The Travelers Companies, Inc., Q2 2009 Earnings Call, Jul-30-2009

Edited Transcript of The Travelers Companies, Inc. Unknown Thursday, July 30, 2009 at 01:00:00PM GMT

Corporate Participants

Bill Hannon

Brian W. MacLean

Gabriella Nawi

Greg Toczydlowski

Jay Benet

Jay Fishman

Jay S. Benet

Conference Call Participants

Alan Schnitzer

Brian MacLean

Brian Meredith

Jay Cohen

Jay Gelb

John Albano

Joshua Shanker

Larry Greenberg

Matthew Heimermann

Michael Nannizzi

Paul Newsome

Vinay Misquith

Presentation

Operator

Good morning, ladies and gentlemen. And welcome to the Second Quarter Earnings Review for Travelers. We ask that you hold all questions until the completion of the formal remarks at which time you will be given instructions for the question and answer session. As a reminder this call is being recorded today July 30, 2009.

At this time, I would like to turn the call over to Ms. Gabriella Nawi, Senior Vice President of Investor Relations. Ms Nawi, you may begin.

Gabriella Nawi

Thank you. Good morning, and welcome to the Traveler's discussion of our second quarter 2009 results. Hopefully, all of you seen our press release, financial supplement, and webcast presentation released earlier this morning. All of these materials can be found on our web site at www.travelers.com under the Investors section.

With me today will be Jay Fishman, Chairman and CEO; Jay Benet, Chief Financial Officer and Brian MacLean, President and Chief Operating Officer. Other members of Senior Management are also in the room available for the question-and-answer period.

They will discuss the financial results of our business and the current market environment. They will refer to the webcast presentation as they go through prepared remarks and then we will open it up for questions.

Before I turn it over to Jay, I'd like to draw your attention to the following on page one of the webcast. Our presentation today includes certain forward-looking information as defined in the Private Securities Litigation Reform Act of 1995. All statements other than statements of historical facts may be forward-looking statements.

Specifically our earning's guidance is forward-looking and we may make other forward-looking statement that accompanies results of operation, financial condition and liquidity, the sufficiency of the company's reserve and other topics.

The company cautions investors that any forward-looking statement involves risks and uncertainties and it is not a guarantee of future performance. Actual results may differ materially from our current expectations due to a variety of factors. These factors are described in our earnings press release and in our most recent 10-Q and 10-K filed with the SEC.

We do not undertake any obligations to update forward-looking statements. Also, in our remarks or responses to questions, we may mention Travelers' operating incomes, which we view as a measure of profit and other measures that may be non-GAAP financial measures. Reconciliations are included in our recent earnings press release, financial supplement, and other materials that are available in the Investor section on our website travelers.com.

With that, I'll turn it over to Jay.

Jay Fishman

Thank you, Gabby. Good morning everyone and thank you for joining us today. Pages three and four of our webcast summarize our second quarter highlights as further described in our press release.

All in bottom-line performance was modestly better than we expected and we are particularly pleased with what we accomplished in written premiums. Brian will have more to say about that a bit later.

The reporting today is somewhat later than usual driven simply by the way the calendar work and the fact that we build in a few extra days in our schedule due to the conversion to a new ledger system which we successfully completed in the first quarter.

Interestingly, this timing has allowed us to listen to a few other calls and to observe some of the market commentary. It has been a fair amount of discussion about market trends. Is this a hard market, a stealth hard market or continuing soft market, a softly harden market, or is the industry on or off the wagon? Any of you can take your own standby.

However we view the conditions, our challenges to execute in the only environment that exists and that's the environment that we face today. What you have heard from us in the past and will hear again today is a very consistent story that the Company is really well positioned to execute across our franchise and to continue to pursue and achieve our financial goals. We are executing, where we see attractive opportunities and where we don't, we pass.

Having said that understand that we are seeing many of those opportunities. We've grown our premiums in both business and Personal Insurance at rate and profitability, which our metrics indicate are at levels, with which we continue to be comfortable. You won't know that we are a very quantitatively driven organization and I believe that many respect Travelers have set the standard for understanding its business and operating on a quantitative rather than an anecdotal basis.

We're going to share some of that data with you this morning, and I believe you will see thought on this in our approach.

Just to refresh everyone's memory, we've been successful driving rate upward generally since the second quarter of last year. That success continues through this quarter as well. In fact, we've been able to achieve positive rate change in each of our three business segments in the quarter.

Nonetheless we are reluctant, as we were last quarter to make declarations about what the future holds. While we are really pleased that we've been able to achieve these rate gains over this period, it has struck us at somewhat kind of retulative to believe that one could with certainty forecast rate gains in a recessionary environment.

We've refrained from making predictions and focus on executing in the environment that we're in. To some extent we feel a bit like the great philosopher Yogi Berra, who understand once observed that it's really difficult to predict anything particularly if it's in the future.

All in the insurance market is much improved from where it was just a year ago. It's been an exciting time not only as a result of our strong competitive positioning but also due to the business that's been in the market place as a result of the disruptions specific to a few individual carriers.

We're staying focused, attending to customers and brokers and agents and working hard to grow our business.

With that let me turn to returns, the metric that we probably focus on most. For the quarter, we produced an operating return on equity of 11.3%. We might ask how we reconcile this return to our long-term goal of achieving a mid-teens return on equity overtime.

Please turn to slide five, and let me share with you an illustrative analysis that demonstrates the impact of current investment yields on our returns. First, given the turmoil on the financial markets over the last year and a half, we made a decision to accumulate cash at our holding company that exceeds our long term target of one times dividends and interest for $1.1 billion.

We currently have a total of $3.3 billion of holding company cash, 2.2 billion in excess of our target.

Our long term philosophy with respect to capital management has not changed and our current expectation is that we will redeploy the excess cash into our share buyback program over time. That redeployment would serve to lift return on equity by approximately a 100 basis points.

Next you all now that short-term yields are virtually at zero right now, compared to a longer term historical yield of perhaps 2.5% after tax. The impact of the shortfall has been to lower operating income by about $25 million per quarter impacting operating return on equity by about 40 basis points.

This is driven by the fact that we maintained a short-term liquid investment portfolio of approximately 4 to $5 billion to ensure liquidity in the event of a catastrophic event and prevent us from having to liquidate assets in a period of economic turmoil.

Lastly it's worth noting the impact of the reduction in yields on our $4 billion non-fixed income investment portfolio. For the quarter, it produced a negative 2.1% return. A more normal annual yield given the risk profile like that of these assets might be around 7% after tax overtime.

This shortfall has the impact of reducing operating income by approximately $100 million per quarter impacting upgrading return on equity by 150 basis points or so. An important observation is that if we don't believe these assets will ultimately yield returns appropriate for the risk.

We will ultimately lower our allocations to this asset class and if we saw our allocation to most certain, less volatile fixed income securities, which even now yield around 3 to 3.25% after tax.

The total impact of these last two items as a reduction of returns of approximately 190 basis points. Our premise is that, we will at some point return to by historical standards, a more normal investment environment.

The slide is not a projection or a restatement in way of current results. The best way to proceed it is that an illustration of why we believe that a target of mid-teens return on equity overtime remains an achievable goal.

We are in a period of unprecedented investment return dislocation and while we have smart and thoughtful about avoiding virtually all of problem areas of investment, the impact of lower yields is having a significant impact on our return on equity.

Before I turn it over to Jay, I would like to make a general comment about returns that are being reported by a number of companies in our industry. As all good companies do, we compare ourselves to the best competitors in the industry and analyze revenues, margins, returns and profitability.

What is apparent from this analysis is that not all companies classify income or losses from alternative investments in the same way particularly as it relates to operating income. Before you come to conclusions about relative returns and profitability, we encourage you to make sure that you look at results on a comparable basis.

And with that, let me turn it over to Jay.

Jay S. Benet

Thanks Jay. I know this sounds a bit repetitious but I have to say and frankly I'm happy to say that our investment portfolio, our reserves, our capital and our liquidity remain in very good shape.

Turning to page six. Operating company capital once again remained at or above all target levels.

Our debts saw a capital ratio is at its 20% target. The mid point of our 15 to 25% AA range and that's after successfully placing $500 million of 10 year 5.9% senior notes during the quarter.

Holding Company liquidity increased to over 3.3 billion or approximately 3 times our target level and that's even after $750 million of second quarter share repurchases and we got negligible amount of debt maturing.

Book value per share $47.29 including 865 million of net unrealized investment gains after tax increased 5% during the quarter. While book value per share of $45.76 ex-FAS 115 increased 4% and we close the quarter with approximately $26 billion of common equity. Our $73.4 billion investment portfolio continues to be a very high quality and well diversified across industries, investment types and individual issuers.

The portfolio is pre-tax net unrealized gain increased from 803 million at the end of the first quarter to almost 1.3 billion at the end of second quarter. Fixed income investments compromised 95% of the total investment portfolio although investment grade investment comprised only 2.5% of fixed maturities and the duration was 4.0.

I do want to point out one thing that did impact the portfolio this quarter. The downgrading of a bond insure that caused the movement of certain of our bonds from the AAA category mostly to the AA category which was just enough to move the overall quality rating of our fixed income portfolio from AA+ to AA. I should also point out that this change was not the result of weakening credit quality in the underlying bonds.

I would also like to mention that during the quarter we adopted two new accountings standards, a FAS 115-2 recognition and presentation of other than temporary impairments and FAS 157-4 determining fair value when the volume and level of activity for the asset or liability have significantly decreased and identifying transactions that are not orderly.

Despite the length of these titles, neither impacted us in any significant way. During the second quarter we produced a net realized investment gain of $8 million after tax, including after tax impairments of only 19 million. For those of you wondering second quarter after tax impairments would have been a little more than $30 million higher under the old standards.

FAS 115-2 also resulted in a $71 million increase made directly to retained earnings as of April 1, 2009 and offset by a corresponding decrease made directly to accumulated other changes in equity from non-owned resources bypassing the income statement.

The information that appears on page 7 is based on the schedule that appears on our Form 10-Q showing unrealized losses on investments, which estimated fair value is less than 80% of amortized cost. This amount has decreased from the first quarter. It now stands at only 374 million, a tiny fraction of both total investment and shareholders equity. We continue to closely monitor these investments as these are the most likely source of future impairments.

I do want to point out however, the FAS 115-2 has changed the nature of the data in the table. For example much of the amounts that appear in greater than 6 months but less than 12 months column is the non-credit loss component for these investments amount to a more likely to have been written off already under the old standards.

These amounts may or may not be written off in future periods depending upon estimates of future cash flows related to these investments and as a result amount to more likely to age in the schedule than they were under the old standards.

Shown on page eight, operating income of 732 million declined 20% from the prior year quarter, this was primarily due to a $170 million tax, I'm sorry $170 million after tax reduction and net favorable prior year reserve development, a $77 million after tax reduction in net investment income.

Margin compression that we had anticipated in our plan based up on recent pricing and loss cost trends and higher than expected non-catastrophe related weather all of which were partially offset by a $101 million reduction in Cat losses.

Now withstanding the favorable Cat loss comparison though our current quarter Cat loss is well higher than we would have expected. Excluding Cats in that favorable prior year reserve development, our GAAP combined ratio was 94.4% and as Brian will speak to in more detail we remain pleased with the underlying profitability of our business.

Second quarter net investment income of 547 million after tax is shown on page nine, down from the prior year quarter, was up from fourth quarter 2008 and first quarter 2009. Tying back to what Jay said earlier in his commentary about ROE, the overall yield of the portfolio continues to be negatively impacted by the very well short term yield environment and negative non-fixed income returns.

The long term fixed income portfolios after tax yield was 3.6%, consistent with the prior year quarter while the short term portfolio yielded only 30 basis points, down from 170 basis points.

The non-fixed income portfolio recovered somewhat yielding a small negative of 2.1% which is much better than a negative 14.9% and negative11.1% in the two most recent quarters. In consistent with our practice, we updated as best we could our non-fixed income returns through June 30 despite the usual time lag in which investment managers report results.

Page 10 of webcast shows the three major contributors to operating return on equity.... interest on corporate debt what we refer to as the passage of time component contributed 8.1 points year-to-date, down slightly from prior years due to lower short term interest rates.

Non-fixed income, NII are much smaller contributors to operating ROE but one that varies from period to period contributed a negative 1 point and underwriting income contributed 4.8 points.

Cumulatively from January 2005, we produced an average annual ROE of approximately 14.2% which is consistent with our stated long term goal of mid teens ROE. And one final note, we did successfully renew our Cat reinsurance program on July 1 and have included a schedule on the Appendix to this webcast.

The amount of National and Northeast only limits remains unchanged as did our $1 billion retention and the various attachment points were essentially unchanged. The cost of the program increased only modestly and with that, let me turn the microphone over to Brian.

Brian W. MacLean

Thanks Jay. As Gabby said, I will speak to the results of all our business segments. John Albano, Alan Schnitzer, Doreen Spadorcia and Greg Toczydlowski are here with us and will be available to answer questions.

Before I go into the individual business unit results, I will provide some broader commentary and I'll start with the rate picture on page 11. We're pleased that we were able to achieve positive rate change in each business segment.

Personal Insurance rates have continued on a positive trend for quite sometime. In business insurance, the rate environment has been improving for the last year and turned positive for the first time in over four years.

Similarly for Financial, Professional & International insurance, rate turned positive at year-end 2008 following two years of negative trend. The relevance of this trend to our future profitability is obvious.

Otherwise in terms of the larger picture claim frequency trends are favorable, in fact negative in some of our businesses and severity is at overall normal levels resulting in improved loss trends. Given these trends, we feel good about our product margins.

Although we continued to experience some margin compression on a written basis, it is at lower levels and in some businesses, margins are stable to slightly improving.

Despite current economic conditions, our premium trends year-over-year have been stable. Even as individuals in businesses have become more price sensitive, our retention levels remain very strong. New business is robust and overall achieving our targeted rate of return. So all in, we feel great about our position and our results this quarter.

Turning specifically to the business insurance segment on slide 12, operating earnings were down from last year primarily driven by the drop in investment income and the anticipated margin compression.

Compared to the prior year, Cat activity was down and favorable prior year development continued but not at the same magnitude as last year. Adjusting to these impacts the combined ratio was a solid 95.5.

Net written premiums have remained essentially flat for both the quarter and year-to-date period. And as I said, given the overall environment, we're extremely pleased with this result. We are continuing to see the impact of economic contraction in the obvious industries like construction and trucking. But most of our commercial businesses are seeing growth.

Turning to the production statistics on slide 13, retention remains strong and renewal premium change is improving and has turned positive in select accounts. But as I already mentioned, the story here is really the rate picture.

The next page takes the renewal premium change data and split it into two primary components, pure rate and exposure change. You can see that across all of business insurance, rate is improving while exposure is declining but at a fairly modest rate. So overall, premium change trends are moving in the right direction.

New business results shown on the next page have improved significantly this quarter and are up 13% quarter-over-quarter, with strong contributions from each business group. In select accounts, we've been talking about our platform rollout and that continues to drive new business.

In the individually underwritten businesses, we continued to see a strong flow of new opportunities and are please that we are winning our share. We've been speaking to you for quite sometime about our competitive advantages, our breadth of product, industry leading metrics, point of sale capabilities and leadership position with independent agents. We believe these advantages matter and are driving the increased opportunities.

In fact, what we bring to the market has never been more valuable. We have tremendous optimism about our opportunities and have strong controls in metrics to ensure we are executing appropriately. With that's spent -- said, we spend a lot of time analyzing the quality of the new business we put on the books and are comfortable because of our analytical capabilities.

The illustration on slide 16 is a simple depiction of a product lifecycle which quite frankly could be any insurance product or product from any number of industries. The profitability of a book of new business almost always improves over time as we better understand the book and take appropriate underwriting risk mitigation and pricing actions.

I doubt this is a new revelation to any of you. So the question here is not just the profitability today of the business we are putting on the books. But do we have the ability to actively manage the business. Do we have the tools to understand the business and track and measure the impact of the actions we are taking?

We believe our metrics and tools, which allow us to analyze the pricing and quality of our new business and renewal business, are as good as anyone of the industry. And we believe we have some of the best coin of sale talent to take this information and make the right decisions in the marketplace.

We measure our expected returns on new and renewal business, we measure our pricing at subsequent renewals, we examine the performance of our renewal book by loss ratio band and we do all of this by line, by business, by office.

The result is that overall the new business that we are riding is generating positive ROEs and more importantly we believe this pricing is consistent with generating our target ROEs overtime. Then we feel great that we've been able to grow share and we're confident that we know what we're doing.

If market conditions change, our approach will change accordingly but right now we're confident about our ability to compete in these market conditions.

Moving to Financial, Professional & International insurance segment on slide 17, operating earnings were down from the last year due to less favorable prior year reserve development. Current year margins shown in the adjusted GAAP combined ratio were very strong with the improvement coming primarily from less -- large loss activity in international.

Net written premiums for the segment after adjusting for the impact of changes in foreign exchange rates was down slightly resulting from fewer construction surety opportunities. We feel very good about the top-line story in these businesses and so let me turn to slide 18 to go over the recent performance statistics.

So you can see the reduction in surety premium which is a direct result of decrease construction spending. We remained the clear market leader in this product and have made a conscious decision to maintain our high quality credit profile.

In these more challenging economic times this is like to less business but has allowed us to maintain our excellent profit margins. As I said in discussing our growth in business insurance new business, we know what we are doing. We know when to grow and when not to and the same applies here.

We continue to feel good about our position in this market and the opportunity for us that the broader economy improves.

On the management liability side, the key dynamic is a great improvement inside the renewal premium change. Renewal premium change is plus 1% but the rate change is plus four. Rate under management liability components of financial institutions is up over 10% and public company liability rates are up 4% which compares to down double and double digits of a year ago. That we feel great about these rate improvements but want to emphasize that given the return levels on these products in the general market place some strengthening is needed.

In our international business retention was down versus the prior year quarter as a result of a planned reduction in Cat exposure within the life book of business. Renewal premiums were positive, was underlying rate improvement at 5%.

New business in the second quarter last year included $50 million from our entry into new businesses in Lloyd. Excluding this impact and the changes in foreign exchange rates, new business was up double digits from last year.

Before I go to Personal Insurance let me take a minute to update you on the impacts of the financial marketplace disruptions on our management liability business. We continue to monitor the analysis that we have shared with you during a last 18 months and our conclusion to remain the same. To give you some context into what we are seeing in the current economic environment and how we are managing it, we put some data together on slide 19.

Year-to-date there has been 64 bank failures compared to 25 in all of 2008. We have management liability exposure to 26 of these institutions, on a total of 32 policies.

Each policy on average has about $4 million aggregate limit. Our total net limit exposed to these 64 banks, failed banks is approximately $100 million and obviously we expect actual losses to be a fraction of that amount. Importantly we had taken actions through our active ongoing risk mitigation and review program and 70% of these accounts before the bank failure.

And these actions will significantly mitigate are open in exposure. So again we go over this material not to give you a complete picture of the financial crisis impact but to illustrate through this the use of this binate, how we are confident in our ability to manage the emerging challenges. Our lost estimate and current earnings guidance incorporate this analysis.

In aggregate for Financial, Professional & International insurance we feel great about this quarter's results. Margins are solid; we are growing where we want to and we are in a great position as conditions improve. Moving to Personal Insurance, we made one change to the exhibit.

All of the written premium and production results shown -- depict our agency book of business which is defined as business sold through agents, brokers and other intermediaries, or said another way excludes our recently announced director-to-consumer initiative.

Turning to slide 20 in Personal Insurance. Excluding the impact of mother nature, both auto and property business continues to demonstrate sound fundamentals and substantial earnings power. Weather did impact operating earnings which were down from the same quarter last year.

You can see that the large cat experience was favorable but non-cat weather related losses in home loans as were significantly higher.

Looking at slide 21, agency autos combined ratio of 96% was of slight improvement from second quarter 2008 due to a slight improvement in both frequency and earned rate.

Agency properties combined ratio of 99% was three points higher than second quarter 2008 driven by the non-Cat weather I mentioned. Turning to slide 22, we continue to be pleased with our agency auto production results especially in light of current market condition.

Renewal premium change has increased to 5% this quarter, which has contributed to a slight drop in retention and marginal pip reduction versus second quarter 2008. Agency property production results remain strong across all the metrics and we remain pleased with the continuing growth of the Quantum Home product and its ability to increase new business volumes despite challenging market conditions.

Across all our business segments, we are continuing to monitor loss trends, profitability in marketplace conditions, as well as the changing economic climate.

So we remain very pleased with new business growth and its underlying performance. We have been and will continue to take rig with loss indications and market dynamics allow us. We are continuing -- consciously expand product offerings and better align our field point of sale capabilities.

In summary while we cannot predict where the economy and the market will go in the second half of the year, we are pleased with this quarters results and look forward to building on that success.

Before I turn it back over to Jay Benet, I want to take this opportunity to introduce Greg Toczydlowski and Doreen Spadorcia.

Greg has been a key leader in the Personal Insurance organization for 16 years and over that time he's had experience in every area of the business. He led the development and implementation of our Quantum product and built and manage the product group for a number of years.

In the last year, his responsibilities were broadened to run the entire agency business on a day-to-day basis in this latest announcement further expenses roll.

Doreen Spadorcia has had experience running profit centers, staff and support areas and quite honestly is the best manager of talent that I have every worked with. She currently runs our 13,000 person claim organization and the results there has been phenomenal. So this is a great opportunity to leverage Doreen's leadership talents by having her work with Greg to manage the strategic direction of the business.

We are confident they will be a great team and help to continue the impressive success of our Personal Insurance. With that let me turn it back to Jay Benet.

Jay Benet

Thanks Brian. Page 23 sets forth our guidance for 2009 which were increasing based up on second quarter performance. We're now projecting fully diluted operating income for share in the range $4.80 to $5.05 compared to our previously announced range of $4.55 to $4.95.

Our guidance now assumes full year Cat losses of 410 million after tax or $0.73 per diluted share based upon actual Cats for the first half in an unchanged expectation for the second half of the year.

No additional prior year reserve development either favorable or unfavorable, no significant changes in private equity and hedge fund valuations for the remainder of the year as we're assuming unchanged capital market conditions, lower real estate partnership valuations due to a continuing downward trend in commercial real estate values, additional share repurchases of 2.25 billion are bringing the assumed total for the year to $3.0 billion and no significant change in average invested assets ex-FAS 115 and a weighted average diluted share count of approximately 565 million shares. With that we would like to open it up for questions.

Questions and Answers

Operator

(Operator Instructions). Your first question comes from the line Jay Gelb with Barclays Capital. Please proceed.

Jay Gelb

Thanks very much. Jay, can you give us some insight in to what level of success you are having from attracting business away from the stress competitors and may be tie that in to new business growth and business insurance that we saw in the most recent quarter?

Jay Fishman

Sure. Well I -- first, the slide that we presented at the Investor Day conference showed my recollection is six competitors and we were showing accounts taken versus accounts lost and net and all of them were positive and I don't have that slide actually in front of me, but they were meaningfully positive.

If we did that slide again for the quarter, it's actually they are all positive and they are actually I believe all somewhat more positive than they were from the slide that we presented at Investor Day.

So we continue to have success in the market place not only from those competitors that perhaps are struggling but from the real solid competitors as well. It's we are -- just we are having real success in the market place day in day out.

I don't know how to quantify that in a context of written premium in the growth, that's I just I'm done it, frankly but it's so I don't have a comment on that.

Jay Gelb

Okay thanks and I have two separate issues. The first is how long do you think it'll take you to complete the pace of the increased share buyback program and then finally if you could comment on the potential for Chinese drywall losses in construction claims that'll be helpful too?

Jay Fishman

Why don't we have John Albano speak to the drywall and then I'll come back for share buyback.

John Albano

Jay, as far as the drywall is concerned, most of the affected buildings were built or repaired in the 2006 and 2007 timeframe. Imports of the drywall as we began a little bit before that but most of what we're seeing in terms of repairs and new building construction is those two years, so we're talking about a couple years of exposure.

Our exposure to Chinese drywall situation would appear to be minimal. We are not a big rider of residential contracts; we are not a big rider of importers of foreign building materials. We have looked at the claim activity, we have looked at our loss our limit of liability for each one of those and we view it as a minimus.

Jay Benet

And I just make an observation and obviously we have done everything one can do to analyze what is an early emerging situation. This is still from a claims and activity perspective quite early and who knows where it will go but what we have attempted to is to understand where the exposure potentially could be analyzed, our commitment to those exposed lines and feel pretty good about it.

But we are watching carefully and we'll report on it periodically as quarters emerged.

Jay Fishman

Jay, as far as the pace of the buy back program I think in prior years we've said that we usually will hold back a little bit in the third quarter given that as capsize.

But in this particular year given the amount of cash we've build up to the holding company, our desire is go into the market more aggressively than that. So for the purposes of thinking ahead, we're just planning on doing it pretty steadily between now and the end of the year.

Jay Gelb

Consistent with the pace you had in the second quarter?

Jay Fishman

Well I mean in terms of the dollar amounts that we're putting forth in the guidance, it would be at a higher amount than what we did in the second quarter.

Jay Gelb

Thanks for the answers.

Jay Fishman

My pleasure.

Operator

Your next question comes from the line of Josh Shanker with Citi. Please proceed.

Joshua Shanker

My first question is whimsical. I'm wondering where the little dog is? I've been waiting for it on TV.

Jay Fishman

You don't watch enough TV. We have spent plenty of money on it and you haven't seen it.

Joshua Shanker

Alright, alright I'll keep watching. And I'm following up on Jay's first question, one of your very large competitors who I won't name spoke earlier this morning and said that they're seeing great submission flown, winning great business in the small commercial arena.

And I'm wondering if there's room for two very large competitors to be doing that and who is loosing the business?

Jay Fishman

Our data speaks for itself. The written premium in select is as presented here. So I don't know anything about anybody else's numbers. I know a lot about our own and if you go to page, where was that the new business page -- go to 15.

We did $154 million in Select, up from $133 million last year, premised largely on the roll out of Travelers' Express and the success that that's having in the marketplace.

So I don't know about anybody else's numbers but there is plenty of room for us to be successful.

Joshua Shanker

And the final question, there is lot of people. Where are deductibles going for small commercial business? Is that a common discussion that you're having? Is that actually unusual? What are your agents experiencing in that regard?

John Albano

This is John Albano. There is really little movement in terms of deductibles on smaller accounts. Smaller accounts tend to have lower deductibles obviously than larger accounts and based on their financial condition, not looking to move that up.

More broadly, we are seeing in larger accounts a little bit of movement in terms of deductibles on some larger accounts but it's not a significant shift.

Joshua Shanker

Okay and thanks for the answers.

Jay Fishman

Pleasure.

Operator

Your next question comes from the line of Matt Heimermann with JP Morgan Chase. Please proceed.

Matthew Heimermann

Hi, good morning everybody. Two questions if I may, just with respect to some of the slight moves down our retention, is this just... how tied, let me rephrase that.

How important has that retention drop been to actually being able to generate deposits of rate changes across all those segments.

Brian MacLean

This is Brian. I think you got a look at it a little bit specifically business-by-business. In Personal Insurance; I think specifically on the auto side, we were ahead of a little bit of the market curve on getting some rate increases filed there.

And there's probably also some economic drivers there with consumers being a little more price sensitive. So we feel real good about that trade off and so we needed to get the price moment and so their it's pretty correlated.

In the small commercial world, there's probably also a little bit of economic impact there with some business failures. Again, not a dramatic number but maybe that's moving our retention of point.

And so we don't think there it's been as connected to the pricing but is to some degree. And in the middle market, the numbers have bounced around a bit but at 85 levels, we continue to feel great about our retention.

Jay Fishman

And again just in the context of looking overtime, the Select retention of 80 is the same as it was in the second quarter of '08. The retention to commercial 85 is the same as that it was in the second quarter of '08 and in other business insurance were from 82 to 81?

I -- hard to see anything in those numbers that would indicate any substantial change or shift. Obviously we've always said retention is an important, maybe the most important leading indicator.

We'll obviously keep on watching it but this is at the moment nothing more than another quarter that I would characterize as being in sequence.

Matthew Heimermann

Okay. And based on that, it sounds like you're still pretty comfortable that that trend can continue through the end of the year?

Jay Fishman

Again I'm trying to resist the notion of forecasting because the market is... when is say the market, I'm really responding more globally to the issue of the economic environment in which all companies compete.

But we're all competing in the same marketplace and given the recession and given the lower payrolls, lower projected sales, lower amounts of transportation, just lower amounts of economic activity which translates into premiums, it's just an awfully difficult time to look into the next two quarters and predict anything other than just being out there and banging away.

And so I'm just going to refrain from it. But I don't see anything in the second quarter where any kind of alarm bells or genuine concerns are there.

Matthew Heimermann

Okay and then with respect to the tip decline in Personal Lines, on the autos, I believe which was auto driven, is there are any particular type of customer that's driving that retentions range?

Greg Toczydlowski

Good morning Matt, it's Greg Toczydlowski, as Brian indicated. We are just seeing the economy generate a price sensitive consumer across a pretty broad group of a profile. So we are not seeing any shift in profile overlap business in.

Right now our focus is very much on the pricing discipline. So looking at where our combined ratios are for the quarter, we feel good about the combination of the two metrics.

Matthew Heimermann

Okay. Thank you and then Jay just one quick follow up. Your portfolio acts the bond wraps, is that AA as well?

Jay Fishman

Yeah, it's either way, it's a AA portfolio.

Matthew Heimermann

Okay perfect, thank you.

Operator

Your next question comes from the line of Jay Cohen with Bank of America Merrill Lynch, please proceed.

Jay Cohen

Thanks good morning. Couple of questions. Jay, slide five was an interesting one, where you adjust for the ROE for these, I think reasonable factors. What adjustment you didn't make was the combined ratio and I guess the presumption would be that the combined ratios you guys are producing now is a normalized level and I am wondering if you can reflect on that a bit and then I will have one more question.

Jay Fishman

Yeah we thought much about it because obviously it's an important element. You got a couple of things kicking around in the there, you've got favorable reserve development and it's certainly appropriate to ask the question to the extent of which that is sustainable and you've got excess cat in the quarter relatively to what we would consider to be a normal cat exposure, normal cat loss last for the second quarter.

So ultimately what we did was, we ran the same analysis, if you go the slide that shows the combined ratio XX, my recollection is let me get to it but I think it was 94.4 is my recollection for that combined

Jay Cohen

That's right.

Jay Fishman

Ratio was XX and even if one where to ramp that up for what might be considered a normal cat exposure, you get to and these are approximates. Jay I think, I'm not getting terrible precise here but even if you call it a 95 and then if you look at we make the assumption that given what's happening with rate and given what's happened with loss trend, that you can envision the circumstance we're on a inert basis looking out there that margin compression potentially could stop.

You'll get to that same mid-teens level. It will a little bit lower obviously 95 versus 94.4 is six-tenths of a point in the other direction but its just arithmetic. And if you are on a 95 combined and assume a more normalized investment return environment. I think it will point you generally in the same direction.

But you can ask questions like what happens if rates get much better? It will be better. Will that have an impact on investment returns because the market changes, I don't know. If rate gets really turns down as the different, its funny

I was asked the question before, if rates this goes back probably by about 6 or 9 months if rates never change and if investment yields never change, how do you get to mid-teens to turn on equity and the obvious answer is we can't.

It's -- there has been a cyclicality to the business and a cyclicality to investment returns and that's frankly why we talk about returns overtime. There is a presumption that theirs a mean line, a normal line within all of those cyclicalities and around that line we think a well run business still has the ability to produce that mid-teens number.

Jay Cohen

Oh that's great. I guess the second one more specific when you discussed some of the bank failures. There was a comment that the company took action ahead of time on some of these accounts and I am wondering what that means? What kind of actions did you take to reduce your risk?

Alan Schnitzer

Jay, its Alan Schnitzer, it's the typical underwriting action you take any time you will look at underwriting riding an account. So its limits it's A side versus B side. The whole nine yards in terms of underwriting.

Jay Cohen

But obviously you feel that it was effective enough to reduce your risk than what otherwise it would have been.

Alan Schnitzer

Sure it's changed the risk profile of those accounts.

Jay Cohen

Okay. Let me stop there. Thanks a lot.

Jay Fishman

Pleasure.

Operator

Your next question comes from the line of Mike Nannizzi with Oppenheimer. Please proceed.

Michael Nannizzi

Thanks. Just a question on guidance. When you look at the change from before to now, how much of that change is due to second quarter cat reserve development and share re-purchase activity versus how much of that change is due to a change in expectations for the latter part of the year? Thanks.

John Albano

This is J. Albano, I think a lot of it is as we said just the guidance changes based on the performance as things develop. So lots of the change in the guidance was driven by the second quarter. The guidance previously didn't include any estimates of favorable development so that's fully factored in. The excess cat's going the other way of factored in as this the weather that Brian was talking about before.

I think if you add up all those numbers and look at the impact of the increase in the share buybacks, and you probably end up with something close to about somewhere between $0.25 and $0.30.

Michael Nannizzi

Got it okay, thank you.

Operator

comes from the line of Brian Meredith with UBS. Please proceed.

Brian Meredith

Yeah, good morning. Couple of quick questions for you. First your big competitor, I guess reported this morning hasn't his best increase in the reserve. I was wondering if you can give us a status on what you are seeing with respect to investment claim activity?

Jay Fishman

Specialist?

[inaudible].

Brian Meredith

We haven't talked about it a long time.

Jay Fishman

We are we review our specialist reserves on a quarterly basis and we did not make any changes to our specialist reserves in this particular quarter. I can't on comment on what somebody else is saying but at least at this point of time nothing is really changed in our view.

Brian Meredith

Great. Second question of Jay, just back of the whole ROE discussion quickly. What would you say that the long term kind of fixed income return did you would expect in your businesses, when you are kind of evaluating the -- where rate levels need to be?

As obviously you have got to respect in fixed income returns to start trending upwards, right, if you got your mid teens ROE.

Jay Fishman

Yes, different strategic point, the illustration that we put forward here is making two adjustments -- is making an adjustment to short term yields which obviously generate into a portfolio quickly. You've got very short duration short yield change, sort of investment income.

The alternative arena actually has a relatively quick responsive rate also. Tight evaluations, equity evaluations and such. Our real fixed income portfolio, we are running a duration of about four and so the change even to the extent that new money rates change, given the share buyback, given the way we are deploying capital, you are not going to see the fixed income investment yield change very much. Its going to continue to just crank out, what it is that crank out.

And then obviously as we as the duration moves it will change slowly. We are talking about a 10 year treasury I look at yesterday I didn't look this morning. Ten year treasury at 3.6. This is an investment environment in the fixed arena that will allow us to get through the mid teens on the presumption that short rates eventually return back for an in effect zero and the alternative investment portfolio begins to return consistent with its realistic profile.

I feel in fact confident about the first. If we are going to have short rates of zero, we are going to have lot of problems that we are going to be dealing with in a couple years. They are going to be quite different from the ones we are dealing with now.

On the alternative investment returns, to the extent that capital where we deployed, again if the ten year treasury is 3.6, if these assets aren't going to get back to an appropriate risk adjusted level over some reasonable period of time, no one is expecting in the next quarter, if they don't get back there we'll eventually cut the allocations to that asset class.

And redeployed it somewhere else when the risk adjusted returns are more appropriate.

So this is the issue was really at the bell ends of our investment portfolio. The very short end and the alternative investment end and the stuff in the middle is just doing fine.

Brian Meredith

And I guess the presumption there also is an as you mentioned earlier that to stable reserve development, one has to continue here as well.

Jay Fishman

Well again I think I answered Jay's question earlier about that to the extent that one were to simply assume that there would not be any more reserve development and cats would become normal whatever that means but normal given our exposure.

If you want to sit down and do the risk math at 95 combined which is about where you get to a current margins. You will actually see that the analysis holds true even in that case. It doesn't it it's still an achievable goal. So how we feel about it to the extent that rate continues to move up. We feel more bullish about it.

We -- to the extent that loss trend continues to remain benign, we feel more bullish about it. So you are right there is any number of variables in this. The extremes at the moment in the context to environment that we operate in and I'm speaking now broadly about insurance and investment, the extremes are at basically zero yields per short term investments and at alternative investments effectively also being zero at the moment.

Those were the two extremes. The underwriting environment that we in is just fine, its just fine I mean again its fine in the current quarter and the time in the context of looking at least where rate seem to be heading, I am going to resist for making the predictions but if you look back to the second quarter of last year, rates have been moving in the right direction and loss trend has been relatively benign, that's a pretty good scenario. I have no idea that it will continue. But that -- all the factors that go into how you think about returns in our business.

Brian Meredith

Great and then last just quickly. Any prospect from agents, with respect to the direct distribution and did that all contribute to the drop in the interest in the quarter, first quarter?

Greg Toczydlowski

Its, Greg Toczydlowski again. We have been very closely with our agency plan and communicating with them and just educating around all our direct to consumer initiatives and including the advertising around that and the partnership has been very strong and quite frankly as they've seen the campaign out there we received many positive remarks around it. So we are going to continue with that partnership but we don't believe it had any impact on our production.

Jay Fishman

I agree with what Greg said but that's not to say that we haven't taken a call or two or three from agents who are bothered, troubled by the -- what they perceive to be a different strategic direction. But they are clearly significantly in the minority and again I'll reinforce what Greg has said, there are certainly no indication that anything as it relates to our business in any subsequent way in buying and this is attributable to that.

Brian Meredith

Okay, thank you for the answers.

Jay Fishman

Pleasure.

Operator

Your next question comes from line of Larry Greenberg with Langen, please proceed.

Larry Greenberg

Thank you and good morning, Jay I want to ask you to predict what rates are going to do going forward? But if I were to assume that your business insurance rate trends were to continue, would you be at a point by the end of this year, where you weren't loosing any margin on the end premiums?

Jay Fishman

Yeah, we actually have spent a lot of time talking about that exact question and we are going to answer it. We are going to talk about written and then we are talk about both because the 2 things are different but I'll let John tackle that question.

No, you want to go. Whatever?

Brian MacLean

No I think John was just hesitating to say what we -- I think given -- Hi, Larry how you're doing.

John Albano

I think what's important in this is that don't perceive this to be a forecast.

Brian MacLean

Right.

John Albano

We are not forecasting rate. You actually asked the question the right way which is if rate trends continue which is not to say that we're telling you that rate trends are going continue.

Jay Fishman

If rates trends continue we would believe that by the end of this year on a written basis, our business insurance segment broadly would be experiencing improving margin.

Larry Greenberg

Great thanks. Second question...

Jay Fishman

It will take a while for that to show up.

Larry Greenberg

Obviously it takes a while to...Yeah I got that. And on the investment side, has Bill got anymore optimistic on the capital markets environment?

Bill Hannon

Hi Larry, this is Bill.

Larry Greenberg

Hey Bill.

Bill Hannon

Obviously the psychology is much better although, we don't have lot of attention to psychology what we invest. If we did, we could have invested very differently going into this crisis.

On balance, it can hurt if the psychology is better because it will make it marginally easier to refinance the large amount of commercial real estate mortgage debt and private sector debt, largely high yield buy out related that has to be refinanced in the next 24 months.

But we still think there will be a considerable shortfall in the amount of debt that has to be refinanced and the capacity of the market to refinance this. And we're determined that as little of that unrefinancible debt as possible be in our portfolio. So at the margin believe it or not, we're probably still reducing risk on a day to day basis. We find there is very little penalty for doing it. In fact in the case of securities, we don't hold any but we hold some that were severely marked down.

The recovery in prices has been amazing. Yet in many cases, the same obstacles to ultimate payment remain and that's we focus on. We focus on getting paid because in a fixed income security which have some 95% of the portfolio, you're up side is to collect the cash close you bargain for.

And do we feel better, I think we feel better with everybody else but we're looking at things as hard noses we ever have.

Larry Greenberg

Great thanks. And I think in the past not too long ago, you had indicated that partnership, private equity, type of assets classes might be, some of the more interesting. Have you or are you inclined to put any new money to work in those asset classes.

Bill Hannon

We've given the message to everyone that we're opened for business but there is surprisingly little quality fund raising activity in private equity. Now there is a lot of noise been made about the secondary market and if secondary assets were trading in volume at appropriate discounts, we certainly have the capital for it but we think there's been a lot more smoke than fire there. So it's been a very quiet year.

Jay Fishman

But not lack of willingness on our part.

Bill Hannon

Not lack of willingness on our part and frankly we've been surprised by the low capital falls in our funds. The negative cash flows that is the excess of capital falls and management fees over distributions is running at a much lower rate than we had anticipated.

Larry Greenberg

Great, thank you very much.

Operator

Your next question comes from the line of Paul Newsome with Sandler O'Neill. Please proceed.

Paul Newsome

Good morning and thank you for the call.

What has shift investments in just a bit, could you describe may be at least qualitatively how within each segment classes as opposed to the allocation you think you're meeting or exceeding sort of industry averages, particular on the hedge front and vividly if you can give us may be an example of how you may be more conservative in your accounting for the hedge funds and if you mention something along those lines in your prepared remarks?

Jay Fishman

Let me speak to the second Paul, then I'm going to turn it over to Bill. We're not more conservative, our alternative investment income or loss is classified within operating income. And so we look at operating income for us, it includes for example the $20 million loss from alternative investments that we recorded in the quarter.

I don't know if everybody else does from a conservative or aggressive perspective but many people classify the alternative investment gains income or loss below the operating income line. So operating income comparability from one company to another is really it's easy to do.

Virtually everybody gives you the disclosure but the nature of the classification is quite different from one company to another is what we are looking at.

Bill Hannon

With respect to our performance obviously we do comparative to publish bench marks we can find and we try to be pretty granular by type of hedged fund and over the last couple of years we have actually done very well relative to those bench marks.

But as a rule what we benchmark here is not performance but risk. We try to keep the amount of risk in the portfolio pretty constant from year-to-year and we grade ourselves at the end of the year by how much return of the return that was possible given that amount of risk we were able to capture. So we do look at the return benchmarks and we are often surprised by how well we do but our primary focus is risk.

Paul Newsome

Okay, thank you.

Operator

Thank you. Your next question comes from the line of Vinay Misquith of Credit Suisse. Please proceed.

Vinay Misquith

Hi, good morning. Two questions first on the ROE, your slide mentioned a higher amount of cash at the holding company. When do you propose to invest the extra $2 billion in cash because it seems that the $1 billion that you plan you use for share repurchases that you will sort of generate in your net income, over the next two quarters?

Jay Fishman

Our guidance is already speaking to approximately $3 billion of actually not, be very specific it says approximately $3 billion of share repurchases for full year. So we obviously know what we have done for the first six months, so you have some sense of what we are anticipating to do for the last six months through the extent that market conditions and circumstances allow, we obviously have the capacity to do more. If market conditions and circumstances for whatever reason become problematic, we'll always adjust our program relative to what's going on in the market.

But I -- we generally been a company that has projected out share repurchases in a way were that our tilt if you will is to probably do more than less assuming that the market continues to support the activity.

Bill Hannon

The other thing I would add is that holding company cash is the amalgamation of lots of activities that take place and one of them is getting money from the operating companies through operating company dividends up to the holding company and that's not done on a basis that says here's what the operating companies earned in the quarter let's bring that up.

It's all different timing track to that. So what we do in projecting out what kinds of share buy back activities we should have as we project, because today's holding company cash here the dividend that will come out and going to come out of the operating company here the payments that we are going be making in the holding company for interest and dividends and things of that sort.

And these are the amounts of cash that we will have at the end of the third quarter, at the end of the fourth quarter and with that more comprehensive analysis we then come up with. Okay, what is the amount of buy back that we should have and what will that leave us at those points in time with regard to holding company cash.

Vinay Misquith

So fair enough. If I could just ask, bring a follow up on that. So when do you thing this penalty that you have because you have excess cash at the holding company when do you think that will sort of go away because you have finished due purchasing extra stock?

Brian MacLean

By putting in this guidance saying that we were going to do $3 billion of repurchases for the year that would bring the holding company cash balance down considerably from where it is.

We still as Jay and Bill have talked about, you know live in this world where you know we have a recession going on. There's economic uncertainty out there. So doing the $3 billion will not bring us down to the target at the end of the year. We're still being a bit cautious but will bring us considerably lower than where we are today.

Vinay Misquith

Sure. And is the $3 billion for the next 12 months or is it for six months?

Brian MacLean

The guidance is annual guidance. So you should think about it as we've done $750 million through the second quarter and the 3 billion for the year. So that would leave 2 billion 250 for the rest of the year.

Vinay Misquith

One separate question if I may. I think you mentioned the frequency and severity of loss cost trends were very manageable. I was just hoping you could expand on that.

Should we see sort of a stabilization or a continuation of very low frequency and severity trends. Do you think that your current profitability would remain the same over the next 12 months despite pricing being flourished?

Brian MacLean

I think again this is Brian. I think again you got to think about it a little bit across the spectrum of businesses because there's a lot of businesses here. Frequency trends in our personal, auto business for example have been running very favorably.

We're constantly like everybody else trying to figure out the causes there. Some of it is economic driven as in people driving fewer miles etcetera, etcetera. But overall the frequency trends we have been seeing across personal businesses and much of our business insurance have been trends that we have been seeing for a quite of a while. So we don't think they are just short term anomalies.

If I get a little of our question I think its similar to the one that are Brian asked a little while ago which is if these trends continue as they are continuing, how do we feel?

Vinay Misquith

Yeah.

Brian MacLean

Again if you have got frequency levels running in some business actually negative and overall I would say better than historical in severity again this is a broad aggregate across the company; severity running pretty typical that's the positive place to be from a loss trend and then if you get some positive rate with that, margins will improve.

Jay Fishman

Obviously as long as rate change even though it was heading in the right direction as long rate change was still negative that was implying compressing margins or be at it a slower rate. Once that rate change passes above zero you are now talking about at least a possibility of expanding margins depending upon on what happens to loss trends and of course the ability to continue to sustain as positive rate gains and it was and again just a commentary about the quarter.

This is a first time in a long, long time where the rate change in all three business segments was positive. So you look out you would say to the extent that continues that's a bullish indicator.

Vinay Misquith

Thank you.

Jay Fishman

Thank you. I don't think we have any more questions and so with that we will close our conference call and thank you all for joining us today.

Operator

Thank you for your participation in today's conference. This concludes the presentation. You may now disconnect and have a good day.