S&P Capital IQ

CONTENTS

W. R. Berkley Corporation NYSE:WRB

FQ4 2011 Earnings Call Transcripts

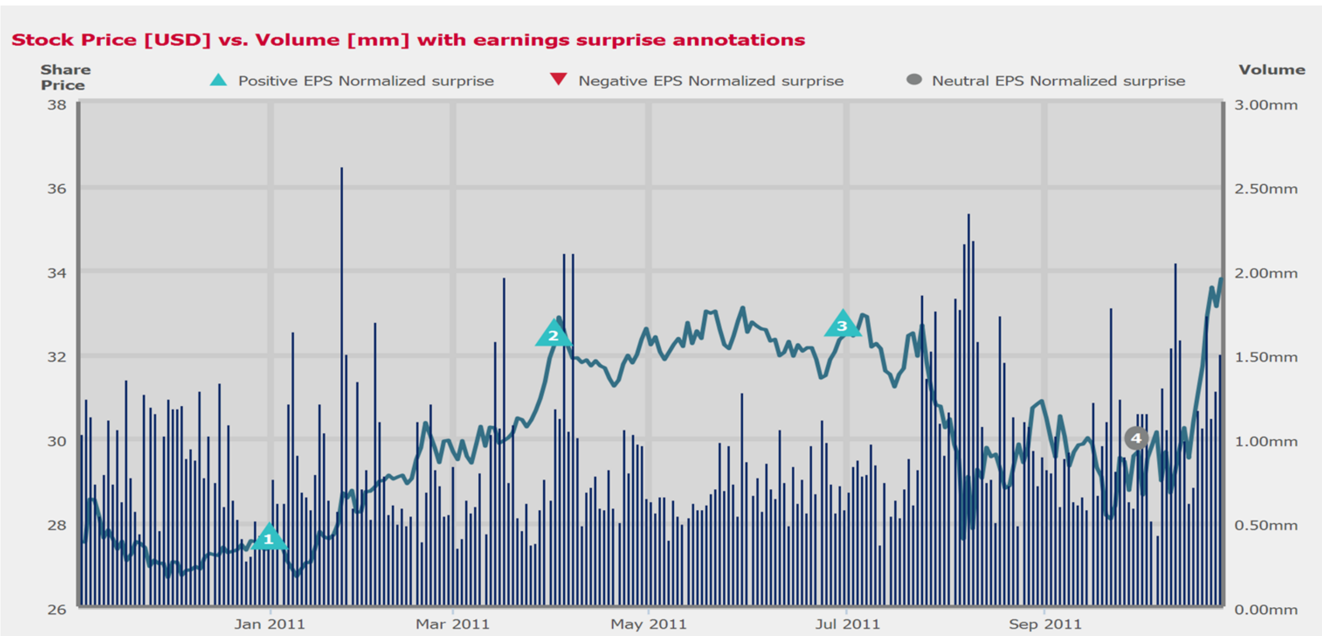
Wednesday, February 01, 2012 2:30 PM GMT

S&P Capital IQ Estimates

	-FQ4 2011-			-FQ1 2012-	-FY 2011-	
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	ACTUAL
EPS Normalized	0.50	0.58	▲16.00	0.64	2.05	2.15
Revenue (mm)	1235.03	1370.95	▲11.01	1295.72	4933.88	5155.98

Currency: USD

Consensus as of Feb-01-2012 1:28 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ4 2010	0.67	0.68	1 1.49 %
FQ1 2011	0.65	0.66	2 1.54 %
FQ2 2011	0.42	0.47	3 11.90 %
FQ3 2011	0.44	0.44	4 0.00 %

Call Participants

EXECUTIVES

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Executive Vice President of Finance

William Robert Berkley
Founder and Executive Chairman

William Robert Berkley
Chief Executive Officer, President and Director

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Presentation

Operator

Good day, and welcome to W.R. Berkley Corporation's Fourth Quarter 2011 Earnings Conference Call. Today's conference is being recorded.

The speakers' remarks may contain forward-looking statements. Some of the forward-looking statements can be identified by the use of forward-looking words, including, without limitation, believes, expects or estimates. We caution you that such forward-looking statements should not be regarded as 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, 2010, 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 call over to Mr. William R. Berkley. Please go ahead, sir.

William Robert Berkley
Founder and Executive Chairman

Thank you very much. Welcome to our year end call. We're very pleased with our quarter and the direction of things. We think that our general expectations are being met. And we'll start with Rob to talk about our operating results for the quarter. Rob, do you want to go ahead?

William Robert Berkley
Chief Executive Officer, President and Director

Thank you. Good morning. For the industry, the fourth quarter seems to follow the same pattern that it has been experiencing for the past several quarters. Noteworthy catastrophe activity, along with a continued deterioration, amongst many of the casualty lines, while at cat events, such as the floods in Thailand, would seem to be exceptional or perhaps unexpected, this view is questionable given the recent industry experience over the past 18 months. Additionally, the eroding performance in several of the casualty lines should not be a surprise to anyone.

There's a reality when rates are continuously cut over an extended period of time and terms and conditions are loosened. Eventually, it will end in tears. Having said this, it would seem as though with every passing day, the industry continues to further set itself up for a classic hard market. The attention of carriers is being forced to migrate away from reserve redundancies and redirected towards the need for additional rates and more discipline to this selection. In fact, there is growing evidence that some carriers not only have been aggressive in their underwriting but also may have been overly optimistic in the reserving practices and may in fact be in for a rude awakening.

Earlier, in 2011, the spotlight was primarily on the need for rate and cat-exposed property and workers' compensation. More recently, it would appear there is developing recognition that broader action is required. Shifting to our organization, the group's network in premium for the fourth quarter was $1.09 billion. This is an increase of 19% over the corresponding period in 2010. The breakdown of this growth is approximately 6 points associated with increased exposures of existing insurers, including auto premiums, 4.2 points of pure rate and the balance from new business.

As in the past several quarters, the company's growth continues to come about primarily as a result of how we had positioned our operations, and more recently, marketplace dislocation, as many carriers continue to adjust their behavior. While the impact of these circumstances are felt group-wide, they are most visible in the specialty and international segments. Additionally, continued gradual improvement in the U.S. economy is providing further assistance to our insured, which in turn we are benefiting from as well.

The group's tight monitoring showed an improvement on average renewal rate of 4.2% in the quarter and just shy of 5% in December. We anticipate this trend of building momentum of rate increase to continue well into 2012.

Further on the topic of price monitoring. It is worth mentioning, our metrics do not fully focus on our renewal business but also on new business. Our data would suggest that the group is achieving slightly higher rates on new versus renewable. This would be an example of one of the many metrics we have that provide comfort with respect to the margin in the new business we are writing. The renewal retention ratio remained again at approximately 80%, providing further confirmation that we are achieving rates without undermining the underwriting integrity of the book. The group's loss ratio in the fourth quarter was 62.7%, which includes 1.3 points or $15 million of storm. Approximately $13 million of the $15 million is associated with the Thailand flood.

The company's expense ratio in the quarter was at 34.1%. This improvement is mainly due to the gradual growth of our earned premium. We anticipate this trend to continuing throughout 2012. The combined ratio for the quarter came in at a 96.8%, however, when one adjusts for reserved development as well as catastrophic events, the current accident year remains at approximately at 99%. Our balance sheet remains strong due to our sound investment philosophy, coupled with effective capital management as well as our thoughtful and measured approach to setting and maintaining loss reserve.

As we had explained in the past, the group's philosophy in setting loss reserves is to initially select cautiously, and we visit these ticks regularly through our rigorous actuarial process. This approach has led to 20 quarters in a row of positive reserve development. The greater property and casualty commercialized market has clearly entered a time of transition. There is no doubt, with every passing day, we are witnessing an increasing pace of change when it comes to carrier behavior. Market participants are not only looking to raise rates, but also narrow their risk appetite. This is not only evident in the rate increases the industry is achieving, but also to the accelerating flow of business into the specialty markets, as well the other rapid growth we are observing in the assigned risk-band segment of the market. We have seen these changes in the marketplace, and marketplace behavior accelerates through 2011 and anticipate it will continue further in 2012.

It this very difficult for any of us to predict the future with any level of precision. On a macro level, things are generally unfolding however as we expected. The moment we have been waiting for is rapidly approaching. Years of underwriting discipline, along with tireless efforts of many, has positioned our organization ideally for a turn in the market. The fruits of these labors will become increasingly visible over the next few years.

William Robert Berkley
Founder and Executive Chairman

Thanks, Rob. All right, Gene is now going to talk about our financial results. And then I'll try to bring it together with our general view of the industry and then where we stand from a positioning point of view the company. Gene, go ahead.

Eugene G. Ballard
Executive Vice President of Finance

Okay, thank you. Well, to begin with, Rob mentioned that net premiums were up 19%, premiums actually increased for all 5 of our business segments and for 38 of our 46 operating companies. That growth, as Rob said, was led by the international segment, which was up 43%, followed by specialty, up 21%, alternative markets, 19%, reinsurance, 15%, and regional by 2%.

Changes in foreign currency exchange rates did not have a significant effect on the -- those gross rates for either the company, overall, or for the international segment itself. The increase in our overall combined ratio of 2.7 points resulted from slightly lower favorable reserve development, as well as modestly higher catastrophe losses. Favorable reserve development overall was $40 million or 3.6 loss ratio points in the quarter compared with $55 million or 5.6 loss ratio points a year ago. Loss reserves developed for all 5 business segments, and reserve development was in line with reserve releases for the year, which totaled $183 million and averaged $46 million per quarter.

Catastrophe losses were $15 million in the quarter compared with $6 million a year ago. The 2011 losses included the $13 million from the floods in Thailand that Rob mentioned, $5 million of that was in our own international business and $8 million was in the reinsurance segment and resulted from our minority participation in the Lloyd's syndicate.

The expense ratio improvement by 0.2 of a point compared to the fourth quarter of 2010 and also compared to the third quarter this year, as volume has grown, and we expect that expense ratio to continue to decline as the recent increases in written premium become recognized as earned premiums over the following year. By operating segment, our combined ratios were 96% for specialty, 93% for regional, just under 100% for alternative markets, 103% for reinsurance and 98% for international. The increase in the combined ratio for specialty was due to lower reserve development for that segment, and the increase in the combined ratio for the reinsurance segment was due to -- also due to lower reserve development and also to higher property losses, including the Thailand floods I referred to earlier. The accident year number that Rob referred to is 99% in the quarter, is exactly where it was for all of 2011.

Operating cash flow, more than tripled to $185 million, and that's due mostly to a 10-point decline in our paid loss ratio. Our paid loss ratio was 59% in the fourth quarter and just under 60% for the full year.

Turning to net -- to investment income. Our net investment income was $117 million in the fourth quarter, that's down from $138 million in the prior year quarter. The income from our fixed income portfolio was $121 million, down $7 million from a year ago. Despite the current and straight environment, the yield on this fixed income portfolio has remained stable at 4% annualized for the fourth quarter of this year, compared to 4.1% for all of 2011 and 4.2% for the full-year 2010.

Income from our merger arbitrage trading account was $7 million, that's an annualized yield of 8%. And our investment funds reported a loss of $13 million, that was primarily related to decline in market value of energy-related investment that are carried at their [ph] value. Those investments were reported on a one-quarter lag. And based on the more recent information we've seen on that, we believe their market values have already recovered that loss.

For all of 2011, investment funds reported income of $11 million. Realized gains were $52 million in the quarter and $126 million for the full-year, that's primarily related to the sale of equity securities. And at December 31, 2011, our unrealized pre-tax investment gains, including those -- including common stocks, were $660 million, up $144 million from the beginning of the year. You'll notice that we added a new schedule to our earning release. It shows a breakdown of our foreign bonds by country and bond category. You also see that we've expanded our foreign bond disclosure by reclassifying approximately $230 million of corporate bonds into the foreign bond category, it's also by country.

Our income tax rate was lower in the quarter, that's primarily due to the realization of previously generated foreign tax credit. And with that, we end up with a net income for the fourth quarter of $118 million and an annualized return on equity of 12.7%.

William Robert Berkley
Founder and Executive Chairman

Thank you, Gene. Let me just try and give you some -- we -- first of all, I have to say that I am more positive and more certain about returning cycle and where things are going than I have been in years. Cycles don't change instantly; they change slowly and gradually until further events accelerate that change. I can't tell anyone what those further events will be. It could be a European insurer of size having difficulty because of the euro. It could be a U.S. company who has reserve problems or an unforeseen event. I can't tell you precisely what it will be. But there's no doubt that a number of companies have not paced [ph] after all of their problems or potential problems in this difficult environment, both financial and industry.

We think that the cycle continues to move along and the increase in pricing, better terms and conditions. It doesn't always get measured. December, as Rob said, we were just shy of 5% average price of leases for the quarter of 4.2%. But that doesn't tell the whole story. There are lots of people who misclassified business and wrote excess in surplus lines business as Bob's [ph]. A 5% or 8% or 10% price increase doesn't solve the problem, when they really need -- a 30% or 40% or 50% price increase. So we might write the business, but at a totally different basis. So some of these numbers are a little misleading, like -- when you hear about price increases. In addition, you have to keep in mind that price increases go back to the price you charged originally. So if you misclassified excess and surplus lines business as standard market business, you can't charge enough marginally additional pricing to have the business become profitable. It's in a different class by itself.

So you have to be careful what you hear and how you react to that. There's no doubt, people are looking at the past several years' results and their recent years of loss reserves and asking whether they're adequately reserved. What their accident year picks have been. We don't believe that our business is worse than many other companies, even though our accident year loss reserve fixed or combined ratio fixed are sort of 98%, 99%, give or take. We think we are a bit on the conservative side. But that's a strategy because we can't judge with a certainty about loss cost trends or when and if inflation is going to be around the corner. We're more confident today that inflation is certainly a few years away, and we will be able to review our reserves with a more positive outlook going forward through 2012 because of that.

So we're optimistic that just as we were able to deliver double-digit returns this year, that we'll continue to do so. We're still able to find some opportunities to invest that give us reasonably good yields. Common stocks don't represent much of our portfolio and that'll probably -- dividend yield income and stocks, all likely to represent a bigger portion of our portfolio. We're all likely -- we're going to buy very high-quality commercial mortgages, 50%, 60% loan-to-value, that we think are very well secured. We're constantly looking for things like that, where you don't get instant liquidity, but not very long duration still. We're not interested in having our duration go out substantially overall.

We think that the cycle, pricing-wise, will accelerate slightly. I have been optimistic. It took until December until we touch the bottom of my pricing expectations of just about 5%, in fact, it was just about, not quite. But the signs are that those pricing expectations are going to look better in 2012 and along with that, we're finding people are coming to us because of our consistent approach.

So even when we maintained our underwriting standards, even when we maintained our pricing, we were always there as a market. When we brought in new teams of people, they didn't close people out. They gave quotes even if they didn't write business. So we have teams of people who came to us, having written $200 million, $300 million, $400 million, $500 million before, and for us, they wrote $20 million or $30 million of business. We're there, sitting there, well armed with capital, and having maintained those great relationships. And people are anxious to do business with us because they were always there, they were always polite, they always quoted.

We think that we're going to get the benefit of that. So it's not going to be the 26 companies we had 5 years ago. It's the 46 companies we have, the core old companies, that we really made up, of Berkley Corp. shrank by 25%. So while you may have seen Berkley Corp. get somewhat smaller, the older company shrank by 25%. Not many of our competitors did that. We think we'll regain that business and then some, and we'll have the benefit of all the new business. So we think we have a great run ahead of us and we're extremely excited.

No doubt, investment income is going to be a challenge. It's the challenge we are most concerned with, but we're pretty confident that we can find opportunities at this point in time to do not quite as well as we may have done 18 months or 3 years ago, but certainly as well as we've done in the past couple of years keeping that yield around 4%.
So with that, Mary, I'm happy to take questions.

Question and Answer

Operator

[Operator Instructions]

And our first question comes from Amit Kumar from Macquarie.

Amit Kumar
Macquarie Research

Just going back to your comment regarding new business pricing and renewal business pricing. Can you sort of talk about the other leg, which is the loss cost trends and assumptions that you have for 2012?

William Robert Berkley
Founder and Executive Chairman

Let me -- first of all, I think that we would say loss cost trends are -- 2% to 3% is our estimate. So we think pricing now significantly exceeds loss cost. Number 2, we think we have built in to our prior year's lost cost, an inflation rate higher than what we have realized. And in fact, it's one of the reasons we're very comfortable with our reserve position now, because it clearly doesn't appear, at this moment, that we're likely to have consequential inflation and we were more conservative than many of our competitors. And we felt it appropriate to build in a loss cost level for that possibility. And I think that we would probably see, even considering medical inflation of certainly less than 3%.

Amit Kumar
Macquarie Research

Okay. That's helpful. And I guess, the other question I have is, you talked about business moving back to specialty. I know that in the past, you have talked about losing a lot of the larger accounts. I'm just wondering, has that behavior changed this quarter? Are you seeing any of that flow coming back to you on the larger accounts?

William Robert Berkley
Founder and Executive Chairman

I think in general, you don't see behavior changing in a broad-based way. What Rob commented is -- he can talk about the graph...

William Robert Berkley
Chief Executive Officer, President and Director

I'm not sure if I would totally differentiate it by scale of account, even though that's certainly one factor. I think I would choose to define that, that accounts that seem to have more hair on them, those are the ones that are more quickly turning up in the specialty market and probably never should have left to begin with, as some of the standard markets are combing through their book and reacting. So the competition around larger accounts, well, that continues to a certain extent because it helps people make their budget. Having said that, I think the great differentiator is really whether there's an issue as far as loss experience goes, with the complexity of the account.

Amit Kumar
Macquarie Research

Got it. And then I guess just finally, you didn't buy back a lot of shares in Q4. And I'm just wondering, just based on what you're saying about the market conditions, would it be fair to assume that, that's something which is somewhat in the background? Just based on the new opportunities you're seeing going forward.

William Robert Berkley
Founder and Executive Chairman

It's always nice when a friend asks that question. So here's -- let me take you through the whole story about it. So then maybe we won't have another person ask that question. First of all, you all know we paid just a little over $28 a share for the stock we bought back, less than book value. So we were happy with the stock we bought back and would've bought more back if we could have it at that price. We always try and buy stock back at an attractive price, even if it stretches our capital position. We would buy back stock. So if we could've bought $100 million of stock back at that price, we would've bought $100 million of stock back at that price or a price near that. We couldn't, unfortunately. So we're price-sensitive to what we pay. What we do is, each quarter, we sit and look and look at where our premium volume is going. How much excess capital we have and we anticipate we have, what our dialogue is with rating agencies and where we're going and ensure how much capital we have that we think is excess capital, and then we move forward from there. I can easily see, if the stock sells at a big enough premium for an extended period of time, deciding to pay a dividend, a special dividend. Even though in some ways, that's sort of wasted money because it doesn't help out people. Look at it, it's a way to get money back to our shareholders and it's certainly something we would consider. I think giving shareholders our money -- their money back and for selling at a particularly premium is better than buying stock back, if we have a lot of extra capital. At this moment in time, I think we will continue to look to buy back stock. It's not that out of our price range. It's somewhat out of our price range. But there's a lot of opportunities. We think there's a lot of opportunities for growth and expansion. And I'm hoping I'll be able to need every dollar of capital I have, but that is a little more optimistic than even I am at the moment.

Operator

Our next question comes from Vincent DeAugustino from Stifel, Nicolaus.

Vincent M. DeAugustino
Stifel, Nicolaus & Company, Incorporated, Research Division

First, starting off with a loss cost trend question and one follow-up, if I may. Looking at workers' comp, medical loss cost inflation from the likes of NCCI, it looks like medical loss cost is running somewhere in the low to mid-single digits kind of you talked about earlier, but that kind of compares to an accelerating pace in the low- to mid-teens in 2001. So my question is, does a lack of rapid medical loss cost inflation acceleration imply less industry reserving angst compared to what we had seen last time versus now going into the next hard market? Does that imply less upward pressure on work comp rates as we kind of accelerate from here?

William Robert Berkley
Chief Executive Officer, President and Director

I'd like to make sure that we understood the question. Earlier, you had referenced some NCCI statistics. Could you share those once more?

Vincent M. DeAugustino
Stifel, Nicolaus & Company, Incorporated, Research Division

Sure. Just looking at the different industry stats and kind of what some of the participants are talking about, it's medical loss cost inflation in the, say 3% to 5% range. And if we look back to kind of what was happening, say 1999 to 2001, we had seen a quite aggressive acceleration of loss cost trends up into the low teens. And so, if we're only running let's say a rather stable low to mid-single digit range, I'd be kind of curious if, without that accelerating very high inflation rate, does that mean that we won't see the same level of adverse development pushing the industry higher on work comp rates as we kind of go into the next hard market?

William Robert Berkley
Founder and Executive Chairman

Clearly, the medical inflation component is very relevant to many lines and few more so than workers' compensation. Having said that, I think the fundamental issue that is driving the change in workers' compensation, it really has more to do with how many dollars people were collecting per unit of exposure. And while clearly, medical is a significant component and people need to contemplate that appropriately in coming up with their pricing, quite frankly, putting that aside for a moment, people just got overly aggressive as to how they priced the business beyond the medical component. I think in addition to that, other trend factors, such as frequency, probably stands out in particular as far as something that people were overly optimistic about and is probably one of the leading drivers as to the change in appetite and behavior that you're seeing in the marketplace today. I think the medical is an important component, I would not solely hitch my wagon to that assumption as to what's driving the change.

Vincent M. DeAugustino
Stifel, Nicolaus & Company, Incorporated, Research Division

Okay. That's very helpful. And I guess just kind of following along the rate topic here. I don't think the lack of adequate underwriting profitability or coordinate net less than income yields, it doesn't seem like that is the surprise there and one I think that's broadly accepted. So I'm just kind of curious if you see any risks pushing the market back into soft territory, if everyone's acutely aware of the poor operating environment. So I guess what I'm asking is if irrationality can persist in this sort of environment if we're all kind of operating in the same environment expectations.

William Robert Berkley
Founder and Executive Chairman

Well, there's no one who can dial a phone that doesn't know that irrationality can exist in anything at any time. So I can't comment on that. But I will tell you that if anything, at the moment, people have not even begun to feel the pain of the underpricing that took place in 2009 and 2010 and certainly in the beginning of 2011. So I think that, irrationality aside, I would expect that there'll be a lot more pain. And if you go back in history, at the turn of the cycle, it always looks like we did worse than everybody else, by printing a '99 accident year, while other people are printing '95s, '92s. And everyone says, God, what happened to Berkley's underwriting, they really have gotten sloppy. And the answer is we haven't gotten sloppy, we just printed the numbers more of a reflection of what they are. So I would suggest that many people in the industry have probably not adequately reflected the current accident years vis-a-vis their pricing. And I think the pain is just beginning, so I would be surprised. But you can't ever bet on how foolish people can be.

Vincent M. DeAugustino
Stifel, Nicolaus & Company, Incorporated, Research Division

Then in terms of that pain coming down the pipe, how would you venture to take a guess on how long it is before we start to see some insolvency stopping up or that really just depend on what reserve numbers companies feel like putting up?

William Robert Berkley
Chief Executive Officer, President and Director

I think, by and large, the industry is well-capitalized. I think if you're going to see an insolvency, it's going to be under -- it's going to be for something coming up that we didn't foresee, someone who had a cap on the reinsurance and they grossly underpriced their business. For someone who's a more modest-sized company with $1 billion dollars of capital and just wrote more than they could understand or someone who has investment problems because they were too aggressive. I'd be surprised if there were any serial insolvencies, with the exception of the exposure somehow or another to currencies or foreign exposures that no one can anticipate.

Operator

Our next question comes from Vinay Misquith from Evercore Partners.

Vinay Gerard Misquith
Evercore ISI, Research Division

Just wanted to get some more clarity on the transition of business from the standard market to the E&S market. And I believe you have mentioned that [indiscernible] occurs because of risk selection rather than just pure price. And so just around that, are you -- I mean, is Berkley able to charge a higher price versus the standard markets? And also, why aren't standard markets taking that business if pricing is up maybe 15% to 20%, as you would be charging because it's an E&S market versus standard paper.

William Robert Berkley
Chief Executive Officer, President and Director

Okay, I think there were a few questions in there. So let me try and address them one at that time. I think, first of all, the observation that we have shared and we have seen over the past several quarters is that the migration of business, back from the standard market into the specialty market and, obviously, it's a [indiscernible] to plummet to that is the non-admitted market. The driver of this is just the realities of the standard market's appetite becoming somewhat broader than perhaps it should have been than its own best interest. It's beginning to change. And not only is the standard market looking for rate increases, if you will, but they are also examining their portfolio and taking note of certain classes of business or exposures that don't really fit within their appetite or their comfort zone. As a result of that, they are combing through their book and they are driving the business to seek another alternative in a specialty market and oftentimes, the E&S market. I would suggest you that, by and large, the specialty market is commanding a higher price than the standard market is seeking. And I would suggest that the E&S market is an extreme, if you will, both in returns [ph] and conditions, as well as pricing perspective. So I do believe that the business that is leaving the standard market into the specialty market is commanding a higher price to be written. Terms and conditions are beginning to tighten and our expectation is that this flow of business from standard to the specialty market will continue to accelerate.

William Robert Berkley
Founder and Executive Chairman

I think I would add one thing in that is the underwriters who have this business and who are looking at it and renewal in the standard market aren't equipped to deal with changing hats and becoming E&S underwriters. An underwriter at XYZ company who's written it as a box doesn't have the beginnings of the knowledge necessary to write it and price it appropriately. They squished it and wished it until it would fit in their box as a Bob [ph] policy, which never should have happened. So the fact is the risk can't fit in their area at all. So it just -- it's not like, gee, we're a Bob an underwriter and we're going to then write something. They just don't have the expertise.

Vinay Gerard Misquith
Evercore ISI, Research Division

Okay, fair enough. So I shouldn't be looking at the plus 5%, saying pricing's not up all that much, why you guys are writing business. It's really, I mean, it's really an apples to oranges, correct?

William Robert Berkley
Chief Executive Officer, President and Director

Yes, sir.

Vinay Gerard Misquith
Evercore ISI, Research Division

Okay, fair enough. The second question was -- I mean, you certainly think -- seem to believe that pricing will rise more this year versus last year. Just want to get a sense of what the opportunity cost is awaiting. So rather than going 19% fourth quarter, why not wait for a few quarters until you get more appropriately priced product to write this year versus last year?

William Robert Berkley
Founder and Executive Chairman

Well, first of all, if you look at every market turn, we always start to grow before the dramatic price because it's easier to renew business once prices start to change. You can't -- this is not a speedboat. This is not a boat that turns on a dime and you say, okay, wait, wait, wait, go. And then all of a sudden, you change how you behave. As you start to see these things changing, you got to persuade brokers, you got to persuade agents to start to give you the business. If I thought I could wait, it would be better to wait until that moment happens, but that's not how the real world works. It isn't like buying a security and selling it. It's -- you're starting on that parade to build up business, which you then hopefully will renew at a higher price next year. And we have the capital to do it and we think -- we don't write any business that we don't think is profitable. So the fact is that we started growing in 2011 because we thought the pricing was beginning to be profitable. And we think that's continuing to be the case and we will renew the business that we wrote in the first quarter of last year at a slight increase, at an increase on top of that increase and so forth. So it's just how we believe you optimize the results for your business. It just doesn't turn around. You just don't go into an agent or a broker and say, give me the business now, here it is. So we just don't think that's how you run a business.

Vinay Gerard Misquith
Evercore ISI, Research Division

Okay, fair enough. And in terms of profitability on the new business, what ROEs do you think the new business is being put on your books right now?

William Robert Berkley
Founder and Executive Chairman

We would hope that we would achieve our 15% return. That's our expectation. Every piece of business that we write, we target that. Now that having been said, there may be one instance, one area or another that doesn't get us to there. But that also depends on the investment returns we can get. It depends on a whole lot of things. But I can assure you that, if we're going to look back at the business we wrote, at the end of 2012, you're going to see certainly an expectation that we will have had a return that would average 15% or more.

Operator

Our next question comes from Greg Locraft from Morgan Stanley.

Gregory Locraft
Morgan Stanley, Research Division

Actually, I just wanted to follow-up on the ROE. Can you do a 10 ROE in 2012? And if so, how will you get there?

William Robert Berkley
Chief Executive Officer, President and Director

Well, I think that we did more than a 10 this past year. And as we have said, we've shifted some of our investment portfolio to realized gains. So some of our investment returns are going to come as gains as well as -- not gains in the bond portfolio, also gains in common stock, even though we're not investing big amounts of money. We've been pretty successful in that. So yes, I think we will. I think that the combined ratio is likely to come down. We think that we still have some level of redundancies and we're not sure how much that is, but we're going to reconsider where we think inflation is going to be in our reserves as the year goes on. But yes, we expect to have a double-digit return.

Gregory Locraft
Morgan Stanley, Research Division

Okay. So -- I mean, I actually have the ROE this year as an 8 and change, not as a 10. But you're saying it include investment gains, so you want to -- is that net ROE? Is that what you're saying, not an operating ROE?

William Robert Berkley
Founder and Executive Chairman

Yes, because we've taken out all of our funds and so forth and taken them out. And we've told people, on 2 calls ago, I believe, maybe 3 calls ago, that given our investment strategy, which is shifting, that we think that income is a better measure, but I think our operating ROE was 9, a little over 9 for the quarter. I think 9.1 for the quarter.

Gregory Locraft
Morgan Stanley, Research Division

Okay, okay. And then I guess, again, to the last question, you mentioned a 15 on new business.

William Robert Berkley
Founder and Executive Chairman

No, no. That was -- the question was, how do we price new business? And the answer is we price new business with a target of a 15.

Gregory Locraft
Morgan Stanley, Research Division

Okay. And when you price it at a 15, are you picking it? I guess it seems to me that you're, philosophically, given how well the releases have continued, you're pricing it for a 15 and then maybe picking it much lower and that's why the reported ROE is significantly below the new business ROE after new business target ROE, after all the core, after several quarters of growth or -- I'm trying to figure out what's holding back the reported numbers from the target numbers.

William Robert Berkley
Founder and Executive Chairman

When they price the business, they're not pricing in cushions on reserves and so forth, the caution that we build in. As well, there's a lag, it takes time. So the results you see now are results from probably 2010, 2009. And so it's a blend of years. It's not just -- what's reported in 2012 will be a combination of 2009, 2010, 2011 and 2012. And it will be a combination of those years; it will be combination of reviewing reserves as we set them up. You have the unfortunate job of trying to make a extremely complex business into something that seems easier to analyze. But as you well know, this blend of accident years makes it a little bit more difficult. I'm sure, if you like, Gene and Karen will be glad to go over and how that blends in. But it's just not one accident year that gets reported obviously.

Gregory Locraft
Morgan Stanley, Research Division

Okay, great. And then the last one is just flexing the balance sheet. You guys are crushing them out of the top line now. The market's getting better. You've obviously built the engine for this kind of a situation. How do we think about the upside to your top line? I mean, I guess, if you continue this, you'll be at a 1.2 plus premiums of surplus by year end. Can you -- how much can you do if you love the business on the front end?

William Robert Berkley
Founder and Executive Chairman

Well, I don't -- first, I don't think we will. I think that if we grow at that rate, you have to remember, we have retained earnings we're generating. So if we do even take a 10 or a 12 because net income is what generates capital. So if you do that, we're only going to be about 1.1. But the fact is, I think, that if we're generating high returns and we love the business, we can probably run at 1.5 to 1 for a period of time. But the cornerstone there, Greg, is what kind of return can we get? We're not going to get over 15% reported returns of net income. Clearly, we're going to be constrained to grow at 15% or 20% after a couple of years. But we think our returns will be good and we think that we'll have the capacity to grow as much as we like.

Operator

Our next question comes from Michael Nannizzi from Goldman Sachs.

Michael Steven Nannizzi

Goldman Sachs Group Inc., Research Division

Just a couple of questions in the regional segments, trying to reconcile written premium trends there to some of the commentary. So first of all, what was the rate change, if you could, in that regional segment to peer price or peer rate?

William Robert Berkley
Founder and Executive Chairman

We don't give it out by segment. Certainly, on the call, we just -- we were not to...

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Okay. So -- but it sounds like it was positive. So...

William Robert Berkley
Founder and Executive Chairman

Every -- all segments had positive rate direction.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Right, okay. So then -- and then exposures were also positive?

William Robert Berkley
Founder and Executive Chairman

I think exposures are reasonable. I mean, I don't think they were positive. I would say -- maybe even down a little bit.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Okay. I'm guess I'm just trying -- So I mean, just kind of listening to other folks and trying to digest what we're hearing is, it seems like U.S. commercial line pricing, particularly at the small end, is where you're seeing some of the better pricing and some exposure growth. But it sounds like you're seeing rate, but not a lot of -- not exposure growth. Just trying to reconcile those trends in terms of how that -- are you seeing that in your book or are you not?

William Robert Berkley
Chief Executive Officer, President and Director

Mike, it's Rob here. I think -- let me take a crack at this. We certainly are seeing rate in the regional book. Exposure growth, it is there, but new business is very difficult to come by, given what our view as to what rates need to be. So we're able to get the rate that we would like on our renewal book, which is, give or take, running around to 80 plus percent in the regional group. Exposures may be up a little bit, and that's coming through in our audits as far as the renewal book. But new business is probably the challenged, really across the board as people are trying to hold on to their books. And quite frankly, the distribution system, given the change in market conditions, is reluctant just to be moving accounts around.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Okay, I see it. I see. And then I guess just -- Bill, just you've kind of talk a little bit about current, your outlook for rates, talking about pricing and earning through. How should we think about the impact of higher prices earning through and offsetting the negative impact of investment yields on earnings? I mean, are we at a point where that should be -- they should offset each other in '12 or do you think that the earns through of pricing is going to overcome the negative impact of investment yields on earnings?

William Robert Berkley

Founder and Executive Chairman

First of all, our fixed income investment yields remained virtually flat, 4.1% down to 4%. So we've been able to find places where we've been able to maintain the fixed income yields. The return on the portfolio was purely from the investment fund returns. And I think Gene already said that, in fact, the loss on investment funds in those, that in fact are reported with a delay of a quarter, already have been made up. So we know the first quarter investment funds are going to effectively offset the loss, so they're going to be positive by, I don't know, what's the number, Gene? The ones we know about.

Eugene G. Ballard
Executive Vice President of Finance

Yes. Well, the loss for this quarter was 13. So it will be something less than that. But it might be -- a lot of that's already been covered.

William Robert Berkley
Founder and Executive Chairman

Right. So the fact is the funds that we reported with a quarter lag effectively are going to be $13 million positive. So that's going to swing investment yield, for example, in the first quarter. It's one of the problems that you have with some of the various accounting changes that are being impacted. In addition to that, we've been able to be opportunistic, and we still have it, while we have good cash flow, it's still not overwhelming as yet. And we may be able to find things to do with the money at this point in time. So I don't think investment income is going to suffer, at least in the first 6 months, which is a plus because the pricing impacts take, as you well know, take 5 quarters to be fully reflected. They get partially reflected each quarter a little more. So it'll be the third quarter before they're mainly reflected and the fourth quarter until they'll be fully reflected. So investment income will be good. There'll be modest impact but very modest in the first quarter of pricing. Hopefully, expenses will be better because volume will increase of earned premium because that comes in right away. So I would think that it would be an accelerating trend. So by the end of the year, things will be better. The risk by the end of the year as cash flow was such that we can't find places to invest the money. The positive is, you will have all those price increases having a greater effect, plus what I expect will be substantial ones this year. So I would expect though is an improving trend, investment income is doing well and not, certainly not going down because we're not investing for the short-term stuff for the most part. So it will be marginal new investment. So I don't think that will be the case. And I think we only have about $1,800,000,000, that's sort of rolled out in the next 12 months.

Operator

Our next question comes from Doug Mewhirter from RBC Capital Markets.

Douglas Robert Mewhirter
RBC Capital Markets, LLC, Research Division

Most of my questions has been answered. I just had a question for Gene. You gave your yield, is that a book yield? And also, is that -- does that approximate new money yields, notwithstanding all the previous comments that Bill has made?

Eugene G. Ballard
Executive Vice President of Finance

Yes, it is a book yield. And it has approximated, as you can tell by the fact that it hasn't changed that much, that we've been able to achieve those kind or nearly that kind of a return on our newer and investment.

Operator

Our next question comes from Josh Shanker from Deutsche Bank.

Joshua David Shanker

Deutsche Bank AG, Research Division

Mike asked most of my questions. The only other question really is in numbers. I'm trying to understand Gene's methodology on ROE. You said 12.7% ROE. I'm trying to get there myself. Can you walk me through it a little bit?

Eugene G. Ballard
Executive Vice President of Finance

That was net income. That wasn't operating income.

Joshua David Shanker
Deutsche Bank AG, Research Division

Yes, I still get only about 12%, though.

William Robert Berkley
Founder and Executive Chairman

I think that...

William Robert Berkley
Chief Executive Officer, President and Director

I don't think we serve the purpose.

Eugene G. Ballard
Executive Vice President of Finance

I guess, the only point I'd make is we use beginning of the year equity, so that just...

Joshua David Shanker
Deutsche Bank AG, Research Division

Maybe that's it. Okay, then that resolves it.

William Robert Berkley
Founder and Executive Chairman

I might add, we have, for 40 years, used beginning year equity, or I shouldn't say 40, at least 15 or 20.

Operator

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

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Many of my questions have been answered as well. But Gene, I'm wondering if you can just give us the reserve development by segment. I know that comes up in the Q and the K, but do you have those numbers?

William Robert Berkley
Founder and Executive Chairman

Jay, I think he'll be glad to go through them, but we don't -- they don't get tied out until the end of today and I'm sure they can go through with them. We have them in the aggregate, but they don't get fully tied out until the end of the day with KPMG signing off. So given it's year end, I'd appreciate it if you'd understand and let him give it to you at the end of the day.

Operator

Our next question comes from Howard Flinker from Flinker and Company.

Howard Flinker

I have 2 comments and 2 questions. One, an extension to your comment about possible bankruptcies would be that the markdowns on sovereign bonds in New York could put tremendous pressure on some of those companies. We just don't know how to -- we don't know how big the markdowns are going to be. And the second, when it comes to return on capital or return on equity, Warren Buffett would have lousy insurance businesses, if we did not include his capital gains. The use of the money is part of your business. So if you'll include it, it seems realistic to me. The first question is a minor -- they're both minor questions. You had a lower tax rate in the fourth quarter, does that come from -- because of capital gains or immunity bonds?

William Robert Berkley
Founder and Executive Chairman

No, it came from foreign tax credit that effectively came in, in this quarter for various technical reasons, but that's all. But in fact, capital gains for us is taxed the same as regular. Municipals do give us a big benefit. Foreign tax credit -- and likely, foreign tax credits will continue to be a benefit as our foreign businesses are expanding.

Howard Flinker

Yes, sure. And second, I'm curious about what I thought was a terrific gesture 2 years ago when BP had that blowout. You paid your clients' claims, I think within 3 days, something like that. And now, it's almost 2 years later. What kind of response have you had from those or other clients? Have you been able to acquire other clients? [indiscernible].

William Robert Berkley
Founder and Executive Chairman

All right, I'll comment philosophically. Answer that, Rob. Rob will talk about the actual business.

William Robert Berkley
Chief Executive Officer, President and Director

I think the answer is that the response from the marketplace was positive. I think people appreciated our timely reaction and getting them the funds that they were entitled to quickly. I think incrementally, it helps us build our brand and build our relationships and reputation. And I believe it's appreciated both within a relatively small community, that being the oil and gas space, both by insureds as well as the distribution system and also being able to empower them to provide that service to their clients in time of life [ph].

William Robert Berkley
Founder and Executive Chairman

I talk to people about why customers are willing to pay a higher price. And with the hesitation of giving a pat on the back to our -- one of our competitors, why do people pay a positive premium to buy their homeowners from Chubb, because Chubb pays their claims promptly and you can -- bought a homeowners policy from Chubb, you have greater degree of confidence of being treated fairly. Building a reputation always takes a long time and doing the right thing is what we think you do when we've been trying to do that for a long time. That was just an example, you do the right thing and people eventually figure out that it's worth paying a little bit more to do business with people who, in fact, deal with you in that way.

Howard Flinker

No doubt. I was just curious. Without mentioning names, that some actual oil and gas companies or drillers come to you and say, we'd like to change.

William Robert Berkley
Founder and Executive Chairman

We deal through brokers and agents. But it's a small community, and I think that all else being the same, people know who have good reputations and bad.

Operator

Our next question comes from Bob Farnam from KBW.

Robert Edward Farnam
Keefe, Bruyette, & Woods, Inc., Research Division

Just a quick question, and pardon me if I missed it. But how has your premium retention been when you've been raising the rates? Have you been able retain the accounts that you've been raising rates for?

William Robert Berkley
Chief Executive Officer, President and Director

The group's retention -- renewal retention ratio is running at about the 80s, which is, give or take, a similar level for us in running the past couple of quarters, which obviously gives us further encouragement that we are able to push rate potentially further and also gives us a level of comfort that the underlying book is not being eroded from a quality perspective.

William Robert Berkley
Founder and Executive Chairman

And I might add, that if you go back a couple of years ago, we were standing firm about pricing. We were in the 70s for a while and we were losing business, not because we were trying to raise rates, but we were trying to maintain rates and we were -- our renewal retention levels were lower, 75%.

Operator

I show no further questions in the queue and would like to turn the conference back to the speakers for closing remarks.

William Robert Berkley
Founder and Executive Chairman

Okay. Well, thank you, all, very much. We're very enthusiastic about where the marketplace is, where things are. Obviously, there's plenty of things that could go wrong in any environment that is volatile and uncertain as the economic climate we're in today. But certainly, we think that certainly in the foreseeable future, things are looking very positive. Thank you all very much.

Operator
Ladies and gentlemen, thank you for your participation in today's conference. This does conclude the program, and you may all disconnect at this time.