S&P Global
Market Intelligence

Chubb Limited NYSE:CB

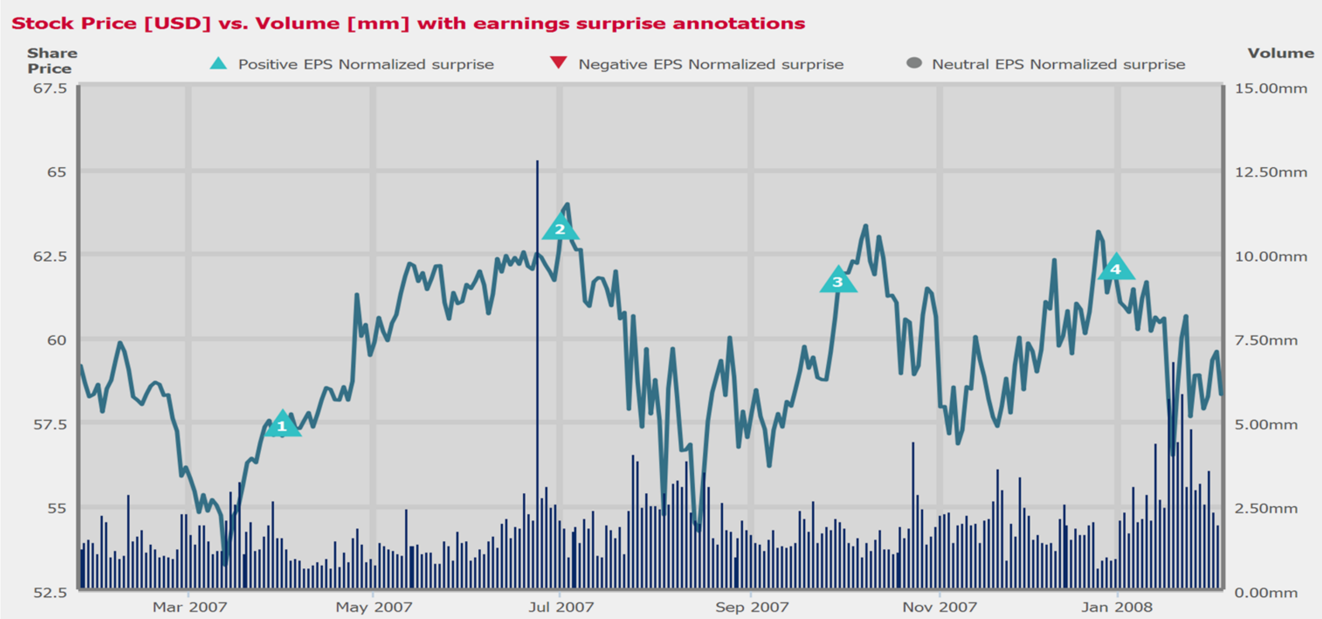
FQ1 2008 Earnings Call Transcripts

Wednesday, April 30, 2008 12:30 PM GMT

S&P Global Market Intelligence Estimates

	-FQ1 2008-			-FQ2 2008-	-FY 2008-	-FY 2009-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	1.91	2.16	▲13.09	1.91	7.65	7.73
Revenue	-	-	▲(1.04 %)	-	-	-
Revenue (mm)	3187.08	3154.00	-	3179.40	12233.58	12451.79

Currency: USD
Consensus as of Apr-30-2008 12:17 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ1 2007	1.75	1.98	▲13.14 %
FQ2 2007	1.84	1.98	▲7.61 %
FQ3 2007	1.82	2.06	▲13.19 %
FQ4 2007	1.90	2.05	▲7.89 %

Table of Contents

Call Participants

EXECUTIVES

Evan Greenberg

Helen Wilson

Phil Bancroft

ANALYSTS

Charles Gates

David Small
Bear Stearns

Jay Cohen
Merrill Lynch

Jay Gelb
Lehman Brothers

Josh Smith
TIAA-CREF

Susan Spivak
Wachovia

Thomas Mitchell
Miller Tabak & Co., LLC

Presentation

Operator

Good day, everyone, and welcome to ACE Limited's first quarter 2008 earnings conference call. (Operator Instructions)

And now for opening remarks and introductions I would like to turn the call over to Ms. Helen Wilson, Director of Investor Relations. Helen, please go ahead.

Helen Wilson

Thank you. Welcome to the ACE Limited March 31, 2008 first quarter earnings conference call.

Our report today will contain forward-looking statements such as statements relating to our financial outlook and guidance, business strategy and practices, world prospects, investments and use of capital, integration and performance of recent acquisitions, our proposed redomestication to Switzerland, general economic conditions, pricing and market conditions, exposures and losses and reserves. Actual results may differ materially. Please refer to our most recent SEC filings as well as our earnings press release and financial supplement, which are available on our website, for more information on factors that could affect the forward-looking statements.

This call is being webcast live and will be available for replay for one month.

All remarks made during the call are current at the time of the call and will not be updated to reflect subsequent material developments.

Now I'd like to introduce our speakers. First we have Evan Greenberg, Chairman and Chief Executive Officer, followed by Phil Bancroft, our Chief Financial Officer. Then we'll take your questions. Also with us to assist with your questions are several members of our management team.

And now it's my pleasure to turn the call over to Evan.

Evan Greenberg

Good morning. We had a busy quarter. We closed two acquisitions in the period, Combined Insurance and the Atlantic Companies personal lines business, both on or ahead of schedule. While early days, Combined is on tract towards achieving the efficiency and growth plans we envisioned for them and in fact will make a stronger contribution to '08 earnings than we originally contemplated and disclosed in December. Phil will provide more details when he updates guidance.

As you know, we also announced in the quarter our intentions to move our place of incorporation from the Cayman Islands to Zurich, Switzerland. The acquisitions and the re-domestication are actions I believe that speak to the medium and long-term strategic positioning of the company. They reflect the continued evolution of ACE.

From a financial perspective, I believe our first quarter results were quite strong, particularly given financial market conditions. After-tax operating income for the quarter was $725 million, up 9.5% over prior year. All divisions of the company performed well and contributed to an ROE of close to 18%.

Net income, which was down 46%, was impacted in the first quarter by volatility of historic proportions in the financial markets, both debt and equity. Consequently book value growth was basically flat, increasing $58 million in the period. I'll return to this subject in a moment.

On the operating income side there were a number of moving parts this quarter. Our underwriting results benefited from prior period development of $137 million, almost exclusively over 90% short-tail lines related. The largest portion of this was in our U.S. crop insurance '07 year book, with the balance in our property lines.

The P&C expense ratio in the quarter was unusually high and not representative of our run rate. The causes of this anomaly were primarily two items which will not repeat and Phil will describe them, though suffice to say, in my judgment, this is not a cause for concern. I expect our expense ratio will be at a more reasonable level for the balance of the year, up about 1.5 points before accounting for the impact of combined.

Our business mix, namely our international business and our international A&H in particular, will account for about a third of that expected increase. The balance, or about 1 point, will simply be related to declining premiums while expenses remain relatively flat as well as a change of mix within P&C.

As I said earlier, the quarter experienced unprecedented financial market volatility. The [set] aggressively eased, the yield curve steepened, credit spreads substantially widened and equities declined. This resulted in a market pricing impact on our invested assets and our variable annuity reinsurance business.

Concerning our investment portfolio, while we reported $480 million of realized and unrealized losses, notably real credit impairments were insignificant at approximately $20 million.

Concerning the annuity business, I believe this quarter's mark is fundamentally transient and distorts the true economic reality. While accounting convention requires us to account for this like a derivative, this is in fact a buyandhold insurance business. The liabilities are long term in nature, and the current mark and consequent reserve movement do not reflect the ultimate value and future cash flows. Again, Phil will elaborate a bit more in a few minutes.

During the quarter, the global P&C insurance markets continued to soften, all lines and all territories, with little exception. Financial institution rates were up modestly, but no other [inaudible]. Overall the softening accelerated during the quarter. In many classes, the rate of decrease in March and April around the world was sharper than in January. But the quarter rate declines in the U.S. averaged high single digits on our retail book and in the low teens on our wholesale business. Remember, these are average percentages and they vary by line.

As I said last quarter, the market continues to become more competitive despite what I believe is overall a more risky environment. We face the twin specters of a global slowdown and U.S. recession as well as inflation. The continued and evolving impact of the financial markets' turmoil will be with us for some time and will continue to be a drag on the global economy.

In my judgment, though, inflation is the more long-term and insidious risk that faces our industry. We have been in a benign inflationary period, and I believe this is likely coming to an end. And yet ironically, insurance rates continue to fall for all the sector-specific market-oriented reasons we know. Fundamentally, it is capital driven.

[inaudible] our focus has and continues to be on holding our renewals and writing less new business, overall driving for growth in those areas that will provide an adequate return while curtailing or eliminating growth in other areas. I hear many of our competitors make similar comments, but time will tell who is and who is not practicing what they preach.

Net premiums written in the quarter declined 4% over the prior year quarter. Frankly, our overall revenue shrank less than we originally projected, due principally to our international operations. The impact of a weaker dollar and the growth in our A&H business and specialty P&C lines all contributed.

A theme across our economy is global companies, and ACE is one of them. And all industries are performing better in this economic environment than purely domestic companies due to continued economic growth in other parts of the world. Specifically, our Latin America and Asia Pacific operations experienced good growth, and our business in Continental Europe was up as well, while our U.K. and Australia businesses were down. Internationally, our retail business, both P&C and A&H, grew while our international wholesale business shrank modestly.

Our North American premium was down, primarily due to a decline in our workers' comp related exposure, both risk transfer and risk management, as well as professional lines, DNO and FI in particular. Certain specialty and general P&C lines, on the other hand, particularly in middle market areas, experienced growth.

Also remember last year in our North America operation we wrote and disclosed a large transaction in the first quarter that did not repeat this year.

Our global reinsurance business shrank due to both competition and increased net retentions on the part of cedents who reinsured to us.

Generally speaking, U.S., London and Bermuda-based wholesale insurance continues to be more competitive than retail, though competition in most areas of retail has become quite fierce.

In sum, I believe we are managing with a clear-eyed recognition of the competitive and risk environment, while remaining alert to opportunities around the world on both the asset and liability side of the balance sheet. We remain confident in our ability to execute and outperform.

With that I'll turn the call over to Phil, who'll add some more color around a few of the items I mentioned and he'll update guidance. Following that, we'll take your questions.

Phil Bancroft

Thanks, Evan. Good morning.

As Evan mentioned, the first quarter was marked by unprecedented financial market volatility in both credit and equity markets. In spite of this, our balance sheet remains very strong. Our cash and invested assets grew by $1.4 billion to almost $44 billion. Our reinstatement leverage continued to drop and is now 83%. Our net loss reserves increased $460 million, and our operating cash flow was $1 billion.

Net realized and unrealized losses after tax were $650 million. This included approximately $480 million from our investment portfolio, $165 million from derivatives principally relating to the GMIB liabilities of our life reinsurance business, and our share of realized and unrealized gains and losses from AGO.

The $44 billion portfolio represents assets invested all around the world. The majority of our investments are dollar denominated, and a significant amount of this is invested from nontaxable jurisdictions. Of the $44 billion, 87% is invested in investment grade fixed income securities, with the remainder allocated among equities, high yield, and other alternative investments, including private equities and hedge funds.

As you can see from our supplement, our investment portfolio is conservative, and we believe our asset allocation is appropriate given the U.S. and nonU.S. operating position.

Regarding the $480 million loss in the quarter, our global equity and high-yield bond portfolios sustained a marktomarket decline of $330 million. These markets have recovered significantly in the first few weeks of April.

As we've previously mentioned, we do not invest in CDOs or CLOs and our exposure to subprime mortgages is minimal. The credit quality of our portfolio is high at double A and has a duration of 3.5 years.

With an historic widening of credit spreads during the quarter, our investment grade fixed-income portfolio incurred a marktomarket decline of $150 million. This decline relates primarily to movements in our triple A, CMBS, and mortgage portfolios. As you can see in our financial supplement, there have been no downgrades or credit losses in these portfolios. In addition, the characteristics have not changed materially since our previous disclosure, and we do not expect any material credit losses.

Our overall portfolio was in a net unrealized gain position of nearly $300 million at March 31.

With respect to GMIBs, as Evan mentioned, our loss resulted from an increase in the fair market value of the liabilities relating to these annuities. In this business we accept both short-term volatility risk and long-term economic risk. From an insurance underwriting perspective this is a cat-type risk business, and it would take prolonged and extensive adverse market conditions to create an economic loss to ACE. We managed the concentration risk to be within our overall risk tolerance, and the results for this quarter are in line with our expectations for current market conditions.

This business is considered a derivative for technical accounting purposes, however we feel our operating income, which includes the result of insurance accounting treatment, is a more meaningful way of looking at this business. In fact, the GMIB liability is treated as an insurance liability rather than a derivative for a direct life insurance writer with no marktomarket accounting required. But because for ACE it's reinsurance, it's treated as a derivative.

We don't believe the short-term view of derivative accounting recognizes the true economics of a buyandhold business. To illustrate, the portfolio valuation as of last Friday indicates a gain in excess of $150 million in the fair market value since the end of the quarter. In a matter of three weeks, the first quarter mark almost disappeared.

We've been writing this business for six years, and while it can produce volatile results, it has produced cumulative risk-adjusted returns through the first quarter in excess of 30% on an operating income basis and an excess of 20% on a net income basis.

The growth in our expense ratio was inflated by 2008 profit sharing commission payments related to our crop insurance business and a large risk management transaction we wrote and disclosed in 2007 that did not repeat in 2008. As you can see on Page 2 of the financial supplement, our P&C expense ratio, excluding A&H, has grown by 3.9 percentage points. This ratio, which is a particular focus for our expense management, increased less than 1 percentage point adjusted for crop in this year's ratio and the risk management contract in last year's ratio.

During the quarter we completed the financing for the combined transaction, borrowing $750 million at an average rate of 4.8%.

This will bring our pro forma debttocapital ratio to 14.5%. In addition, we've elected to use repurchase agreements of $1 billion instead of liquidating higher yielding investment assets. This will temporarily increase our short-term debt for approximately two quarters.

We provided an update to our guidance in the press release. Our EPS guidance now includes an estimate of $0.25 per share for Combined's income, which is 3.4% accretive. Our original estimate, which we discussed on the Combined acquisition call, was $0.19 or 2.6% accretive for the same timeframe.

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

Helen Wilson
Thank you. At this point, we'd like to take your questions.

Question and Answer

Operator

(Operator Instructions) Your first question comes from Jay Gelb - Lehman Brothers.

Jay Gelb
Lehman Brothers

First, we've heard a fair amount about crop insurance programs from some other companies as well as ACE. Could you explain that in a bit more detail?

Evan Greenberg

What would you like me to explain, what it is?

Jay Gelb
Lehman Brothers

Yeah, why don't we start there?

Evan Greenberg

Okay. Basically what it does is it insures farmers against weather events - temperature, moisture-related that could affect crop yields. That's in essence the net-net of what the program's intended to do. How it works takes into consideration not just yield but price of crops because it really gets at their total economic loss.

We share the risk with the federal government. It is a federal government sponsored program originally created, as my colleague Brian Dowd likes to say, to keep bread at under $1 a loaf because it was around the time of the Great Depression that it was created.

And what you do is we insure it. We have an MGA who we've had a very long-standing relationship with. It goes back preACE, CIGNA. It's over 20 years. We are the second-largest writer in the country of this business. Wells Fargo is the largest. You write it through independent rural agents in particular who solicit the business from farmers, and the federal government provides in excess of loss protection that varies by crop by state.

Jay Gelb
Lehman Brothers

Does that increase ACE's sensitivity to commodity prices?

Evan Greenberg

ACE's sensitivity to commodity prices? No, not really. But it is considered in the overall when you look at price of crop and you look at yield. It starts with yield due to weather. And we've been writing this business, I'd say, for many years.

It's not speculating on commodity prices of crop. That would be wrongheaded to go in that direction.

Jay Gelb
Lehman Brothers

And then on the guidance can you give us a sense of what's embedded in our outlook for the property casualty investment income for the rest of the year?

Phil Bancroft

What I would say is if you look at our guidance, you'll note that it's up for Combined, obviously. And really the only other adjustment that we made is that we've taken down investment income to some extent, recognizing the market conditions and the interest rate environment. So the guidance is really as it stood initially, with those two changes.

Jay Gelb
Lehman Brothers

And then if I could just make a request from a disclosure perspective. I don't know if ACE would consider breaking out the components of investment income going forward by asset class. That would help us perhaps see where some of the volatility's coming from.

And then if ACE would be able to provide pro forma results for the combination of Combined Insurance by segment as well as on a consolidated basis historically, I think that would be helpful as well as we build our models.

Evan Greenberg

Yeah, your first one we'll take under consideration. Your second one, we're going to improve our disclosure going forward to give more color around our A&H business in totality, but we're hardly going to break the Combined out separately from that. It now becomes part of our A&H business. And then you'll be able to ask questions about our A&H and we'll describe what's going on.

Operator

Your next question comes from Susan Spivak - Wachovia.

Susan Spivak
Wachovia

A couple of questions. First, I thought your comment on inflation was quite interesting and I was just wondering, in your opinion, how long will that take to really show up in the loss costs? That's the first question.

And then I was wondering also as we go into the Florida renewal season, do you expect to write more insurance or reinsurance business in the state?

Evan Greenberg

Good question, Susan.

First of all, on the loss cost side on inflation, I can't pin an exact time. I'm not measuring it in months. I'm measuring it more in years. But I do believe in the medium term, so over the next two or three years, we're going to see loss costs tick up. I just don't see how you can't. Building materials based on commodity prices are going up all over. Consumer, we all know. I won't pontificate about it. But we all know what's going on with consumer prices and that eventually finds its way into [inaudible].

The weak dollar is inflationary to all imports and so, you know, over time. And, you know, if you believe a Democrat's getting in the White House, I think that's going to have an impact ultimately on the legal environment.

And so to me I think over the medium term. And remember, we're pricing today for the long term and that's why I make that comment.

Regarding Florida, well, time will tell wherever we're going to get paid the best. I have to tell you, last year we thought the pricing was best in our E&S business and secondly it was in the excessive loss per cat. It was not in the primary [inaudible] shares. We thought that was underpriced, and if that market continues that way then we'll have the same pattern going into this season.

Susan Spivak
Wachovia

And if I could just sneak one more in, do you have any potential new [CB star benchers] on the horizon.

Evan Greenberg

Not [inaudible]. If you know something, tell me.

Susan Spivak
Wachovia

I was hoping you would tell us.

Evan Greenberg

No, I don't.

Operator

Your next question comes from David Small - Bear Stearns.

David Small
Bear Stearns

Just two quick questions. Evan, in your prepared remarks you talked about a mix change in your book within P&C. Can you just elaborate on that a little bit?

Evan Greenberg

Yeah. We wrote less risk management business. We wrote less risk transfer workers' comp. And so, you know, the risk management is large account. We did write greater - particularly in North America, I'm referring to, and to a degree internationally, but more North America - we did write more middle market specialty type business. And that brings with it typically a higher expense ratio. It's got a little higher commission to it than large account business does that's on a fee basis or has a low commission.

David Small
Bear Stearns

Then my second question is just on D&O. Could you just give us an update on where you're seeing loss trends coming in from the recent credit crunch, and also could you maybe just help us understand how your '07-'08 loss takes were impacted by that?

Evan Greenberg

Yes, I shall. Right now we've seen further development due to subprime and financial market turmoil in the quarter. It was not out of line. It was in line with what we expected. I don't want to say it was modest. It wasn't extreme. It was just pretty much what we'd expect as fine. It was on the D&O side in particular. On the E&O side we didn't see much development at all, a little bit.

All of the development to date is within our reserves. Our ultimate projection hasn't changed and it is within our reserves. And it was fundamentally within the '07 year, though we do have some recognition in our initial loss picks for '08. And that's about what I can tell you.

David Small
Bear Stearns

And then just one follow up on that. We've heard from a number of people that FI professional liability, the pricing's going up. Would you use this as an opportunity to increase your share in that line?

Evan Greenberg

Well, we haven't so far, no. We have not so far. The pricing is up modestly.

David Small
Bear Stearns

Okay.

Evan Greenberg

Nothing that we thought was very interesting.

Operator

Your next question comes from Jay Cohen - Merrill Lynch.

Jay Cohen
Merrill Lynch

Just so I understand it, on the Combined side it sounds as if the international premiums will be in the overseas general business. I'm assuming the U.S. premiums from Combined are in the life business?

Evan Greenberg

It's correct. And Jay, it's not like we're playing some shell game, but it's how we manage the business. So the international makes the most sense to be within the P&C because that's where our international A&H is, that's where all the management is, that's where our greatest international presence is that can support the Combined in its expansion, both in general management and support services, etc., overseas, plus, as I say, line-specific management, so we put it there.

The U.S. side is written on life company paper, it even has a little life insurance within it, and it makes most sense to be with our life company management, and that's where our greatest expertise is for handling that.

So that's why we'll be reporting it through those two places though we will - right now we break out A&H. We show you a kind of a line breakdown within the segment within the supplement. We show you P&C, and we show you A&H and life. We'll do some more disclosure there, and we haven't really decided exactly what it's going to look like, but beginning in the second quarter we will have some more disclosure to show you a little more about the A&H in its totality.

Jay Cohen
Merrill Lynch

And then the second question, do you see any of the proposals in the agricultural bill impacting your crop business?

Evan Greenberg

What has happened so far - and I'm about 2 minutes smart on this so if you go too far, I'm going to ask Brian Dowd to jump in, who's about 10 hours smart on it.

Jay Cohen
Merrill Lynch

I'm 30 seconds smart.

Evan Greenberg

Okay. What they really do, and this benefits the large writers ultimately - such as ACE - versus the smaller writers, the government cuts back to the private sector in essence how much the reinsurer, because the government is the reinsurer, pays as a ceding commission is the best way I can say it for administrative expenses and for commissions that you pay the agents.

And so if you're not a large writer of it, it is a negative arbitrage for you. And boy, you're really hoping for a good crop year.

If you're a larger writer, you have economies of scale and so that cutback in ceding commission in essence, which is what it is - they call it some funny acronym, but that's what it is - it has less of an impact on you though it has an impact.

So that's what the farm bill right now, that's the biggest issue within it.

Jay Cohen
Merrill Lynch

Yeah, that's what I heard from others.

Operator

Your next question comes from Charles Gates - Credit Suisse.

Charles Gates

I, like Susan, congratulate you on your inflation comments. Hey, here's my question. Seemingly a large portion of the Combined insureds in the United States - and I guess the revenue from U.S. operations represents some 60% of revenue - seemingly those guys are in the eye of the storm here with regard to subprime and very high gas prices. What do you see as the impact of that?

Evan Greenberg

You know, Charlie, it's a funny thing. I was out at Combined yesterday, by the way, working with them, getting an update on where we are. You know, I grew up in the A&H business and we were comparing notes about what happens in a recession because my experience has been that particularly in middle income people will actually buy more insurance because they're very risk averse. And there is a sense of a need - you feel vulnerable and a need for protection - and remember, this is the most primary of protection because this is in many cases the only insurance that this group, this cohort, will purchase. So I don't necessarily generally see a decline.

On the other side of the coin what you can run into is gas prices and your agents traveling to make sales.

When I compared notes with the Combined people, they have had this exact same experience, that typically in this kind of a period sales don't suffer. If anything, they go up a bit. And also recruitment of agents becomes a lot easier.

Operator

Your next question comes from Josh Smith - TIAA-CREF.

Josh Smith
TIAA-CREF

A couple quick ones. On the GMIB derivative losses, you did put some disclosure in your K on Page 82 that talks about sensitivity to equity market's down, interest rate's up, [inaudible] up. Is it fair to assume that it works this similar percentage if those move the other way?

Phil Bancroft

It is.

Josh Smith
TIAA-CREF

And then quickly on the $650 realized and unrealized, you broke it up to [non-grade] high yield equity. The equity looked a little bit more than 10% which is the U.S. is down. Is that because global markets are down more, and also what were the products where you had the realized and unrealized losses? Was it ADS, corporate [inaudible]? It didn't look like it was in MBS.

Evan Greenberg

It was in triple A CMBS, and our mortgage portfolio was the fixed-income component. That was the $150 million that I mentioned.

And I would say that our equity loss was in line with global markets, right? So our equities are spread throughout the world and our losses matched.

Josh Smith
TIAA-CREF

And then finally on reserves, you've trailed your peers in reserve [inaudible], which I take as a good thing, but obviously it picked up this quarter, short-tail business mostly. Others released significantly more reserves, and I guess I have a question on your releasing methodology. Do you consider that a line might be under reserved before you release reserves in a specific line or is it all done in silos?

What I'm getting at is a lot of people think we're on the precipice of a big D&O liability here, and if you thought that would you be slower in releasing reserves in other lines?

Evan Greenberg

No. Every line stands on its own, and every line's reserves must be adequate. And that's all we post.

We do our reserve studies through the year. The vast majority of our casualty related reserve studies come between the second and the fourth quarter. And every reserve study stands on its own, and that is both in its totality and within each accident year.

Operator

Your last question comes from Thomas Mitchell - Miller Tabak & Co., LLC.

Thomas Mitchell
Miller Tabak & Co., LLC

Following up on your comments about inflation, which seem to be well timed, can you give us some indication of in theory if inflation does increase over the next several years, let's say three to five years, what potential impact that would have on your existing long-tail reserve assumptions?

Evan Greenberg

You know, we study that. We never really reduced our - let me say it differently. Our loss cost assumptions on our historic book have been in our judgment, even considering the future, reasonable. We have pegged them fairly conservatively. I've said before that it varies typically between 6% and 10% depending on the jurisdiction and whether you're looking at primary or excess casualty related business.

So we haven't and we have said before, we did not take an optimistic view when we were looking at a more benign loss cost environment in the past years because we believed that it was transient and, you know, we know what the tail is. Though remember that the payout patterns vary by class of casualty. Some, you know, the payout pattern could be that a substantial percentage is paid out after three years, some it's after five or seven or 10 years. So it's more sensitive the longer the tail.

I hope that helps you.

Operator

With no other questions in queue at this time, Helen, I'll turn it back to you for today's closing remarks.

Helen Wilson

Thank you very much for your time and attention this morning. We look forward to speaking with you again at the end of next quarter. Thank you and good day.

Operator
Ladies and gentlemen, thank you for your participation. This does conclude today's ACE conference. You may now disconnect your phone.