S&P Global
Market Intelligence

The Allstate Corporation NYSE:ALL

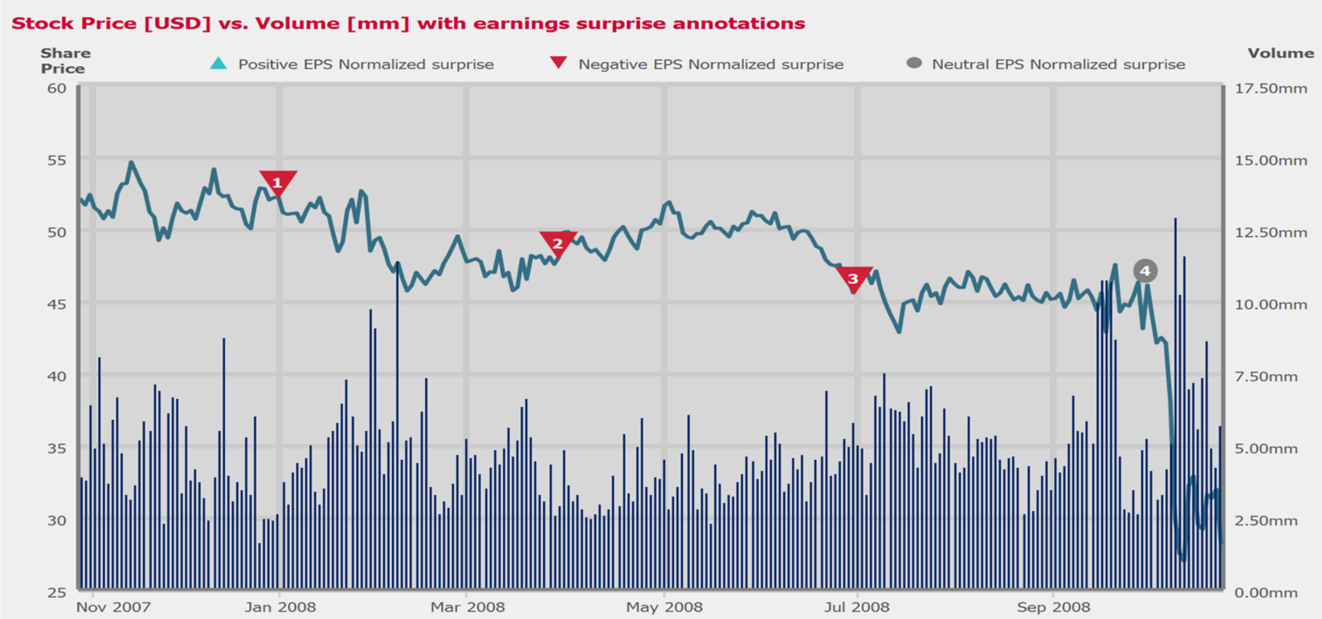
FQ4 2008 Earnings Call Transcripts

Thursday, January 29, 2009 2:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ4 2008-			-FQ1 2009-	-FY 2008-	
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	ACTUAL
EPS Normalized	1.35	0.97	▲(28.15 %)	1.38	3.57	3.22
Revenue	-	-	▲0.28	-	-	-
Revenue (mm)	6649.14	6668.00	-	6616.80	26961.48	26967.00

Currency: USD
Consensus as of Jan-29-2009 1:35 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ4 2007	1.32	1.28	▼1 (3.03 %)
FQ1 2008	1.62	1.33	▼2 (17.90 %)
FQ2 2008	1.30	1.24	▼3 (4.62 %)
FQ3 2008	0.66	(0.35)	NM

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Call Participants

EXECUTIVES

Don Civgin

Judy Greffin

Robert Block

Samuel H. Pilch

Thomas J. Wilson

ANALYSTS

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Brian Meredith
UBS

Daniel Johnson
Citadel Investment

Gary Ransom
Fox-Pitt Kelton

George Ruebenson

Ian Gutterman
Adage Capital

Jay Gelb
Barclays Capital

Joshua Shanker
Citigroup

Matthew Heimermann
JP Morgan

Meyer Shields
Stifel Nicolaus

Paul Newsome
Sandler O'Neill & Partners

Vinay Misquith
Credit Suisse

Presentation

Operator

Good day, ladies and gentlemen, and welcome to the Allstate Corporation fourth quarter 2008 earnings conference call. (Operator Instructions) I would now like to turn the conference over to your host, Mr. Robert Block, Vice President of Investor Relations.

Robert Block

Good morning, everyone. Thanks for joining us today. Last night released our results for the fourth quarter 2008 and our investor supplement. Both can be found on the Allstate website under Investor Relations.

Today joining me on the call are Tom Wilson and Don Civgin, who will share their thoughts on our results. To help us in the Q&A session we have Judy Greffin, Sam Pilch, and George Ruebenson. During the Q&A period we ask that you limit yourself to one question and one follow-up, so that we can get to as many questions as possible in our time together.

Please note that our discussion may contain forward-looking statements regarding Allstate's operations and that actual results may differ materially. Please refer to our 2007 Form 10-K, the third quarter 10-Q, and yesterday's release for information on potential risks. Also we will discuss some non-GAAP measures for which you will find reconciliations in the press release and in investor supplements.

This call is being recorded and a replay will be available shortly following the conclusion of the call.

Now let's begin our discussion with Tom Wilson.

Thomas J. Wilson

Good morning. I will begin with on overview of our results, then Bob will cover property liability and Allstate Financial and Don will discuss investments, liquidity, and capital. As always, we value our dialogue with you so there will be plenty of time for questions at the end.

Allstate remains financially strong despite what was a tough environment in 2008. We generated $518.0 million of operating income for the fourth quarter and $1.8 billion for the year, despite a $1.9 billion increase in catastrophe losses.

Our property casualty business had an underlying combined ratio of 86.8 for the full year and that was better than the range we committed to a year ago and in line with our updated outlook.

Allstate Financial and our investment portfolio were adversely affected by the virtual shut down of the fixed income markets. That resulted in $1.9 billion of realized capital losses in the quarter and $5.1 billion for the year. Those capital losses reflect both declining market values and an expectation that the economic recession will create credit issues in the future.

That said, the portfolio generated cash flow of $8.6 billion from interest and principal payment, which was virtually identical to the contractual obligations in our expectations. In addition, our focus on increasing liquidity resulted in substantially lower investment income as we moved to the short end of the curve. As a result of the realized capital losses we had net loss of $1.7 billion for the year.

Despite the challenges of a significant number of catastrophes and tumultuous investment markets, our proactive approach to risk management enabled us to be highly liquid and well-capitalized. We have over $20.0 billion of cash and liquid investments which provide ample liquidity to cover our relatively modest fixed charges and maturing debts.

Our catastrophe losses on hurricanes Ike and Gustav would have been nearly twice as high without the risk mitigation efforts we instituted over the last several years. We avoided the losses that many others in the industry have experienced by exiting our variable annuity business in 2006.

On the fixed annuity side, fixed annuity sales were down 29% for the quarter. During the year we moved in and out of the markets as we maintained pricing discipline in order to get acceptable returns. On a longer-term basis fixed annuity sales in 2008 were about half of our peak volumes in 2004.

Finally, our 2008 risk mitigation efforts to hedge the equity in higher interest rates generated net gains of about $250.0 million. Further, our proactive sales of securities enabled us to avoid losses from the major company failures in 2008 and further market declines. This proactive approach generated over $0.5 billion in value.

All of these efforts resulted in Allstate entering 2009 well capitalized and financially strong. We believe we have the flexibility and strength to deal with the continued upheaval in the financial markets. Don will cover more of that in detail in just a few minutes.

Financially it was a tough year and we all played the price with a significant decline in our stock price. Our three goals for 2009 reflect our expectation that the economic and business climate will remain difficult.

First, we will protect Allstate's financial strength. We will focus on preserving auto insurance margins and reducing catastrophe risks. Allstate Financial will take the necessary steps to narrow its focus and reduce costs. It does remain a core part of our strategy, which is to reinvest protection and retirement for the consumer. We will maintain high liquidity and reduce the duration of our fixed income portfolio despite the negative impact on operating income.

Secondly, we will need to increase customer loyalty to provide additional revenue growth. Acquiring and retaining customers is vital to our success. Bottom line, we need to serve our customers better than anyone else in the industry. I am disappointed by the lack of significant improvement in 2008 on customer loyalty and we are highly focused on improving that result in 2009.

Lastly, we will continue to reinvent protection retirement for the consumer by rolling out new products and services. This is consistent with our focus on delivering value and will continue to differentiate us from the competitors.

Bob will now go into the business units details in greater depth.

Robert Block

Let me quickly go through the results for property liability beginning with net written premium. For the year we wrote $26.6 billion, a decline of about 2% from 2007. The combined effect of a competitive market place, particularly in auto insurance, and a softening economy in terms of auto and home sales negatively affected the premium results.

Earned premiums followed the written trend, declining about 1% to $27.0 billion.

Downward pressure on the top line will continue into 2009 as the economy struggles to regain momentum.

For the fourth quarter total net written premium dropped 3.9%. Allstate brand standard auto fell 2.9%, primarily due to a drop-off in new business reflective of the reduction in auto sales, as well as a slight decline in retention. As a result, units are down slightly from September's levels and off by 1.8% from year end 2007.

On a positive note, we have seen a new business pick-up in California, where we introduced Your Choice auto during the fourth quarter.

The average premium did increase in the quarter. Pricing in the market remains fairly rational.

Allstate brand homeowner insurance continues to reflect the downward pressure from catastrophe management actions as well as the negative economic effects of falling home sales.

Encompass auto premium written is down significantly as we take actions to improve the margins.

In our emerging business lines we have seen favorable net written premium trends as efforts to penetrate these markets are bearing fruit.

From a margin perspective we finished the year with a small underwriting profit despite experiencing catastrophe losses of $3.3 billion. 2008 catastrophe losses were the second worst in our history and were affected not only by hurricanes and wildfires, but also one of the most active tornado seasons on record. And these results could have been worse had we not taken aggressive cat management actions over the last several years.

Adjusting for the effects of catastrophe losses and prior-year reserve re-estimates, our underlying combined ratio for the year was 86.8%. This was in line with our latest outlook and slightly better than the original range we provided last February. For the fourth quarter the combined ratio was 96.4%, an increase of 0.5% from 2007.

The underlying combined ratio was 91.5% versus 88.6% in the fourth quarter of 2007. The 2.9% variance is primarily due to increased current severities for auto injury coverages, higher non-cat-related losses for homeowners and 0.5% increase in the underwriting expense ratio, partially offset by a favorable auto frequency result.

Auto loss cost trends continued to perform in line with our pricing assumptions. The frequency results for both property damage and bodily injury were well below the prior-year quarter. We did see some of that favorable trend erode in the month of December with the onset of winter weather.

Paid severity results for property damage were excellent in the quarter with an increase of just 0.7%, bringing the year to an increase of only 1.1%. Paid severity for bodily injury moderated somewhat in the quarter to an increase of 4.5%, finishing the year at 6.2% increase from 2007. The injury severities experienced some upward pressure throughout the year. As a result, we increased our current year's severity targets for these coverages adversely impacting the underlying combined ratio for both the quarter and the year.

Switching to a quick review of Allstate Financial, premium and deposits for the fourth quarter were $1.6 billion, a decline of about 14%. As Tom mentioned, this decline was primarily due to reduced fixed annuity sales as we seek to maintain pricing discipline to improve returns.

Operating income for the quarter was $89.0 million, similar to the third quarter of 2008 but $69.0 million lower than the fourth quarter of 2007. The primary reasons for the decline were lower investment income and higher operating expenses, partially offset by favorable mortality results.

With respect to the investment income trends, we have kept a significantly higher percentage of the portfolio in liquid assets, negatively impacting the overall yield.

We produced a net loss for the quarter of $1.0 billion compared to a slight profit in the fourth quarter of 2007. We had an after-tax net-net realized capital losses of $611.0 million, an unfavorable back unlocked after-tax charge of $274.0 million, and a $219.0 million after-tax reduction of DAC related to a premium deficiency assessment for life products.

For the year we posted a net loss of $1.7 billion.

The unprecedented deterioration in the financial markets significantly impacted Allstate Financial's ability to produce acceptable returns. Over the course of the year we have taken several actions to address this: dramatically increase the level of liquidity in the investment portfolio; we focused emphasis on fixed annuity new business returns versus volume; and have initiated a strategic review to narrow the business focus and lower expenses in the future.

This review will target annual savings and operating expenses approximating $90.0 million and anticipates a reduction of around 1,000 workforce positions over the next two years.

For 2009 operating income for Allstate Financial should come in at around $300.0 million as spread compression, lower asset balances, and high levels of liquidity will put pressure on the bottom line.

Now I will turn the conversation over to Don.

Don Civgin

I would live to dive a little bit deeper into four areas: first, some additional details on investment income; second, the biggest drivers of our net loss for the quarter; third, the status of our unrealized loss position; and fourth, capital and liquidity.

Allstate's consolidated net investment income was $1.33 billion for the fourth quarter of 2008, a decline of $298.0 million from the fourth quarter of 2007. This decline was across both operating subsidiaries and was due to lower average asset balances, reduced investment yields, and increased short-term investment balances reflecting proactive liquidity management.

While much of the decline reflects overall market movements, our conservative management of liquidity is responsible for approximately one-third of the decrease and was done intentionally to protect our financial position. Our net loss for the fourth quarter was driven primarily by net realized losses of $1.9 billion and DAC-related charges of $759.0 million, both pre-tax numbers.

Our net realized losses for the quarter had several large components: $652.0 million of impairment write-downs; $585.0 million of net losses on the settlement and valuation of derivative instruments; $357.0 million of net losses on sales; and $241.0 million of change of intent write-downs.

Our impairment policy continues to be consistently applied as in previous quarters. We record impairment write-downs on individually identified investments in instances where the fair value of the investments has declined below the cost basis and we conclude that the decline in fair value is other than temporary.

For the fourth quarter of 2008 these policies resulted in $652.0 million of write-downs. $467.0 million of the impairment write-downs were related to fixed income securities. And while we recorded these charges, 80% of those securities are currently performing in line with anticipated or contractual cash flows.

The derivative losses primarily reflect $448.0 million in valuation losses on interest rate swaps used in our asset liability management activities. These hedges worked as intended, but an offsetting benefit is in the fair value of related liabilities which is not recognized on the income statement.

Of the $357.0 million of net losses on sales, the majority reflect the execution of tax planning strategies, primarily with our equity portfolios, in order to proactively realize capital loss carry-back benefits. These strategies, along with refunds related to 2008 estimated taxes, will result in over $1.1 billion of cash refunds in 2009.

Change of intent write-downs were primarily the result of being proactive with our risk management and return optimization programs. Tom mentioned that this program had substantial economic benefits for Allstate throughout 2008 by allowing us to get ahead of the game in being able to manage our portfolio, but we incurred an accounting cost in doing so.

During the fourth quarter we also took substantial charges against our deferred acquisition cost balance. After a comprehensive review we took a $274.0 million after-tax charge for DAC unlocking, resulting from realized capital losses on both actual gross profits and expected future gross profits.

We also reduced deferred acquisition costs by $219.0 million after tax, related to premium deficiencies resulting from changes in mortality and its impact on annuities with life contingencies. We view the DAC unlocking charge to be the product of the credit crisis while the premium deficiency charge is viewed as non-recurring.

The combination of the substantial net realized losses and DAC-related charges were the primary drivers of the net loss of $1.1 billion for the fourth quarter.

During the quarter, Allstate's pre-tax net unrealized capital losses totaled $8.8 billion, mostly from fixed income securities, which was comprised of $2.5 billion of gross unrealized profit and $11.0 billion of gross unrealized losses.

The increase in our unrealized position is something we watch carefully. There are three important things to note: first, we intentionally have created a strong liquidity position in order to meet our cash obligations, which insulates us from having to liquidate assets in an unanticipated fashion; second, the vast majority of the fixed income portfolio in unrealized loss position continues to provide cash principal and interest payments in accordance with the contractual terms; and third, 93% of the fixed income portfolio with gross unrealized losses is rated investment-grade.

During 2008 both the high level of catastrophes and turmoil in the investment market created a great deal of interest in capital and liquidity. You should know that we have been, and will continue to be, completely focused on these two priorities with the goal of protecting and enhancing the financial strength of Allstate.

At year end 2008 Allstate held $12.6 billion of capital, of which we held $3.6 billion in deployable invested assets at the parent holding company level. We have fixed charges at the parent company relating to dividends and interest. These amounts during 2008 were about $1.2 billion. And we have $750.0 million of debt maturing in December 2009. Having said that, we have substantial earnings capacity at the operating subsidiaries and unused lines of credit of $1.0 billion.

I said last quarter that we have a healthy respect for our and everybody else's inability to predict what the markets will do. Our job is to proactively position Allstate to protect and enhance our capital decision and we are committed to doing exactly that.

One of Allstate's successes during 2008 has been the way we have defensively built and maintained our liquidity levels. The result is that at year end 2008 approximately $20.0 billion of our investment portfolio is invested in cash or other liquid investments that are saleable within one quarter without generating significant additional net realized capital losses. This represents over 25% of our total portfolio.

We have developed a well thought out cash forecasting process which helps us stay current with future anticipated needs and limits our exposure to having to liquidate assets unexpectedly. In this financial environment we believe that strong liquidity is an absolutely critical component in protecting Allstate's financial strength.

As Tom said, 2008 was a tough year. The proactive way in which we managed throughout the year protected Allstate and positions us to build on that strength in 2009.

Thomas J. Wilson

The underlying combined ratio for 2008 beat our commitment set a year ago. For 2009 we expect the underlying combined ratio to fall within the range of 87% to 89%.

We had operating profit of $1.8 billion despite significant catastrophe losses, lower investment income, and the cost of substantially increasing liquidity.

Our high quality and diversified investment portfolio enabled us to avoid large discrete individual losses but we were not able to outrun the market and incurred $5.1 billion of realized losses. As a result, we had a net loss of $1.7 billion.

Our proactive approach to risk mitigation served us well. Our stock price declined significantly in 2008 and we entered 2009 financially strong and highly focused on maintaining our financial strength and positioning Allstate for long-term growth and profitability.
So now let's start the dialogue portion of today's call.

Question and Answer

Operator

(Operator Instructions) Your first question comes from Jay Gelb - Barclays Capital.

Jay Gelb
Barclays Capital

On the capital position, with the significant erosion of value, with investment losses accelerating, and S&P cutting the rating, what level of comfort do you have that you won't need to raise fresh equity capital in 2009?

Thomas J. Wilson

We feel comfortable with where we are with our capital position today and maybe take those in reverse order, while S&P reduced our rating, it will have no impact on our business, and they cut it double-A-minus so that's exactly a terrible rating.

Secondly, with respect to the things that could affect our capital position, as Don went through, if you look at the two that impacted us in 2008, it was significant catastrophes and we have talked at length about our risk mitigation programs, the reinsurance activity.

And in the investment portfolio we are obviously maintaining high liquidity so that we can continue to realize the cash that comes off that portfolio.

I want to be very clear about something. In the portfolio, we collected $8.6 billion of cash last year, which was $3.0 million less than we thought we were going to get. And when you look at the amount of cash relative to the market value, or the carrying value, of those securities, it's relatively high. In total it's about 12% but when you look at some of the securities that have been marked down the most, like if you take RMBS, we received 42% of the market value of that in cash in 2008.

So we feel like we have good strong cash flow. We have ourselves positioned so we don't sell anything and we have the strength of our auto insurance operations continuing to generate a good return. So we feel good about 2009.

Jay Gelb
Barclays Capital

On the Allstate Financial business, I believe the target RBC ratio is 300%. Can you give us a sense of where that is as of year end?

Thomas J. Wilson

We would be close to what we consider our target. I don't want to give you the number because I've been told that we are not allowed from a legal and regulatory standpoint, regulatory in particular, to be throwing that around in terms of selling. We're at our target, how about that?

Operator

Your next question comes from Joshua Shanker - Citigroup.

Joshua Shanker
Citigroup

Can you give any clarity into segmenting the unrealized loss for the quarter and maybe for the full year? You actually gave some of the data for the full year, but how much of that is in securities that have a liquid market that you feel very comfortable a) in your ability to sell, and b) the extent to which you're confident that recovery value is not even questionable?

Thomas J. Wilson

There are a number of pieces to that. First, as Don pointed out, we have over $20.0 billion of securities we could sell within one quarter that do not have an unrealized capital loss on them. So if you are worried about if we have sell things and that unrealized comes into the income statement and then we $20.0 billion in terms of liquidity.

In terms of where it comes from, we have broken it out in detail in the Investors Supplement. Of course, most of it is fixed income.

Joshua Shanker
Citigroup

Well, we have for annually, not really for quarterly, though.

Thomas J. Wilson

Oh, you want the quarterly. I can get your there. The change in the unrealized in the fourth quarter was $4.7 billion. So that's how much it went up. $1.6 billion of that was corporate, which reflects both spreads and credit impairments. $1.2 billion was CMBS, which largely reflects spreads, you know the spreads just went through the roof on CMBS after they changed the TARP program in September. About $900.0 million each from munis and asset-backed securities. Munis was a spread issue and asset-backed securities had both spread and credit impairment in it.

Joshua Shanker
Citigroup

Could you talk about the dividends a little bit. A lot of interest to investors.

Thomas J. Wilson

As you know, we approved the dividend for the fourth quarter, which we kept at the same level we had throughout the whole year. We look at the dividend every quarter, we will look at it again in February. As the Chairman of the Board I reserve the right for the Board to decide whatever they want to do every quarter and those people who tell you they can predict it for the whole year, in my opinion, are not approaching it from a corporate governance standpoint the right way. That is solely the right and responsibility of the Board, which I lead.

Operator

Your next question comes from Daniel Johnson - Citadel Investment.

Daniel Johnson
Citadel Investment

On the operating side, can you talk a little about what's going on in personal auto pricing? I don't think we have the same data in the press release that we used to have. Just looking at the average earned premium for standard auto, it looks reasonably flat for most of last year, including the quarter.

George Ruebenson

Two things. We took modest rate increases during the course of 2008. Our goal is to keep within the margin that we have given you, the combined ratio of 87% to 89%. So we react to the rate needs as quickly as we can and we have been fortunate because we did not get out of whack with the target so we don't have to catch up. So we took modest increases in 2008.

One thing that has been happening, though. Because of the deteriorating economy we are seeing consumers making changes that basically engineer their premiums down. Specifically, they are dropping collision and comp, they are going to higher deductibles, they are going to lower limits. We are seeing a change from a lot of platinum sales at our Your Choice auto to more of value and more endorsement changes where people take a lower premium policy. But we still believe that we are adequately priced.

Our competitors, on the other hand, have had to take increases much more severe than we've had. At the end of last year we noticed that people were taking many more rate increases than they did decreases and many more positive changes than they did earlier in the year. That has continued throughout 2008 and actually in the last quarter we've seen a significant number of our competitors having to take rate increases much more severe than we've had to.

Daniel Johnson
Citadel Investment

Given that most of the consumer issues of 2008 were seemingly September and beyond, not that the rest of the year was great, but would it be fair to say from an earned premium point of view we really haven't seen that sort of buy-down mentality just went?

George Ruebenson

I'm not sure. I can't predict what the economy is going to do and consumer behavior. I think the people will be rational in their purchase of the product. The one thing I want to remind everybody is that in a recessionary environment typically auto insurance does very well. It is not something that people can do without. So there will be some movement, I think, in the average premium. But again, it's all embedded in the pricing. So again, go back to the margin guidance that Tom gave, 87% to 98%. We did better than that in 2008 and we think that's the reason we're [inaudible] in 2009.

Daniel Johnson
Citadel Investment

On page 10 of the supplement where you break out the DAC data, the $3.25 billion of incremental DAC this year from realized gains and losses, help us get some sort of confidence that that is actually real shareholders' equity, given that we've seen some DAC write-offs already. And I think you have mentioned that there is a limit to which you can keep putting the DAC back up on the balance sheet.

Samuel H. Pilch

With respect to the limit, there is a limit you can't capitalize more than you originally incurred.

Secondly, the DAC that appears in the unrealized is subject to the same testing that was conducted in the DAC unlocking and therefore the recoverability of the DAC has already been determined.

The way the accounting model works is that we put out the unrealized, the DAC such as it will occur, should we realize the losses. So there are limitations and interactions that go on between OCI, other comprehensive income, and net income.

Daniel Johnson
Citadel Investment

If the unrealized losses all go away, meaning positively, then this $3.0 billion goes away, and if these unrealized losses become realized that the $3.0 billion needs to be adjusted downward as well?

Thomas J. Wilson

Maybe we could take you through all the potential alternatives offline.

Operator

Your next question comes from Matthew Heimermann - JP Morgan.

Matthew Heimermann
JP Morgan

You mentioned in the press release that your dividend capacity in the P&C company for 2009 is $1.3 billion. Do you intend to actually take that dividend this year?

Thomas J. Wilson

That is a decision we will make throughout the year. As Don pointed out, we have $3.6 billion of cash and capital up at the holding company so we have plenty of capital to pay any of our fixed charges and cover any obligations we have with the parent company. So we will see where we go throughout the year.

But our philosophy usually has been take maximum dividends out of the insurance company so that it gets up with the parent company so it has the most financial flexibility. It will just depend on how the year goes.

Matthew Heimermann
JP Morgan

It seems like a bunch of the capital in the P&C sub is somewhat cross credit with DAC. So given that dependence has increased does that diminish the capital flexibility that you would have to take that out relative to past years?

Thomas J. Wilson

Not because of the stacking of corporate subsidiaries that you described. Obviously the requirement to put more capital into our life insurance company has reduce the capital flexibility we have in the total corporation, whether we take it from Allstate Insurance Company and put it down there or we take it from the parent company. But when we look at the capital of Allstate Insurance Company we look at it on a stand-along basis, excluding the Allstate life investments.

Matthew Heimermann
JP Morgan

How sensitive is that asset going to be, I guess time is an important element in terms of the recoverability of that asset, so let's say that we have investment marks don't change at all this year, can you give us a sense of what the write-down might look like, if there is one in that type of scenario?

Thomas J. Wilson

Sam can answer but my guess is it really has less to do with marks than it does the cash flow characteristics.

Samuel H. Pilch

That's correct, Tom. There are assumptions for losses but as you noted, assuming that there aren't any additional losses, the DAC would continue to be recoverable and there should not be an unlock for that purpose.

Matthew Heimermann
JP Morgan

But if we do see a transfer of, per the press release, then I guess it just depends on the magnitude of any realization out of that unrealized, even if the market doesn't go up or down?

Thomas J. Wilson

I think what Sam says, if the market doesn't go up or down, we have the right amount of DAC. And that will amortization off over the course of receiving the cash and income from those investments.

Matthew Heimermann
JP Morgan

I'll follow up offline. I was just confused because it seemed like the press release implied that if there were additional realized losses that there would be DAC ramifications.

Operator

Your next question comes from Gary Ransom - Fox-Pitt Kelton.

Gary Ransom

Fox-Pitt Kelton

I had a question on investment income, whether the fourth quarter investment income we saw reflects fully the impact of moving to more cash or is there more to go as we move through 2009? Is there more movement to shorter duration and lower yields?

Thomas J. Wilson

Let me make a comment about the whole year. The lower yields hit, I think Allstate Financial had about $400.0 million worth of investment income lower just because of yield. So that dropped from the 3% range into the zero land. It had a huge impact on our profitability this year. So we have obviously been in that position for a while.

Gary Ransom
Fox-Pitt Kelton

Just looking at the fourth quarter itself, is the fourth quarter run rate reasonable or is there more reduction coming?

Thomas J. Wilson

What I would do is go back and look at what happened to the, if you look at short-term rates in the quarter, they were pretty low throughout the whole quarter and that's really where it came. So while we don't have variance in that specific question, I think I would just say that short-term rates have been down all quarter.

Gary Ransom
Fox-Pitt Kelton

But you're not also planning to shift more of the assets into short-term and having a bigger proportion in short-term assets?

Thomas J. Wilson

We will probably shorten the total duration of the portfolio in 2009 reflective from a risk-mitigation standpoint, reflecting the potential for rates to go up as opposed to go down any further from here.

Gary Ransom
Fox-Pitt Kelton

On the expense ratio, I realize it was up a little bit versus a year ago but it's also quite a bit higher than the run rate from the first part of the year. Was there anything unusual about the expense levels in property causality?

Don Civgin

There were several one-time payments that we had. We had a technology write-down, we had the funding of the profit sharing, and we had a couple of unusual things in the quarter. The number is not an indication of what we expect for the duration of 2009.

Operator

Your next question comes from Analyst for David Lewis - Raymond James & Associates.

Analyst for David Lewis
Raymond James & Associates

On the investment portfolio, do you have any exposure to some of the European hybrid securities?

Judy Greffin

We do. We do have some exposure to the European hybrids. Our overall exposure to hybrids, at market, is a little over $1.0 billion. Exposure to U.K. and other European institutions and we manage them closely and we have monitored the situation in terms of the actions that have been taken by the government to prop up the banks.

Operator

Your next question comes from Ian Gutterman - Adage Capital.

Ian Gutterman
Adage Capital

Can you talk a bit about cap management for this year in the context of in the past when we were buying reinsurance largely we were concerned about earnings predictability and it was never really going to be a capital event, where it seems this year, given the uncertainty about dividending money up to the parent and what the life company might need and so forth and the operating leverage is higher in the P&C subs than in the past, that if there were a large cat that maybe it could have a significant impact on your capital flexibility, maybe as much as any future realized losses that may or hopefully don't develop, so are there any changes you are making in your reinsurance buying so that everything you have planned out doesn't change because we have a cat and you have and $1.0 billion or $2.0 billion loss and you have to go raise capital for that even though you've got everything right on the investment portfolio side from your planning?

Thomas J. Wilson

First, our catastrophe management program was really around our desire to exit from the business of insuring for modeled catastrophes called hurricanes and earthquakes. Of course, we're almost totally out of the earthquake business except for a few dangling participles. And in terms of fire following in California and a little bit in Kentucky.

So the program was really designed around saying we don't think that's a good bet so we don't want to be there. So we have, as you know, reinsurance, really, in individual states all along the coast from New York all the way around to Texas, we call it sort of the wall of protection, so it was done for an economic reason first. It does have the benefit of stabilizing earnings as well.

Then in line with that idea that we didn't want to really be in that risk, we bought over $2.0 billion, which is really a capital management protection program. That's not an earnings thing. So after the first $2.0 billion we have the other $2.0 billion covered. So that was a big driver there.

The $1.0 billion to $2.0 billion cat loss you talk about, I would point out we had $3.3 billion this year and we still made money and we made money in the year when we had hurricane Katrina, as well, although we had the negative investment result from that year. So the challenge for us this year has really been non-modeled cats which are wind storms, tornadoes and as we talked about in the second and third quarter, that was a big driver of losses for us. And George's is working hard to decide how to appropriately do that. But buying reinsurance for coverage at that level, I believe, George, you looked at it and decided it's not economic.

George Ruebenson

We have spent a fair amount of time trying to find out whether there were any significant changes in the climate, as we did with looking at the hurricane predictions. And with hurricanes we found out that the water was getting warmer and because of that the intensity of the hurricanes would be greater.

On the other hand, we looked to see if there were any changes in climate that would increase the number of tornadoes, specifically, and there is nothing that we have been able to find out. In addition, we looked at what our exposure was over the years and it is fairly consistent with what our homeowner writings have been. So it has been problematic for us during the last year but we don't see where there is the necessity to make any changes.

In addition, if were to buy reinsurance to get down to the very low level that you would need on some of these, it's just not economic for the company.

Ian Gutterman
Adage Capital

Maybe the way I should have phrased it is, as you said, the $2.0 billion ex $2.0 billion was to protect capital but when it was put on you had a lot more excess capital and you had a double-A rating across the board where now if go from a double-A-minus to an A-plus due to a cat, that's more significant, the operating leverage is higher. So I'm wondering would it be better to have $3.0 billion ex $1.0 billion? If $2.0 billion was the amount you could tolerate in the past when you had lots of excess capital and now that capital is tighter is $2.0 billion still a good retention or should that be lower.

Thomas J. Wilson

Of course, you can never predict the future. We're comfortable with $2.0 billion over $2.0 billion. On the upside to that, the size of the program you get your limits in the marketplace and in terms of lowering it, then you start looking at what will happen with non-model cats, with model cats. We're comfortable with $2.0 billion over $2.0 billion. Plus we have programs everywhere else, too.

Ian Gutterman
Adage Capital

The gross unrealized losses, the market value is less than 70% of amortized costs. I believe that was a $6.7 billion number. There are always lots of questions about if these things are less than 80% or less than 70% why aren't they impaired. And I know it's not that simple, maybe they have only been there for a very short period of time, but can you give us some comfort why the great majority of that $6.7 billion recover is because given 15% of that, that's $1.0 billion, that's a big realized loss. I understand most of it should recover but how do I get comfortable if 99% recovers and not 75%?

Thomas J. Wilson

I guess it would start with if you just look at our valuation process rather than jump into the numbers. Our valuation process is comprehensive, complete. We have a number of different people look at it. Sam's people are all over it. Judy has got several different teams that look at it. We look at both external, internal marks. We always put down what we think the value is and then we have strict rules around when it's impaired. We haven't gotten behind on that one and I don't think this process will let us get behind.

That said, if things continue to deteriorate we take the approach of writing it down when it is. That's why you see our realized capital losses, we always do what we think is economic. If we want to sell something, even if we have to put it into no longer intend to hold until maturity and take the loss on it, we have done that. We do what is economic, based on our view of the valuation.

So it's very important for us economically to have the valuations right and we feel good about that process. If you want, offline Bob can take you through the different pieces of the below 70%, 70% to 80%.

Operator

Your next question comes from Meyer Shields - Stifel Nicolaus.

Meyer Shields
Stifel Nicolaus

I'm just trying to put together two data points from the press release and your commentary where you talk about the company taking bigger rating pieces in the fourth quarter, in the press release you talk about competition being an impediment to net premium growth.

Thomas J. Wilson

If you go back to 2007, you remember in the first and second quarter of 2007 a number of our competitors were taking price decreases when we were holding prices relatively flat or taking small increases. Then in the second half of 2007 they started to take more increases than decreases and that has continued on for the last year or so.

So the way this business works with six month policies, it takes a while for that to work through the system, so we feel like our strategy of small and frequent is better than dramatic and rapid and big ups and downs. We think it's better for our customers, we think it's better for long-term retention.

That said, we have become less competitive in the higher risk drivers as a result of the decreases people took in 2007 but we think we are working our way back. We're not trying to blame anything on the market, the biggest thing we can do to drive growth right now is to get customer loyalty up.

George Ruebenson

We are still very competitive in the better IS scores. The problem we are having is there are fewer people in the better IS scores. And also with the economy as difficult as it, there are just not as many cars being bought, which again, is one of the triggers. So it's difficult to expand during this time when the economy is bad and cars are not selling.

Tom talked about the competitive position. That's simply a price-competitive position. What we are working on is the value of the product and making sure that our service improves dramatically so that people realize that Allstate is affordable and that our service is even better. We have never been a peer-price play.

What's happening though is because the margins of our competitors are worse than ours, they are taking increases that we do not have to take right now, which should help us a little bit more in the future.

Meyer Shields
Stifel Nicolaus

Does the deterioration you are seeing in insurance scores, that I guess is a ramification of the weak economy, is that a predictor of worse loss experience?

Thomas J. Wilson

No, because what we have is pricing for the correct score.

Meyer Shields
Stifel Nicolaus

Can you talk more about stuff that didn't work to improve customer loyalty over the course of 2008?

Thomas J. Wilson

We have obviously had a number of programs we have talked about before in terms of call back, getting the agencies engaged, but there is something that we haven't talked to you about before that I think is very important. We have a 401(k) savings plan that is part incentive and part retirement for our employees.

And the payout, there is a guarantee and then there is some upside to it. Traditionally we have done that around operating earnings. In 2009 that will be on customer loyalty. So we are telling all of our employees that we can and must do this and you will be rewarded for it and it has a high priority for us at the company.

George also has a number of operational activities going on, down to the individual and agency owner level, that those people who do not treat our customers well and do not deliver customer loyalty, will no longer be part of the Allstate family.

Operator

Your next question comes from Brian Meredith - UBS.

Brian Meredith
UBS

What impact was the increase in the BI severity in the quarter on the auto loss ratio?

Robert Block

I would have to get back to you on the specifics. About half of the increase or so in total was due to the increases in current year severities.

Brian Meredith
UBS

Do you have the stat surplus for the P&C operations and the life operations?

Thomas J. Wilson

We haven't closed the stat books yet.

Brian Meredith
UBS

But you gave us what your dividend capacity is.

Thomas J. Wilson

It's an estimate and a lot of it is based on prior earnings.

Brian Meredith
UBS

It didn't seem like there was much activity on the commercial home loan portfolio as far as write-downs. Can you talk about what is going on there?

Thomas J. Wilson

Are you talking about the $10.6 billion of commercial mortgages?

Brian Meredith
UBS

Yes.

Judy Greffin

The portfolio, we have talked about it before, it's a well diversified portfolio. We've got about 1,000 loans. Minimal write-down activity in 2008. The commercial real estate market is weakening. We expect it to weaken throughout 2009. The portfolio if is in pretty good shape. We have seen some deterioration in LTVs throughout 2008. I think we have quoted about a 57 LTV. We are currently looking closer to 66. But manageable within a well diversified portfolio plus the portfolio, at this point, continues to cash flow, our debt coverage ratio is about 1.8 times and the activity around the leases within the properties continues to be strong cash flows within the properties.

Brian Meredith
UBS

Some of the banks have had to take hits with their commercial loan book. I figured you may have to take one.

Thomas J. Wilson

We feel okay with what we've got. Remember the size of the loans.

Operator

Your next question comes from Vinay Misquith - Credit Suisse.

Vinay Misquith
Credit Suisse

How much of capital has a downgrade from double-A to double-A-minus free up from you from the S&P and would you also be willing to go to a single-A?

Thomas J. Wilson

It doesn't free up any capital. Their choice is what their choice is. We run our capital based on what we think economically we need. We look at both economic risks, which has our enterprise risk return model in it, we look at the regulator requirements. We look at their views but it doesn't really free up any capital for us.

We feel well capitalized where we're at, going from double-A to double-A-minus doesn't really impact our business much at all. We're not really doing much in the institutional markets these days in fixed annuities and the rest is retail.

But I think the key point is we want to stay financially strong so we don't have an objective of lowering our rating.

Vinay Misquith
Credit Suisse

Should you have some pressure on unrealized losses would you be willing to take it down to the A level?

Thomas J. Wilson

We continue to manage our company so we have the right amount of capital. What the rating agencies do is their choice and it doesn't really have a great impact on our business. Our number one goal this year is to protect Allstate's financial strength so I'm going to continue to do that.

Vinay Misquith
Credit Suisse

How are the rating agencies and the regulators looking at the $700.0 million of additional stat capital that you generated from the accounting changes? The one was adding for the default tax assets and you also had another accounting change that did about $350.0 million worth of gains on your stat books.

Samuel H. Pilch

The regulators look at it favorably because it is indicative of this [inaudible] to the company. But they are also involved in it so they are informed as we do things.

Vinay Misquith
Credit Suisse

My point being that you have $700.0 million worth more of stat capital. Does it really benefit you or do the regulators look through it saying this is a non-cash item therefore we will look through it. Both from the regulators and the rating agency perspective.

Thomas J. Wilson

As Sam said, the regulators are involved in it and aware of it and approve it. The rating agencies, you'll have to ask them how they view capital these days. They keep adjusting for changes in the external environment. But we feel comfortable with where we are on capital.

Operator

Your next question comes from Paul Newsome - Sandler O'Neill & Partners.

Paul Newsome
Sandler O'Neill & Partners

I was hoping you could talk a bit more about the life insurance DAC write-down with respect to the traditional products. It makes sense to me that you would write something down on the interest-rate sensitive but I think you said that you also were changing mortality assumptions when you unlocked the DAC and I haven't seen a mortality =-related charge that size in a while. What was the change in thinking on the mortality business?

Samuel H. Pilch

With respect to the analysis of the DAC, we group our products into these investment products, which is a FAS97, and then the insurance products, which is the FAS 60. That's what we're talking about.

With respect to it, we have both annuities as well as life insurance in there. We have been monitoring the mortality experience that we have been incurring on the annuity book and starting in 2007 going into 2008 we commenced a study and as a result concluded that the individuals covered by the annuity program were expected to live longer. As we finished the year we did the evaluation of future cash closed and concluded that the DAC was no longer fully recoverable and therefore we wrote it down by $336.0 million. And that is indicative of the additional annuity costs that we are going to incur over the next 20 to 30 years.

Paul Newsome
Sandler O'Neill & Partners

But usually you see, because you have you have a fair amount of traditional life products, death protection business, well offsetting that. Is it just your mix of business that changed this? And why now? My understanding is you haven't really seen it in acceleration in the last several years of mortality improvements like you did in the 90s.

Samuel H. Pilch

We haven't the growth in the life insurance business sufficient to offset the developing deficiency in the annuity business. With additional growth and focus on insurance products that situation will be abated.

Operator

Your last question comes from Alison Jacobowitz - BAS-ML.

Alison Jacobowitz
BAS-ML

Just wondering with the weaker economy with your focus on retention, are you seeing an increase in shopping? And with the review of the life business, how far are you willing to take it? Might you consider exiting the business altogether and if not, why not?

Robert Block

People are obviously more price sensitive and if you look at our current advertising campaign as a tag line at the end is call Allstate first. What we've found is that if you can get people to call you first and you can save them money, and with our new pricing, we've got SRM6, we can save a lot of money for a lot of people. Look at the ads and Dennis Hasford talks about we can save you $518 versus Geico and then he goes through a series of other people.

So if we can get people to call us first and work on our service so they do consider us, we can then do a better job of acquiring new customers. Obviously the thing that we have to be sensitive to is the value of the service we provide to keep our customers. But there is more shopping going on, yes.

Thomas J. Wilson

On the second question, we are reducing expenses by over 20% at Allstate Financial we are adjusting for the reality of that profit stream and where we have that business position today. We are narrowing its focus but we are not going to get out of that business in total. Part of our goal is to reinvent protection retirement for the consumer. Middle income people need both life insurance protection and retirement savings, even more now than they did a couple of years ago. That doesn't mean we can do it the old way, it means we just have to find a new more profitable way to do it.

There are portions of that company which are highly profitable and earn great returns. We avoided the VA downfall obviously but we were not able to avoid the increase in spreads, which has crushed current profitability. So we are going to do what we need to do to make that business profitable, but we still believe that there is great opportunity to cross sell our existing customers.

Let me close with a summary of where we have been and where we go before you all sign off. 2008 was a tough year. Nobody likes to lose money. Not our shareholders and not this management team. Our business model, the capital and management were all tested over the last 18 months and the results show that the strength, resiliency and flexibility of our business model are strong.

Our results show our management team has the capability, aggressiveness, and willingness to act and act in a way that is necessary to succeed. We remain financially strong despite a terrible year for catastrophes and a meltdown in the investment market. We earned $1.8 billion of operating income by being good and disciplined in our auto insurance business.

Our conservative and proactive approach to business has served us well and we entered this environment with a high quality, highly diversified fixed income portfolio that still generated $8.6 billion of cash last year which was almost exactly equal to what was owed and expected.

In the face of declining valuations we have put an expansive risk mitigation program in place in the middle of the year that created $0.5 billion of value. Over the last three years we have proactively reduced our catastrophe exposure and a result our losses on hurricanes Ike and Gustav were cut by half. We sold our VA business in 2006 because we didn’t like the risk profile. This avoided creation of a huge liability when equity values declines this year. We reduced the size of our fixed annuity sales by more than half over a four-year period.

In response to drops and profitability at Allstate Financial we are narrowing our focus and cutting our costs by 20%. To preserve capital we cut our 2008 share repurchase program in half from 2007 and then we stopped it altogether in the middle of the year.

And despite this near-term focus on operational excellence and risk management, our shared vision is alive and well. We have over 50,000 Allstaters that are engaged in our customer focus strategy of reinventing protection retirement. Our first step out of the box, Your Choice auto, has sold over 4.6 million policies, which is more than most companies have in total.

Focusing on value is the right long-term strategy for sustainable growth and profit. Our four operational priorities of operational excellence, customer focus, enterprise risk management, capital strength have not changed, have continue to serve our company well, and will be a strength for us, no matter what the external environment is.

So thank you for your interest in Allstate. We’ll see you next quarter.

Operator
This concludes today’s conference call.