S&P Capital IQ

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W. R. Berkley Corporation NYSE:WRB

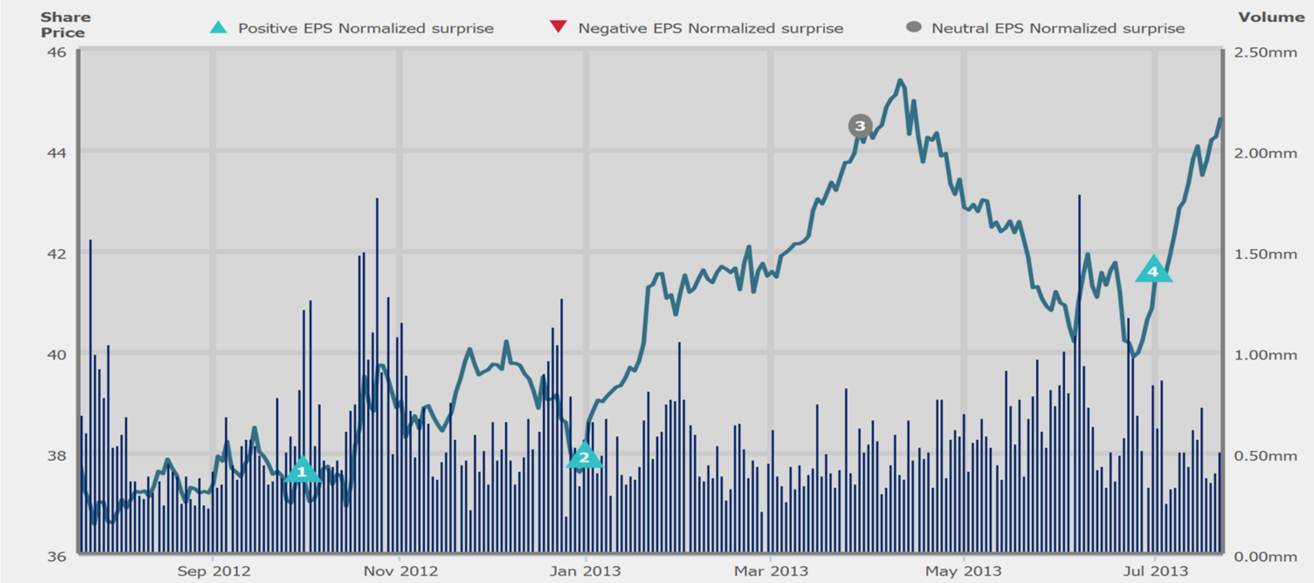
FQ3 2013 Earnings Call Transcripts

Tuesday, October 22, 2013 2:30 PM GMT

S&P Capital IQ Estimates

	-FQ3 2013-			-FQ4 2013-	-FY 2013-	-FY 2014-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.73	0.77	▲5.48	0.82	3.02	3.22
Revenue (mm)	1530.69	1634.12	▲6.76	1565.43	5993.32	6569.29

Currency: USD
Consensus as of Oct-22-2013 1:28 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2012	0.54	0.61	▲1 12.96 %
FQ4 2012	0.49	0.64	▲2 30.61 %
FQ1 2013	0.74	0.74	●3 0.00 %
FQ2 2013	0.68	0.70	▲4 2.94 %

Call Participants

EXECUTIVES

Eugene G. Ballard
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William Robert Berkley
Founder and Executive Chairman

William Robert Berkley
Chief Executive Officer, President and Director

ANALYSTS

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Evercore ISI, Research Division

Presentation

Operator

Good day, and welcome to the W.R. Berkley Corporation Third Quarter 2013 Earnings Conference Call. Today's conference is being recorded.

The speakers' remarks may contain forward-looking statements. Some of the forward-looking statements can be identified by the use of forward-looking words, including without limitation, believes, expects or estimates. We caution you that such forward-looking statements should not be regarded as a representation by us that the future plans, estimates or expectations contemplated by us will be, in fact, achieved.

Please refer to our annual report on Form 10-K for the year ended December 31, 2012, and our other filings made with the SEC for a description of the business environment in which we operate and the important factors that may materially affect our results. W.R. Berkley Corporation is not under any obligation and expressly disclaims any such obligation to update or alter its forward-looking statements, whether as a result of new information, future events or otherwise.

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

William Robert Berkley
Founder and Executive Chairman

All right, good morning. We're pleased with the quarter and the direction of things. We'll start our call with Rob talking about our operating results, then he'll turn the call over to Gene and then I'll continue trying to give you a summary and take questions. So Rob, the floor is yours.

William Robert Berkley
Chief Executive Officer, President and Director

Good morning. Market conditions in the third quarter, by and large, were a continuation of the trend that we've seen over the past several quarters. The casualty market and the workers' comp market continue to benefit from rate increases. The professional markets, on the other hand, continue to be a bit of a mixed bag, with EPL pricing as well as private and non-for-profit D&O getting significant rate increases, lawyers also getting rate increases. Having said that, public D&O remains also very much bifurcated between the primary and the excess, with the primary getting meaningful rate increases, while the excess remains somewhat flat.

On the other end of the spectrum, the medical space, no pun intended, is somewhat of a bloodbath, quite frankly, with rates continuing to fall off, and the other miscellaneous D&O is also exceptionally competitive.

In our opinion, the professional space is probably some 12 to 24 months behind the casualty market when you think about it from the cycle.

The property market continues to fray around the edges. Clearly, a result of a lack of cat activity, along with the increasing supply of reinsurance capacity. These 2 factors are clearly putting a fair amount of downward pressure on pricing.

Now if we can turn our attention more specifically to our operations. Rate adequacy continues to be a priority for us. We are pleased with the 6.4% of rates that we got during the quarter. More specifically, we got 7% of rate in our domestic insurance operations. Yes, it is very much the fact that the U.S. market is ahead of many of the other markets outside of -- or around the world, I should say, as far as hardening.

Rate increases, we believe, will continue to move at this pace for the foreseeable future. It's worth noting that this is the 11th quarter in a row where we were able to achieve rate. And the compounding of this rate on rate, if you will, as we referenced in our press release, is quite meaningful.

Obviously, rate in a vacuum is something that one needs to be very careful of. When we think about rate, we need to make sure that we're not experiencing adverse selection as these higher rates are coming through. Our renewal retention ratio is the tool that we look to, to make sure that our rate increases are not creating this adverse selection. And our renewal-retention ratio for the quarter remained at approximately 80%, where it's been for the past several quarters.

The other tool that we look to on the topic of pricing is new business relativity, what the rates are for our new business versus a similar exposure in our renewal book. And based on this tool, we're seeing that we continue to get a bit of a higher rate for new business versus renewal business, and for the quarter, it was approximately 2.3% higher.

Gross written premium for the quarter was $1.667 billion. This is up 12% from the corresponding period. Approximately half of that, as you may have noticed, was associated with rate. The lion's share of the balance had to do with exposure increase. Auto premiums was not particularly consequential. All 3 segments contributed to the growth, and more specifically, 40 of our 47 underwriting operations contributed to the growth.

The loss ratio for the quarter was at 60.1%, which is a 2-point improvement compared to last year. We achieved this improvement in spite of the fact that we had $4 million more in cat losses. On an accident year basis, the improvement was at a similar level going from a 63.7% last year to a 61.5% this year.

Finally, it's worth mentioning that we are seeing a continued improving trend with our paid-loss ratio, and this certainly is an indicator, from our perspective, as to how the book is running. In addition to that, when we look forward at our policy year loss picks, certainly we are seeing the benefit of the earned premium coming through over the foreseeable future at these higher rates.

With regards to the expense ratio, it was basically flat and coming in at a 33.8%. Gene is going to be touching on this shortly, but to make a long story short, we had a little bit of noise in there, which he'll be speaking to. If you back some of that out, the improvement was probably, give or take, 0.5 point, maybe a little bit more.

When you put all the pieces together, we came in at a 93.9%, which is an improvement of approximately 2 points. And if you look at it on an accident year basis, it's probably a similar level of -- or it is a similar level of improvement.

While our Chairman is going to be spending some time talking about our balance sheet shortly, I did want to make a few comments as it relates to the topic of loss reserves. Loss reserves are something that we take very seriously. We have historically and continue to have an approach that we feel as though one needs to set initial reserves with taking -- with a cautious approach, with the idea, over time, as more information becomes available, you will tighten up those picks given the fact that you'll have better information. The fact of the matter is that we are in a business where we do not know our cost of goods sold until after the sale has been made.

As a result of that, we feel as though that it's important to take a very measured approach in setting those initial picks. This is demonstrated by 27 quarters of positive reserve development, which is quite consistent with our approach, once again, of initially being cautious with picks and tightening as things develop over time.

When we look out at the market, we're surprised by the number of people that seem to be talking down the hardening of the market. The fact of the matter is it's simple math and common sense that would suggest that rates need to go up further. While we are aware of the comments that others are making in the marketplace, we are focused on our actions and what we can do to build our business going forward.

William Robert Berkley
Chief Executive Officer, President and Director

Thank you, Rob. Gene, you want to talk about the numbers a bit?

Eugene G. Ballard

Executive Vice President of Finance

Sure, okay. Thanks. As Rob said, we had another solid quarter, highlighted by further improvement in our underwriting margins and increase in investment income compared with a year ago and significant capital gains.

Starting with the underwriting, our net premiums were up 11.5% overall to $1.4 billion. Net premiums for the domestic and reinsurance segments were each up 11%, and the international premiums were up 18%.

Premium growth was led by our 2 largest lines of business, other liability and workers' compensation, which were up 18% and 13%, respectively. Our overall combined ratio for the quarter was 93.9%, 2 points better than the third quarter of 2012 due to improvement in the underlying loss ratio. That is the loss ratio before cat losses and reserve releases. The underwriting loss ratio was 60.1% in the quarter compared to 62.1% a year ago.

The underlying loss ratio improved by 2.5 points each for the domestic and international segments and by 1 point for the reinsurance segment. Just to repeat what we talked about in the call last quarter, a 2-point improvement in the loss ratio is what you get when you do sort of a simple reasonable net test of the underwriting trends. Prices were up 6.5%, and if you assume a loss cost trend of something around 3%, that gives you a net trend of 3.5 points. And if you take our accident year loss ratio from the third quarter of '12, which was 64%, and take 3.5% of that, you get just right at 2-point improvement, and that's what we're showing.

Back to the quarter, then. Catastrophe losses were $13 million or 1.0 loss ratio points compared to $9 million a year ago, and favorable reserve development was $33 million or 2.3 loss ratio points, up slightly from $28 million a year ago. The favorable reserve development this quarter was concentrated in our domestic segment. The overall expense ratio increased 0.1 point to 33.8%, and the domestic segment expense ratio increased slightly over 1 point.

The reason for the domestic segment increase, there's 3 main factors. First, we are earning less seeding commissions as a result of shifting some of our reinsurance programs from quota-share structures to excess-of-loss programs. Second, we incurred some one-time cost relating to reorganizing parts of our regional business in the quarter. And third, we're continuing to invest in new ventures, including 2 start-up companies, as well as several expansions into new products and territories within existing companies.

We expect the revenues from these new ventures to begin to increase in the fourth quarter of this year and offset that expense ratio trend. Our paid-loss ratio for the quarter and for the year-to-date period was 54%, and that's the lowest paid-loss ratio we've had since 2008. That's the main reason for operating cash flow more than doubling in the quarter to over $300 million.

Our investment income was up 8% to $126 million in the quarter, due primarily to higher returns for investment funds. That increase was partially offset by a decline in fixed income returns due to lower reinvestment rates for bonds that are either maturing or being prepaid.

The overall annualized portfolio yield was 3.4% in the quarter, up from 3.2% a year ago. In addition, realized investment gains were up 61% to $44 million in the quarter, with a majority of those gains coming from the sale of equity securities.

At September 30, 81% of our portfolio was invested in cash and fixed income securities, unchanged from June 30. The average duration was 3.2 years, down from 3.3 years at June 30, and the average credit rating was unchanged at a AA-.

Our overall effective income tax rate increased to 30% in the quarter, up from 27% for all of -- for the full year 2012. That increase was due to a decline in the portion of the portfolio invested in municipal bonds. Municipal bonds represent 27% of our overall portfolio at September 30 compared with an average of 34% in 2012.

So in total, that adds up to net income of $137 million, up 36% from a year ago, and an annualized yield of 12.7%.

William Robert Berkley
Founder and Executive Chairman

Thank you, Gene. Let me try and go through a few things that I think are highlights and important to make sure you understand about where we're going and what's going on and then take your questions.

First of all, we see price increases continuing. I had generally thought they would do a little better. I had talked about 6% to 8% with a little more pressure on the upside. There seems to be less pressure on the upside. I would still use 6% to 8% as a range. And in fact, we are seeing some price increases significantly more than that, but I would narrow the range. I think it's going to be hard for us to have 8% going forward. I think it's going to be more in the 6% to 7% range. But there's more erratic behavior out there, so there are some lines of business that we're seeing better increases. So I'm not changing my view, but I'm thinking that the 8% is less likely, although I think we will be better than 6%. So if I were to choose a number, it would still be sort of 6.5% to 7.5% as opposed to 6% to 8%.

We still see across-the-board pressures, less so on large commercial risks, especially property risks. The securitization of non-tail risks is having an impact on cat business and those large property risks. There's lots of people who have investment portfolios who are looking for non-related risk profiles, and therefore, you're seeing an increase in cat bonds and other kinds of behaviors. That's going to continue to impact back on the business.

We think that people are beginning to recognize that investment returns are going to stay at this lower level, certainly for another 18 months, if not longer. And I'd rather we consider the level they need of underwriting profitability to achieve adequate rates of return. Ever 100 basis points, as we've said, in loss investment income means you need, give or take, depending on the line of business, 4% or 5%, 6%, 7% more in underwriting profit. So whereas historically, people would say, if you're right at a 93%, 94%, 95%, you'd get a good return, today, that number is 88%, 90% kind of a number to get a good return on your capital. So we think there'll be continued pressure on that, and that's beside the fact that prices today, when adjusted for the inflationary pressures on loss cost, are still not even approaching where they were in 2004. So you still have the need for pricing just to get back to those underwriting profits and that doesn't offset the need to make up for investment income.

We have been moving our investment portfolio around. We've been changing where we put our money. Our common stock portfolio is moving into a little bit different strategy. You saw we sold a bunch of stock, common stock. It's being reinvested with a slightly different hedged strategy using other kinds of securities, but basically, it's back -- the common stock portion will be back up to where it was before, maybe a little more in a slightly different strategy.

While we took down our municipal position and cash increased, again, it was a function of managing our portfolio. You're likely to see our municipal bond portfolio increase, primarily in the 7- to 10-year duration as that's where the yield curve for the moment is most attractive from our perspective. And we're looking to expand that back up closer to the 30% part of our portfolio. I think that overall, though, cash flow continues to be strong and we would not expect the duration of our portfolio to be anything short -- we would expect it to continue to be shorter than our liability duration.

While it might go from 3.2 to 3.4 years, it's going to stay under the duration of our liabilities because inevitably, out there, that risk of inflation and increased interest rates is there. So we're investing with a different set of criteria, so we will have less money and fixed income securities and look for other ways to generate investment returns. We continue to strive for and achieve gains of at least $25 million a quarter, excluding our bond portfolio. We think we'll be able to continue that for an extended period of time. We've been able to do that for quite a while, certainly helped by the secular boom market trends, but made up partly of our private equity investments. And we're quite pleased.

We think one of the best signs of looking at how our company is doing is focusing on the paid-loss ratio. And our paid-loss ratio, which sort of peaked in 2010, has continued moving downward quarter by quarter, and we're pretty pleased with where we are now, and we think it is likely to continue down. It's a good sign and it's a good way to say, our year loss peak's good. The day was late. It's a good absolute test. The one thing you know in this business for sure is money, and that paid-loss ratio is as good a test as you can get.

So we continue to be pretty optimistic. I think that we see continued opportunities. As Gene mentioned, we had a couple of new startups. We added operating units to some of our existing business. It's been an excellent time to find great people interested in companies that are looking ahead instead of looking back. Fortunately, we're in that position.
So with that, I'm very happy to take any questions. The operator will start now.

Question and Answer

Operator

[Operator Instructions] Our first question is from Amit Kumar of Macquarie Capital.

Amit Kumar
Macquarie Research

Two quick questions. First is a broader question for Bill on the industry. In terms of comments on aggressive competitors, now we know that these things sort of take time to play out. Do you get the sense that there might be some of these name spacing problems on the immediate horizon, or are we talking more longer term?

William Robert Berkley
Founder and Executive Chairman

Well, some of them have already faced the problems in there in the public domain, Tower, Meadowbrook, Torus, [indiscernible], that people already are facing their problems doing it. There certainly are others that may not be in the same very difficult position of these companies, but who are trying to deal with their problems, who have plenty of capital but are saying, gee, we stepped in the wrong direction, we made some wrong assumptions and are going to withdraw from the business. And I think there's plenty of those. And there certainly are a few more who have gone in wrong directions. There are large global companies who always saw the grass being greener in other places, and they found out it was AstroTurf. And it didn't work out that well. So I think that we've yet to see the dramatic changes these people are having to take. But I think they're all starting to take -- the worst part -- one of the things that's interesting, and I'll digress a moment, is it was hard to believe that the peak pricing was in 2004, maybe early 2005, because the earned premium peaked the end of 2005 or early 2006. But the peak pricing was the end of 2004 or early 2005. Prices went down just a little bit, and then in 2007, they started to go down faster. But there are people who lost a lot of money, and the worst losses probably were incurred in 2009 and 2010 because of the accumulation of those low prices. And if you aggressively wrote business then, you still were writing at terribly low prices in 2011, certainly the beginning of 2011. So those people are just now having to face up to that low-pricing environment. So I think there's quite a bit more of pain to go and a lot of people who are going to say, what are we going to do, and who are very, very short on their reserves for those -- some of those things and are going to have to try to figure out a solution. But everyone doesn't have to go out of business. Some of the people are plenty well capitalized and have plenty of smart people. They just have to face the reality that we have to do something. There will be more, however, than the 3 I mentioned that will go out of business.

Amit Kumar
Macquarie Research

Got it. That's helpful. But the only other question I had, and this one is for Rob, you mentioned the new business relativity metric of 2.3%. In Q2, that number was 3.6%. And I'm sort of trying to figure out why would it decline that much?

William Robert Berkley
Chief Executive Officer, President and Director

You mean, why would the -- we're talking about, I don't know, what, 100 basis points?

William Robert Berkley
Founder and Executive Chairman

Yes, you have there, when he said 2%, a little over, 2% or 3%, it was 103% or 102%. It's not very much there. It's like charging $103 or $102.

Operator

Our next question is from Michael Nannizzi of Goldman Sachs.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Rob, I guess there was one question -- or the one comment in the press release, you talked about some standard carriers maybe stepping away from business that they were writing or some specialty business they were writing during the soft part of the market, and maybe that's manifesting. Can you give a little bit more context to that? I mean, what sort of accident years, calendar years are we talking about? And you just -- it doesn't seem, at least, well, I haven't heard of standard carriers seeing a lot of adverse development in -- even in kind of subsegments. Just wanted to get a little bit more context if I could.

William Robert Berkley
Chief Executive Officer, President and Director

Mike, I think the answer to your question is that what we're seeing is it's just a greater number of submissions coming into the specialty market from the standard market. Ultimately, we saw people try -- looking back, if you will, probably starting in 2007 and 2008 and reflecting on the profitability from the prior years, and their natural reaction is they want more so they start to cut rate, loosen terms and conditions and broaden their overall appetite. If you look at, for example, the casualty market and certainly some of the stuff that we participate in, if you figure that the average duration of the reserves is 3-plus years, it takes a little bit of time for that to come into focus. And what we've been seeing over the, I don't know, past several quarters is that's starting to come into focus more and more, and as that is coming into focus, it's forcing a change in behavior of some of the standard market. And again, it's manifesting itself by them beginning to revisit what their appetite is, and again, we're seeing more coming into the specialty market. So it's interesting because you can see the bit of a tug of -- the internal tug of war of some of these -- particularly some of the larger carriers that typically operate in the standard market, and their appetite has grown. They tend to get the underwriting discipline back and ask their underwriters to be pushing for more rate and narrowing the appetite, and then they see what it does to their top line and then they'll send another message sort of the next quarter, so what they want them to do because they don't like it when the top line starts to fall off. So as my father had mentioned earlier, you're seeing a little bit of mixed behavior, where people are struggling with what their appetite should be. But by and large, we continue to see a increasing level of discipline in the standard market, hence, the specialty market is getting more of a crack at things.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Got it. And I guess -- and just kind of looking at your growth, I mean, can you talk about the areas where you're growing, kind of the attributes of the business that you like that is causing you pursue growth versus the areas where you're seeing the most rate, Mike? So is it -- if we were to like, which we can't see, but if we were to kind of try and compare those areas that are showing the biggest, the most growth versus the areas we're gaining the most rate, is there a relationship there, a positive relationship there, or are there other factors involved?

William Robert Berkley
Chief Executive Officer, President and Director

I think, clearly, there is a relationship between growth and margin, if you will. And oftentimes, there is a relationship between rate that can be achieved and the margin that you believe you will obtain. Obviously, for our purposes, we're very focused on making an underwriting profit, and we're pleased to see that there are certain lines and classes where we're getting to the point where there's very much a green light and we will not just be growing because of rate, but we will become more aggressive if things continue down the path that they've been on in trying to add to exposure or policy count. I think as far as getting very granular as to where we see the best opportunities, typically, that's not something that we've looked to highlight because we don't think it's in our shareholders' best interests to advertise where we think our best margins are today or where they will be tomorrow. But what I would suggest to you is that oftentimes where the market has gotten the ugliest is oftentimes where you will see the greatest or the most severe reaction and the pendulum will swing farthest going in the other direction, and you just need to make sure that you don't jump back in prematurely.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Got it. And I guess more specifically, like with the international segment, I mean, that's been in a kind of double-digit, mid-teens sort of growth trajectory for several quarters now. I mean, I know...

William Robert Berkley
Chief Executive Officer, President and Director

Yes. As far as the international goes, there's really been a couple of things that have been driving that growth. One would be some of the markets that we're in where their economies are doing particularly well and they have been for several years. So whether that's in Australia or whether that's in some of the Scandinavian territory, Norway, for example. Certainly, Germany has fared much better than a lot of Europe, and there has been particular opportunities in the auto space. But -- and then, of course, we've seen some opportunities in Latin America, even though that does come with its complexity as well. So again, the growth outside of the U.S. has been primarily, as far as insurance goes, related to the strength of some of the economies around the world. And as far as reinsurance and the growth that we've had there, that has more to do with, quite frankly, the reinsurance operation that we started in Europe and which has gotten some good initial traction. And again, our reinsurance business down in Australia, that rates in Asia, they have gotten a pretty good bump as well because of the general economic conditions of that territory of the world.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Great. And then one real quick one if I could. In the domestic segment, which it sounds like that was the lion's share of development, can you just talk about either the lines of business or the accident years that drove that favorable development?

William Robert Berkley
Chief Executive Officer, President and Director

Yes, sure. I think, as far as that goes and the details, what we would suggest is that you follow up with Gene, if you wouldn't mind, or Karen as to some of the more detail or minutia, and we'll share with you what we can at a more granular level, Mike.

Operator

Our next question is from Josh Shanker of Deutsche Bank.

Joshua David Shanker
Deutsche Bank AG, Research Division

I'm wondering if you can give us some more information about the noninsurance aviation businesses. They had a very good quarter from a profit standpoint, and I really don't know a lot about those businesses, so I could use an education.

William Robert Berkley
Founder and Executive Chairman

It's just an investment. It's a business that we invest in as we've invested in other businesses, and we carry the costs. And frankly, it's not a fabulous return. It's an okay return. It just suffered a lot in the economic decline, and it's returning to doing sort of what we expected. It refurbishes parts. It sells parts globally. It has a couple of FBOs. It sells used and new airplanes. But there's nothing -- there's nothing extraordinary about it. It's really returned back to the level it was at, but it's doing well. We have really outstanding people, and most of -- many of their competitors didn't survive the economic downturn at all.

Joshua David Shanker

Deutsche Bank AG, Research Division

Do you think that the 3Q '13 result is closer to run rate than the last few quarters?

William Robert Berkley
Founder and Executive Chairman

Yes. We would think it would be closer, yes.

Operator

Our next question is from Vinay Misquith of Evercore.

Vinay Gerard Misquith
Evercore ISI, Research Division

The first question is on the impact of some competitors taking large charges. So we've seen that recently. Are you surprised that you've not seen a corresponding sort of increase in pricing in the industry because you have some comparison, the weaker competitors taking charges?

William Robert Berkley
Chief Executive Officer, President and Director

You know, the reality is trying to figure out what your competitors do is a Rubik's Cube. We look at what we see and know is going on out in the field and we wonder how that corresponds with their day-to-day behaviors. So yes, it is strange to us about things like that. But some of our most aggressive competitors are facing problems in the business they wrote. And we don't see them dealing with those problems, but we know they will. They have to eventually. It does take time for bad results to get reported in financial statements. But eventually, they do get there, and so we have plenty of companies that are out there that have problems that they have not dealt with, then will come home to roost. And in some cases, as the 2 companies I mentioned, they may not have the resources to deal with them fully, but in others, they have the resources, but it will be a painful process. The real question is, will people try and solve the process or will they behave like ostriches and stick their heads in the ground and pretend they don't exist? And so they are unavoidable, at which time you have crises.

Vinay Gerard Misquith
Evercore ISI, Research Division

All right. The second question is just a few numbers question. First is on the net investment income. The yield on the core portfolio was lower than we expected. I think you mentioned that you're increasing the duration of the municipal portfolio.

William Robert Berkley
Founder and Executive Chairman

No. We're going to. That was a pro -- that was a -- I was forecasting, not -- that is not where we are now.

Vinay Gerard Misquith
Evercore ISI, Research Division

Sure. So just looking into the future, should we expect a roughly flattish?

William Robert Berkley
Founder and Executive Chairman

I would think our net yields will not go down. Part of that decline is we have a lot more cash than we've usually had. We had over $1 billion of cash yielding 0.25%. So that has a huge impact on our yield.

Vinay Gerard Misquith
Evercore ISI, Research Division

Sure. So the fact that you are putting more money into munis you think will sort of fall as...

William Robert Berkley
Founder and Executive Chairman

I would expect our returns will not go down next quarter.

Vinay Gerard Misquith
Evercore ISI, Research Division

Okay. And on the tax rate, that was higher this quarter, I believe, also because of higher -- I mean, a lower proportion of munis. Should we look at the 31% effective tax rate as the run rate, or should that go down especially because your [indiscernible]...

William Robert Berkley
Founder and Executive Chairman

I would surely hope it goes down, but that's going to be a question of how quick we can get more invested in munis. And there's a -- tax rate is a complicated series of issues, and you can also -- pardon me?

William Robert Berkley
Chief Executive Officer, President and Director

Because you've got to mention it's also impacted by the size of the realized gains. The realized gains are all taxed at 35%, and that was a pretty big number this quarter.

Vinay Gerard Misquith
Evercore ISI, Research Division

Okay. That's helpful. So you think that a normalized tax rate would be sort of high 20s, do you think?

William Robert Berkley
Founder and Executive Chairman

Gene is shaking his head because the microphone obviously has a camera.

Eugene G. Ballard
Executive Vice President of Finance

Yes. I was shaking it. Yes.

Operator

Our next question is from Greg Locraft of Morgan Stanley.

Gregory Locraft
Morgan Stanley, Research Division

Just wanted to ask about capital deployment. You haven't done much in the way of buybacks in recent quarters. If that trend continues, it'll be the lowest than -- 2013 will be the lowest year in many years. How are you thinking about buybacks these days?

William Robert Berkley
Founder and Executive Chairman

As you know, Greg, we don't really tell people what we're going to do about buying back stock. Last year, and you may recall, we paid a dividend, a special $1 a share dividend because we had extra capital. We're going to try -- we try and measure how much capital we have, what we do and where are the opportunities. And we make that assessment and try to weigh that over the alternative of dividend, buying back stock and opportunities to deploy the capital in the business. And we would expect to continue to do that. When the time -- when the stock traded down, we bought some stock back. It traded up, we didn't. So we're continuing that same strategy. We think we have more capital than we need at the moment. But we think aggressively buying stock back, at the moment, may not be the right thing. We think that they're, likely, are going to be some opportunities to do something, and we also need to weigh the opportunities of returning cash in the form of a special dividend or increasing the regular dividend if we find we can't buy back stock.

Gregory Locraft
Morgan Stanley, Research Division

Okay. And then, I guess, since you brought it up, the special dividend, was that sort of a -- was the timing on that designed around the increase in tax rates? Or is that opening up a new kind of avenue for you to do it at the current stock valuation? Is that something you'd like to...

William Robert Berkley
Founder and Executive Chairman

We have always told people that there's a trade-off, that managing capital is a key element in the property casualty business. Opportunities to use the capital in the business, one. Two, buying back stock or dividends, special or increase regular dividends. And I think that, that continues to be the issues we face. At that moment in time, the tax issues certainly impacted us to make that decision. It made it a more effective use of a special dividend. But it's still the issue on the table that we have to think about.

Operator

[Operator Instructions] Our next question is from Ken Billingsley of Compass Point.

Kenneth G. Billingsley
Compass Point Research & Trading, LLC, Research Division

I just wanted to follow up on some comments that were made twice just regarding pricing and your look back to 2004 profitability. And when you talk about the continued need for pricing, obviously, the rates are not moving as quickly up as they did before. Do you at least believe that, that 2004 profitability levels for underwriting are achievable -- unachievable given just where capital is in the market?

William Robert Berkley
Founder and Executive Chairman

No. We think you can achieve the profitability levels of 2004. But what we're trying to say is that even if you get the underwriting returns, then you're not going to get the return on capital that you had then because interest rates are so much lower. So yes, I think that -- I think the prices will continue up for another at least 18 months, if not longer, at which time, I think you'll probably be approaching pricing -- underwriting profitability levels of 2004. However, even when you're at that level, you're not going to have the overall profitability levels you had in 2004 because investment income is going to be down substantially.

Kenneth G. Billingsley
Compass Point Research & Trading, LLC, Research Division

And regarding the new capital that's come in, obviously, it's from -- as you said, from the lines that don't have a tail. But do you feel that, that pressure is going to be put on those reinsurers and international companies to deploy that capital into lines that may, again, more compete directly with standard market business, even in the special market as well?

William Robert Berkley
Founder and Executive Chairman

How long a story do you want?

Kenneth G. Billingsley
Compass Point Research & Trading, LLC, Research Division

How long do you have?

William Robert Berkley
Founder and Executive Chairman

Not long enough on this conference call. So I'll briefly tell you that when this company went public 40 years ago, the 15th -- or the 16th, the day of the Arab oil embargo. I can still sitting -- remember sitting at my desk and writing the forecast for EF Hutton about what we would do and how we would do it. And I changed one little number and it was an amazing change in the return on capital. And I changed it 0.5%. And who could argue with a 0.5% change? And I suddenly realized how fallacious forecasts in this business were because you made these small assumptions and you built everything around them. I think these capital suppliers who are entering the business entirely based on models and forecasts are going to find out that human judgments actually are of value and important. And a number of them will get badly burned as they step away from the highly forecastable pieces of the business to other parts. So yes, they may step and put their toe in the water in other things, and I can assure you it will be extremely costly and short-lived.

Operator

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

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Yes. A couple of questions, I guess for Gene. Gene, in your prepared remarks, you had talked about the accident year loss ratio by segment or the change from the year ago. Could you go over those again? I missed those numbers.

Eugene G. Ballard
Executive Vice President of Finance

And what were you referring to exactly?

Jay Adam Cohen
BofA Merrill Lynch, Research Division

I believe you talked about the improvement in the accident year loss ratio, excluding catastrophes by segment.

William Robert Berkley
Founder and Executive Chairman

He did.

Eugene G. Ballard
Executive Vice President of Finance

Right. By segment, I did. I said that the underlying loss ratio improved by 2.5 points for the domestic and international segments and by 1 point for the reinsurance segment.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Perfect. The other question was in the press release. As you talked about improving returns, you mentioned the expense ratio. As you think about the expense ratio going forward and any improvement, is it largely simply a function of maybe less investments and simply growth in the business, or are you taking more specific action to reduce the expense ratio?

William Robert Berkley
Founder and Executive Chairman

Let me talk about a few things. There were some expenses that were unique and were likely to recur going forward. That will probably take maybe between $5 million and $6 million out that won't happen going forward. In addition, there was probably $3 million to $4 million of expenses for businesses that generated effectively no revenue. That will have corresponding revenue to some degree in the fourth quarter, although that will still not get up to speed. It will have a less impactful aspect on the fourth quarter and going forward. So those 2 things are more measurable. The change in the reinsurance is going to continue to be impacted as we move from quota share to excess for a number of lines of business. That will be offset over a 12-month period somewhat as we get more earned premium because the nature of taking a quota share to an excess is we'll get more earned premium. But it takes more time to get that through the financial statement. All that being said, we are also trying to focus to be sure that while expenses never were a cornerstone to any insurance company's success, and we don't think it's the guidepost to being a successful company, we do want to be sure we haven't gotten sloppy and that we're paying attention. Do we have the right numbers of people and the right people and the right structures everyplace to ensure that we're doing the right job? So I think that all that together, what we expect will be continued growth in premiums. So I think it's a bunch of different things, Jay. But we would think that you'd very quickly see a substantial improvement in the dollars and a measurable improvement in the expense ratio.

Operator

Our next question is from Larry Greenberg of Janney Capital Markets.

Lawrence David Greenberg
Janney Montgomery Scott LLC, Research Division

I guess, Bill, just a bit of an academic question. I'm looking at the paid-loss ratio, which I too have always thought is an important indicator. But I always thought that was best analyzed in kind of a stable book of business, and the reality is you guys have added so many new ventures that I'm wondering -- I mean, obviously, you know the numbers behind the numbers a lot better than we do. But doesn't it make it more difficult to rely on that as an indicator from the outside when there's so many new activities going on?

William Robert Berkley
Founder and Executive Chairman

Why don't I make -- I'll let Rob make a comment, and then I'll add on it. Go ahead, Rob.

William Robert Berkley
Chief Executive Officer, President and Director

I think the observation is a very fair one that you need to take into account, whether it's a stable environment or whether you have a bit of apples and oranges. Having said that, when we're able to look into our business, obviously, in a different way than you're able to and we look at it on an apples-to-apples basis, the trend is quite apparent. Then the other comment that I would share with you is that when we look at our mature businesses, because again, when you're looking at the younger businesses that are growing a bit more, but when we look at our mature businesses, I mean, look at what's happening with claim counts, we certainly are seeing things move in a positive direction. And in part, that's a result of the underwriting actions beyond just rate increases that we have been taking over the past several years.

William Robert Berkley
Founder and Executive Chairman

I think the other thing is, I don't think you can look at a paid-loss ratio as an independent thing. I think that when we look at it, what we really do is -- and we go back all the way to 2006, and we look at the incurred-loss ratio to the paid-loss ratio and look at how they relate and what are those trends. So what we're trying to say is, "Hey, if your paid-loss ratio seems to be getting out of line one way or the other with your incurred, that probably means you're not reserving enough. If your paid-loss ratio is moving in the other direction, it probably means you're being more conservative." And one of the interesting things is when the cycle gets worse, it absolutely says you're not being more conservative, and your paid-loss ratio goes up. And when the cycle gets better, it's the reverse. And this -- you could have heard me give this speech in 1986. I gave the same speech, but we were a lot smaller company, so nobody paid attention to me, but same speech. So I think the answer is the paid-loss ratio taken alone, independently, doesn't tell you anything. It's when you look at it with respect to the incurred-loss ratio and the direction of things because so many things can impact any number. I mean, it's a problem with the insurance business. Any one number can -- means lots of different things. You have to look at it in the context of lots of other pieces of information. So for us, it's that paid-loss ratio relative to the incurred because the incurred is what's in your financials. So what you're really trying to say is, "Does the incurred make sense?" So if you saw that paid-loss ratio going up and the incurred was not, then you should worry. If the incurred is going down and the paid is going down, it's a good directional sign.

Operator

Our next question is from Howard Flinker of Flinker & Co.

Howard Flinker

Bill, you're right that forecasts are 179, 180 degrees wrong, except at the Fed, where they're omniscient. They're always right. I've got a question for your memory, Bill. About 3 or 4 years ago, when the rig in the Gulf of Mexico blew up, in about 3 days or so, you said you would pay all claims. And it seemed like a pretty foresightful idea to acquire more customers. From your memory, did that pay off?

William Robert Berkley
Founder and Executive Chairman

Yes. The answer is, our guy who ran that business is named Frank Costa. He did a wonderful job. And he was a real expert in the business. And he went out and, in fact, his vision was correct, that people appreciate the fact that we stepped up and wrote a check, and that business has grown. He's done a wonderful job.

Operator

Our next question is from Ron Bobman of Capital Returns.

Ronald David Bobman
Capital Returns Management, LLC

I think Larry Greenberg might be the only person on this call who may have heard you in '86 make that statement, Bill. I had a question on reinsurance, and I'm wondering if you're seeing, in the context of Berkley, buying reinsurance? Any knock-on effect, whereby traditional reinsurers are showing themselves to be more aggressive and more competitive in selling intermediate- and longer-tail reinsurance coverages by virtue of the more competitive and shortage of opportunities for them to sell the shorter-tail new capital-focused line?

William Robert Berkley
Founder and Executive Chairman

I think Rob will have comments in addition to mine on this. But I would say that the reinsurance marketplace is still reasonably disciplined, but on the longer-tail lines, but it is certainly more competitive than the direct side of the business. And everyone is feeling the pressure of new capital entrants and concerned about where and how that's coming. That's why Berkshire Hathaway went into the large E&S business, because they felt the pressure of capital. A big capital account wasn't enough just to get the business any longer. There were lots of people competing for that. Rob, your view, just thoughts?

William Robert Berkley
Chief Executive Officer, President and Director

All right. I think generally speaking, clearly, there is more competition that has come into the property cat space. Trying to draw a clear correlation between the behavior of many reinsurers as a result of some of this alternative capital coming into the property cat space and how that's driving a -- possibly a change in behavior in the casualty market, I think it's probably a little bit early to reach a conclusion.

William Robert Berkley
Founder and Executive Chairman

So as I said, I think there's pressure, but it's not -- you're not showing anything dramatic other than in the cat space.

Operator

Our next question is from Bob Farnam of KBW.

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

I just -- can you provide any color, maybe, on the 2 new start-ups that you're talking about?

William Robert Berkley
Chief Executive Officer, President and Director

One would be -- Gene, these were in your comments. I assume that the ones that you're referring to is design professional within the architecture and engineering space?

Eugene G. Ballard
Executive Vice President of Finance

And the -- a regional company in the Southeast.

William Robert Berkley
Chief Executive Officer, President and Director

And then, of course, our new regional business, which we -- I believe we announced perhaps last quarter, but it's still getting in the process of up and running this quarter, which will be focused on the Southeast. And as we've discussed in the past when we've chatted about our regional model, we feel as though one of the differentiators between a regional model and a national carrier is a focus on a particular territory. And we have reshuffled a couple of things so we will have an operation that's dedicated to the Southeast. And also, as a result of that, we will be able to focus another operation even moreso on the Mid-Atlantic and another regional company on its core territory. So those are the 2 start-ups. It's architects and engineers and it's the formation, which I believe, again, we had announced last quarter in the Southeast.

Operator

Our next question is a follow-up from Michael Nannizzi of Goldman Sachs.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Just one quick follow-up on the international segment again. I'm sorry to keep asking on this. But the underlying combined, as you said, was 250 basis points better. How much did noncat weather contribute to that year-over-year improvement?

William Robert Berkley
Chief Executive Officer, President and Director

For the international segment?

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Yes.

William Robert Berkley
Chief Executive Officer, President and Director

Well, the noncat -- the cat activity was minimal in both last -- the third quarter of last year and the third quarter of this year. So that didn't impact it...

William Robert Berkley
Founder and Executive Chairman

No significant improvement because of...

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Like the model, Bob, whatever the -- whatever large but not cat losses were that are inside the underlying, was that -- that wasn't materially different?

William Robert Berkley
Founder and Executive Chairman

No, sir.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Okay. So I guess the question is, then, I mean, is rate in excess of -- is it rate is running in excess of loss trend in that segment, so that's what helped contribute to the margin expansion, or is it mix or something else that helped to drive that year-over-year improvement?

William Robert Berkley
Founder and Executive Chairman

I'll take a crack, and then I think Gene will probably correct me. But I believe it certainly had something to do with rate. It certainly had something to do with mix. And then, of course, the other component as far as the combined ratio goes is the expense ratio is getting better as that earned continues to build. As, Mike, you recall and we've referenced early in the call today, we've had a reasonable amount of growth in that group of companies, and we have for some number of years. So we are really starting to see the benefit of that higher earned coming through, and we're able to leverage that expense base with it.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Maybe I might have misheard. I thought Gene had said it was 250 on the underlying loss. Was that...

Eugene G. Ballard
Executive Vice President of Finance

Right.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Okay. Okay, so it wasn't -- so it was mix and then...

Eugene G. Ballard
Executive Vice President of Finance

Those 2 points -- in other words, it was 2 points for the overall company and it was 2.5 points for international, as they benefited a little bit more. Their rates were not out of line with the rate increases for the rest of the business. So it...

William Robert Berkley
Founder and Executive Chairman

They also had some benefits from expense. Rob was just adding the additional information.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Got it, got it. Okay. And then just maybe my math might be faulty here. But just from Gene's comments, it looked like there was some adverse development there in the fourth quarter. If that's right, and like I said, certainly, my math can be wrong, but if that's right, is the driver of that development different than what it was in the third quarter?

William Robert Berkley
Founder and Executive Chairman

Well, first of all, it was the third quarter was the adverse development. You said fourth.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Yes. No, third. No, no, no, that would be -- yes, sorry about that. Third versus second. I'm ahead of myself by a quarter.

Eugene G. Ballard
Executive Vice President of Finance

And what was your question, then?

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

I guess, what was the driver of that development? So there was adverse development in the second quarter, and then, if my math is right, there was some adverse development in the third quarter.

Eugene G. Ballard
Executive Vice President of Finance

[indiscernible] Yes.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Yes. Were those similar drivers of -- in terms of what caused that adverse development, or is it just individual policies here or there?

Eugene G. Ballard
Executive Vice President of Finance

Yes, it's similar. It was a modest amount. It wasn't any difference between where it was coming, coming from the same source, basically.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

And that was, as a book of business, that was which area?

William Robert Berkley
Founder and Executive Chairman

I don't think we've mentioned it.

Operator

I'm showing no further questions at this time. I would like to turn the conference back over to management for closing remarks.

William Robert Berkley
Founder and Executive Chairman

All right. Well, thank you all very much. We appreciate -- we're quite enthusiastic about the balance of the year. Clearly, capital management is on the forefront as we go forward. We expect continued price increases, and as I said, I sort of bring my band a little closer, from 6% to 8% down to sort of 6.5% to 7.5%. But we're quite optimistic and expect the balance of the year and next year to generate returns well within the range of our expectations and continue to have capital gains in line with the recent past. So thank you all very much. Have a great day.

Operator

Ladies and gentlemen, this concludes today's conference. Thanks for your participation, and have a wonderful day.