S&P Capital IQ

CONTENTS

The Allstate Corporation NYSE:ALL

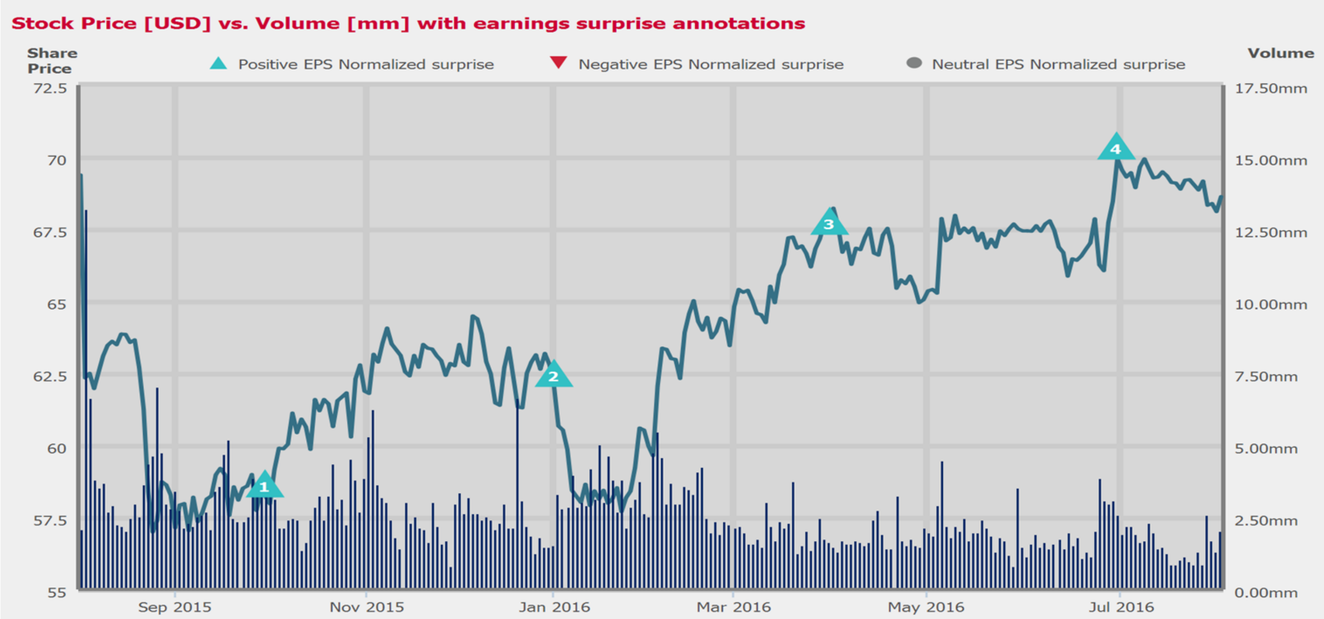
FQ3 2016 Earnings Call Transcripts

Thursday, November 03, 2016 1:00 PM GMT

S&P Capital IQ Estimates

	-FQ3 2016-			-FQ4 2016-	-FY 2016-	-FY 2017-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	1.26	1.26	0.00	1.62	4.33	6.17
Revenue (mm)	7864.33	7869.00	0.06	7906.50	31302.50	32154.12

Currency: USD
Consensus as of Nov-03-2016 11:52 AM GMT



- EPS NORMALIZED -	CONSENSUS	ACTUAL	SURPRISE
FQ3 2015	1.30	1.52	16.92 %
FQ4 2015	1.33	1.60	20.30 %
FQ1 2016	0.67	0.84	25.37 %
FQ2 2016	0.58	0.62	6.90 %

Call Participants

EXECUTIVES

Don Civgin
President of Emerging Businesses - Allstate Insurance Company

John Griek

Mary Jane Fortin

Matthew E. Winter
President and President of Allstate Insurance Company

Steven E. Shebik
CFO & Executive VP

Thomas J. Wilson
Chairman & CEO

ANALYSTS

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

Elyse Beth Greenspan
Wells Fargo Securities, LLC, Research Division

Joshua David Shanker
Deutsche Bank AG, Research Division

Kai Pan
Morgan Stanley, Research Division

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Robert Ray Glasspiegel
Janney Montgomery Scott LLC, Research Division

Ryan James Tunis
Crédit Suisse AG, Research Division

Sarah Elizabeth DeWitt
JP Morgan Chase & Co, Research Division

Presentation

Operator

Good day, ladies and gentlemen, and welcome to the Allstate Third Quarter 2016 Earnings Conference Call. [Operator Instructions] As a reminder, today's program is being recorded.

I would now like to introduce your host for today's program, Mr. John Griek, Head of Investor Relations.

John Griek

Thank you, Jonathan. Good morning, and thanks, everyone, for joining us today for Allstate's Third Quarter 2016 Earnings Conference Call. After prepared remarks by our Chairman and CEO, Tom Wilson; Chief Financial Officer, Steve Shebik; and myself, we will have a question-and-answer session.

Yesterday, following the close of the market, we issued our news release and investor supplement, filed our 10-Q for the third quarter and posted the results presentation we will discuss this morning. These documents are available on our website at allstateinvestors.com.

As noted on the first slide, our discussion today will contain forward-looking statements about Allstate's operations. Allstate's results may differ materially from these statements, so please refer to our 10-K for 2015, the slides and our most recent news release for information on potential risks.

Also, this discussion will contain some non-GAAP measures, for which there are reconciliations in our news release and our investor supplement. We are recording this call, and a replay will be available following its conclusion. And I will be available to answer any follow-up questions you may have after the call.

And now I'll turn it over to Tom.

Thomas J. Wilson
Chairman & CEO

Well, good morning. Thank you again for investing your time to keep up on our progress at Allstate. I'll start with an overview of results, then John and Steve will provide more detail. Also here with us this morning are Matt Winter, our President; Don Civgin, the President of our Emerging Businesses; Mary Jane Fortin, President of Allstate Life and Retirement; and Sam Pilch, our Corporate Controller.

This quarter, we delivered balanced operating results. Underlying auto margins improved. Homeowners results remained strong, and we generated good total return on the investment portfolio.

Let's start on Slide 2. Net income for the quarter was $491 million and operating income was $474 million, which was $1.26 per share. Operating income was adversely affected by elevated catastrophe losses and a $99 million increase in reserves of discontinued lines. The property-liability recorded combined ratio was 95.5 for the quarter. And the underlying combined ratio was 88, both for the quarter and the first 9 months of the year, which is at the favorable end of the full year outlook that we gave you in February of 88 to 90. Investment income was 7.3% lower than last year's third quarter, reflecting last year we sold about $2 billion of long duration bonds in the payout annuity portfolio. And the results were lower interest income, and we had strong return on the performance-based portfolio in 2015's third quarter.

Total investment returns remained strong at 1.3% for the quarter and 5.2% for the year, driven by both net investment income and price appreciation in the bond portfolio.

Let's go to Slide 3. On a total company basis, about half of the decline in property-liability policies was offset by providing consumers a broad set of unique products using different brands and distribution channels, most notably because of Allstate Benefits. The results for each of the 4 segments of the property-liability market are shown on the bottom diagram on this page here. So the Allstate brand, which is in the lower left, comprises 90% of premiums written that serves customers who prefer branded product and value local relationships. Policies in force at the Allstate brand declined in the third quarter of last year by 2.3% as we continue to raise auto insurance prices. And you can see the impact of those actions on both new business and retention.

Allstate brand auto net written premiums grew by 4.1%, which reflects a 7.7% increase in average written premium. If you continue down that column, the Allstate brand auto insurance underlying combined ratio was 95.9 for the third quarter of 2016, which is 2.2 points better than the prior year quarter.

Homeowners in the next column had a recorded combined ratio of 75.9. The underlying combined ratio in the far right column was 86.9 for the Allstate brand.

Moving over to the right. Esurance serves customers that prefer a branded product but are comfortable in handling their own insurance needs. Policies in force decline 0.6% from a year ago due to lower new business and retention. Net written premium grew by 5.4% as the 6.4% increase in auto average premium more than offset policy declines. The recorded underlying combined ratios of 109.8 and 106.0 reflect a different economic model in this segment, where acquisition costs are expensed really in the first policy year versus spread out as commissions over the life of the policy. The underlying auto loss ratio of 75.7 is still above our long-term target, so we continue to implement margin improvement actions.

Encompass in the upper left competes for customers that want local advice, are less concerned about a branded experience and are served by independent agencies. Encompass remains focused on improving returns. And consequently, policies in force declined by 12.6% from the same quarter a year ago. The recorded underlying combined ratios of 98.3 and 89.3 in the third quarter were better than the third quarter of 2015.

Answer Financial in the upper right serves brand-neutral self-service customers. It's an aggregator that does not underwrite insurance risks. Total non-propriety written premium of $158 million in the quarter grew by 6% from the prior year.

Let's turn to Slide 4. As you know, we established operating priorities each year to focus our decision and to provide clarity to all of our stakeholders. The first 3 priorities are intertwined and relate to ensuring that we have a profitable and sustainable business model. We balance these efforts with a focus on both short-term results and long-term value creation. To better serve customers, we're building new capabilities for Allstate agencies so they can be better trusted advisers. For example, we successfully introduced a new personalized insurance proposal and now have done over 2 million of those. At the same time, to earn an appropriate return on capital, we've increased auto insurance prices, which has a negative impact in customer satisfaction and growth. To grow the entire enterprise, we're leveraging our brands, customer relationships and capabilities, including having Esurance sell homeowners insurance and expanding Allstate Benefits.

Now as you know, we proactively invested our $81 billion investment portfolio to achieve the best risk-adjusted return over time periods that are either appropriate for the liabilities event or consistent with our risk appetite on capital. Steve will talk more about the investment results in just a minute.

Lastly, to create long-term growth, we're expanding Arity, our connected car platform, and working to further expand our portfolio of consumer protection products.

Now let me turn it over to Don.

Don Civgin
President of Emerging Businesses - Allstate Insurance Company

Thanks, Tom. I'll start on Slide 5. Property-Liability earned premium of $7.9 billion in the third quarter of 2016 was 2.9% higher than the same period last year. During the first 3 quarters of 2016, earned premium grew by 3.5%. Third quarter catastrophe losses of $481 million were 78.1% higher than the prior year quarter. Catastrophe losses of $2.3 billion through the first 9 months of 2016 were $908 million higher than the first 3 quarters of last year. The recorded combined ratio for Property-Liability was 95.5 in the third quarter of 2016. When we exclude catastrophes and prior year reserve reestimates, the underlying combined ratio for the third quarter and the first 9 months of 2016 were both 88.0, which is better than 2015 and at the favorable end of our annual outlook range of 88 to 90. Property-Liability operating income of $452 million in the third quarter 2016 was 17.8% below prior year results due to higher catastrophe losses and a $99 million reserve increase for discontinued lines.

In the chart on the bottom left, the blue line represents net written premium growth, while the red line shows policy in force growth. Property-Liability's policies in force were 2.6% below the third quarter of 2015, while net written premium increased by 2.1% over the same time period. These trends were heavily influenced by our auto profit improvement actions across underwriting brands. The widening gap between these 2 trend lines reflects increased average premium per policy.

The bottom-right graph shows the recorded combined ratio in red in comparison to the underlying combined ratio in the blue bars. And it illustrates that most of the quarter-to-quarter volatility is due to catastrophe losses.

Going to Slide 6. The chart on the top left shows the quarterly underlying loss ratios and combined ratios for Allstate brand auto. The underlying combined ratio of 95.9 in the third quarter of 2016 improved by 2.2 points compared to the third quarter of 2015, driven by a lower underlying loss ratio. As seen on the chart on the top right, annualized average premium increased to $966 or 7% compared to the prior year, while underlying loss and expenses increased by 4.5%, increasing the favorable gap to $40.

Underlying loss and expenses are shown by the red line. Underlying losses are based on a sophisticated and segmented approach to establishing loss reserves. We use a wide range of operational and financial statistics and multiple techniques to estimate loss costs. For example, gross frequency reflects actual notice counts reported in a particular time period, and we use that data to record losses and reserves for each notice count received as opposed to estimating an accident year loss ratio based on aggregate claims data. Similarly, paid frequency is used to estimate how many of those reported claims will ultimately be paid and helps us measure and better manage paid severity claim staffing.

To provide you insight into the underlying results, we disclosed several frequency statistics and paid severity transfer the property damage and bodily injury coverages, which are shown on the bottom 2 graphs. Property damage claims represent about 20% of loss costs and reflect both the frequency of accidents and the average paid severity for claims. As you can see, frequency in the blue bar began to rise in the last quarter of 2014 and first quarter of 2015 and then accelerated until being essentially flat for the last 2 quarters. Paid severity, however, continues to increase, although the rate of increase has come down throughout 2016.

Bodily injury claims comprised about 30% of loss costs and have more volatile underlying statistics because of the longer time period it takes to settle these claims and a greater dispersion in the amounts paid per claim. The decrease in paid frequency and increase in paid severity during the third quarter are related and reflect payment mix and claim closure patterns that were impacted by changes in bodily injury claims processes to require enhanced documentation of injuries and related medical treatments. And as a result, fewer claims were opened and paid in the third quarter of 2016, but those that were paid had higher average payments. Normalizing for the process enhancement made to bodily injury claims in the quarter, both injury paid claim frequency and severity consistently measured would have been generally consistent with those observed during the first half of 2016.

One of the components of our profit improvement plan is claims operational excellence. We are always looking for ways to improve claims processes and continue to settle claims fairly, deliver the best possible claims experience to our customers and settle claims as efficiently as possible. And while claims process changes have impacted some of our operational statistics, we take the impact of those changes into account when setting reserves. And as a result, claims process changes have not impacted our recorded underwriting results.

Slide 7 provides detail on the auto profit improvement plan. We have continued to diligently pursue approval for higher auto prices where appropriate. And you can see on the lower left chart that in the third quarter 2016, we received approved rate increases estimated at $209 million across all 3 brands. This brings our total for the first 9 months of 2016 to $1.2 billion, higher than the full year of 2015.

The chart on the lower right shows average premium increased 7.7% compared to the prior year quarter, an acceleration of the trend we have seen since the middle of last year. And average net earned premium shown by the gray line lags average written premium and is up 6%.

Moving to Slide 8. The chart on the left shows Allstate brand auto policies in force have decreased, which reflects the auto margin improvement plan and are 2.5% below the prior year quarter. The chart on the right highlights that while new business and customer retention have been impacted by our profit improvement actions, our absolute levels in new business production have stabilized over the last couple quarters.

Slide 9 highlights the continued strength of Allstate brand homeowners. The chart on the left shows the recorded combined ratio remained a very strong 75.9 in the quarter despite significant catastrophe losses. On a trailing 12-month basis, the recorded combined ratio is 84.3.

The chart on the right shows annualized average earned premium per policy increase by 2.1% over the prior year quarter, and average underlying loss and expense per policy increased by 2.4%. The gap between these 2 measures improved by $7 compared to the third quarter last year.

And now I'll turn the call over to Steve.

Steven E. Shebik
CFO & Executive VP

Thanks, Don. Slide 10 provides an overview of our profitability and growth trends for Esurance and Encompass. The Esurance recorded combined ratio as shown on the top-left chart was 109.8 in the third quarter and 106.0 when catastrophes, prior year reserve reestimates and the amortization of intangibles are excluded. Do remember, with the direct distribution model, combined ratios are impacted by acquisition expenses being written off much faster than the agency channel, where commissions are spread over the policy life. This result is also adversely impacted by expenses related to expanding into homeowners insurance and new markets. The underlying loss ratio of 74.7 is higher than our long-term target, and we will continue to take actions to raise Esurance returns.

On the top right, Esurance written premium was up 5.4%, while policies in force declined by 0.6 points compared to a year ago, reflecting the auto improvement initiatives.

The chart on the bottom left shows Encompass' improvement in both recorded and underlying combined ratios. The recorded combined ratio of 98.3 was 3 points better than the third quarter a year ago, and the underlying combined ratio of 89.3 improved by 1.6 points.

The chart on the bottom right shows the top line trend, which, as you can see, was impacted by profit improvement actions. Policies in force shown on the bottom right by the gray line declined by 12.6%, while net written premium represented by the blue line declined by 9.7%. Encompass will continue to take pricing, underwriting and expense actions in order to achieve target margins.

Turning to Slide 11. Allstate Financial premiums and contract charges totaled $571 million in the third quarter of 2016, an increase of 6.1% when compared to the third quarter of 2015. Allstate Benefits grew 11.3% in the third quarter with an increase of 444,000 policies over the prior 12 months. Allstate Financial's operating income and net income were $94 million and $80 million in the third quarter of 2016, respectively.

Operating income was $44 million lower than in the third quarter of 2015, due primarily to lower investment income. Across the bottom, we show net an operating income for reach business. The Allstate Life business operating income of $51 million in the third quarter decreased $7 million compared to last year due to higher expenses and lower investment margins.

Allstate Benefits operating income of $25 million for the third quarter was relatively consistent with the third quarter of last year.

The annuity business generated operating income of $18 million, down $36 million from third quarter 2015, primarily due to reduced investment income resulting from the 2015 portfolio repositioning and lower limited partnership income compared to a very strong prior year quarter.

At the top right of the slide, we provide the liability balance invested mix for our immediate annuity business before and after the portfolio repositioning. The proceeds from the sale of long-duration bonds are being invested over time in performance-based and public equity investments, as you can see by the increased allocations of these assets in the chart.

While we will maintain a significant allocation to interest-bearing investments, we will continue to increase our performance-based investments, which are well suited to the long-dated immediate annuity liabilities.

Slide 12 shows our investment results. We increased our emphasis on performance-based investment after the financial crisis to replace market risk with idiosyncratic risk by emphasizing ownership over lending. This increased allocation to investments, such as private equity, real estate, timber and agricultural-related businesses from $4.1 billion a year in 2012 to $5.8 billion in 2016, as shown on the upper-left chart. These investments require a higher economic and regulatory capital, but we expect they will deliver attractive long-term economic returns for our shareholders.

Total return for the third quarter in the upper-right was a solid 1.3%, reflecting a contribution from investment income of 90 basis points and an increase in the portfolio's value primarily from lower market yields.

Gross investment income is shown on the bottom-left graph. You can see performance-based investment results shown in gray are the primary source of income variability between quarters. Performance-based investments generate income of $147 million for the quarter, somewhat lower than the strong results from last year.

Investment yield by business segment is shown at the bottom right. The Property-Liability yield is closer to current market yields as a result of its shorter duration. Allstate Financial's yield has obviously impacted last year's immediate annuity portfolio repositioning, but the yield remains higher due to its longer duration and because investment cash flows have been used largely to fund liability reductions.

Slide 13 illustrates the continued strength of our capital position and highlights our financial flexibility. Shareholders' equity increased to $20.9 billion in the third quarter with a debt-to-capital ratio of 19.6%, a reduction of 0.4 points from the prior year quarter. Book value per common share of $51.48 increased by 8.3% over the same period a year ago, primarily due to increased unrealized gains in the investment portfolio and income generation partially offset by capital return to shareholders. We held $2.7 billion of holding company assets at quarter's end, which, when combined with our modest leverage ratio, provides a high degree of financial flexibility.

During the third quarter, we returned $389 million to common shareholders through a combination of dividend and share repurchases. By the end of the third quarter, we returned almost $1.5 billion to our common shareholders.
Now I'll ask Jonathan to open the line up for your questions.

Question and Answer

Operator

[Operator Instructions] Our first question comes from the line of Elyse Greenspan from Wells Fargo.

Elyse Beth Greenspan
Wells Fargo Securities, LLC, Research Division

First question, in terms of the commentary that you provided on severity in terms of bodily injury and the process changes you saw in the quarter. So it seems like that was just a reconfiguration between frequency and severity, and we'll see those trends move back to normal in the fourth quarter. So I guess, is it -- the right way to think about it is that there was no real impact on your underlying auto margin from those changes?

Matthew E. Winter
President and President of Allstate Insurance Company

Yes. Elyse, it's Matt Winter. Thanks for the question. Well, as you correctly pointed out, there's a fluctuation, as you see on Slide 6. You see some offset between frequency and severity. That being said, there were some process changes that do influence some of those results. So we'll see it normalize, but it may not go back to exactly where it was previously because there were some of those changes. As John referred to in his remarks, there's some enhanced documentation requirements. So the mix changes. I think in response to a question you asked last quarter, I talked about the timing impact and the peristalsis that sometimes occurs in the claims area where you have a buildup of claims that are then processed. And especially in BI with the long tail on it, you can see that happen. So you can expect to see some fluctuation. But the general trend here that you see at the bottom right on Slide 6, which is that, overall, the combination between frequency and severity is declining and offsetting itself, that we expect to continue.

Elyse Beth Greenspan
Wells Fargo Securities, LLC, Research Division

Great. And then just to follow on to that, as you said, the -- getting to a more favorable loss cost environment, we talked about frequency and severity. How do you guys think about what type of rate you need to take from here? I mean, the level of rate increase did slow a bit in the quarter. Just kind of a forward view as you think about the rate you might take into Q4 and into 2017, just kind of high level.

Matthew E. Winter
President and President of Allstate Insurance Company

Well, I can't give you -- we don't forecast or predict rate that we're going to take in the future. What I can tell you is that we continue to look at actual rate need, and the rate need is based upon pay trends. We look at that rate need. We look at our indications, and we make determinations on a localized basis that take into consideration economic capital, the rate need, our competitive position and a bunch of other criteria in determining what our rate need is and in determining what rate we'll take. But I think it's impossible for me to predict for you what that will look like in the future.

Thomas J. Wilson
Chairman & CEO

So what -- this is Tom. I mean, to add my thoughts. So as the [indiscernible] increase rate, I mean, obviously, so as our costs go up, we need to recover those costs. So that's part of it. And if, in fact, those costs moderate over time, we will expect that component of price increases to go down. That said, we still need to increase our margin to where it has been historically. So I think you should expect that our price increases stay above our cost increases until the time we get back to our target margin.

Operator

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

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

I guess, one -- couple of questions here just outside of auto. But in Allstate Financial, as we look at this quarter post the disposition of Lincoln Benefit, should we be looking at these levels as sort of where you expect them to be? I mean, it seems like there's maybe a little bit of variability on one element of the business, but the others seem to be sort of squarely at that run rate. Just -- I'd love to get some -- a little bit of color on that.

Thomas J. Wilson
Chairman & CEO

Mike, let me make just a comment strategically about the position you talked about, then Mary Jane can talk about the results at Allstate Life and Allstate Benefit. So first, Lincoln Benefit. I think it was 2014 when we saw this. And we're kind of -- we kind of came around the track on that one already, and so you saw that really beginning in last year's numbers. This year, what you're seeing is a different strategic choice, which is the choice to do a different asset liability matching program in the annuity business. So those -- we have about -- as Steve mentioned, we have about $12 billion of payments that are due over the next 40 to 50 years in that immediate annuity business. Of course, we have to have investments that generate returns to make those payments. With current interest rates, it would not generate. If we took all that money and invested it, today, first, we couldn't get the right duration. Secondly, the rate on that would not be enough to generate enough earnings to pay all those amounts off, so we would then have to put some capital in. What we've chosen to do is put the capital in now and invest in equities, which will generate a higher return. When you get past the 10-year period, the return on equities is twice that of bonds, and the risk is about the same. So we think that's a good use of shareholder capital from a strategic standpoint. That's a different use of capital than the capital you're talking about freeing up from Lincoln Benefit. Mary Jane, you might want to make some comments about Life and Benefits.

Mary Jane Fortin

Yes. I'll answer that. So for the Allstate Life business, this quarter, the earnings were down. And in this quarter, we did have our annual review of DAC unlock. So this quarter does have the $2 million impact in the Life business for that. And also, we did have some onetime expenses that did impact the quarter, so that is impacting the results this quarter. We have been running favorable in our mortality, which is for the last 4 quarters, we have been experiencing favorable mortality, which has been impacting those results in a positive way. In terms of the annuities, as Tom mentioned, we've been actively putting the $2 billion to work. $1.3 billion has been put to work year-to-date. The returns on the performance-based investments were 10% in the quarter, which is in line with our long-term expectation. So that really reflects kind of the run rate for the annuity business. So we'll continue to actively invest in that asset class, which will generate earnings additionally over time.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Great. And then, Tom, one question for you, I guess, on Esurance. I mean, I remember post the transaction, you talked about -- a lot about economic value of policies and sort of thinking about that platform on a marginal basis. And I guess what we've seen here recently is we've been taking a lot of rate action consistent with what you're doing in the rest of the auto book. I guess I would think that like at a time like this, when you're still smaller than the 2 big direct peers, that this would be like the exact time that you would want to really grow that business maybe at a time when others are not growing -- or at least everyone is not growing as rapidly. Can you just comment a little bit about on that and sort of how you're thinking about it? It seems like -- feels like maybe Esurance is managing a little bit more the output in terms of earnings as opposed to that sort of platform-building element.

Thomas J. Wilson
Chairman & CEO

Okay, yes. Thank you, Mike. First, Esurance is a better company now than when we bought it because of the skills and capabilities we brought to it, whether that's branding, marketing, claims, pricing preferred, customers getting into the homeowners business. So we added value, and it's a good, strong company and a much stronger competitor now than it was 5 years ago. It has grown a lot. It's doubled in size. We accepted a lower return on capital from the auto insurance business at Esurance during that growth than we did from the Allstate brand because we wanted to lean into the growth, as you point out, but it was always above our cost of capital. So with ours, like, okay -- as Matt and Don and I and others, has talked about, we're like, okay, we'll take a lower term, but it's got to be above what our cost is because we should be creating shareholder value as we grow. That continues to be the case. We continue to write it above our cost of capital as we look at the vintage years of each of the products. That said, when we ran into the increase in frequency and severity that impacted all of the brands, we chose to slow growth some because we don't want to write it at below the cost of capital. We've now got our pricing position in a better place, so I do expect that we'll begin to grow that business again like we'll grow our other business. But we don't -- I don't feel like we're at the place right now where we should throw hundreds of million of dollars of marketing money at growth there, in part because while we've dramatically improved the brand, we still need to get our consideration and awareness up. And that takes a number of years to invest in that. So we like what we got. It's been growing. I think it can be -- it certainly has broadened our strategic platform and gave us a broader set of capabilities to compete in the market with. But it's not to the point where I feel like we should run hundreds of millions of dollars of underwriting losses. That said, we don't really manage them to the P&L. We manage them to the economics. And because we're big enough, we can take the underlying losses from that business if we believe it's economic.

Operator

Our next question comes from the line of Sarah DeWitt from JPMorgan.

Sarah Elizabeth DeWitt
JP Morgan Chase & Co, Research Division

On the severity trends, Travelers saw an uptick from higher attorney involvement, more fatalities and more occupants per vehicle. And they suggest that they might be recognizing a trend before the rest of the industry. Are you seeing anything on this front? Or how are you avoiding this?

Matthew E. Winter
President and President of Allstate Insurance Company

It's Matt, Sarah. We're not seeing the same kind of trends that some of our competitors have reported regarding severity. Clearly, if you look at our paid severity trends on the bottom right on Slide 6, you'll see that there's been some fluctuation. But for the most part, since the beginning of 2015, it held relatively constant and I'd say, in line with inflationary indices.

Sarah Elizabeth DeWitt
JP Morgan Chase & Co, Research Division

Okay. And then on the auto insurance underlying margin, should we expect any uptick in the fourth quarter because of seasonality? Does that tend to be a seasonally worse quarter? Or would rate increases more than offset that?

Thomas J. Wilson
Chairman & CEO

Yes, Sarah. Obviously, we can't give you a forecast for the fourth quarter because we don't do those forecasts. But I would go off a little bit and just say we're extremely comfortable with 88 to 90 underlying combined ratio being the range we're going to be and obviously, because we're at 88 flat for the first 3 quarters. What we'll do is in February, when we announce the full year results, we'll give you a new outlook for next year.

Operator

Our next question comes from the line of Kai Pan from Morgan Stanley.

Kai Pan
Morgan Stanley, Research Division

First question, do you have any early indication from Hurricane Matthew losses?

Thomas J. Wilson
Chairman & CEO

No. I mean, any indication. We have no indication we'd like to -- we plan to share with -- publicly. We obviously are active out there. We've gone -- we have claims people on the ground doing a bunch of work [indiscernible], a bunch of people doing stuff. But we have -- as you know, we have a normal monthly cat release, where if we have catastrophes over $150 million in a quarter. We disclosed it to you all. That is -- when is that?

Steven E. Shebik
CFO & Executive VP

2 weeks.

Thomas J. Wilson
Chairman & CEO

It's in 2 weeks on Thursday. So we -- and because that was an October storm, it would fall into that, so you should have some indication of what the number would be if we do a release in 2 weeks.

Kai Pan
Morgan Stanley, Research Division

Okay, good. We'll be waiting for that. Your core loss ratio in auto improved quite a bit year-over-year, but it's still much higher than the 60%, 80% average in, like, 2013 and '14. Is that still the target you want to get back to? And how long could it take?

Thomas J. Wilson
Chairman & CEO

Well, first, that's the $100 per share question. The -- I'll maybe answer and Matt will have some -- I'll give you part of view, and Matt will share with you his. First, we don't really just target the underlying, we target the reported. So we believe that as printed is what you need to shoot for. We have -- there's nothing that I see in the value we provide to consumers or in the competitive space that would tell me that we couldn't earn the kind of returns in the auto business that we have earned historically. Nothing has changed in terms of our skills and capabilities other than we've gotten better. So I think we should be able to earn the kind of economic returns we earned in the past. Matt, you might want to make a comment about target combined ratios.

Matthew E. Winter
President and President of Allstate Insurance Company

Yes. It's Matt. The only thing I'd add to what Tom said because I think he's 100% correct, fundamentally, there's nothing that's changed in the overall business that would imply limitations that didn't exist before regarding our ability to earn appropriate returns. But the way we really manage the business is towards the creation of long-term economic value. And so that's not just targeting a specific combined ratio, whether it's recorded or underlying. It's the combination of earning an appropriate return and being able to grow the business at that appropriate return. And so we will optimize around long-term profitable growth in the business.

Kai Pan
Morgan Stanley, Research Division

Okay. Then related, at what point are you stepping back the rate increases more focusing on the [indiscernible]?

Thomas J. Wilson
Chairman & CEO

I think what Matt said was here's -- let me see -- one more layer of detail on that. Until we know what frequency and severity is in the future, we can't really determine when we'll be changing our pricing, right? So if frequency and severity keeps going up, we'll have to continue to raise our prices so our customers pay for the -- an appropriate amount of money for both the costs we have and the returns we should get given our skills, capabilities and the capital we put at risk. To the extent that frequency and severity level out, then -- and we got back to the kind of returns Matt was talking about, then you would see it come down. But it's really -- until you can predict frequency and severity, you can't really predict future price increases.

Operator

Our next question comes from the line of Greg Peters from Raymond James.

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

I wanted just to follow up on some of the commentary on the recorded versus the underlying combined ratio. And I noticed in one of your answers, Tom, you said you wanted to increase the margin back to where it has been historically. And I guess when I'm looking at an 88% underlying combined ratio, considering all the headwinds that you guys have had to deal with, it's a pretty impressive result. And I've always, in the back of my mind, been thinking strategically that as the loss ratio -- the underlying loss ratio began to improve, that you would start ramping up expenses again, advertising, et cetera. Has there been any change in your approach or thinking on that?

Matthew E. Winter
President and President of Allstate Insurance Company

Greg, it's Matt. Let me try to take that. So as we shift out of rate-taking mode and enhanced focus on profitability and get back to a more balanced approach, it's not just a question of just ramping up expenses for advertising because that's just one component of what's necessary to get the system growing. So it's multiple components. It's quote volume. It's rate competitiveness, which impacts close rates. It's capacity in agencies. And it's number of points of presence. And what happens when you're unfortunately taking a fair amount of rate, and we have over the last several quarters, is it impacts all of those things. It's not just that you're not advertising. A lot is you're eating up agent capacity, you're impacting your close rate. It's hard to put on new agencies in that environment, and so your number of points of presence tends to stabilize. So as we get more stable and as we believe we can see frequency and severity stabilize and that puts us in a better position to begin the growth initiatives, you'll see a whole bunch of things change, and one of them might be some additional marketing expense. But it's only a small component. And I would that marketing in and of itself, if you don't have the agent capacity and if your competitiveness isn't there, it's not a very efficient spend. So we'll consider that among the other levers that are available in the business to work towards long-term profitable growth.

Thomas J. Wilson
Chairman & CEO

Great. That's a good question. And I think there's -- I want to make sure we're clear on our philosophy on expenses. So I think some people, as we've gone through this increase in frequency and severity that Matt talked about, look at the reduction in expenses, so we'll just cut expenses so we could make our number. That's not the case. Our philosophy on expenses is not let's do a target P&L number. It's -- first, don't spend it if your customers don't want it. Do spend it if your customers do want it. Secondly, Matt talked about this integrated basis. And that's if you advertise and your agency is not ready or your competitive position is not right, then it doesn't really make any sense. So we really do run it on an integrated basis. And then we also invest for the long term. So I don't want you -- in 2011, remember, I think I announced it, we made maybe like $750 million or something like that in net income, and we didn't back off a wit on our advertising spend because we knew we needed to do that to stay competitive for the long term. So we will always have things, whether it's advertising, technology, investing. So we try to manage it really on the long-term economics that Matt was talking about. So it's our philosophy. But -- and sometimes, when I read some of the reports that have come out, it feels like people are thinking we've got this. We're managing just to get that P&L number, and that's not the way we run our business. To the extent we can cut our costs, Matt's got a big program going on in continuous improvement. We're reducing our costs as aggressively as we can. To the extent we need to use that money to invest in something else, we will because -- as long as we think it makes sense for us.

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

That's great color. Considering you've held on to your underlying combined ratio target and all the headwinds, it still is a remarkable accomplishment. Just one other area, and I noticed that you referenced it briefly on -- in your slides. I think Slide 3. Just -- continues to be a considerable amount of oxygen spent on driverless cars and its impact on auto insurance. Can you give us an update on what you're doing with Arity and what your thinking is in this area?

Thomas J. Wilson
Chairman & CEO

Sure. I'll go up for a second, and then I'll come down very quickly to Arity. So we think the personal transportation industry is going to change dramatically, and we think that's an opportunity for us to do more for our customers. The reason it will change dramatically as it's incredibly inefficient, so we have about $4 trillion tied up in hardware called cars and trucks and stuff like that. We spend about $2 trillion a year in direct costs, making that work. Capacity utilization is in the -- even in peak hours, is in the 30%, 34% range, and there's one person in a car. A 20% improvement in the efficiency of that system will be a 5% increase in household income in America. We think that's going to happen. It's going to take a while to happen because it's an economically dispersed system. Nobody controls all of this. There's lots of different pieces to it. So it's not just the autonomous car. It's shared vehicles. It's machine to machine communication. It's better stoplights. It's -- there's a whole bunch of stuff that's going to change in that system. Arity is one of our efforts to take advantage of that. So Arity is outside the insurance company. It provides services to Allstate and Esurance. The services that the insurance company gets from it is, first, it gives them the ability to do a more accurate price for our customers because we know exactly how they drive, where they drive and when they drive. And -- but we have a different model than others. We've taken it beyond pricing to include things like improving the driving experience, so adding applications onto our continuous connection to help those customers have a better driving experience, and then also to use that technology for other things. So there's many other uses -- many other ways that value could be created by cars being connected. We can share that value with customer. We can use that value to reduce cost for other people and capture those costs. There's really a 3 focus -- 3-part focus: better pricing, better services and additional ways to use a connected car. So Arity is pursuing all 3 of those. It will do that for our insurance companies. We'll do it for noninsurance companies, and we will also do it for other insurance companies as well. So we think it's a platform where we will all be stronger because we are together without giving up our competitive ability to price with our own data in the marketplace.

Operator

Our next question comes from the line of Ryan Tunis from Crédit Suisse.

Ryan James Tunis
Crédit Suisse AG, Research Division

So I just had a follow-up on some of these process changes. And I guess, first of all, if you could just elaborate a little bit on the thought process that went into putting those in place. And also, is it possible that those changes could have a positive exogenous impact on frequency going forward? In other words, was the lack of those changes potentially something that maybe caused frequency to spike up in 2015?

Matthew E. Winter
President and President of Allstate Insurance Company

Ryan, it's Matt. So we'll distinguish between process changes that impacted PD and those that impacted BI. If you recall in the last quarter and potentially the quarter before that, I referred to our desire in this environment to capture more and more information regarding the claim and PD so that we're better able to manage staffing costs and appropriately serve our customers and ensure that the claims machine is ready to deal with and help out customers at this time. So we began capturing a greater amount of information at first notice of loss, especially on the PD side. And so we told you at that point, and it continues to hold true, that there's a differential between the gross and the paid and that we will overcapture information on PD and have some of those claims closed without payment. And that's okay as far as we're concerned. We're more interested in effectively managing the system and taking care of customers than anything else. And so if we have to have some dislocation in the numbers and some volatility in the numbers to do that properly, we'll do that. On the BI side, as John said in the opening comments, this really had to do with just requiring some enhanced documentation for injuries and related medical treatment in our numbers. And so that does influence the mix. It does influence the -- because it impacts the mix and the timing, it impacts both the frequency and severity. But it -- none of these things impact our overall actual loss trends or our reserving or the P&L because, as John mentioned in his opening comments, all of these changes and all of this information is factored in along with our pay trends and all of the other information that we review on a very careful basis in setting our reserve levels and determining our actual loss cost. So yes, we have some volatility in some of the operational claim statistics that we show you. But no, it doesn't imply any real change in the actual P&L-type statistics that we manage the business on, take rate based upon and report on.

Thomas J. Wilson
Chairman & CEO

Ryan, this is Tom. Let me -- maybe one other additional angle on that. We're always trying to get better, right? So -- and you see that show up. As Matt points out, I think splitting in those 2 categories is absolutely right. You will see to the extent -- we're pretty -- the way we do our reserving, we -- if we see it, we book it, and we don't -- but we have to see it. So to Matt's point, you do see it in PD earlier, so those claims tend to get resolved in about 90 days to the extent we're getting better. And to your extent, you would see it in this stuff on the BI basis. That takes several years to really get your arms around it, so that tends to be -- it takes much longer to settle those cases. So whatever we've done in opening practices, to Matt's point, that is reflected in our loss cost. And if you look at our reserving practices over a 10- or 20-year period, we have a pretty consistent ability to accurately predict what losses are.

Ryan James Tunis
Crédit Suisse AG, Research Division

Okay, that's helpful. And then just a follow-up on, I guess, how to think about the reunderwriting of the book, the repricings. We've seen retentioning come down, and obviously, we associate that with better margins. But I'm curious if -- maybe you guys can talk a little bit about how you make sure that you're getting -- that you're not losing policyholders that are already meeting profitability objectives. Like, in other words, is there may be a way you can quantify for every 3 drivers you lose because they don't want to renew at the rate that's appropriate, you maybe lose one because they -- you had a -- that you wouldn't have wanted to lose. And I'm just curious. How much of the loss -- or yes, the -- how much of the loss retention potentially is you guys losing clients that were already meeting profitability hurdles?

Thomas J. Wilson
Chairman & CEO

Ryan, Matt will give you a specific answer to your question, but I would say we don't want to lose any customers. We just want to get the right price for them.

Matthew E. Winter
President and President of Allstate Insurance Company

Ryan, it's Matt. So let me follow up on that. It's a really good question. And I think it's important to remember, I've been talking during this entire profit improvement program over the last 18 months about the fact that we -- as we've taken rate, tended to take segmented rate. And that is we did not just spread rate along the entire book in any geography, but did it by sub-segment looking at those categories of customers where we were having margin pressures. So we didn't take the rate in equal doses across an entire book but, in fact, broke it down so that we were applying the rate need to those segments of the business that were most problematic. In some cases, that tended to be newer customers, shopping customers, segments that as we had expanded our books over the last couple years tend to be more volatile and they shop more often. And so if we had pressure in that segment and we took rate there, it's not surprising that we had some renewal pressure. But we try very hard, as Tom said, not to lose any customers and not to have any impact. But it is an unintended consequence -- an expected consequence but an unintended consequence of our need to get margin-appropriate. Any time you take rate, you stimulate shopping behavior. And we know that when you stimulate shopping behavior, you are going to lose some segment of those customers. And the same thing will happen to our competitors as they now take rate and begin to disrupt their books as well. We will be the recipient of some of that. And we hope that as we emerge out of -- you will recall, we took a lot of rate in the last quarter, in the second quarter and -- in some of the larger states, so that is why our number looked particularly large in second quarter. But as that comes down a little bit, we hope to be less disruptive to our customer base. And on a system-wide basis, we hope to get back to a more normalized basis, where we're not disrupting customers. It's not good for customers. Obviously, we think they're all better off staying with Allstate. And it's also not good for our agencies who are dealing with that disruption.

Operator

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

Joshua David Shanker
Deutsche Bank AG, Research Division

So just back to this BI, PD recalibration. Is there any risk in future quarters as you go through a processes change that we've missed something and this is a -- this will lead to, whether in your favor or against you, a favorable or unfavorable development?

Thomas J. Wilson
Chairman & CEO

Josh, it's Tom. We have a really sophisticated set of processes the way we estimate loss ratios. So as Matt mentioned, we start with the actual number of claims that get reported. We then go through it and say how many are paid, how many are not paid. We do it by state. We do it by risk class. We do it by coverage. We have a whole variety of statistical methods we use to determine what those trend lines look like and where it goes. We do it by year. We do it -- I mean, we slice and dice it whichever way. So the answer is we feel very good about the way in which we do it. It's after it. And I would just say there's obviously, as you point out, some volatility and some risk. But we try to mitigate that by being thorough. And so with the statistic you see on the bottom of that page, you just -- one of many, many, many statistics we use to determine it. So we think we're after it and that we'll just continue adjusting it as we go, whether that's up or down.

Joshua David Shanker
Deutsche Bank AG, Research Division

So it looks radical to us because of the limited amount of information we're receiving from your end. Things haven't changed in that of a radical way.

Thomas J. Wilson
Chairman & CEO

I think that's accurate, yes. And there are times when I said that we'd give you that information because it -- we do try give you complete transparency, but hopefully it doesn't lead to misinformation as opposed to it's just one of many statistics.

Joshua David Shanker
Deutsche Bank AG, Research Division

And then on asbestos, I'm always surprised when you guys get the flu. Can you talk a little bit -- I mean, I -- we have heard this thing for how -- why you have exposure, why it's up right now, why unlike some of your competitors we shouldn't think this is really a necessity for it to be an annual event? And I'm modeling forward. Should I assume 0 in the years going forward? How should I think about it?

Thomas J. Wilson
Chairman & CEO

Well, I can't tell you what to assume going forward because we think that the reserves we have right now are accurate for what we will pay out in the future on a discounted basis. So that's [indiscernible].

Joshua David Shanker
Deutsche Bank AG, Research Division

That makes sense, of course. But in terms of -- you have indirect exposure. You didn't write those policies. Is that right?

Thomas J. Wilson
Chairman & CEO

No. We have 2 kinds of exposure. We have some indirect, as you pointed out, which is we did reinsurance with other people. We also have some direct exposure. We spend a fair amount of time, and that business is aggressively managed both in terms of the data we have, the -- collecting information on policies, what we plan on going to arbitration. As you know, we haven't written this stuff for a good 30 years. So -- but -- and when we've had our claim practices, our reserving practices benchmarked for their accuracy and effectiveness, we always hit high marks on that. So we think we're as good as -- in fact, better than the average in the industry. You can decide whether that's good or bad. If you look at our history, you would see that, occasionally, we do have to put up every [indiscernible]. We do look at it in some level of detail every year. I was going on to think that IBNR is like 50% to 60% [indiscernible].

Steven E. Shebik
CFO & Executive VP

58%, I think.

Thomas J. Wilson
Chairman & CEO

58%. So the incurred but not reported is more than half of the amount we have of. So -- and while not completely after its statistics, the survival ratio is double-digit in years depending on the coverage and stuff like that. But it's over 10 years for most of the policies -- or most of the coverages. So we feel -- it's out there. It's the gift that keeps giving. I can tell you that we used -- and environmental used to be much higher, and it came way down as asbestos went up. So because this stuff has been out there for so long and is likely to be out there for so long, some of the other trends that are not predictable show up. So people if back off on environmental cleanups, then your environmental stuff goes down. If asbestos -- if they find a new way to go after the sons and daughters of the people who were impacted by asbestos and say -- they got it by their parents coming home where you have asbestos on their clothes, that's a new litigation wave, and then it goes up. But we think it's about right, and it's not a huge portion of our liabilities on the balance sheet.

Operator

Our final question then comes from the line of Bob Glasspiegel from Janney.

Robert Ray Glasspiegel
Janney Montgomery Scott LLC, Research Division

Telematics, the -- this is an Arity commercial. Is it possible that it's already making a big difference for the companies that have it and the ones that don't? Are you seeing worse frequency and severity trends? And how's the launch going for Arity?

Thomas J. Wilson
Chairman & CEO

Let me see if I can answer your question succinctly. First, it is making a difference for those companies that have it. It's making a difference for us. I don't think that, that overwrites the overall industry impact of higher frequency and severity. So I don't think that telematics will enable you to get around the fact that there's just more miles driven and people get in more accidents when they drive more. So I don't think that's an answer for why some people's combined ratio does not appear to have moved as much as others. I can only answer what they do. I do think that it is an opportunity for us to further do more sophisticated pricing, for other people to do more sophisticated pricing, which, if you look back over a long period of time when we first moved into credit, first moved into more algorithmic pricing for auto insurance, has led to more stability in overall returns for the industry. So I will just point out the fact that many people today are moving their pricing with respect to frequency and severity because they have the analytics to know it. And so I think in the long term, it's just good for stability and lower volatility in auto insurance profitability.

Let me just close by thanking you all. So in looking forward, we're going to stay focused on our 5 operating priorities. We try to balance long-term and short-term priorities in a way that enables us to build a sustainable business model that creates values for our customers, our shareholders and all of our stakeholders. So thank you, and we'll talk in the fourth quarter.

Operator
Thank you, ladies and gentlemen, for your participation in today's conference. This does conclude the program. You may now disconnect. Good day.