S&P Global
Market Intelligence

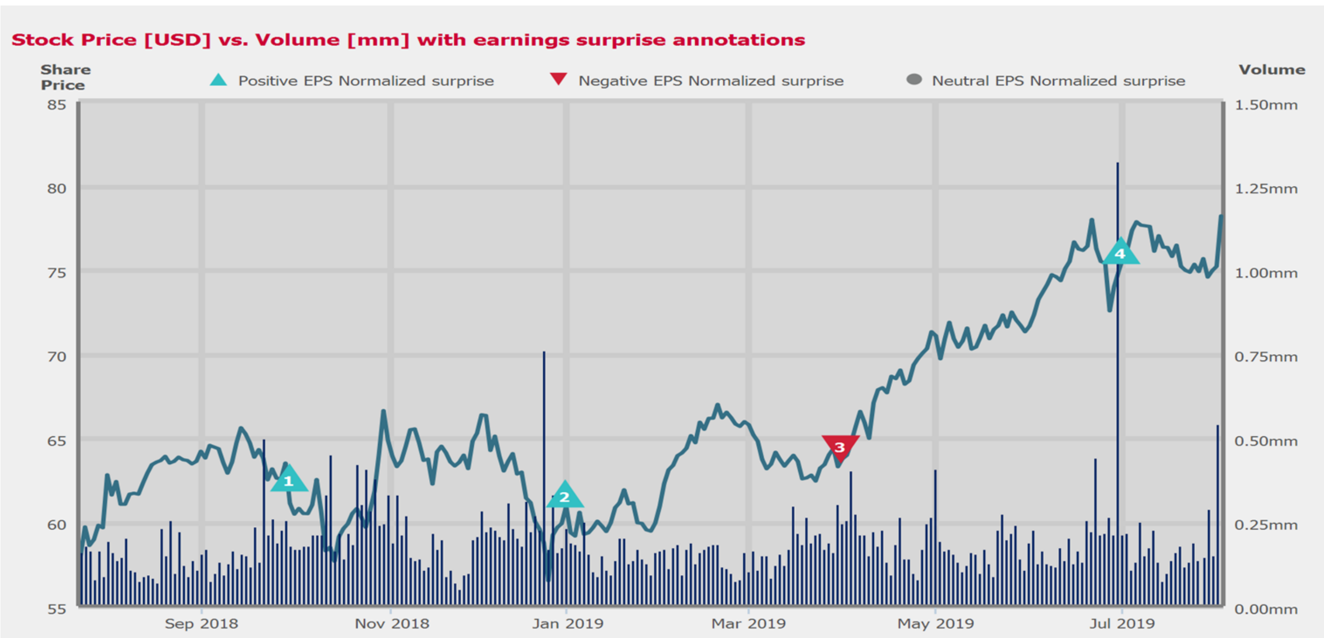
Selective Insurance Group, Inc.
NasdaqGS:SIGI
FQ2 2019 Earnings Call Transcripts

Thursday, August 01, 2019 1:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ2 2019-			-FQ3 2019-	-FY 2019-	-FY 2020-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	1.06	1.16	9.43	1.08	4.15	4.34
Revenue (mm)	707.82	708.20	0.05	715.80	2851.10	2977.00

Currency: USD
Consensus as of Aug-01-2019 12:24 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2018	0.91	0.99	1 8.79 %
FQ4 2018	0.93	1.20	2 29.03 %
FQ1 2019	0.94	0.90	3 (4.26 %)
FQ2 2019	1.06	1.16	4 9.43 %

Table of Contents

Call Participants 3
Presentation 4
Question and Answer 10

Call Participants

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Chairman & CEO

John Joseph Marchioni
President, COO & Director

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Presentation

Operator

Good day, everyone. Welcome to Selective Insurance Group's Second Quarter 2019 Earnings Call.

At this time, for the opening remarks and introduction, I would like to turn the call over to Senior Vice President, Investor Relations and Treasurer, Rohan Pai.

Rohan Pai
Senior VP of Investor Relations & Treasurer

Good morning, everyone. This call is being simulcast on our website, and the replay will be available through September 3, 2019. A supplemental investor package, which includes GAAP reconciliations of non-GAAP financial measures referred to on this call, is available on the Investors page of our website, www.selective.com. Certain GAAP financial measures will be stated in the call that are also included in our previously filed annual report on Form 10-K and quarterly Form 10-Q reports. To analyze trends in our operations, we use non-GAAP operating income, which is net income excluding the after-tax impact of net realized gains or losses on investments, unrealized gains or losses on equity securities and debt retirement costs related to our early redemption of our debt securities in the first quarter. We believe that providing this non-GAAP measure makes it easier for investors to evaluate our insurance business.

As a reminder, some of the statements and projections made during this call are forward-looking statements as defined by the Private Securities Litigation Reform Act of 1995. Forward-looking statements are not guarantees of future performance and are subject to risk and uncertainties. We refer you to Selective's annual report on Form 10-K and any subsequent Form 10-Qs filed with the U.S. Securities and Exchange Commission for a detailed discussion of these risks and uncertainties. Please note that Selective undertakes no obligation to update or revise any forward-looking statements.

Joining today on the call are the following members of Selective's executive management team: Greg Murphy, Chief Executive Officer; John Marchioni, President and Chief Operating Officer; and Mark Wilcox, Chief Financial Officer.

And with that, I'll turn the call over to Greg.

Gregory Edward Murphy
Chairman & CEO

Thank you, Rohan, and good morning. I'll first make some introductory remarks and then focus on some high-level themes and initiatives that enhance our strategy and position us for continued profitable growth. Mark, then will discuss our financial results, and John will review our insurance operations in more detail, providing additional color on key underwriting initiatives.

Our second quarter results were excellent, reflecting ongoing superb underwriting results coupled with outstanding investment income performance. For the quarter, our combined ratio was 93.1% and after-tax net investment income was up 27% to $48 million that generated non-GAAP fully diluted operating earnings per share of $1.16. For the first half of the year, we generated very strong annualized non-GAAP return on equity or ROE of 12.8%, which exceeded our full year target of 12%. Our ROE targets are established annually based on expected interest rate levels, our weighted average cost of capital and excess margin over weighted average cost of capital, as well as the general property and casualty market conditions. The targeted ROE then determines our insurance product pricing on a risk-adjusted basis by Line of Business and provides the baseline for the financial portion of our annual incentive compensation plan.

For the quarter, all aspects of our underwriting operations performed remarkably with: 1) overall net premium written growth of 7%; 2) solid renewal pure price increases of 3.4%; 3) strong retention; and 4) new business that was up 7% to $146 million. We continue to execute on our initiatives around increasing our share wallet within our Ivy League distribution partners appointing new partners as well as growing in our 5 recently opened states. Based on the first 6 months, our insurance operations generated an annualized ROE of 6.4 points. We continue to maintain a leadership position at commercial lines renewal pure pricing, that was up 3.1% in the quarter, 80 basis points over the Towers Watson CLIPS first quarter pricing trends, while maintaining stable retention. New business growth was strong, up 9% to $111 million. Our current view of the commercial lines marketplace is favorable both from a pricing and a pure premium standpoint. For the first 6 months of the year, our overall observed casualty claim frequency count for the current accident year have been reported below expected levels. In addition, favorable commercial lines prior year casualty reserve development improved that segment's loss and loss adjustment expense ratio by 2.70 points.

In addition, our ongoing efforts to enhance customer experience or CX through digital offerings and other value-added services are making a difference in overall customer satisfaction. For example, our continued diligence through targeted vehicle recall emails gained the attention of the National Highway Traffic Safety Association. After seeing an article about our efforts through our public relation push, this association wants to partner with us on a multi-channel drip campaign where automobile manufacturers will provide us with a list of things of vehicles, that still [have to cut a] airbag repair, which we then can match to our database. So collectively we reach customers with the most dangerous, do not drive warning. Vehicle recall notifications coupled with our efforts to reduce distracted driving to our selected private product offered free of charge to commercial lines accounts are significant part of making our communities safer.

Our Investment segment had excellent 6-month results for the year driven by 1) operating cash flow that was 12% of net premiums written; 2) $918 million in overall fixed income purchases on an after-tax yield of [2.9%]; and 3) partially offsetting that where reductions in LIBOR, of 49 basis points, a decline in the U.S. 10-year Treasury rate of 68 basis points, and lower spreads. For the first 6 months after-tax investment income was up 21% to $89 million and produced a very strong annualized ROE of 9.2 points.

Reflecting on the first half of the year, there are few topics that I would like to comment on. First, while the industry results have elevated from generally moderate catastrophe loss activity so far this year. It's important to remember that we're coming off [a string] on 8 consecutive quarters between 2017 and 2018, during which catastrophe and non-cat property losses were elevated. Severe winters, hurricanes, tornadoes, wildfires and severe convective storms were all extreme events that the industry must continue to anticipate in property experience. The recent earthquakes in California served as a further reminder of the potential of large tail events. In our opinion, the pricing and underwriting of the product lines do not fully reflect the financial volatility, embedded exposure and needs more rate to meet its targeted risk-adjusted combined ratio.

Second, it appears that the industry will need to continue to grapple with the prospect of a prolonged low interest rate environment with the 10-year treasury yield standing at about 2% at June 30, 2019. Lower new money yields will place pressure on overall portfolio yields for the industry requiring companies to drive further improvement in underwriting results. Our agile approach to pricing and underwriting, as well as claim improvements especially demonstrated in the performance of our underwriting results. As we've often said in the past, we'd love a low interest rate environment as it compels companies to improve their underwriting pricing and risk segmentation, our strong technical and underwriting capabilities above average underwriting leverage at 1.4x to 1x and proven track record of effectively managing renewal price and retention positions us well.

Third is a lot of discussion in recent months about commercial lines pricing environment. Let me start by saying that the only pricing that matters is overall renewal pure price and the level that we requires determined by 3 factors: one, the prior 4-year on level accident year combined ratio starting point; two, expected loss trend; three, expected ROE contributions from investments. Our combined ratio for the fiscal 4-year period ending June 30, 2019 was an excellent 93%, and the loss trend is anticipated to be in the area of 3% to 4%. We expect commercial lines pure pricing in the 3.5% range and are excited about the potential growth opportunities that may arise as other companies to move to address profitability in their books of business. Finally, we continued to make substantial strides in enhancing our customer experience capabilities, which is a true differentiator in the marketplace. This is a shared journey with our Ivy League distribution partners to deliver a superior experience with our collective insurance. The investments we've been making in our digital strategy allow our customers to engage with us in the manner of their choosing and we've introduced value-added technologies and services such as: 1) Selective Drive for our commercial automobile owner of the customers; 2) proactive messaging; 3) swift claim fast-tracking; and 4) easy claim rate, which is a mobile appraisal solution that facilitates claims estimates within hours based on uploaded photos. We believe these initiatives will improve retention and hit ratios over time.

We feel confident in our ability to maintain attractive ROEs given the implied profitability embedded in our business, coupled with our renewal pure price increases versus the expected loss trend. With half of the year behind us, our full year expectations have been revised as follows: an improved GAAP combined ratio, excluding catastrophe losses of 91%, down from 92%, this excludes any additional prior year loss development. Catastrophe losses of 3.5 points after-tax net investment income of $180 million, which includes $13 million of after-tax investment income from alternative investments. Overall, after-tax investment income expectations remain unchanged due to lower anticipated after-tax new money yields on our core fixed income portfolio. An overall effective tax rate of approximately 19%, which includes an effective tax rate of 18% for net investment income, reflecting the tax rate of 5.25% on tax-advantaged municipal product as well as a tax rate of 21% for all other items. And weighted average shares of $60 million on a fully diluted basis.

Now I will turn the call over to Mark to review the results for the quarter.

Mark Alexander Wilcox
Executive VP & CFO

Great. Thank you, Greg, and good morning. For the quarter, we reported a record $1.21 of fully diluted earnings per share and $1.16 of non-GAAP operating earnings per share. We generated an annualized ROE of 14.5% and a non-GAAP operating ROE of 13.9%. Through the first 6 months our non-GAAP operating ROE of 12.8% is above our 2019 12% ROE target.

We are pleased with our track record of generating consistent double-digit ROEs for the 5 consecutive years. For the quarter, our high quality underwriting results contributed 7.1 points of ROE and investment income contributed a solid 9.6 points of the overall ROE. We enjoyed another strong quarter of growth with consolidated net premiums written [up] 7%. Underwriting profitability was strong with the second quarter combined ratio of 93.1%. On an underlying basis or excluding catastrophe losses and prior year casualty reserve development, our combined ratio was 91.1%. For the first half of the year, our reported combined ratio was a profitable 93.9% and our underlying combined ratio was 92.1%, which represents a 160 basis points of margin improvement over the strong yield -- over the first half of 2018. Our 90% ex-cat combined ratio for the first 6 months is better than our original full year guidance of 92% for 2019, and as a result, we have updated our full year ex-cat combined ratio forecast to 91% for the year, assuming no additional prior year casualty reserve development.

For the quarter, catastrophe losses added 4.6 points to the combined ratio, which was in line with our expectations, which is seasonally adjusted. Non-cat property losses accounted for 14.4 percentage points on the combined ratio, which is slightly better than expected. In addition, in the second quarter, we experienced $17 million of net favorable prior year casualty reserve development driven by $12 million in the workers' compensation line and $5 million in the general liability line, which improved the quarter's combined ratio by [2.6] percentage points.

For the first half of the year, net favorable prior year casualty reserve development reduced the combined ratio by 2.1 percentage points. While catastrophe losses were 3.9 points. Unlike last year where we had pressure on both the current and prior accident years in the commercial auto line that resulted in increased ultimate loss ratio picks, reported losses are coming in with an expectations in the commercial auto line of business thus far this year. Non-cat property losses accounted for 15.7 points on the combined ratio during the first half of the year, which is in line with our expectations.

Our expense ratio came in at 33.5% for the quarter, which is up 60 basis points from the comparative quarter driven by higher employee bonus compensation as a result of the improved underwriting profitability. Our 33.4% expense ratio for the first half of the year was in line with the prior year period. Overall, we continue to seek areas of efficiency and cost savings for balancing these savings with investments in our operations for the company's long-term success, including investments in our people, technology and key initiatives such as geo-expansion and significantly expanding our customer experience capabilities. As we mentioned earlier this year, we expect our expense ratio to remain relatively flat this year, assuming we hit our targeted level of underwriting profitability. However, if the strong year-to-date results continue through year-end, there will be some modest upward pressure on the expense ratio due to profit-based expenses with agents and employees.

Corporate expenses, which are principally comprised of holding company costs and long-term stock compensation totaled $9.6 million compared to $3.3 million in the comparative quarter. The primary reason for the increase in the quarter was higher long-term stock compensation expense resulted from the strong appreciation in our share price during the period. For the first half of the year corporate expenses totaled $22 million compared with $15 million in the year ago period driven mainly by the 23% increase in our stock in the first half of '19 versus a 6% decline in the first half of 2018, which increased stock compensation expense related to the liability portion of our awards. After tax corporate and interest expenses reduced our annualized non-GAAP operating ROE by 2.8 points during the first 6 months of the year, compared to 2.4 points in the first half of 2018.

Turning to investments. For the quarter, after-tax net investment income of $48 million was up $10 million, or 27%. The excellent performance was primarily result of the strong contribution from our alternative investment portfolio and high yields on the fixed income portfolio compared to a year ago. The overall after-tax yield of the fixed income portfolio, including high yield was 2.9% during the quarter compared with 2.8% the year ago. The average new money yields on the fixed income portfolio during the quarter was 2.7% after tax, approximately 13% of the fixed income portfolio is invested in floating rate securities, which reset principally based on 90-day LIBOR. We've been tactically managing investment portfolio seeking opportunities to optimize the after-tax book yield, while maintaining high credit quality and managing duration risk. Our average credit rating remained strong at AA minus and the effective duration of our fixed income in short-term investments portfolio is down modestly to 3.3 years.

On a sequential basis, the pre-tax book yield on our core fixed income portfolio decreased 2 basis points in the quarter, after increasing 47 basis points last year and 4 basis points in the first quarter driven by the lower interest rate environment. On a go-forward basis, we expect pressure on our book yield given the significant reduction in rates since peaking early in the fourth quarter for [RCM, whether] as Greg mentioned, we are reaffirming our full year 2019 forecast of $180 million for after-tax net investment income, which as a reminder is up from our original 2019 forecast of $175 million. Risk assets which principally include high yield fixed income securities, public equities and alternative investments portfolio accounted for 7.9% of total invested assets as of the end of the second quarter, which is up modestly from year-end mainly reflecting additions to private credit mandates.

Our alternative investment portfolio, which includes limited partnerships and private equity, private credit and real asset investments and reports on a one-quarter lag generated a strong pre-tax gain of $7 million for the quarter compared with $2 million in the year ago period.

Turning to capital. Our balance sheet remains strong with $2.1 billion of GAAP equity as of June 30, an increase of 15% so far this year. Strong appreciation is the value of our fixed income portfolio resulted in net unrealized after-tax gains, totaling $145 million on the year-to-date basis. Growth in tangible book value per share, plus accumulated dividends was 7% in the quarter and is up 23% on a trailing 4-quarter basis.

Our premiums to surplus ratio was approximately 1.4x and we've targeted a range of 1.4x to 1.6x in recent years. So we are on the low end of our target. And this combined with our $257 million of holding company liquidity provides us with meaningful capacity to grow as market opportunities present themselves.

We continue to adopt a conservative stance with respect to managing our underwriting risk appetite investment portfolio, reserving processes, reinsurance buying and catastrophe risk management. At this higher operating leverage each combined ratio point pointing to about [1 point] of ROE, which is about twice that of the industry average. In addition our 3.12x in investment leverage into each point of pre-tax book yield on our investment portfolio and results in about 2.5 points of ROE. This model positions us well to generate superior returns in today's lower interest rate environment.

And with that, I'll turn the call over to John to discuss our insurance operations.

John Joseph Marchioni
President, COO & Director

Thanks, Mark, and good morning. I'll begin with the results of our operations by segment and then provide an overview of some of our strategic initiatives. Our Standard Commercial Line segment, which represents approximately 80% of premiums generated net premiums written growth of 8% for the first half of the year, continuing its track record of strong profitability. For the 6 months, the segment generated new business growth of 10%, stable retention of 83%, renewal pure price increases of 3.2% and an excellent combined ratio of 93.7% or 92.7% on an underlying basis. Our highest quality standard commercial lines accounts, which represented 49% of commercial lines premium, we achieved renewal pure rate of 1.8% and point of renewal retention of 91%. On the lower quality accounts, which represented 11% of premium, we achieved renewal pure rate of 8%, while retaining 78% at point of renewal. Our ability to analyze the risk and return characteristics of each piece of business at an extremely granular level allows us to achieve additional loss ratio improvement through mix of business changes, while maximizing overall retention.

Going down to the results for the first half of the year by commercial line of business, our largest line general liability achieved an 87.8% combined ratio, which included favorable reserve development, totaling $7 million, or 2.1 points. We achieve renewal pure price increases of 2.4% for this line. While loss trends have been generally benign in recent years, we are closely monitoring loss severities.

Our workers' compensation line generated an 83.9% combined ratio for the first half of the year, aided by favorable reserve development, totaling $20 million accounted for 12.7 points on the combined ratio. This favorable development related primarily to lower than expected severities for accident years 2017 and prior. Renewal pure pricing was down 2.8% and we continue to take a cautious approach to underwriting this line, which on a current accident year basis is generating a combined ratio of 96.6. Workers' compensation pricing for the industry has come under sustained pressure and loss cost filings by NCCI and other individual state bureaus continue to be negative. If loss trends were to increase or even flatten out, it would likely result in deteriorating combined ratios for the industry.

Commercial auto remains an area of focus for us and the industry, as a result have been significantly worse than target levels. The combined ratio for this line was 106.5%, there was no prior year development and liability claim frequencies remain in line with expectations for the current year. We continue to keep a close watch on claims trends in bodily injury from both a frequency and severity standpoint. To improve profitability, we achieved price increases averaging 7.3% this year on top of similar price increases in each of the past 2 years. In addition, we've been actively managing new and renewal portfolios and target business segments and improving rating and classification inputs. Over the longer term. we expect accounts that adopt our recently introduced Selective Drive program will have greater insight to their commercial auto risks and have the potential to reduce their loss experience.

Our commercial property book generated 98.1% combined ratio. Results for this line have tended to be profitable, but volatile due to elevated levels of non-cat losses driven by adverse weather and large fires. We have seen some signs of price firming in this class, but believe the industry needs to address profitability through additional pricing and underwriting actions to reflect the overall performance and embedded volatility in this business. Our renewal pure price increases averaged 4.3% and we are taking steps to address the drivers of the higher loss experience through business mix shifts and safety management efforts.

Our Personal Line segment, which represented 11% of first half premiums, reported flat premium volume driven by renewal pure price increases averaging 5.4%, retention of 83%, and a 25% decline in new business driven by an extremely competitive market for personal auto. This segment produced a combined ratio of 95%, or 88.4% on an underlying basis.

In personal auto, net premiums written volume was flat and the combined ratio was 100.4% a substantial improvement relative to 104% a year ago. Renewal pure price increases averaged 9.5% for personal auto liability and 5.1% for physical damage. We need to continued profitability improvement with earn rate exceeding loss trends, but putting pressure on new business.

The homeowners line reported a 1% premium decline relative to a year ago and a combined ratio of 97.4%, including 15.6 points of catastrophe losses. Despite some expected volatility and quarterly results, profitability of this line has generally been strong in recent years and renewal pure price increases averaged 2.6% for the first half of the year.

Our E&S segment, which represented 9% of total premiums, generated 14% net premiums written growth, primarily reflecting the on boarding of new distribution relationships. This segment generated a 93.6% combined ratio, a meaningful improvement relative to a year ago and renewal pure price increases, averaged 4.5%. Over the past 2 years, we've undertook a number of deliberate steps to achieve price adequacy, improve the business mix and centralize our claims handling processes, which are contributing to the improved combined ratio performance in this segment. We are pleased with this performance and expect to generate more consistent profitability going forward.

I'll switch now to some of our strategic initiatives, which are key to achieving our objective of generating best-in-class operating and financial performance over the long term. First, I'd like to highlight our continued investment in building out our franchise distribution model, which is the foundation of our ability to generate consistent profitable growth. Our distribution partners are the best in the industry and our franchise model is enabled by our empowered field-based servicing capabilities, which remain a true differentiator in the marketplace. We've often spoken of our objective to obtain a 3% commercial lines market share over time in the states in which we operate. This is built around appointing partner relationships that control approximately 25% of their markets and seeking an average share of wallet of 12% across those relationships. We believe that executing on this objective provides us a substantial runway for growth in coming years, allowing us to effectively double our premium volume without substantially altering our risk appetite.

Our current agency market share stands at approximately 20%, and our share of wallet is approximately 8% in our legacy states. We appointed a total of 52 new distribution partners in 2019, bringing the total to approximately 1,350 partners, and 2,280 storefronts. Our goal for the year is to appoint 100 new distribution partners.

Over the past 2 years, we embarked on a geographic expansion strategy, opening 5 new markets consisting of New Hampshire and a Southwest Hub incorporating the states of Arizona, Colorado, Utah and New Mexico. Execution of this strategy has gone extremely well and our operations in the new states are performing in line with our expectations with current in-forced premiums of $50 million from these new states.

Another major strategic initiative has been our efforts around enhancing the overall customer experience and our objective is to position Selective as a leader in this area and we have built capabilities that allow customers to engage with us in a 24x7 environment. Our self-service and digital service offerings continue to experience strong adoption rates and our proactive communication initiative is receiving strong customer response.

We see increased demand for our Selective Drive product for commercial lines customers with vehicle fleets. The product allows business owners to leverage features such as logistics management, improved safety guidelines and telematics based driver storm. In addition to improve driving behavior over time, we believe value-added services such as this will improve retention rates and new business ratios.

Looking out to the remainder of 2019 and beyond, we are extremely strong financial and strategic position. We are investing in technologies, tools and people that will position us for long-term success and are confident in our ability to generate superior financial results for our shareholders over time.
With that, we will open the call up for questions. Operator?

Question and Answer

Operator

[Operator Instructions] Our first question is coming from the line of Amit Kumar of Buckingham Research.

Amit Kumar
The Buckingham Research Group Incorporated

Just very quickly on some pricing. You talked about the industry facing the need to pursue pricing because of past issues. Would that translate in your pure pricing modestly declining going forward as you look at this market share or could there be some pressure from the new business penalty for you?

Gregory Edward Murphy
Chairman & CEO

Yes. So let me start and John can certainly head in. So -- as I went through our whole presentation -- our pricing is one of the most disciplined processes that we're going through. And as I mentioned on the call, we're looking at the past 4-year odd level, that's your baseline, where do you start, what's in that? What level of noises in that and how do you expect trend to move forward? And then where is your investment returns? So as I mentioned the 3 factors, right now, the 1, that we expect the most amount of pressure to be honest maybe on the investment performance due to 1) the lower, where we are on the LIBOR in the 90-day LIBOR, where we are in the US 10-year and the fact that spreads have narrowed in roughly in the 40 basis point range across many sectors. So that part of it is going to put additional pressure to put pricing at the right level for 2020 right out of the box. I would tell you that what I had in my prepared remarks is that the favorable aspect that we view is 1) the fact that our current observed levels of current accident year claim count for casualty is below what we expect. So that is your early indicator of how your current accident year is going to move because there's 2 things that affect your accident year; [there's] frequency and severity. And if your frequency is off the mark early on, you know that you're going to have pressure on your pure premium calculations. So we're not seeing that. And the other part then that is relieving a little bit of pressure is the fact that we continue to see favorable development and the favorable development is basically lowering that starting point that we're at and why we are kind of favorable on where we stand as we feel all of those things line up well for us. But the pressure is probably more applied on the investment income side that it may be is anything underwriting specific.

John Joseph Marchioni
President, COO & Director

No. I think Greg covered a lot there. Amit, this is John, and let me just add a couple of additional points as clarification here. So because we're achieving our target margins, our focus from a pricing perspective and how we set our targets is focused on maintaining those current profit levels. To the extent as Greg indicated investment returns come under increasing pressure as we look out to the future quarters that requires us to lower our combined ratio expectation to make up for the difference from an overall ROE perspective and that's how we'll manage it going forward. Now as you heard from Greg's earlier comments there is pressure in the market to improve underwriting results. And I think this is also part of your question that does present opportunities for us. Because our margins are strong and we have -- and our views now for well over a decade, very sophisticated underwriting and pricing tools as companies start to take more aggressive stance on rate. They want to pushing some high quality accounts into the market that present great opportunities for us to write new business. And we do think that's a benefit to us in terms of how our position. The other point I think worth noting is we also strive to make sure that all of our lines of -- major lines of business are either achieving or approaching their target combined ratios. And as you've seen in our results and our prepared comments, we are still working to lower commercial auto and part of that is through rate, part of that through other underwriting mix in claims, improvements. And property while generating a positive underwriting result is running above where most companies would want it to because of the inherent volatility in that line. So these lines of business for the industry are being masked somewhat by the very strong results in workers' comp. But workers' comp now is in a negative rate situation and when you look out to the future that's going to be addressed. So there's a number of pieces there, but it's certainly a dynamic marketplace.

Amit Kumar
The Buckingham Research Group Incorporated

So if I step back, do you get the sense on the commercial piece and this is maybe a broader question. Can you talk about what the loss trends might be running at in terms of some numerical values? I'm trying to figure out how much will pricing -- how much is pricing versus loss cost trend margin running at?

John Joseph Marchioni
President, COO & Director

So in our commentary we had that we believe it's in the 3% to 4% range and that's --

Amit Kumar
The Buckingham Research Group Incorporated

The rent overall?

John Joseph Marchioni
President, COO & Director

Yes. So loss trends overall is what we feel we're running out today.

Mark Alexander Wilcox
Executive VP & CFO

So still we get complaint. Let's just make sure we make this point. I know you guys are hearing a lot from our competition and -- so let's just baseline for a minute, if we could. So our pricing in commercial lines running in the 3 spot 2; 3 spot 3 area. If you looked at it all in, on a renewal basis like many of our competitors are reporting, which I'm not a believer in were like 2x. So I just want to make sure that when you guys sit there and you start to compare, Murphy told loss trend was going to be in the 3x to 4x renewal pricing is a 3 spot 3, I've got a margin diminishment, all right. That's where we are pure pricing. I just want to make sure that, that is clear for you guys, 1. 2) Then, and John has talked about this over and over again. We drive the hardest a lot out of our underwriting and claim improvement based on what we're doing in terms of the segmentation of our business and how we are not kind of driving higher rate level or nonrenewing some of the accounts at the poorest performing levels and that's how and plus all the claim activity that we've done, that has improved the cost of goods sold, all work in as part of our overall improvement. And again I want to -- I don't want to sit here and tell, hey we're up 6% in overall renewal pricing, but because I don't believe in that, but I just want to make sure that you guys have all of the moving parts when you start to compare Selective and Selective's performance for 2020 versus some of the comps you may be looking at. That's all.

Amit Kumar
The Buckingham Research Group Incorporated

Yes. That's another to verify your comment because everyone has a different way to compute what the pricing number is, and it's not apples-to-apples in many cases. So --

Mark Alexander Wilcox
Executive VP & CFO

That's the point that I'm trying to make. And when we start reporting results ex-comp, and then compare the ex-comp results to your rate level, ex-comp and then tell me how those numbers stack up.

Amit Kumar
The Buckingham Research Group Incorporated

Yes. That's a fair comment. But the only other question, and I will stop after that is, it's interesting to listen to your comments in commercial auto, when you said it was -- it seem that it was stable versus Q1 and I feel like commercial auto is that Elephant and everyone has a slightly different take on it. Can you just talk about what changed Q2 versus Q1 and also maybe talk about the broader discussion as it relates to commercial auto and some other lines regarding the jury awards and the total environment and has the thought process changed on that or not? Thanks.

Gregory Edward Murphy
Chairman & CEO

So let me start, and then John -- this is Greg, so let me start. First of all, there is no change in our view at Q2 versus Q1. Our current accident year is running at above [6]. It stays at above [6]. I think the commentary that you're hearing is just more data accumulated. After the first quarter, we told you that overall observed trends were better than anticipated on the claim count casualty side and that was for the overall book and I don't want to get down to such specificity by line, but that overall trend continues and that's our view of commercial lines in totality. But the commercial auto has our view at that 6 months versus 3 months is not different. What is the benefit is some of the pressure that we've seen on the prior accident years, we're not seeing any of that yet today and view that we're comfortable with where we are reserved well levels where we have our severity pits for the '18, '19 and '17 years, feel good about that and feel good about [indiscernible]. But I think where people got offline or a little bit off their budgets, which just principally driven by claim frequency counts and then followed by some elevated severity, which is what you're talking about, We have seen some pockets of higher severity and certain parts of the country, that's something that we are closely monitoring, it's not an overall trend. But you know, we are very, and much tuned into what's happening on the severity side of the book. So let me turn it over to John to add some additional color to that.

John Joseph Marchioni
President, COO & Director

Let me just address the second part of your question relative to additional trends, social trends. We do monitor litigation rates and attorney involvement rates and across all of our casualty lines including auto, they have been very stable. Now we certainly hear other market participants, public commentaries on that topic. And we're mindful of that. But from our perspective we have not seen any material change in litigation rates. But as I've also referenced in the past, we really pride ourselves in our claims organization in early communication with claimants, an ongoing communication with claimants, which I think is the best way to give them a sense of how the claim is going to be adjudicated and in many ways will reduce the likelihood for them to feel the need to involve an attorney in that claim adjudication.

Operator

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

Jon Paul Newsome
Sandler O'Neill + Partners, L.P., Research Division

I just wanted to -- not really beat the commercial auto, the dead horse, but actually I want to ask another question that maybe thinking you [bring all that]. I have a theory that there is a difference between folks that use ISO only policy forms in rates versus those that tend and use their own system and own pricing. So my question is, just as my theory is certain with what you've experience and where do you sit on that spectrum of how you underwrite your commercial auto? Is it mostly your forms and data, or is this a lot of ISO and industry level stuff?

John Joseph Marchioni
President, COO & Director

So Paul, this is John. Let me take a crack at this. We are largely an ISO-based company, in terms of forms, rules and rates. We do have our own proprietary endorsements and those are used to modify coverage in many cases they add coverages that are segment specific for different industry classifications. But I think the important point, and our sense is that's largely the case for most market participants, whereas in personal auto, it's a little bit different where some of the bigger companies are using their own underlying data and are less relying on ISO. For commercial auto it's predominantly ISO-driven. But I think that's really just the underlying rate plan that starts the process in terms of pricing adequacy on an account-by-account basis. What's equally important is the accuracy of the information you have relative to vehicle type, vehicle radius, vehicle usage, that's an important consideration, but also the underlying pricing models that we use. So when you think about the ISO class plan that's what underlies your base rate for the average risk by certain classification type. You then modify that based on individual risk characteristics in our case, using our multivariate predictive model that separates from a future profitability expectation best from worse and modifies -- recommends to the underwriter how to modify that file base rate, which is based on ISO loss costs. So that's our approach. We think it gives us an advantage. We're not alone and taking that approach, but there is a lot of companies in the market that are just relying a 100% on the ISO class plan not using their own tools and models to modify it.

Jon Paul Newsome
Sandler O'Neill + Partners, L.P., Research Division

Could you talk a little bit more about the E&S business turnaround that was quite dramatic? And what are your thoughts sort of prospectively, now that you seem to have, you've got that to a really decent level of profitability?

John Joseph Marchioni
President, COO & Director

So I'll start again. Paul, this is John. We're pleased with what we're seeing there. And again, it's been a few quarters in a row now and we like that. We're not declaring victory by any stretch, but we think we're on a very good path. We have seen very strong property results that underlie the results that you're seeing over the last few quarters that we'll have inherent volatility in it going forward just like our core commercial lines business as underlying volatility on the property line of business. That's less than [a quarter] of our premium, or about [a quarter] of our premium [indiscernible] asked we're predominantly a casualty writer. There has been no prior year development, unfavorable or favorable in the last couple of quarters, which is also a positive. So you're getting a sense of what the underlying casualty book is running and you have seen improvement. That improvement is driven by pricing actions that have been taken, it's been driven by underwriting actions in particular exiting a few smaller segments of the business that we're not generating significant premiums, but we're adding some volatility to the results. And also a lot of the claims changes that we made by migrating to our Selective claims operations have improved the performance of that portfolio as well. So we feel good about where it is. We continue to believe and this has always been our philosophy getting into this business is, we expect to achieve our target margins for this business consistently and we're willing to accept a little bit more volatility quarter-to-quarter, year-to-year with regards to premium growth based on market conditions. As we sit here today, we're getting solid growth. We've got solid margins coming through, and we're pleased with the path that we're on. But to the extent the pricing starts to drop off, but we don't believe we're going to achieve our target margins will at the top line flattened out and that's the case.

Gregory Edward Murphy
Chairman & CEO

So Paul, this is Greg. Just that only add is that, so we want to get the contract in binding business growing again. We'd like to see a little bit more discipline in the contract binding pricing and that's where I would say that what we experience doesn't necessarily match up with the broader base E&S trends that you are hearing about margin-wise, but again like John said, we feel good about where we are on the operation and want to continue to maintain performance at this level, but it is a small book of business and the numbers can get pushed around by not that large events.

Operator

We have a question coming from the line of Christopher Campbell of KBW.

Christopher Campbell
Keefe, Bruyette, & Woods, Inc., Research Division

I guess first question is on personal auto, so rates accelerated and premiums were down year-over-year, I guess how would you just describe the competitive environment you're seeing in personal auto?

John Joseph Marchioni
President, COO & Director

Chris, I think clearly what we're seeing is a rapid shift down in rates and that doesn't necessarily mean negative, but generally speaking broadly across the market, what was a pretty strong rate environment and based on the rate filings we see come through company-by-company state-by-state has quickly dropped down into the very low-single digits and again generalizing each company is going to be a little bit different, but it has moved fairly quickly, and I think it's in reaction to some of the bigger companies that I've seen improvement in our own underlying trends, but that's really what happens. We've continued to have additional rate running through our book relative to the filings that we've made over the last couple of quarters and that's really hurt our competitive positioning for new business based on the rapid change in the market environment.

Christopher Campbell
Keefe, Bruyette, & Woods, Inc., Research Division

So what's your view, I mean, if you're thinking competitors are going to low single digits what's your view of like loss cost inflation for the industry?

Gregory Edward Murphy
Chairman & CEO

We don't view loss trend in personal auto really that different than overall. So I'd put it in the 3% to 4% category until you start to see miles driven our gas prices, or other things really start to fluctuate right now with very low unemployment there is a lot of people on the road. And let me just add one other comment, Chris, relative, I mean we're trying to improve. We feel really good. We've always viewed personal lines as 3 different operations within that division; the home, and as we've always told you our goal in home is to get it into a [low-90] in a normal cat year, normal cat year in homes about 14 points. And we're pretty much there when you look at it on a multi-year basis. We have 2 states that we continue to focus on the home, but on the home book that we need to make further improvement. Our flood operation improves our combined ratio by about 60 basis points and it's the 1 hedge that we do have to adverse weather. So that's a positive because we actually made additional funds based on how the claim reimbursement works and the FEMA program and that's a positive. And then the auto, which is what John was touching on. You're stuck in the comparative [rates], the question is we need to make some fine-tuning improvements in our expense ratio. And then I think, look at how we militate some of the increases in the overall and target some of our increases that we need to do very granularly so we improve our positioning in that comparative greater that's used in every agency.

Christopher Campbell
Keefe, Bruyette, & Woods, Inc., Research Division

And then kind of just one more like on the commercial line side. So these competitors retrench and start to raise rates. How does this impact like your willingness to grow. So I would think that your combined -- your core combined ratios are pretty good, right. I don't think you guys really need to take it on a rate. So I mean, but you still look like mid single-digit rating or premium increases. I mean can you get the double-digits in commercial lines like if everybody starts raising rates?

Gregory Edward Murphy
Chairman & CEO

Yes. As I said in my commentary, again it's some of it depends on how the sophistication of the competition does it. I would say to you today anybody that socialized rates going to get into hurt badly because if you only have -- if you don't have the sophistication that John walked you through just in commercial auto and therefore your distributing rate more socialized across your segmentations, across your accounts, across your geo-locations, that's a huge opportunity because those accounts will enter the market and then we will have an opportunity to run our very sophisticated modeling against and see where we price out at, and I view that as a competitive advantage in this marketplace. And this is the opportunity that we would want to grow. And if we had the opportunity to post some out-sized growth levels, we would be willing to do that, but it has to be at the right pricing in the marketplace.

John Joseph Marchioni
President, COO & Director

Yes. Just add to that, Chris, to Greg's point, to the extent we have opportunities to put our foot down and grow a little bit more rapidly. In the past, we've talked about the sustainable growth rate [probably] about 75% of the forward ROE, given the dividend payout ratio. And let's call it around 9%. We’ve grown at about 7% thus far year-to-date. We're at the low end of our range, as I mentioned in my prepared comments in terms of a premium to surplus ratio and we have adequate and ample capacity at the whole curve to drop down into the insurance subs. So from a capital position, from a leverage perspective, we have ample capacity to grow market opportunities present themselves.

Operator

We also have a question from Mike Zaremski of Credit Suisse.

Michael David Zaremski
Crédit Suisse AG, Research Division

Greg, in your prepared remarks, you said you feel pricing for the industry, commercial wise should probably stay around current levels and you talked about lower interest rates. And I also believe you, you talked one of the reasons being some competitors seeking to improve their results. I didn't -- I might have -- so I'm just trying to -- if I'm understanding you correctly, just want to understand -- do you feel that a number of your competitors are hurting? And if so, is it commercial auto, like, is something changed in the last quarter or 2, or you feel kind of more confidence that the industry is -- you feel more confident about your views on pricing?

Gregory Edward Murphy
Chairman & CEO

Well, let me just start with the fact that our expectation is different than a lot of other companies. So let me just make sure we've got that clear. I mean our core baseline is we want to print a number in excess of our weighted average cost of capital. That's where we feel we need to be. We told you last year that when we started 2019, our target is [12]. We will recalculate that target for ['20], and we'll tell you what that target is and that becomes the basis for what we need to get rate wise and it becomes the basis for our incentive compensation plan. So those are all very much in line and where the rest of the competition is, I mean, you can tell me, you look at the performance, it's all over the place. There are some very large commercial lines writers that are not printing margins even at the weighted average cost of capital. And so what I'm really referring to is the fact that a) not a lot of companies are at the baseline they need to be #1. #2, as the low interest rate comes in, companies are going to have to make that up in improvements and the question is, if you thought you needed a certain amount of improvement, now you need more than that because of the lower yield environment. And now the question is, does the competition have the tools, agility, sophistication, to be able to deploy that added a granular level? And when they don't have that capability, we are very sophisticated now in our ability to go out and harvest that business to increase our share of wallet. And these are the things that John is mentioning as we try to drive higher share of wallet. We want to make sure that everything that we're doing on a CX basis, our customer experience, what we're doing is so unique that agents now are starting to better understand what we're driving to end customers, understand the value that it brings to a client to be able to do proactive communication to them on billing reminders, product recalls, vehicle recalls, what we're doing on our drive product and now mostly, recently will be entering the market for our customers, for our security mentor product, which is another tool that will be offering for producers to add additional value of point. So all of these things obviously, should allow retention to go higher and should improve hip ratios at point of sale. So when they're sitting there offering different carriers and they say, who has the best-in-class customer experience to my end customers, who is trying to maintain a 24-hour 7 environment, which is where are the goal that we're driving ourselves too. We're like the only carrier out there that's really doing that with the exception of maybe the captives that could have some of that capability, but when you talk about an agency company relationship, we are very far ahead, and I don't know, if you noticed that we recently got a 5-star rating. And the only commercial lines carrier to get a 5-star rating was Selective. So again, I know we're kind of going through a lot, but those are the things why a cost -- why an [agent is going] to have their best-in-class customer with Selective.

Michael David Zaremski
Crédit Suisse AG, Research Division

And so you've talked a lot about telematics on the commercial side over the last couple of quarters or maybe more than that. So do you -- are you guys feel a first mover in that, in telematics for commercial auto? So I think only you guys progressed right now and talk about it.

John Joseph Marchioni
President, COO & Director

We think we're the first mover in terms of how we've deployed it. Again it's telematics-based we're not using it for rating purposes like you see on the personal line side. This is more [a way] to give a value-added offering to commercial business owners. So they could better manage their fleets. And at the same time, because of the Telematics you're creating greater awareness around driving behaviors of individual drivers in these fleets of vehicles, which we think improves experience overall and gives agents some additional service to offer their clients, which will help them win and keep more business. As far as we've seen there is nobody else that's deployed a product like that, but it's not the same telematics-based rating platforms you've seen really permeated through the personal line side of the business.

Gregory Edward Murphy
Chairman & CEO

So Mike, this is Greg. And when you think about, so obviously there's 3 things that we do as an industry: 1) [we're a form] of capital, so by an insured -- having insurance they need less capital on their balance sheet; 2) it provides back together after a claim; and 3) we make our community safer. One of the biggest things that our drive product does and we are pushing it hard is because it's not plugged into the computer, the vehicle works through other power sources, is actually works off the phone. And because it works off the phone, it can detect distracted driving, which is a huge issue in a marketplace. Selective Driving is something that we view as a major issue something we want our trusted Risk Advisors, our agents, our producers pushing at point of sale. That look, we want to make you a safer account by having the Selective Drive product not only do you know where your vehicles are, not only do you get a scoring on every one of your drivers for every week, how well they're driving, but you also understand when they distracted driving in addition to fleet maintenance, an addition to other things that you want to know as an owner. So that's a valuable tool to an owner, particularly we've had a lot of construction business for an owner of the construction account to know where all other people are, know where all other vehicles are. On a Friday afternoon at 2 o'clock, you want to know who is still on the job site versus who is not on the job site. So this is what you get from this product and it's offered as part of just being a Selective customer. So again it's a real value-added product that is very unique in the marketplace.

Michael David Zaremski
Crédit Suisse AG, Research Division

I'm sold in the product. I [just don't]…

Gregory Edward Murphy
Chairman & CEO

[Audio Gap] commercial lines account, I'll have the drive account this afternoon. I personally deliver to you, Mike.

Michael David Zaremski
Crédit Suisse AG, Research Division

Last question might be for John. To the extent it's not proprietary. Maybe you can give us a flavor some of the strategies, carriers like yourself used to kind of help mitigate workers' comp suggested rate decreases. Lot of times, we see some of these headlines from certain state saying [10%], 18% rate decreases and I -- I know, I'm curious like yourself talked to being able to mitigate some of that.

John Joseph Marchioni
President, COO & Director

Yes. So let me just be clear on how we manage pricing. We reprice individual accounts based on the pricing tools that we have relative to the right price for the exposure presented. Loss cost filings do change the headline number that you see relative to an individual states loss cost change is the overall book in the state that it applies to, it affects each individual book differently based on your mix of industry classifications, so it's not a straight comparison. There are individuals credits and debits on individual accounts that are based on risk characteristics. Those will move on a renewal policy based on the underwriters review of the change in characteristics, as well as the change in the underlying loss cost. And that's how we administer pricing on an overall basis. It has resulted in pricing. In our actual renewal portfolio, it's different from what you see on the overall loss cost filings, but it's still our focus is always on making sure that each account is priced appropriately based on the exposure presented.

Michael David Zaremski
Crédit Suisse AG, Research Division

So if there is -- if the industry is in a credit position, you can give them less current less credits and that offsets some of the mitigate some of the [suggest].

John Joseph Marchioni
President, COO & Director

Yes. Mechanically that's how it works. But again, the underwriting documentation behind that needs to explain why that's appropriate for that individual account, and that's what we really pride ourselves on.

Gregory Edward Murphy
Chairman & CEO

And Mike, we got a great claim operation on the comp side. That's very focused in on pure premium or cost of goods sold whatever words you want to use on it. So they are really doing down in terms of tendencies when we get a claim, how do we get it fast track. Are we creating a claim, a climate for a back injury or obesity or both. And then how do you manage the outcome on that claim. How do you escalate them to the right people and we're actually now looking at our cost of goods sold separated our pure premium calculations separated into very granular level, whether it's needs back shoulders, okay, what's the need costs. How many needs you're doing? What are we seeing in the trend in needs? And then how is that driving overall your cost higher. This is what John is talking about. You just -- right now it almost seems like the NCCI calculations have frequency going 0. And that's not going to happen, you're going to see an uptick in frequency, and at some point you have to be very mindful of severity in this line and when it turns, it's going to turns, we think it's going to turn pretty severely, and that's why we're very careful about it, and that's why we see that are very disciplined in what we're trying to do in the marketplace. We're running on an accident year basis, our comp at about [96%] right now. On an accident year basis, that's where we are, but that's not that far off what our target risk adjusted performance should be. So is there a little bit of room in there, yes. But part of it may be affected by prior years continuing to drop down, but still at the end of the day, a [96%] versus your target, you don't have enormous amounts of room in that today.

Michael David Zaremski
Crédit Suisse AG, Research Division

But just one follow-up, you said NCCI's frequency going to 0. If I understand…

Gregory Edward Murphy
Chairman & CEO

It's a joke. That's a joke. They've got frequency in maturity going to zero registry wide. It's a joke, sorry. I should have classified it as a joke, but frequency is not going to zero, Mike, okay. I'm sorry.

Michael David Zaremski
Crédit Suisse AG, Research Division

But the launch of training frequency is negative, right?

Gregory Edward Murphy
Chairman & CEO

It has been declining, but I would say more of the story in comp, particularly in all this favorable development you're seeing has been severity focus and what your long-term inflationary embedded trends were in medical versus what you were actually experiencing that's where a lot of the release, it's been a little bit of frequency, but it's been a lot of severity buried in these numbers. You know your frequency count in comp within 18 months. I mean I actually sit across the table shaking his head. I will tell you that percent competence that he has, but I know what it is. And so your frequency numbers really aren't moving around that launch. It's the severity that's really changing and it's changing versus what they've embedded in [that diagonal] they go way back to the beginning of time. I could say it that way. But I wanted to clarify for everybody, the zero frequency is a Joke.

Operator

At this time, we don't have any questions on queue. Speakers you may proceed.

Gregory Edward Murphy
Chairman & CEO

Alright. Thank you very much. If anybody has any follow-up, please contact Mark, or Rohan. Thank you very much for your participation in the call today. Thank you.

Operator
Thank you, everyone. And that concludes today's conference. Thank you all for joining. You may now disconnect.