S&P Capital IQ

CONTENTS

W. R. Berkley Corporation NYSE:WRB

FQ4 2012 Earnings Call Transcripts

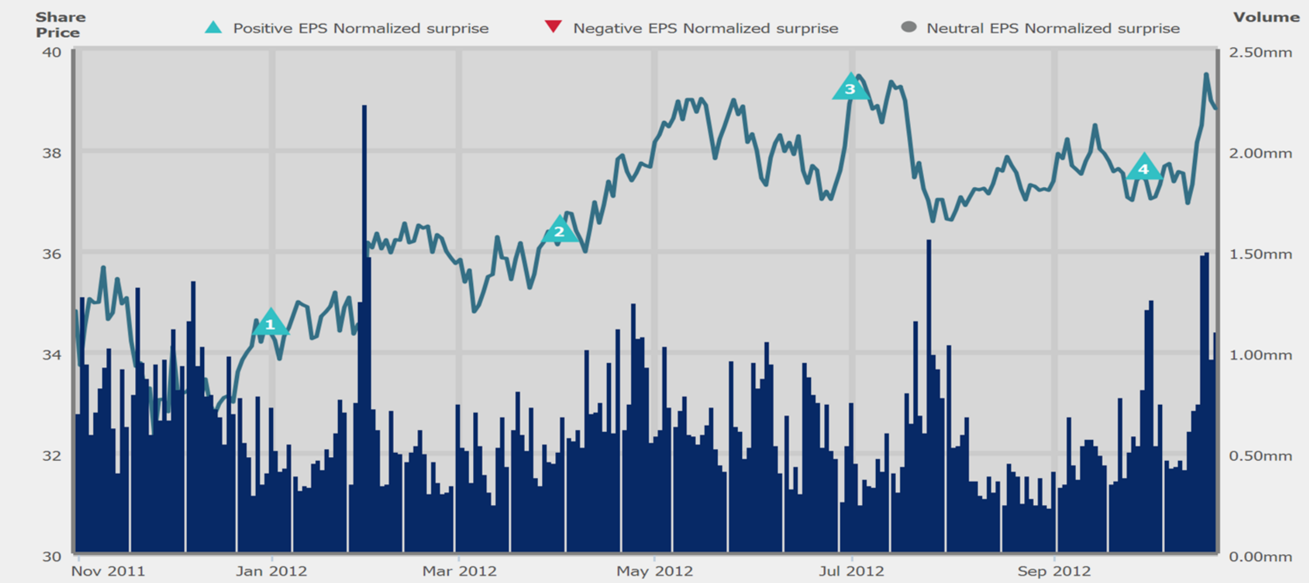
Tuesday, January 29, 2013 2:00 PM GMT

S&P Capital IQ Estimates

	-FQ4 2012-			-FQ1 2013-	-FY 2012-	
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	ACTUAL
EPS Normalized	0.49	0.64	▲30.61	0.73	2.47	2.61
Revenue (mm)	1428.60	1608.60	▲12.60	1450.10	5476.63	5823.55

Currency: USD
Consensus as of Jan-29-2013 1:28 PM GMT

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



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ4 2011	0.50	0.58	▲1 16.00 %
FQ1 2012	0.67	0.73	▲2 8.96 %
FQ2 2012	0.61	0.65	▲3 6.56 %
FQ3 2012	0.54	0.61	▲4 12.96 %

Call Participants

EXECUTIVES

Eugene G. Ballard
Executive Vice President of Finance

William Robert Berkley
Chief Executive Officer, President and Director

William Robert Berkley
Founder and Executive Chairman

ANALYSTS

Amit Kumar
Macquarie Research

Brian Robert Meredith
UBS Investment Bank, Research Division

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Joshua David Shanker
Deutsche Bank AG, Research Division

Meyer Shields
Stifel, Nicolaus & Company, Incorporated, Research Division

Vinay Gerard Misquith
Evercore ISI, Research Division

Presentation

Operator

Good day, and welcome to W.R. Berkley Corporation's Fourth Quarter 2012 Earnings Conference Call. Today's conference is being recorded. The speakers' remarks may contain forward-looking statements. Some of the forward-looking statement can be identified by the use of forward-looking words including without limitations, believes, expects or estimate. We caution you that such forward-looking statement should not be regarded as a representation by us that the future plans, estimates or expectations contemplated by us, will in fact, be achieved.

Please refer to our annual reports on Form 10-K for the year ended December 31, 2011, and our other filings made with the SEC for a description of the business environment in which we operate and the important factors that may materially affect our results. W. R. Berkley Corporation is not under any obligation and expressly disclaims any such obligation to update or alter its forward-looking statements, whether as a result of new information, future events or otherwise.

I would now like to turn the call over to Mr. William R. Berkley. Please go ahead, sir.

William Robert Berkley
Founder and Executive Chairman

Thank you very much. Good morning. We were very pleased with our quarter. We were especially pleased with the direction, everything seems to be moving in. And before I go on about my enthusiasm, I'll let Rob talk about the year's results, the quarter and the year's results and then Gene will talk about the numbers and then the real enthusiasm will come through. Go ahead, Rob.

William Robert Berkley
Chief Executive Officer, President and Director

Thank you for the introduction. Good morning. The fourth quarter was a continuation of the story that has been unfolding for the casualty market over the past few years. Growing concerns among certain market participants over prior year loss reserve development continues to serve as a catalyst for a changing behavior. Additionally, there would appear to be an increasing awareness of the impact that diminishing investment income is having on the industry's economic model. While this macro situation is widely discussed, the sense of urgency and tackling these issues seems to vary from carrier to carrier. Having said this, there is an ever-growing percentage of the market that is pursuing rate in an effort to remedy the situation.

On the other hand, the property market certainly did not have a business-as-usual quarter. Hurricane Sandy provided a reminder that bad things happen and on occasion in a very big way. Once again, the industry received a wake-up call with the regards to the imperfections of both cat modeling as well as local building codes as we endure the impact that a large tropical storm can have on a region.

Though many companies managed to make a profit in the fourth quarter in spite of Sandy, the question remains if the industry is truly achieving an appropriate risk adjusted return for this product given the level of a volatility it assumes. Workers' compensation remains one of the lines of business where the market is most aggressive in seeking rates. Having said this, given how soft the market have gotten for comp, along with lost trend and lower investment returns, it would be premature to view this currently as a green-light product.

The excess casualty market is also showing early signs of a return to underwriting discipline as meaningful rate increases are beginning to be attainable. On the other hand, there continues to be naive optimism in much of the professional market where rate increases remained far too modest. Additionally, the lack of rate increases in both the marine and parts of the property market remained surprising in light of the recent loss activity.

The company's rate monitoring of renewal business for the fourth quarter indicated an improvement of 6.5% over the corresponding period in 2011. Our new business relativity was 1.09%, which indicates our new business is priced 9% stronger than our renewal business. All 5 business segments contributed to this improvement in rates, though not equally as the domestic insurance segments ranged from 5% to 11%.

Also worth noting with this was the eighth quarter in a row the group achieved additional rate and consequently, the fourth quarter in a row where rate-on-rate was obtained. While the 6.5% was slightly less than what we've achieved in the third quarter due primarily to mix of business, it is generally in line with what we have achieved in 2012. We remain convinced the market has maintained its pricing momentum and it has been further confirmed by what we have seen so far with our January 1 business. As in the past, we continue to believe we are obtaining this improved rate without jeopardizing the quality of our book, which is evidenced in part by our renewal retention ratio which continues to remain at approximately 80%.

When one puts these 2 pieces of information together, it is clear -- it clearly supports the idea that underwriting margin is improving. Net written premium for the quarter was $1.228 billion. This represents an increase of 13% compared to the fourth quarter of 2011. All 5 business segments contributed to this growth which ranged from 20% to 8%. More specifically, 34 of the 45 underwriting operations grew in the quarter. When one looks more closely at the growth, you see 6.5 points associated with rate, 6 points associated with exposure, and 0.5 point with audit premium. The company's loss ratio for the quarter was at 64.6, which includes 3.2 points associated with Sandy. While 4 out of our 5 segments were impacted by Sandy, the majority of the loss was in our international and reinsurance segments. The expense ratio for the period was at 33.5%, which is an improvement of 0.008%. As we have suggested in the past, we anticipate this trended -- we anticipated this trend due to our increasing earned premium.

When one puts the picture together, you end up with a combined of a 98.1%. However, when one adjusts for storms as well as reserve development, we believe the company is running at about a 96.5%, which is an improvement of approximately 3 points when compared with the fourth quarter last year. This improving trend should continue as higher rates and increased volumes continues to be reflective in our earned premium. The balance sheet -- the company's balance sheet remains particularly well positioned to take advantage of this improving environment. This is demonstrated not just by the quality of our investment portfolio, but also the strength of our reserve, again, confirmed by 24 consecutive quarters of positive development. So far, it appears as though our 2010 and 2011 accident year picks are holding. With every passing quarter, it is becoming more apparent, we are entering a hard market. The number of carriers seeking broad rate increases continues to grow and the minority of companies that continues to act irresponsibly is a dwindling population. While it has truly have not yet reached the point where there's low hanging fruit, it has been many years since we as an organization have been so encouraged by the market.

William Robert Berkley
Founder and Executive Chairman

Thank you, Rob. Gene, you want to pickup, please?

Eugene G. Ballard
Executive Vice President of Finance

Okay. Well, in spite of the impact of Sandy, we were able to report significant growth in our net income for the quarter due to higher investment incomes, substantial realized gains as well as improvement in our core underwriting margins before catastrophe losses.

I'll start with underwriting. As Rob mentioned, premiums were up 13% to just over $1.2 billion and the growth was pretty evenly spread across the group with alternative markets up 20%; international, 16%; reinsurance, 15%; specialty, 11%; and regional, 8%. Our underwriting profits were $24 million in the quarter compared with $34 million a year ago and the overall combined ratio was up 1.1 percentage points to 98.1. The increase in the combined ratio was a result of our losses from storm Sandy. Although relatively modest considering the size of the industry loss, our net loss from Sandy of $40 million before tax, added 3.2 percentage points to our overall loss ratio for the quarter. We had significant reinsurance recoveries from both our per risk reinsurance treaties as well as our catastrophe reinsurance treaties. The losses by segment are in the earnings release but one thing to note is that we allocate reinsurance companies -- recoveries to specific business units based in part on the unit share of the cost of the treaty. So as a result, recoveries by company in segment are not directly proportional to the gross losses incurred and that's why you see relatively smaller Sandy losses with the specialty and regional segments.

Our underlying loss ratio before catastrophes and reserve releases declined 2 percentage points from a year ago to 63% due to the impact of year-over-year price increases on underwriting margins. As Rob said, we expect that trend to continue as business we've already written at higher prices is earned over the next 4 quarters. Favorable reserved development was $20 million or 1.6 loss ratio points in the quarter, that's down from Q4 of 2011, but right in line with the reserve releases for full year 2012 which averaged $26 million per quarter. Approximately half of the favorable development in the fourth quarter was attributable to the reinsurance segment.

Our expense ratio improved by 0.8 percentage points to 33.5%, again, as a result of price increases and growth in premiums. The alternative markets and regional and international segments reported lower expense ratios with international down $6 million as recently started companies have achieved more scale. The specialty and regional expense ratios were up slightly due to higher seasoned reinsurance cost and higher commissions including contingent commission accruals. Our net reserves increased $91 million in the quarter to $8.4 billion at year end, and the paid loss ratio decreased by 2 percentage points to 57.0. Investment income was $152 million, up $35 million or 30% from a year ago. The increase was due to investment funds which are in $27 million in the quarter compared with a loss of $12 million a year ago, with stronger earnings this quarter from both energy funds and real estate funds. Income from the remainder of the portfolio was down $4 million or 3% to $125 million in the quarter, and the annualized yield on the overall portfolio was 4.1% for the quarter and 4.0% for all of 2012. We also reported realized gains of $116 million during the quarter including the gain of $68 million from the sale of one of our private equity investments. At year end, 84% of our portfolio was invested in cash and fixed income securities with a duration of 3.4 years and average credit quality of AA-. The pretax unrealized gain on securities that are carried at fair value was $797 million at December 31. We paid out $1.09 in dividends during the quarter including the special dividend of $1 per share in December and we also repurchased 170 shares of our own stock at an average cost of $37 per share.

William Robert Berkley
Founder and Executive Chairman

176,000 shares.

Eugene G. Ballard
Executive Vice President of Finance

176,000 shares. So that adds up to net income of $165 million and the annualized return on equity of 16.7%, that gives us an ROE of 12.9% for the all of 2012. That's 2 points higher than full year of 2011 and just 2 points shy of our long-term goal of 15%.

William Robert Berkley
Founder and Executive Chairman
Thanks, Gene. As I've said, innumerable times, this is a long-term business. We saw these changes taking place and beginning to evolve a while ago. We're seeing the fruits of our investment in new startups that have taken place over a number of years. The benefit of startups are twofold: One, as opposed to buying something, you don't get someone else's problems; and two, you don't get intangible assets on your balance sheet. You get to tax deduct the expenses of building the business, and you don't have carry forward issues as you go forward. We're seeing the rewards of that, and we expect to continue to see that. We're very enthusiastic about going forward where we see changes. While various people may say they had rate increases of 5% or 7% or whatever, first of all, everyone has to keep in mind, price increases start from whatever pricing level you have, and different people have different strategies to acquire new business, to grow their business and no one should try and get this to a fine point that the difference between a price increase of 6% or a price increase of 7% is material over the short run. We think that we pushed the market as best we can every day and most of our companies are prepared to

not write business if they can't get what they think is an adequate pricing level. Because of that, some of our companies have grown while others have in fact not grown at all. We think that's the strategy and the strength of our enterprise and our structure. We continue to seek out and to some extent, find new and unique investment opportunities that allow us to get better returns. We expect some of our private equity investments will result in further realized gains this year and we have found some new things to invest in that we think will give us subsequent returns because in fact, you're always investing for the 2 or 3-year ahead future as you look for those kinds of opportunities. So we believe that this is just the beginning of improved results as earned premium reflects those price increases. We think that it will continue. And it needs to because in fact, a lot of people will be surprised at how much returns will be impacted by the current lower rate. If you're in the reinsurance business, you need 7 points on your pricing just to offset a 100 basis points decline in investment returns. And if you're in the standard markets, price increases have to be 3 or 4 points. So you not only have to make up, the decline in prices since 2008, but you have to go further than that to offset the investment income. So people haven't yet fully recognized how much they have to raise prices. But it's beginning to happen and people understand that whereas in the past, a 95% combined would give you a good result. Today, you've got to get that combined down into the area of 90%. So we continue to work towards that improved combined ratio. We think we're on our way. We expect that we'll see continued improvement as our earned premium reflects price increases and we're extremely optimistic. With that, Mercy, do you want to come on in and we'll take questions?

Question and Answer

Operator

[Operator Instructions] Our first question comes from Josh Shanker from Deutsche Bank.

Joshua David Shanker
Deutsche Bank AG, Research Division

In terms of looking at the combined ratio, compared to where it was 2 years ago before the price increases, it's not yet materially better, I know that it takes time for written to become earned, but is that happening more slowly for any reason? I mean, we would've -- I would've thought it would be better now given the rate increases that you've reported?

William Robert Berkley
Founder and Executive Chairman

Well, I think that, first of all, you have Sandy in there this year.

Joshua David Shanker
Deutsche Bank AG, Research Division

Well, you've even take the cats out. I would take the cats and development out on it. That's it, I guess.

William Robert Berkley
Chief Executive Officer, President and Director

I was just going to add, putting the -- if you take the one-timers out, Josh, I think that things are improving, perhaps not as quickly as some would expect. But in part, that's a result of quite frankly, how we pick our design ticks, as we discussed in the past calls, because of our sensitivity to trend and inflation and things of that nature, it's not a very -- it's not just a straightforward, simple formula how things will flow through. So just because you get x points of rate, it's not just going to completely flow through. Depending on the line of business and the product, we make certain assumptions as to how we see future loss costs. So is it going to come through? Yes. Is it going through more and more as the earned premium builds as you've suggested? Yes. But as -- again, we've suggested in the past, we don't want to declare a victory prematurely on our business just -- and let the full rate increase flow through because again, we like to err a bit on the side of caution when it comes to our picks.

William Robert Berkley
Founder and Executive Chairman

All right. I think we also have to recognize that there was more positive development when you go back to 2010, for instance, by a significant amount. I think the positive development in 2010 was sort of 4 points better than it was. And so while the loss ratio look the same, in fact, there was really 4 points of more positive development in 2010 than there was in this year. So as there becomes less positive development, the current accident year is picking up that slack.

Joshua David Shanker
Deutsche Bank AG, Research Division

If I look at x development in cats, I have a 64.1% loss ratio for 2010 and for the full year, and for 2012, it's 63.6%, about 50 basis points of improvement. I don't know, maybe my numbers aren't quite right there?

William Robert Berkley
Founder and Executive Chairman

I don't have the sheet right in front of me. It's not quite right, but it's directionally right. I think that we -- it was slightly better than that, but the answer is, it has not fully gone in. I think we're also are probably being a little more conservative in our loss picks at this point in time because we're more concerned than -- candidly, than it seems needed in the current environment. We're probably more concerned with inflation than many of our peers. And that on -- our current loss picks are probably a bit more conservative.

Joshua David Shanker
Deutsche Bank AG, Research Division

And then on your optimism. You're as optimistic as ever, although I think at this point, you would've thought that rates could be approaching 10% on renewals given what you said in the past, are there spoilers out that are preventing you from reaching...

William Robert Berkley
Founder and Executive Chairman

I think what I said is in 2013, I expected price increases to be in the 8% to 10% range. I think that I'm hoping that, that's the case. I think that no business that's led by a pessimist generally succeeds and that is my view, yes.

Operator

Our next question is coming from Amit Kumar from Macquarie.

Amit Kumar
Macquarie Research

I guess it's related to the last question on pricing increases. Maybe just talk about what you might be seeing for 2013? I mean, do you see that 6.5 already turning to sort of 7.5, 8-ish? Or just because this is the fourth quarter you've gotten a rate-over-rate, maybe just talk about the directional trends until now?

William Robert Berkley
Founder and Executive Chairman

I'll make one comment and then I'll turn it over to Rob. I do think that one thing we saw differently than some other people, we did see better prices in October, November than we did in December. December was a more competitive pricing month. But so it's hard to look. It still goes month-to-month how competitive things are. Rob, do you want to comment?

William Robert Berkley
Chief Executive Officer, President and Director

Yes, I will. I guess just to add on to what you said a moment ago, it's not unusual you see people trying to make their year-end budgets. So they give the full-court press, if you will, in December. Having said that, in spite of that full-court press, the environment was still one where it was pushing for more rates. Our general view is that you will see the marketplace looking for as much of a rate increase or more during 2013. Trying to predict with such a fine brush, if you will, down to what would some might suggest are basis points, that's a pretty slippery slope. But generally speaking, there's nothing that leads us to believe that '13 will not be a continuation of what we saw in '12 and it's more likely that rates will continue to build, if you will, from where they are rather that erode or diminish.

Amit Kumar
Macquarie Research

That sounds interesting. I guess the other question is also on margin improvement. My sense is, I guess, what you're saying is that if loss costs remained at similar levels, simplistically, we should at least see a 300-basis point, 300-plus basis point improvement for 2013. Is that -- maybe it's too simplistic, but is that fair?

William Robert Berkley
Founder and Executive Chairman

I think that we would expect that overall, the improvement in margins '13 to '12 should be in that level.

Operator

Our next question comes from Vinay Misquith from Evercore Partners.

Vinay Gerard Misquith
Evercore ISI, Research Division

The first question is on the expense ratio. I'm just curious, we saw some expense leverage this year, do you expect to see more of that in '13 versus '12? Has the build out of the platform really been finished in '12?

William Robert Berkley
Founder and Executive Chairman

I think that, yes, you'll see more expense benefits as time goes on. As profitability increases, there is more incentive payments to producers and the management, but we think that overall the expense ratio should come down significantly.

Vinay Gerard Misquith
Evercore ISI, Research Division

Okay, that's helpful. The second question is in growth opportunities. Apart from few other players, maybe one other specialty player that maybe there is some more business coming into the excess itself plus lines market. Have you seen that trend increasing recently?

William Robert Berkley
Chief Executive Officer, President and Director

This is Rob, the answer is that we are seeing more submissions coming in whether the -- I would suggest that the specialty market population is growing but it certainly has not reached anything approaching what traditionally we've seen in a hard markets, so you can see as throughout we've commented on occasion throughout 2012, you can see that groundswell beginning to build, but I don't think that we fully hit our stride yet, but it's coming.

William Robert Berkley
Founder and Executive Chairman

I think that if we were -- if you were to ask us what is a little different about this market change, I think that's one of the things that we haven't seen as quickly as we would've thought appropriate for our expectations and our look at the market. And that really is we would have thought that there'd be a lot more business flowing into that specialty market than seems to be flowing into that market at the moment. But it's coming much slower than we would have expected.

Vinay Gerard Misquith
Evercore ISI, Research Division

Sure, fair enough. One last numbers question. Since business mix has changed a little bit, just curious, what your normalized cat loss ratio should be for the year?

Eugene G. Ballard
Executive Vice President of Finance

For '12?

Vinay Gerard Misquith
Evercore ISI, Research Division

No, for '13.

Eugene G. Ballard
Executive Vice President of Finance

'13. It is pretty hard to say, but historically, it's been around 2, 2.5 points.

William Robert Berkley
Founder and Executive Chairman

I don't think our business mix has changed so materially, I think that we have -- we do have a little more exposure on a gross basis. But we have been pretty good at buying strategically and spending a lot of our own money on it, reinsurance. I mean, one of the things that I find interesting is that people always say if it weren't for cats, we would've had x result. But in fact, the reason we have better results is because we buy reinsurance and it impacts our results every year because we pay premiums for it. So I think in fact, the 2.5 points, probably 3 or the outside will be what we would expect and we wouldn't think it would be much more than that. The rest of our cat gross exposure is in fact, in our reinsurance line, reinsurance purchases.

Operator

Our next question comes from Meyer Shields from Stifel, Nicolaus.

Meyer Shields
Stifel, Nicolaus & Company, Incorporated, Research Division

Robert, take your point about not reading too much into small fluctuations in terms of the average renewal premium rate increases, but I guess, one thing that stands out is that, at least in the last hard market, you did see what was very clear acceleration from quarter-to-quarter, in terms of the magnitude of rate increases, and I was wondering if you could talk about why you think we're not seeing just more obvious acceleration?

William Robert Berkley
Chief Executive Officer, President and Director

So I think it depends on when you choose the point in time that the market started to turn. If you choose the fourth quarter, if you will, of 2001, then that's one thing. If you look back, so in our opinion, when the market really started to turn which was late 2000, I think you would see, again, much more of an incremental building or a gradual groundswell that came about. So I think that it is likely that you're going to see the momentum build, will it be as a perfectly smooth curve? No, I don't think so, but historically, I'm not sure if there's ever been. Obviously, if we have, just to add to that, I think if we have a noteworthy event that could be a shot in the arm, if you will, that will change the circumstance, and I also think as I suggested in my comments and others I suspect have discussed, the impact of investment income. It seems to be something that everyone in the industry is talking about but very, very few are actually contemplating that when they think about how they price their products. So I think that possibly could be the second shoe to drop.

William Robert Berkley
Founder and Executive Chairman

I think that, I might add, that the cycle for the E&S business especially, was down much harder. So the bottom of the cycle was harder, so you really needed those tremendous increases in prices just to get back to equilibrium. This cycle was not down as hard. And you didn't have, what I call a fear event to take place. That fear event still hasn't taken place. It was the World Trade Center that was the fear event. At the bottom of the cycle things started moving up. It moved up then they started to turn back down again, but the fear event didn't take place, it was merely the issues that caused the normal cyclical swings in the business.

Meyer Shields
Stifel, Nicolaus & Company, Incorporated, Research Division

Okay, that makes perfect sense. I'd wanted to ask quickly about the recent hire for Southeastern standard lines. Is there something that you see particularly attractive about that market or is it just an area of growth?

William Robert Berkley
Chief Executive Officer, President and Director

I think all of the above. We think it's an interesting part of the country which has performed reasonably well and has good future potential. We also philosophically have a view as to how big a regional company can be from a territory before it really is no longer a regional company. And we concluded that Georgia was a state that we wanted to have more of a presence in and we wanted to have our base, if you will, to serve the surrounding states more local as far as its proximity to those. So it was really a strategic decision, a combination of the talent that was available, how we view the marketplace and our view as the need to be somewhat local in a region of the country truly to have a differentiator towards a business model.

William Robert Berkley
Founder and Executive Chairman

Let me go off on a slight tangent. We have a different view than most of our competitors who have a business and then think they'd grow by expanding and expanding, and then you get to be an almost national company instead of a regional company or a specialty company that keeps adding new pieces to it as opposed to our view, which is you keep small pieces that are close to the customer, close to their specialty, with great expertise that you don't have to succeed by having a bigger and bigger company. Those aren't our views. So we were in some of the states around Georgia. Georgia is a big state where there's a lot of opportunities, and we felt like this was a real opportunity and we didn't want a -- to have one of our companies from 3 states away, decide to move in and be another nonlocal company there. We think that strategy to keep units small, keep them close to the customer in everything we do. And then we think that's one of the core ways we differentiate ourselves. The guy who's making all the decisions is going to be in that marketplace.

Operator

Our next question comes from Brian Meredith from UBS.

Brian Robert Meredith
UBS Investment Bank, Research Division

A couple questions. Here, first one on, Bill, I wonder if you could talk a little bit about what you're seeing with respect to loss trend? I mean, you mentioned that inflation is one of the concern for you. Is this still running kind of what you said it was in the third quarter and what gives you some concerns about potential trend acceleration?

William Robert Berkley
Chief Executive Officer, President and Director

If we break a trend down maybe into medical versus everything else, Brian, medical continues to be a thing of concern for all industry participants. As far as everything else, trends still seems to be somewhat benign. But we have a general concern as to where inflation is going and we think that, we will not be completely insulated from that obviously, it was referenced a few moments ago as it related to portfolio that clearly impacts us on the risk-bearing side of the business, how we'd price our products and how we reserve for our self. So again, what we've experienced so far doesn't necessarily give us a big reason to pause, it's more as we look out the front windshield and see what may be coming our way, that we feel as though it is prudent, not necessarily to assume that future trend will necessarily be what we've experienced to date.

William Robert Berkley
Founder and Executive Chairman

Brian, this is Bill. I think that, to add to that, as Rob said, when you look out the front window, you try and look ahead, and for us, first and foremost, insurance companies, in spite of what people talk about, do better in inflationary environments than in noninflationary environments. So we're not afraid of them. But there's both 2 things that impact it, and you have to be prepared for that. The risk of a fixed income portfolio with a longer duration and the risk of an investment portfolio that can't keep up giving you returns. So I think that what we're trying to say is we're trying to be careful in establishing our reserves, assuming that within the life expectancy of that duration which is 3.5 years, give or take, that we've considered that sometime in that period inflation will come home to roost and we want to be sure we don't have an adverse surprise there. And the other thing is, in our bond portfolio, we're going to have to just constantly be watching that duration. The duration has come down over the past couple of years, a little bit, and it's likely to come down a little more as we look out. So if we do nothing as far as cash flow and reinvestment, our duration comes down from 3.4 years to 2.4 years. It may not come down that much, but our duration is clearly going to shorten up over the next 12 to 18 months. We think inflation is out there and while we don't know when, we think it's clearly going to be out there.

Brian Robert Meredith
UBS Investment Bank, Research Division

That's great. And then second question, Bill, on the 15% ROE target which you hope to achieve here, I'm just curious, how likely do think that is achievable given that there's a lot of companies out there that have basically lowered their ROE expectations in the current interest rate environment. They're happy with either high single-digit or low teens return on equity? You think you're going to face some resistance there? Do you think it's -- you can still achieve it in this rate environment?

William Robert Berkley
Founder and Executive Chairman

Well, if you lower your target, you're surely not going to achieve it. We believe that it's achievable and we'd rather have that as our goal and our target and fall short and then, say, we're going to settle for a lower target. It is going to be tough with this interest rate environment, there's no question about it. Every single person the management team talks about it. They understand it. Clearly, we did a little better at that with our 12.9% return this year. And we think that in '13 we'll be able to do better than that. Whether we get to 15% or not, I can't tell you. But everyone in this company is really cognizant of it. Our Long-Term Incentive Plan, we've established 5 years ago, paid out and only paid out about 57% because we didn't hit that 15% return. So -- but if you don't meet the standard, lowering the standard doesn't help. We believe that for us to achieve outstanding results for our shareholders, we ought to keep that target. Now, that's not to say we think we'll make it every year. But I certainly wouldn't lower it consequentially.

Brian Robert Meredith
UBS Investment Bank, Research Division

Thanks. And then Bill, just one quickly. Could you give us your thoughts on what you think is going to be happening with interest rates here the next 12 to 24 months?

William Robert Berkley
Founder and Executive Chairman

In the shorter end of that, I think interest rates are not going to move up very much. In the long run, I think you're going to probably see interest rates move up. And think you have so many variables in the concept of one world between Europe, Japan, China and the U.S., it's no longer this forecast of what's happening in America. It's really a much more of a global picture and currencies trade so freely. So I don't see anything happening that's going to cause interest rates to move up in the next 8 to 12 months. I think as you go out further than that, I would expect interest rates to move up.

Operator

Our next question comes from Jay Cohen from Bank of America.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Couple of questions. I guess, one question on the alternative market segment, it looks like the loss ratio there was quite a bit lower than it had been running, I'm wondering if there's anything unusual there?

Eugene G. Ballard
Executive Vice President of Finance

Yes. Well, that's the segment that's been achieving the highest rates across the group. It's predominantly workers' compensation. So we're seeing more of that benefit comes through the other way on the other segments.

William Robert Berkley
Founder and Executive Chairman

The alternative market is primarily workers comp and that's where the biggest rate increase has been.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Got it. Can you also tell us how the arbitrage fund did this quarter?

Eugene G. Ballard
Executive Vice President of Finance

It essentially broke even for the quarter.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Okay. And then lastly, so you had mentioned that you're finding newer places to invest. If you could talk about what you see as the most opportunities are?

William Robert Berkley
Founder and Executive Chairman

Well, obviously, I have to talk retrospectively because I'm not -- it's just that the best -- the clearest example is for about 3 months, we found mezzanine mortgages that were opportunities because they were loan-to-value and still in a range of first mortgages. So a mezz mortgage where loan-to-value was under 60%, where we could get 6% or more. But that only lasts for a short period of time, so we put to work, let's just say, $100 million, $150 million, and the market changed, and that rate came down to 5%. And there are other things like that where we provide debt financing in like small quantities for special projects that aren't so big to attract big investors but we can step in, get done and do it for particular funds that have special-purpose vehicles where we're very well collateralized 2, 3, 4, 5 to 1, and give us the opportunity. People have lots of time to do that. They don't have to wait for us. They don't need us. So we're continually finding those things. The biggest problem, Jay, is that they come in $50 million or $100 million pieces and it's very difficult to find out how quickly they're going to last, but you have to be cautious and not put so much money in any one of them at any given moment in time. So these smaller pieces give us diversification. But by the time we go for the second piece, other people have found it or they found other people. So it's a constant hunt for opportunities and it's -- it continues and we've got a couple of new ones that we're just doing, but obviously, I'm not anxious to talk about them because I'm not anxious to make the investment cycle shorter than it is, it's short enough already.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Yes, yes. I guess the other issue for the investment, again, as you're shortening duration, that's going to put some additional pressure on the fixed income portfolio.

William Robert Berkley
Founder and Executive Chairman

I think I'd said we will take advantage of shorter duration as we see this move ahead, but I don't -- I'm not expecting that certainly for the next 6 months. But I think that we will -- somewhere in the 12 to 24 months period, try to do that. And it will also depend on how many of these other opportunities I can find to give us some benefits. I think we sit here and say that in the short run, inflation is a trouble. In the long run, inflation is a benefit. Knowing when you pull the trigger to protect yourself for the short run is a critical management responsibility.

Operator

[Operator Instructions] Our next question comes from Amit Kumar from Macquarie.

Amit Kumar
Macquarie Research

This is to settle for clarification on the prior discussion on margin. Then, we were talking about that 300 -- at least 300 basis point improvement, did that also include an improvement in expense ratio? Or is that an addition to that?

William Robert Berkley
Founder and Executive Chairman

That was what we thought would be our gross improvement. It could be -- we could benefit more, but you have to understand there's also a negative impact from the expense ratio because of a change in accounting. So where that exactly falls, I'm not sure. We were giving you an approximation. Someone asked us would be, I mean, we should see at least and I said yes. I'm not trying to make your job easier, Amit.

Operator

Thank you. I'm showing no more questions at this time. I'll turn the call over to Mr. William R. Berkley for closing remarks.

William Robert Berkley
Founder and Executive Chairman

Okay. Well, I think that one of the things that differentiates companies is how well they prepare for the future, how carefully they look at the future, and how they make strategic decisions. We think we do some of those things especially well from buying reinsurance to investing, to expanding and strategy of managing businesses that are close to the customers. We're very enthusiastic, we do see that 300 basis point improvement in margin, we think that the adequacy of our reserves has never been stronger and we're very excited over the next several years to take advantage of what's clearly a hardening market. Can I say that it's the hardest market ever? Certainly not. But is it going to allow for profitability? Yes, and there's more than adequate ways, absolutely. But thank you, all, very much. Have a great day.

Operator
Ladies and gentlemen, this does concludes today's conference. You may now disconnect. Thank you.