bills or more severity? Is it the fact that we have -- we've grown a lot, so newer people? So more to come on that. But Mike is all over it, and literally we've gone through a lot of data to understand the BI severity, so that we can correct any actions from a process improvement perspective.

Yaron Kinar

Got it. Okay. We'll keep track of that, I guess. Then my second question is around PLE. So I think in the 10-Q, you mentioned that you've made some targeted underwriting changes in the new product model, and that's what -- some of the PLE erosion. Can you maybe explain what you're trying to achieve, right, by these changes? And I don't know if you'd be able to quantify what portion of the PLE decline came from those changes specifically?

Susan Patricia Griffith
President, CEO & Director

I touched about this a little bit in the last call. A big portion of some of the decline in PLE was the process change that we made. And the reason we did it was for our lifetime underwriting profit goals. So we were -- we had a process in place. It was basically a time frame that you could renew without a lapse. And when we looked at that time frame, one, we thought it was too long because we were able to tell that those customers were not profitable. And when we narrowed it down, one, we're more consistent with the industry; and two, we make money on those customers.

So we knew we would lose some customers and that would decline in PLE. I think to -- I can't necessarily quantify specifically but we have our usage-based insurance. And as we continue to evolve that model and we have people that are surcharged, they tend to leave as well. So a couple of different components. But the process change was the biggest component. We should see that diminished a little bit after the second quarter, after if it's gone through the book.

Operator

Our next question comes from the line of Mike Phillips with Morgan Stanley.

Michael Wayne Phillips

Morgan Stanley, Research Division

I want to hit on, I guess, my first question is on the other side of the -- of all side on frequency. And this is not a new topic obviously but you said in the past that you don't price for the frequency changes, the favorable frequency. I guess I just want to understand that a little bit better. If that's what you said then kind of why not, if long-term returns and short-term trends are still very favorable kind of talk about why you're choosing not the pricing ladder, if it's what you meant by that?

Susan Patricia Griffith
President, CEO & Director

What we don't do is we can't -- there are so many macroeconomic trends that go into frequency. So severity, we can pretty much pinpoint what we think is happening, where frequency, it could be vehicle miles driven, it could be our mix of business on the book, it could be gas prices. So there's so many things that's go into it. It's hard to have the specific input. So what we do is we watch that trend to see what's happening, but it's much more difficult than severity. Do you want to add anything?

John Peter Sauerland
VP & CFO

Sure. Yes. We absolutely priced the frequency. We have a frequency assumption that's forward looking to some degree driven obviously by the past. I think our previous statements have been that the frequency assumptions we made for forward-looking pricing weren't as big of a decrease as we've seen. So we didn't price for the level of decrease in frequency that we've seen, we have been assuming smaller frequency declines in our pricing. But not again, as much as we've seen recently.

Michael Wayne Phillips
Morgan Stanley, Research Division

That's helpful. Second question on the commercial side, Commercial Auto, can you talk about what you see in terms of different loss experience for, I guess, your core commercial versus kind of the ride-share business?

Susan Patricia Griffith
President, CEO & Director

Yes. I mean commercial also has 5 different, what we call BMTs. So it is across the board from a tow truck to a sand and gravel holder. So they are very different across the board. And TNC is a higher frequency, I think, because they are in more of an urban area. So I can't give you specifics on that. We look at that specifically with each of the BMTs, the TNC, we look at state, we look at especially in the bigger states where there's a lot of construction going on. So it varies dramatically. It would take me quite a while to go over it. I am going to have John Barbagallo who runs our commercial business, attend the next webcast because I think he can go into a deeper dive on how we look at that product from a profitability perspective and a growth perspective.

Operator

The next question comes from the line of Elyse Greenspan with Wells Fargo.

Elyse Beth Greenspan
Wells Fargo Securities, LLC, Research Division

My first question, Tricia, in your Shareholder Letter you mentioned that there are some signals of a softening, personal auto market. I was just hoping that you could just give us a little bit more color on what you are seeing and how you guys are kind of trying to combat that and just kind of policy growth thoughts, given expectations at the market could be a little bit softer?

Susan Patricia Griffith
President, CEO & Director

Sure, Elyse. So let me give you sort of a little bit of the punchline, but I don't want to walk back and walk you through how we've been thinking about for the last couple of years because we have a lot of tenure at Progressive, so we've seen hard and soft markets come and go. So we're just seeing less price movements. So whether it's less rate take or actually many companies are taking slight decreases. So there's just less shopping. And so people are satisfied with the rate, less shopping.

But let me walk you back a couple of years ago because as we have this robust or have -- continue to have this robust growth in profit, what we wanted to do is we wanted to take a look and say, okay, during times where there was a soft market, what are the things that we did or didn't do that we would want to do differently in this next market? And of course, things always change so it's never the specific point in time. But a couple of years ago, we did -- about 1.5 years ago, we did a deep dive into saying okay, what would we do differently and sort of kind of gauge that around our operational strategies to continue on this growth. Because we really enjoy this great growth and profitability and we wanted to continue and we want to set ourselves up to continue that.

So just recently, as we've seen less rate take in the market, less shopping in the market, prospects are a little bit more challenging to get where we have great conversion though, so that has enabled us to continue to grow. We got together a group of people, Pat Callahan, our Personal Lines President got together just to have a summit to say, "Okay, what -- how are we going to get on front of this while we're in this really great position to continue this?" So clearly we continue to increase our marketing. And we're getting -- we're having a lot of unique marketing, where actually you'll see something new next week from us with our special line -- with our motorcycle in particular product -- a new campaign that we're excited about. And we're looking at different ways to market in different areas to get the customers that we desire.

On the agency side, and I wrote about this a lot in my letter, we've done a lot of investments for the agents and we're really trying to focus on agencies, that we believe can continue to help us grow, that may be haven't grown as much as other ones and work with them on our product and our systems to have them sell more Progressive, make Progressive #1 or #2 in their firm. And then overall, I think when we think about combating the soft market I think about what we talked about for years. And that's the whole Destination Era strategy. Obviously, we invested in a homeowners company, and we have many other unaffiliated partners that we work with. So making it easy for our customers.

So HQX, we have a Progressive home buy button in 8 states now and we have other unaffiliated partners we work with to make it really easy to buy that home and connect it with the auto. We also have -- and we've talked about this a lot. When we talked about the Destination Era, a lot of people that are going to graduate, ultimately, they have an auto and may be a renter's policy, now they're going to graduate. So how do we market to them? We have metrics that we look at in the Destination Era that -- we look at auto plus another product, when customers have more products and they are able to have our service and on the claim side and the CRM side and they like it, likely they're going to have more products.

And if you compare the auto plus 1 metric, from March of this year to March of 2018, we're up about 8.5%. So that's actually just kind of scratching the service -- surface. Pat's team and actually teams around the company are working on, okay, what do we do? And we're just seeing slightly the softening, so we want to really get out in front as to continue to set ourselves up to enjoy profitable growth for some time to come.

Elyse Beth Greenspan
Wells Fargo Securities, LLC, Research Division

Okay. That's very helpful. My follow-up, we're just -- I want to go back to the severity conversation from earlier when you had mentioned that there were 7 states that have really kind of been a red flag for you guys. Are those state that you've grown -- that the growth was greater in over the past few years than other states that would make you think that maybe it was greater growth?

Susan Patricia Griffith
President, CEO & Director

I would say, about half of them are. So yes, we have grown so much in every state. But yes, there's couple of larger states where we have grown tremendously, and that's where we are really taking the deep dive to understand and create hypotheses to get our arms around it.

Operator

The next question comes from the line of Mike Zaremski with Credit Suisse.

Michael Zaremski

Follow-up to one of the previous questions about the target underwriting changes that will continue through the second quarter. Are those changes behind some of the underlying loss ratio improvement? And I think the last quarter on the call, I asked you guys about that. You said it was due to business mix changes. And I'm curious if this is a major component to that.

Susan Patricia Griffith
President, CEO & Director

These are really more process changes. Our underwriting is a little bit different. It would be a portion but I don't think it would be a huge amount. A lot of it is our ability to make sure that we care about expenses deeply. Our mix of business continues to change. I didn't mention this when Elyse asked the question, but we are seeing our agents more and more quoting us, the preferred business that we are starting to come to enjoy. So it's a portion but I wouldn't say it's a major portion of it.

John Peter Sauerland
VP & CFO

And most of our underwriting activities are focused on incoming customers. The process change that Tricia mentioned was the renewals, so obviously enforced customers with us. But the predominance of our underwriting efforts when we talked about them over the past, I don't know, 5 years or so, have ensured that we are getting accurate information from people coming in the door and risks whose intent is truly to ensure.

Michael Zaremski

Okay, great. And my last question is regarding your ambitions to grow into small business commercial, BOP. In terms of the playbook, I'd be curious, is the majority of your current commercial auto book, is that sourced through brokers? And two, in terms of the BOP business you are selling today, are you privy to the underwriting and loss ratio data that is ultimately going on to the third-party paper that you are using?

Susan Patricia Griffith
President, CEO & Director

So the majority of the BOP already know is from unaffiliated third parties. So we just rolled out our -- and sold our first policy on Good Friday for our BOP coverage. And we're going slowly because we want to understand the system implications, et cetera. So we have it in Ohio, handful of agents, we're going to add on more agents in May and then continue the rollout, so it would be slow and methodical just to make sure that it's a good process for the agents, a great product for the customer, et cetera.

So we -- slow and steady, what we're happy about is that we invested in this a couple of years ago because we think -- as we think about horizon 2 initiatives, this was an important piece of it. And again, John will go into -- John Barbagallo will go into detail on the next webcast on what we're doing in commercial. We don't use the data from the other companies, so it's to inform us of what we do. We bifurcate that data.

Michael Zaremski

And your commercial auto book today -- is the commercial auto -- is that sourced mostly through brokers?

Susan Patricia Griffith
President, CEO & Director

Commercial auto -- I get what you're saying. Through our independent agents, yes, the majority of our commercial auto business is -- does go through commercial agents. We rolled out the BQX, the soft launch of BQX a couple of months ago, which is BusinessQuote Explorer, so we'll continue to have more direct and online but right now, I'd say about 95% of ours goes through independent agents.

John Peter Sauerland
VP & CFO

In terms of premium, for first quarter is about 84% of premium went through independent agents. So -- but slight majority.

Operator

So I'm actually going to take a question from the webcast right now. So this question is from a current shareholder, and their question is what is Progressive's view on investing in alternative asset classes, specifically private equity?

Susan Patricia Griffith
President, CEO & Director

Do you want to take that one, Jonathan? Okay. We'll have Jonathan Bauer answer that.

Jonathan Bauer

Sure. Thanks very much for the question. We take a very thoughtful approach to all of our investing at the moment. How we've currently decided to split it out is public equities that we indexed, as I mentioned before. Actively managing fixed income. Within that fixed income portfolio, we focused on having more liquid securities, as we mentioned in terms of mortgages, treasuries and corporate bonds. We always stay open to looking at other opportunities in terms of alternative asset classes. But at this point in time, we felt that we'd prefer to stay in more liquid asset classes and have chosen not to invest in private equity.

Operator

The next question comes from the line of Jeff Schmitt with William Blair.

Jeffrey Paul Schmitt
William Blair & Company L.L.C., Research Division

Question on severity, it -- with 7.8% in the quarter, looks to be above the industry or at least at the high end of the industry. I think it had been running below for you guys fairly recently. Do you have any sense on what may have driven that shift?

Susan Patricia Griffith
President, CEO & Director

We don't have the quarter, the industry quarter results yet. So we'll compare after that. But there is the 3 components that we talked about, the BI severity specifically, our soft tissue in several states, the physical damage or -- of severity in terms of components and car parts. And then our PIP severity went up a little bit based on, I talked about this in the last call, on a Supreme Court case that the industry lost in Florida. So -- and that's the main piece. We'll continue to watch it and watch what happens in industry.

John Peter Sauerland
VP & CFO

To what I'd add, we are looking at a quarter, and maybe you've seen a couple of other reads from other companies in the quarter. If you look over the long term, I mean, decades or even years, generally you see our severity trends track fairly well at the industry. We are also the subject of the same inflation trends for parts, for medical services, et cetera. Where you see our trend diverge from the industry is on frequency. So our frequency trends have either been going up less than the industry over the longer term or more recently going down more.

And we think there's a lot of things that go into that, but certainly we think our pricing segmentation goes into that, the underwriting efforts that I mentioned previously as well as our shift to a more preferred end of the customer spectrum. So over the longer term, I think you'll generally see our severity trends similar to the industry. We think if you look over the longer term again, the frequency is where we find the advantage.

Jeffrey Paul Schmitt
William Blair & Company L.L.C., Research Division

Okay. That's helpful. And then just one more on the Robinsons segment. Could you discuss how growth looks there versus a year ago and what your outlook is?

Susan Patricia Griffith
President, CEO & Director

Yes, growth continues to be strong. We're growing the fastest in Robinsons. I think in both direct and agency by a lot. We only have about 2.5% of the home market, with our PHA and our platinum agents. So we believe that there is a lot of runway there. And we have our agency team working with our agents to make sure they think about us when they are thinking about auto and home bundled, but that's a place where we continue to be really bullish on our ability to grow and grow substantially, which, of course, the more we have that preferred segment relates to frequency. So we're really, really excited about that.

John Peter Sauerland
VP & CFO

And on the direct side, we've obviously been putting a lot of new products in place or new methods of quoting, HomeQuote Explorer is a great example where we're making it easier for Robinsons to either graduate to Robinsons with us or come to us as new customers, our advertising mix has shifted towards messages that are geared towards that segment of the population. So that's helping drive business there. And as Tricia mentioned, getting agents to change behavior around whom they think of Progressive best serving, it takes a while. And we've seen that shift she mentioned earlier in agents quoting us on we think their most preferred households, and within the independent agent channel, we'll actually find a lot more potential for Robinsons growth than the direct channel. So we're really excited about that.

Operator

The next question comes from the line of Meyer Shields with KBW.

Meyer Shields
Keefe, Bruyette, & Woods, Inc., Research Division

Tricia, I was hoping if you could comment on whether the growth that you're seeing in the Robinsons sector implies that all else equal, Progressive is less vulnerable to market competition than 5 years ago or some prior period?

Susan Patricia Griffith
President, CEO & Director

Yes. I mean it's hard to quantify, but I would say, that's one of the reasons why we chose to invest in ASI, and invest in relationships with other unaffiliated partners. We know from data when customers have more than 1 product, their likelihood to stay is longer. Their stickiness is better. And we wanted to be as part of our strategy, we want to make sure that -- and I think you said this in a webcast, I think, John Sauerland said, we want to be able to say, yes, we got that, we can get that for you. And so whether it's on our paper or not, yes, I do believe you are less vulnerable if you have more and more products and services that can take care of as many consumers as possible.

Meyer Shields
Keefe, Bruyette, & Woods, Inc., Research Division

Second question, unrelated. Is the shift to the Robinsons having any impact on the average claim settlement in the legacy nonstandard book? In other words, is it changing the mindset of claims adjusters?

Susan Patricia Griffith
President, CEO & Director

No. I mean I would say our claims adjusters -- and this is I think a little -- couldn't be different than what I've heard from adjusters that come from other companies. We focus on every customer, whether they are Sam or Diane Wrights or Robinsons, we make sure we give them the best service ever. So I don't believe that Robinsons affect the Sam's. Of course, a lot of the Robinsons have higher limits, so that could be a dependent factor as well. But I don't think that has an effect.

Julia Hornack

Well, that actually appears to be the last question in the queue. So Joelle, I'm going to hand the -- hand it back over to you for the closing scripts.

Operator
That concludes the Progressive Corporation's First Quarter Investor Event. Information about a replay of the event will be available on the Investor Relations section of Progressive's website for the next year. You may now disconnect.