S&P Global
Market Intelligence

The Travelers Companies, Inc. NYSE:TRV

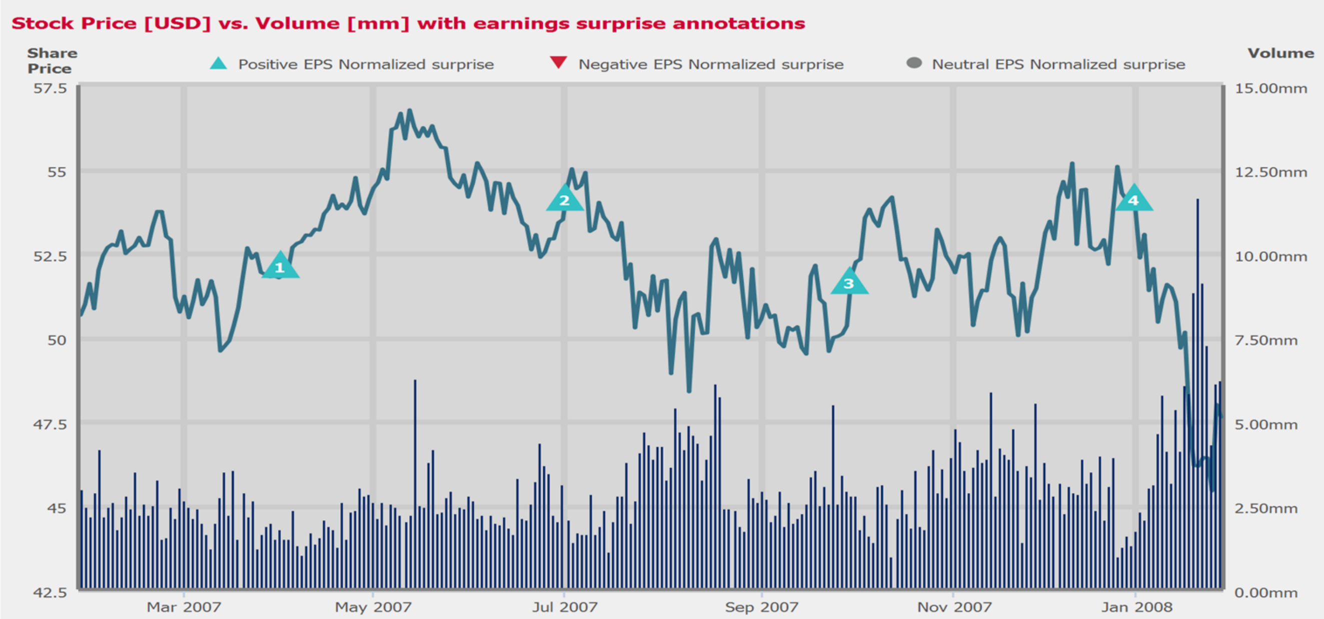
FQ1 2008 Earnings Call Transcripts

Thursday, April 24, 2008 2:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ1 2008-			-FQ2 2008-	-FY 2008-	-FY 2009-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	1.54	1.61	4.55	1.53	6.02	5.99
Revenue	-	-	(0.84 %)	-	-	-
Revenue (mm)	5385.19	5340.00	-	5385.86	21527.59	21410.34

Currency: USD
Consensus as of Apr-24-2008 2:57 PM GMT



- EPS NORMALIZED -	CONSENSUS	ACTUAL	SURPRISE
FQ1 2007	1.45	1.50	3.45 %
FQ2 2007	1.49	1.73	16.11 %
FQ3 2007	1.49	1.81	21.48 %
FQ4 2007	1.60	1.63	1.88 %

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Call Participants

EXECUTIVES

Brian W. MacLean

Jay S. Benet

Jay S. Fishman

Joseph Lacher

Michael Connelly

William H. Heyman

ANALYSTS

Alain Karaoglan
Banc of America Securities

Dan Johnson
Citadel

David Small
Bear Stearns

Ian Gutterman
Adage Capital

Jay Cohen
Merrill Lynch

Jay Gelb
Lehman Brothers

Josh Smith
GIAA

Larry Greenberg
Langen McAlenney

Matthew Heimermann
JP Morgan

Presentation

Operator

Good morning, ladies and gentlemen and welcome to First Quarter Earnings Review for Travelers.

(Operator Instructions)

At this time I would like to turn the call over to Mr. Michael Connelly, Vice President of Investor Relations. Mr. Connelly, you may begin.

Michael Connelly

Good morning and welcome to the Travelers discussion of the first quarter 2008 results. Hopefully all of you have seen our press release, financial supplement and web cast presentation released earlier this morning. All of these materials can be found on our web site at www.travelers.com under the Investor section.

Today with me is Jay Fishman, CEO, Jay Benet, Chief Financial Officer, Brian McLean, Chief Operating Officer, Joe Lacher, Head of our Personal and Select businesses, as well as other members of senior management.

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

Before I turn it over to Jay, I'd like to draw your attention to the following on page one of the web cast.

Our presentation today includes certain forward-looking information as defined in the Private Securities Litigation Reform Act of 1995. All statements other than statements of historical fact may be forward-looking statements. Specifically, our earnings guidance is forward-looking and we may make other forward-looking statements about the company's results of operations, financial condition and liquidity, the sufficiency of the company's reserves and other topics. The company cautions investors that any forward-looking statement involves risks and uncertainties and is not a guarantee of future performance. Actual results may differ materially from our current expectation due to a variety of factors. These factors are described in our earnings press release and in our most recent 10-Q and 10-K filed with the Securities and Exchange Commission. We do not undertake any obligation to update forward-looking statements.

Also in our remarks or responses to questions we may mention Travelers operating income which we use to measure of profit and other measures that may be non-GAAP financial measures. Reconciliations are included in our recent earnings press release, financial supplements, and other materials that are available in the Investor section of our website, www.travelers.com.

With that I'm going to turn it over to Jay.

Jay S. Fishman

Thank you, Mike. Good morning everyone and thank you for joining us today.

In the first quarter we again produced strong financial results. Turning to Page 2, operating income per diluted share in the quarter was $1.61, up 4% from last year's first quarter. Operating return on equity was 15.6% and we posted an overall combined ratio of 87.6%. Book value per share, even after the $1 billion of share buy backs we completed in the first quarter, increased 3% from year end and 14% from one year ago. At the top line, net written premiums grew 2%, adjusting for the sales of Afianzadora Insurgentes and Mendota.

Given the insurance marketplace, we are very pleased with these results and we continue to find opportunities to grow our business thoughtfully and profitability. Jay is going to cover our investment income results in some detail in a few minutes.

Before I turn it over to Jay, if you turn to Page 3, I would like to spend a minute or two sharing with you our thoughts on the factors that we believe will allow us to create substantial shareholder value.

First, we have a series of important sustainable competitive advantages, starting with our product breadth. Our ability to underwrite successfully and respond to our agents' various product needs matters significantly to them in that it helps them be more productive in their own businesses. A by product of this breadth is the diversity it provides our company, we believe, better supporting more sustainable and consistent profits.

Our scale is another key advantage, affording us both an opportunity to analyze data and I think in that regard predict a modeling that may be unique in our industry and to produce more predictable underwriting results over time.

Next, we also have an extraordinarily important position with independent agents and our focus on helping them grow their businesses is reflected back to us in their commitment to us, as evidenced by the increasing flow of high-quality business opportunities they present to us and in their recognition of the value we create for their customers. We believe they advocate for us based on the merits.

An example of our ability to meet agents' needs is our strong focus in improving the ease of doing business with us and this is evidenced in winning platforms such as Travelers Express, Quantum Auto and Home, and our new industry edge middle-market products.

You've all heard about Quantum Auto and Home before, but Travelers Express is a new business platform that is being rolled out for small commercial-flow business and is currently up and running in 37 states for multi-peril and 6 states for worker's comp. Submission rates are up 50% where it's been introduced and we are currently doing 40% of our new flow business through that platform. That percentage will grow as we continue to roll out. From an agent's perspective, it really is a big deal.

Another example is the data that we make available to our field people and our distributors, analyzing the business that we do with them. We believe that ability, and the capacity that it gives to our agents to manage their business, is unmatched in our industry. At our Investor Day coming up on May 22nd we plan on giving you insight into how all this makes an important difference at the point of sale. We'll have much more to say about it then, but I encourage your attendance. It will be worth your time.

These competitive advantages translate into an ability to generate top-tier results and substantial excess cash flow, as evidenced by nearly $9 billion of income over the past two years and with each year's operating return on equity approximating 18% and $5.1 billion of share repurchases over the past two years, including $1 billion in this most recent quarter.

While it's obviously forward-looking, and it's not a prediction on our part, based on these results it is not at all difficult for us to envision substantial excess cash flow over the near- to intermediate-term. Combine that capital generation ability with our commitment to balancing book value growth with right-sizing our capital and you can understand the opportunity we see to create shareholder value. We are very well positioned. The strength of our balance sheet and liquidity enables us to continue to focus our attention on executing our strategy and positions us to consider investment portfolio opportunities that may come along as a result of the current investment environment.

And with that let me turn it over to Jay.

Jay S. Benet

Thanks, Jay.

Page 4 of the web cast summarizes our first quarter financial performance. Our net earned premiums increased by 1% quarter-over-quarter and operating income, which exceeded a billion dollars for the seventh quarter in a row, was down 6% in dollar terms and up 4% on a per share basis.

While I will speak to net investment income later in my commentary, I wanted to take a minute here to discuss net realized investment losses, which amount to $41 million after tax, or $61 million pre-tax, in the quarter. Included in net realized investment losses were impairments of $38 million pre-tax, the same modest amount that we experienced in the fourth quarter of 2007. These first quarter impairments relate mostly to two small fixed-income investment portfolios that are, or were, managed by external managers. With these portfolios we cannot assert an intent and ability to hold the investments to maturity under the other-than-temporary impairment accounting rules. Therefore, when any bonds in these portfolios are in a loss position, even if the losses result solely from interest rate movement as opposed to credit deterioration, we are required to recognize these losses as impairments. Other items that contributed to first quarter net realized investment losses were the mark-to-markets on our Treasury-rate futures contracts, which we use to manage portfolio duration, and the mark-to-markets on certain common stock warrants that we hold. Importantly, our investment portfolio remains very healthy and very well-positioned.

Our Level 3 financial assets, as defined by FAS 157, were only $519 million, or less than 1% of total financial assets, and we ended the quarter with pre-tax net unrealized investment gains of $863 million. Our weighted average diluted share count of 628 million continued a significant decline due to share repurchase activity. We repurchased 20.8 million common shares in the quarter at a total cost of $1 billion and since the second quarter 2006 inception of our share repurchase program, we have bought back just under 100 million shares at a total cost of approximately $5.1 billion, representing 14.3% of the outstanding shares as of the beginning of that period.

Turning to Page 5, our balance sheet continues to be in terrific shape. We ended the quarter with almost $26 billion of common equity ex-FAS 115 and book value per share ex-FAS 115 of $42.36, which was up 3% in the quarter and up 14% since a year ago. All this after $3.2 billion of share repurchases and $742 million of common stock dividends in the past 12 months.

Our capital remains at or about target levels. Our AA free claims rating remains under review for possible upgrade from Moody’s and we continue to generate significant amounts of excess capital and liquidity.

Our debt to total capital ratio decreased to 18.5% in the quarter compared to our 20% target, as we chose to pay down $400 million of debt that matured in March from operating cash flows. While we are maintaining 20% as our target for debt to total capital, it is important to note that we can self-fund the very modest level of debt that is scheduled to mature in the next few years.

The rest of the information on the slide is pretty self-explanatory, but I did want to point out that holding company liquidity of $1.5 billion exceeded our target of one year’s worth of interest and dividends by $400 million.

As the data on Page 6 indicates, both CATs and net favorable prior year development played a meaningful role in this quarter’s results. CATs were mostly concentrated in the business insurance segment. They related to February tornadoes and hail storms in the Midwest and Southeast, and while twice as high as in the prior year quarter, were not at all out-sized with respect to normal expectations that we have for winter storm losses.

Net favorable prior year reserves development of $261 million after tax, which was also concentrated in our BI segment, primarily resulted from better than expected loss results in CMP, general liability, and property for recent accident years due to the improved legal and judicial environments, enhanced risk control, underwriting and claim processing initiatives, favorable trends in certain large claim exposures, and the recognition of higher than anticipated CD recoveries.

And in addition, BI also experienced favorable development of approximately $55 million related to hurricane Katrina, primarily due to a recent court decision clarifying policy coverage language. While this decision eliminated various uncertainties related to ultimate losses for Katrina, it did not resolve all uncertainties and we await further resolution of these matters in the future.

As the slide indicates, our combined ratio, adjusted for CATs, net favorable prior year reserve development and last year’s timing impact of the change to the fixed value-based agent compensation program increased by 2.4 points, which is a bit higher than the approximately 1 point that was factored into the initial guidance for the full year that we provided last quarter.

So Brian is now going to give you some color on the combined ratio.

Brian W. MacLean

Thanks, Jay.

Building upon what Jay just outlined, let me take a few minutes to discuss our consolidated combined ratio performance. So turning to Slide 7, the net effect of pricing changes, loss trends, and shifts in the mix of business are driving the 1 point increase in the ratio that we expected.

In addition, during the quarter there have been a few factors that further increased the combined ratio. Across several of our business insurance markets, we had an uncharacteristically high number of large property losses—and just for your reference, the net retained amount per risk for commercial property exposures is generally limited to $15 million. We don't believe there's anything systemic here and we don't anticipate a recurrence but during this quarter property drove about ½ point of compression. In personal insurance non-capped weather losses added 7/10 of a point to the combined ratio, so all in, we realized a variance of 2.4 points in the quarter and we think that will work out to about 1.5 points for the full year, and that's ½ point more than we had originally projected.

So that's the combined ratio arithmetic. But what does it tell us about the overall market? Well, in the aggregate, our message is very consistent with prior quarters. The market is tightening, with commercial rates continuing to decline and new business pricing more competitive. But at least for our book, given the competitive advantages Jay outlined at the beginning, our market is tightening, but modestly.

Looking at the details on Slide 8, you can see that retentions remain historically high across virtually all the businesses. The trend for the past five quarters has been consistently strong, particularly in commercial accounts, our core middle-market business. In our international operations, retentions were very solid at 81% but were down from previous quarters due to the deliberate underwriting actions to limit our Canadian earthquake exposure.

These high retention levels reflect our strategy to leverage our solid margins and keep the profitable business we have on our books. We believe these high retentions reflect the value of our franchise to our agents and our customers and they have not been attained at the expense of meaningful across-the-board rate accommodations.

Pure rate change on the renewal book continued softening, but in the low single digits. In fact, the pure rate change improved slightly from recent quarters and was marginally better than our expectations. In the market the biggest declines in rate have been seen in the larger accounts and as you know, we are primarily a small- to mid-size account player, so our overall picture is somewhat better.

On Slide 9, we show total renewal price change, which reflects both the rate and exposure change. RPC was generally consistent with recent quarters with the exception of our international business, which has been impacted by a reduction in exposure from some of our Lloyd's businesses.

New business dollars are also shown on Slide 9 and here you can see evidence of some softening but overall solid new business performance. In the aggregate new business submission, that's our deal flow, was up in most of our businesses and in some businesses up dramatically. This is a testament to the strength of our new product offerings and the leading position with our agents, two or our major competitive advantages.

The number of accounts we actually wrote as a percentage of quotes, our hit ratio, was slightly lower than the same quarter last year. This decline in hit rate suggest some more competitive marketplace for new business; it also demonstrates that we remain unrelenting on our fundamental underwriting discipline, avoiding pricing that is sometimes driven to levels lower than we are willing to delve.

Turning to Slide 10, business insurance delivered another strong quarter with operating income up slightly from the same quarter last year. The combined ratio over the quarter was 86.6%, an improvement of approximately 5 points from the first quarter of last year, and as we discussed earlier, driven by favorable prior year development.

Net of the items here, margins deteriorated about 2 points, again about half from the expected deterioration in market conditions and half from the large property loss activity I already mentioned.

Frequency rates in the quarter continued to decline slightly.

On Slide 11 you see that net written premiums grew 2% in our core and 1% in total quarter-over-quarter. In spite of the softening in the marketplace we delivered a solid performance as the result of our strong, diversified product platform and our depth of distribution.

Turning to financial profession and international insurance on Slide 12, the segment continued to produce very positive results with operating income up 33% from the same quarter last year driven primarily by positive prior year development in our international operations.

The combined ratio improved 8 points quarter-over-quarter from 89.4% to 81.4%, again affected by the prior year. Even net of this development FPI's combined ratio was a very solid 88.8%. The business continues to perform at very profitable levels.

FPI net written premiums were up 7% for the quarter, 11% when you exclude our Mexican surety premium from 2007.

Bond and financial products premium quarter-over-quarter was up 30% primarily due to changes in our reinsurance treaties.

We saw strong production in the construction services portion of our surety business. This growth was offset by reductions in liability lines where new business pricing is very competitive.

International premiums decreased due to exposure reductions in travel and personal accident insurance products at Lloyd's, the underwriting actions we took to limit Canadian quake exposure, and increased reinsurance costs. These factors more than offset the impact of favorable foreign exchange rate movements.

Last quarter we spoke at length regarding the potential implications of financial sector stress in our management liability and surety industry exposures. Since then we have continued to monitor developments in the marketplace and assess our potential exposure. The conclusions remain the same. As we told you last quarter, the 2008 guidance incorporates the results of our ongoing analysis of D&O exposure to disruption in the capital markets and the estimate in the 2008 guidance is not materially different from the estimated losses for 2007. We are comforted by both our diversity and profitability of business in the management liability and surety lines and our management liability and surety business continues to meet our return thresholds.

So overall, our results in this quarter were really strong, and in light of the current market conditions we believe outstanding. Solid margins, great retention levels, modest price declines on a retained book, and a significant flow of new business opportunities has allowed us to modestly grow the top line in a very disciplined way and we believe this reflects our strong underwriting culture. In short, [inaudible-audio scratch] that are competitive advantages really matter and probably matter most in toughest market conditions.

So with that, let me turn it over to Joe Lacher to cover personal lines.

Joseph Lacher

Thanks, Brian.

Looking at Page 13, personal insurance segments produced solid results with a combined ratio of 92% and $181 million in operating earnings. Continued to deliver strong production results with consistent retention, renewal pricing and year-over-year [inaudible] growth in both the auto and the property line. When comparing the quarter's profitability with the first quarter of 2007, earnings were down $85 million and the combined ratio was up 6.7 points. This was driven by several things. First, results were impacted by increased non-catastrophe weather-related claim frequency. Brian spoke about some of that a moment ago. This increased the combined ratio by 3.2 points. Additionally, the impact of lower net investment income and the absence of the one-time accounting expense benefit related to the fixed value-based agent compensation, discussed previously, also impacted the segment.

Turning specifically to property on Page 14, we posted another quarter of strong results. Policies in force increased 3% versus the prior year's quarter, retention remained at 86%, and the renewal price change of 6% was a bit lower than we have experienced in the last four quarters. Our combined ratio of 85% for the quarter was very strong despite the increase in non-catastrophe weather-related activity.

We continue to be pleased with the reception and the early results of Quantum Home, our homeowners product utilizing our industry-leading product segmentation. Over the last quarter the product was implemented in 7 additional markets, bringing our total to 38 states plus the District of Columbia. We are on track to roll out the remaining targeted states throughout 2008.

Looking at our auto business, we are pleased with our production results, which are consistent with recent quarters. Retention remains stable at 83%, renewal price change was 1%. Excluding the impact of the Mendota sales and policies in force increased 2% over the prior year quarter. Our auto combined ratio for the quarter was 99%, up 12 points from a year ago's 87% combined.

Let's turn to Page 15 and I will try to help you appropriately compare these numbers and to project our run rate going forward.

First, we do not believe that the 12 point differential between quarters is reflective of the change in underlying underwriting results. There were several non-run rate items affecting comparability. First, the auto combined for the first quarter of 2007 benefited 5 points from net favorable prior year reserve development and from the timing impact of the transition to the fixed value-based agent compensation program. Neither of these items benefited the first quarter of 2008. Additionally, the first quarter of 2008 experienced a level of non-catastrophe weather-related losses, which we believe are outside of what would be considered normal. This adversely impacted the quarter's auto combined ratio by 2 points. Excluding these items, the combined moved from 92% to 97%. The normalized 97% is very comparable to the full year 2007 normalized combined ratio of 95%. The differential between these normalized numbers is attributable to the impact of market conditions, which include loss inflation being somewhat above rate changes, and to a small increase in expense ratio. Looking forward, we anticipate an auto combined ratio in the high-90s, or something 2-4 points above the normalized 2000 levels.

This should presumably go without saying, but for clarity, the total company 2008 guidance incorporates an assumption of a 1.5 point increase in the total company combined ratio. The anticipated changes in the auto combined ratio are incorporated, and have been incorporated, into all of our guidance communications.

Turning to Page 16, we're seeing loss inflation in low- to mid-single digits, excluding the anticipated impacts from the broader risk profile of Quantum. Similar to recent quarters, we're seeing this driven by low- to mid-single digit increases in frequency with severity trend essentially flat.

I'm going to turn to the market for just a moment before passing it back to Jay. In our experience, the auto marketplace remains competitive. That being said, we're seeing more auto rate increase activity being initiated across the marketplace. Our activity reflects that trend. In the first quarter of 2008 we generated nearly twice as many auto rate filings as we had done in the first quarter of 2007. We anticipate similar activity for the next several quarters.

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

Jay S. Benet

Thanks, Joe. Net investment income is shown on Page 17. It was $650 million dollars after-tax, significantly below recent quarters. NII for the fixed income portfolio, which remained very strong and was up $11 million from the prior year quarter, was impacted somewhat from lower short-term rates. The non-fixed income portfolio, however, produced only $27 million of NII in the current quarter as compared to $127 million in the prior year quarter.

It is important to note that this portion of the portfolio, like the fixed income portfolio, produced a positive return and was not impacted by significant write downs. When compared to prior quarters, the low level of non-fixed-income-related NII resulted from lower real estate and private equity partnership gains due to low transaction volumes given current market conditions.

Overall our after-tax yield was 3.5 % for the quarter.

Page 18 provides updated information concerning our guidance for full year 2008. We now expect fully-diluted operating income per share of $5.55-$5.85, which compares to our previous range of $5.40-$5.75, and which would still generate an operating return on equity of approximately 13%-14%. Our revised guidance incorporates the first quarter net favorable prior year reserve development and the 1.5 point increase in our full year underlying combined ratio that Brian discussed. It also assumes a continuation of lower short-term interest rates and the more challenging environment we experienced in the first quarter for non-fixed income investment returns. Our guidance also assumes full year CAT losses of $525 million pre-tax and $340 million after-tax, or $0.56 per share after-tax, which represents our average annual loss expectancy as indicated by our CAT modeling, no further prior year reserve development, either favorable or unfavorable, slight growth in average investment assets after approximately $2.7 billion of share repurchases, and a revised weighted average diluted share count of approximately $612 million after share repurchases and employee equity awards.
And with that, we would like to now open it up for any questions that you might have.

Question and Answer

Operator

(Operator Instructions)

Your first question comes from the line of Jay Gelb with Lehman Brothers. Please proceed.

Jay Gelb
Lehman Brothers

Thanks very much. I was hoping we could get a bit of insight on the outlook for the net investment income line, sort of in the two pieces of so-called fixed income and the other, given the gyrations of the credit markets.

Jay S. Fishman

You're speaking now, Jay, about the guidance for the remainder of the year and what or assumption is with respect to it?

Jay Gelb
Lehman Brothers

Correct.

Jay S. Fishman

We've assumed that quarters two, three, and four for this year are just the same as Q1. And in fact, if you look at the guidance you will see obviously that we increased it for the actual realized favorable development in the first quarter and then decreased it for the difference in net investment income. So we are now simply assuming that two, three, and four are virtually identical to one.

Jay Gelb
Lehman Brothers

Okay, that's helpful. And then on the guidance—I guess this is more of a comment than a question, but just going back in my model, Travelers has had reserve releases for the past 13 quarters, so I'm just not sure I understand why you always assume you're not going to have any going forward, given I think most of the estimates on the Street assume for the reserve releases.

Jay S. Benet

This is Jay Benet. The rules that we operate under certainly cause us to look at all facts and circumstances that we know of at a particular point in time to estimate what our reserves are. And from that we make our best estimate. So, we're not, in our reserving processes, trying to create a circumstance where we are necessarily developing reserves in favorable or unfavorable ways. They do represent best estimates. There are factors at work, however, that impact our reserves and those factors include things like the claim initiatives that we have, changes in the [inaudible] environment; all kinds of things that we're constantly updating. And as those factors emerge, we've been very fortunate in looking at things that have been positive for our reserve development. So we would hope that they would continue, we don't know that they will, and we just at any point in time come up with what we really believe to be the best estimate of what we believe the reserve should be.

Jay S. Fishman

Jay, I would just add to that the process that we go through to evaluate reserve is extensive and rigorous and fairly company-wide. And I don't fully understand how people can have visibility through reserve development that they would feel comfortable incorporating into guidance when in fact the process that generates that conclusion hasn't occurred and doesn't occur until the future. So I think if you have enough visibility to reserve development then we'd be comfortable in encouraging you to incorporate it in our view of guidance. I can't figure out why you wouldn't recognize it in earnings. So we let the process run its course. It's a rigorous, controlled process and actuaries do exactly what they're supposed to do and we're hopeful that there will be a more favorable development, but it's impossible to predict.

Jay Gelb
Lehman Brothers

That's a fair point. And then my final question is on surety. We've heard some rumblings about there being a bit more stress on the homebuilders' side, with regard to the residential subdivision improvements. Can you update us on that issue?

Brian W. MacLean

Jay, this is Brian. Yes, we clearly monitor it very closely. As we've talked about in the past, our market share exposures in that segment are significantly less than our broader surety market shares, but we're still a decent player.

Jay S. Fishman

I'm not aware of any change and we obviously can update this and if it turns out that it's different we will. I believe we had, at the end of the fourth quarter one notice of claim in the subdivision book and I'm not aware of any change since then. So, we've been reading the same things you have in The Wall Street Journal and The New York Times on pressure in the housing market, but it hasn't evidenced itself yet, in any event, in defaults in any serious way in the subdivision business. And we should check those claim numbers because I'm speaking really very much from memory. I don't have a fact book sitting next to me with the numbers, but that is my recollection, and we'll confirm the numbers.

I think that really is a function of the nature of our business. It's a narrow book; I think we had 65 individual programs that are in place. They are largely with well-capitalized—at least for the housing industry—kinds of developers. I think we're at the cream of the crop in that regard but obviously things can always change perspectively.

Jay Gelb
Lehman Brothers

That's very helpful. Thanks.

Brian W. MacLean

We actually—we did do that stress test that we displayed in our year-end call and we revisited that and it's no different than what we showed before.

Operator

Your next question comes from the line of Alain Karaoglan with Banc of America Securities. Please proceed.

Alain Karaoglan
Banc of America Securities

Good morning. I have a few questions. The first one is on the financial products business. The accident year combined ratio actually improved this quarter versus last year. That's surprising given that rates are declining, some of the lost cost trends in that area may be increasing. Could you comment on that, what's occurring? Was there anything unusual last year in the accident year combined ratio?

Brian W. MacLean

It's primarily shifting and mix in products there. And as you know, some of those products have dramatically different profitability targets and combined ratio targets and as we've shifted some of that book that's had probably the biggest single impact there.

Jay S. Fishman

I'm thinking back to the fourth quarter analysis we did, Alain, and one of the things that we shared with you and I remember Brian mentioning it here was that our analysis of the management liability exposure from the capital markets disruption fit actually within the estimated loss pick that we had established last year and frankly still believe that that holds true in respect with the loss pick of this year. So, your comment about loss trends increasing, I'm not sure I understand that. At least as it relates to our business. And what we're showing here obviously is [inaudible] but I don't think we've seen anything yet in our financial and professional services businesses that cause us to believe that the loss ratios, or loss experiences, in that businesses are going to be historically out of character.

Alain Karaoglan
Banc of America Securities

Okay. The next question is on the personal auto segment. You're getting combined ratios that are starting to get below your targeted return on capital. The expense ratio is 28 points which is significantly higher than some of your competitors and in the past you mentioned that you looked at the combined ratio overall, so as long as that was below the target it was fine. Now we're above that. How long will you tolerate a combined ratio that's at 97% or above, in order to achieve your goals? And when would you expect the expense ratio to get back to a more normalized rate, given what you're spending on that front?

Jay S. Fishman

Great question. What we look at all the time is, again, the combined ratio and it's projected move going forward. We have a target range of profitability, we've talked about that a number of times, and go through a rigorous process to review that. Our projection for the full year is that we'll be within that target profitability range. We'll be at the higher end of that range, but we'll be within that target profitability. We are very actively watching the marketplace, we see conditions where in general wash trends are exceeding rates, and that's not inconsistent with, I think, every piece of data you guys have seen, and as a result we've stepped up and increased our rate activity.

And I mentioned in my prepared comments that we had virtually doubled, or nearly doubled, the number of auto rate filings in the first quarter of 2008 than we did in the first quarter of 2007. Those were biased towards increases and we anticipate continuing that activity in the next couple of quarters to respond to all of those pressures on profitability.

Now that will take a while to earn in. As you go through rate changes. Which is why we expect the combined to be a little higher through part of this year. But the benefits of those rate changes will come in the back part of this year and in the next year.

Speak with Joe about your anecdotal observations about trends and [inaudible] in the industry.

Joseph Lacher

In terms of the loss trends, Jay?

Jay S. Fishman

No, filing. Filing trends.

Joseph Lacher

What we're seeing, and we talked about this a little bit last quarter, we saw a reduction in the number of rate decreases in the fourth quarter and increase in the number of rate increases. That same trend was visible, and a little bit more so, in the first quarter. So we do think the marketplace is moving towards some increased level of increasing rate activity.

Alain Karaoglan
Banc of America Securities

And Liberty Mutual announced yesterday that they're buying Safeco. Do you have a view on whether that's going to give you opportunities in terms of attracting agents or books of business, or do you think that's going to lead to a more competitive environment as both will try and retain the business that they have on the books?

Jay S. Fishman

I don't think, given the size of it, that it's going to change very much. I think we all compete aggressively every day, heads up, and we try our best to knock each other out—I say that tongue in cheek of course. I'm just saying that we do compete aggressively; I think we'll continue to compete aggressively and whether Safeco is an independently traded company or owned by Liberty Mutual, I don't expect to change the competitive environment at all.

Alain Karaoglan
Banc of America Securities

And would it give you any opportunities on books of business or things like that?

Jay S. Fishman

I don't know, Alain. I just don't know.

Alain Karaoglan
Banc of America Securities

Okay. And just a clarification. You mentioned the gap combined ratio guidance increase of 1.5 points. Is the starting point on 97 the 90% combined ratio?

Jay S. Fishman

It would be the prior year ex-CATs, ex-prior year developments, and ex-the impact of the agent commission change.

Brian W. MacLean

We have that number.

Alain Karaoglan
Banc of America Securities

And I just want to confirm that it's 90%.

Jay S. Fishman

We'll get it for you.

Alain Karaoglan
Banc of America Securities

Okay. Thank you very much.

Operator

Your next question comes from the line of Matthew Heimermann of JP Morgan. Please proceed.

Matthew Heimermann
JP Morgan

Hi. Good morning. Jay, just a question. You made a comment about increasing sales with additional products through existing customers. I know that that's something that you talked about in the past, but I was wondering if you could give us some examples of where you're having some success doing that?

Jay S. Fishman

I'm not sure who the question—I don't think I made reference to it.

Matthew Heimermann
JP Morgan

I think in the press release it was noted.

Jay S. Fishman

Oh, I'm sorry.

Brian W. MacLean

This is Brian. I think where that's really starting to have traction is obviously in the commercial areas. Both small commercial and middle-market. One of the things we've really been driving in our whole Travelers Express roll out is to expand our appetite in small commercial from what was previously a significantly heavily weighted CMP book of business to a much more balanced comp and auto business. And we feel great about that. And we've had some real traction there. Part of that is the technology and, you know, the Travelers Express for comp has been rolling out and will be fully out by the end of the year. So that's been a big part of it.

The other piece is in our, broadly speaking, middle-market environment where we have done a much better job as a company--and really, this is a journey we've been on for three or four years now--to really preserve our specialized product industry underwriting focus, but at the same time come at the marketplace—both agents and customers—with a more of a connected view. So we've been fairly significantly increasing from market customers our penetration in different products for those customers. So it's selling the comp and the auto where we sell the liability or vice versa or whatever, and the property. But we've had some real traction there.

Jay S. Fishman

Do you want to comment about embedding products at all?

Brian W. MacLean

Yes. Another way to do that is to take some of our specialized product from the line of business prospective and embedding those coverages right into the product that we sell. So it could be some of the professional liability coverages, it could be a lot of different things, where we. . .

We've had a lot of success with boiler, for example. We've embedded the boiler coverage right into our standard offering and have really had some dramatic impacts from that.

Matthew Heimermann
JP Morgan

And that last comment you made, is that specific to the industry focused underwriting or is that more broadly than that even?

Brian W. MacLean

It would be a little more broadly. I mean, there's a decent amount of that that would be going through Select. So how do we take some of those products and embed them into our Select offering so that we're selling lots of it to a broad array of customers.

Matthew Heimermann
JP Morgan

Okay. That's helpful. Thank you. The other question I have is you made mention—well, the press release made mention and I forget whether it was Brian or Jay—the increasing retentions in bond financial international. What product specifically did you increase the net retentions there?

Brian W. MacLean

It was primarily in our surety business.

Jay S. Fishman

And it was an active decision based upon loss experience versus cost. The loss experience in the business that had been seeded out has been pretty solid and comparing it against the cost of seeding that business out, it just made sense to retain it.

Matthew Heimermann
JP Morgan

And was that a function in changing XOL, or pro rata?

Jay S. Fishman

The XOL.

Matthew Heimermann
JP Morgan

Okay. Thank you.

Operator

Your next question comes from the line of Josh Smith of GIAA. Please proceed.

Josh Smith
GIAA

Hi. Thanks for taking the call. In the December presentation you gave some detail on claim counts for the management liability. Can you update us on those for 2007 claims and 2008 claims?

Brian W. MacLean

You now, Josh, we gave a lot of detail last quarter. We really don't want to get into a quarter-by-quarter claim count of a fairly micro issue here. Again, I would go back to—we've clearly been watching very closely. We've update regularly all of our analyses and we come to the identical, same conclusions that we told you about last quarter.

Jay S. Fishman

There clearly have been more claims, and we do know what they are. I'm not suggesting that we don't but I think it's appropriate to say that the claim activity is consistent with the loss provisions that we made in 2007 and remains very consistent with the guidance that we—or the loss provisions that we've incorporated into the guidance for 2008.

Josh Smith
GIAA

Great. And just a clarification on your guidance. You talked about the combined ratio being up 1.5 points, but auto up 2%-4%. Does that imply that everything else is down, and if so, why would that be with pricing getting tougher, other than mix shift?

Jay S. Fishman

I think maybe we're confusing something, but let's make sure. We originally in the guidance indicated that we expected combined ratio to increase 1 point looking into 2008. And now we've increased that to 1.5 points. The principal reason why we're increasing it to a point and a half is because of what occurred in personal lines in the fourth quarter and that portion of it that—the first quarter; I'm sorry, in the first quarter—and that portion of it that we expect to continue to reoccur in two, three, and four. When you look purely at personal lines, I think that's the 2.4 points. When you spread it over . . .

Josh Smith
GIAA

I got it. I got it. So everything else is up as you expected but personal is a little bit more and that's going to bring it up.

Okay. Thank you.

Jay S. Benet

The other thing that I would add, and that's to answer Alain's question from before. You know the basis for that analysis was a 90% combined ratio last year for the full year ex-CATs, ex-prior year development, and ex- the impact for the change in the agents' comp.

Jay S. Fishman

So you were absolutely on target, Alain. Good for you.

Operator

Your next question comes from the line of Larry Greenberg from Langen McAlenney. Please proceed.

Larry Greenberg
Langen McAlenney

Good morning. I'm just wondering if with the strength of your balance sheet and the dislocations in financial markets, whether Bill Heyman is perhaps looking to increase the risk profile at all of your investment portfolio, taking advantage of some of those dislocations?

William H. Heyman

Hi. This is Bill Heyman. We come in every day and comb the secondary markets for bargains. There are actually fewer than the newspapers make it sound. Much of the money that has been lost by some of our competitors has been on products where there was a lot to embedded leverage or where they took leverage. The actual market prices of financial assets provide some bargains and we have found a few. But we haven't piled in wholesale yet. First of all, we're not sure that this is the final level. And second, our attitude towards risk is pretty consistent. We think all things being equal, there is virtue in being able to tell a simple story on the asset side. We think complexity of products has direct relationship to liquidity. And we're big enough to assume some liquidity risks, but we want to be paid for it. That said, we're in every day. We found a few things but we're not, at this point, inclined to radically change our risk profile.

Jay S. Fishman

And, Larry, that's not to say that we've not been approached with opportunities to do things that would be different from what we've done before and as anyone should be now, we're open minded: we look, we do due diligence, we analyze. And so far we're very comfortable where we are. But our eyes are wide open. And we did speak to that very specifically in the press release, the comment that--not having issues right now gives us two, I think, significant luxuries. The luxury of being able to just focus on our business, which really is a great time to be able to do that. And secondly, the luxury of being able to consider alternatives and we'll see where they go.

Larry Greenberg
Langen McAlenney

Thanks very much.

Operator

Your next question comes from the line of Ian Gutterman of Adage Capital. Please proceed.

Ian Gutterman
Adage Capital

Hi. Just a couple of quick ones. First, the expense ratio was up close to a couple of points. I know probably about half of that is the change in the contingents, but the other point, can you explain what's going on there and what your plans are to address that? I know obviously Jay has a past of being very successful in cutting expenses in this kind of environment.

Jay S. Fishman

Was it one or 1.4 points? I remember 1.4 points attributable to the age in comp. But, look, I think—and I've said this before—that we continue to be extraordinarily focused on being cost-conscious. Gel, for example, put out an announcement a couple of weeks ago now, that we were consolidating nine service centers into seven. We were effectively eliminating two person line service centers. And the reason for that is we now have the technology and the infrastructure to be able to handle it in those centers. So we're going to continue to do that and find opportunities. And whether we were making more money or less money doesn't change that focus. That focus exists regardless of the environment we're in.

Simultaneously, you can't not to continue to make the kinds of investments that have been really remarkable, I think, in the story of this company. It would have been easy not to have invested in Quantum Auto and in the early days our results would have looked better, but from a competitive position now we wouldn't be nearly in the position that we are. And the comments that I made about Travelers Express, we're just spot on in the same regard. To talk about a submission rate that's up 50% is, in my experience, unheard of and it really is a perfect application of providing a technological need to an agent desire that supports both businesses. And that will produce real results.

One of the issue we, as senior management, face all the time is the trade off between being thoughtful about making those investments recognizing that they pay off over time. So I think we're going to be—I think we are going to continue to be relentless about managing our expense base, but we're also running this for the long-term value creation and we're going to continue to make the investments that make sense.

And to some extent, the expense ratio will be what it will be. And it's not because we drive—it's easy to run a business targeting to an expense ratio; it's also easy to not be successful that way. I think the way that you're successful is to look at it project by project, dispersement by dispersement, and wrestle with it and that is our orientation. That's what we did in the early days to drive the expense base down. And that's what we do now to make sure the money that we spend is worth spending.

Ian Gutterman
Adage Capital

And I agree with all of that. I guess I was just trying to understand a little bit better—between Quantum and Express, is there a bit of a bulge in the investment spending that might decline a year from now or do you think that's just the way the game is now, that you're constantly going to be competitive and the leading edge, there's always going to be this level of investment spending?

Jay S. Fishman

Yes. And again, to sit as a CEO, and say that regardless of the environment, we're going to continue to act in a certain way, I think is fool-hardly. Given the environment that we envision—and in fact the environment that we're in right now—we're going to continue to spend, we're going to continue to invest.

And this is—you know, I look back on the last two years, we had a return on equity of 18% round numbers in each of the last two years. Our guidance points us to 13%-14% return on equity this year, in spite of a, I think, an unprecedented investment arena. We just feel terrific about how the company is positioned. Truthfully, I'm not sure I could feel a whole lot better about it. And we're going to continue to find those opportunities.

Now, if five years from now we're looking at a market that is dramatically different, then the thresholds for investment go up and the kinds of returns that are demanded go up and we'll gear it back. But in the near-term I think it would be inappropriate to assume that there's any dramatic spending reduction that you're going to see out of here.

Ian Gutterman
Adage Capital

Okay, great. And then just one quick numbers question. The change in the surety insurance, will that benefit net premium the next three quarters as well, or was it a one-time benefit in Q2 through Q4 gross?

Brian W. MacLean

Yes, it's a one-time shot. Don't expect a 30% bump.

Ian Gutterman
Adage Capital

I got it. And that's just true for written or is it true for earned as well?

Jay S. Benet

It earns out over the quarters.

Jay S. Fishman

And I know you're thoughtful enough to recognize this, but when you're retaining more, the impact to the bottom line is simply the difference between what the cost of the session would have been and what provision you're going to make on the business that's being retained. So, don't assume that the change in the retention produces a dramatic change in profitability. It's on the margin.

Ian Gutterman
Adage Capital

I know. Exactly. I just wanted to make sure when I run it through my model I do it correctly.

Jay S. Fishman

Great.

Ian Gutterman
Adage Capital

Okay. Thank you.

Operator

Your next question comes from the line of Jay Cohen with Merrill Lynch. Please proceed.

Jay Cohen
Merrill Lynch

Thank you. You know, I was looking at the pure price changes that you highlighted in your presentation and on the commercial side it does suggest some stabilization. Should we read into that? Certainly what you hear from others is that it's not stabilizing, that prices continue to head lower. Sometimes at a faster pace. What can you point to that can account for what looks like a stabilization for you guys?

Jay S. Fishman

I think, Jay, that one of things that, for whatever reason really isn't internalized, is the extent to which we are a small-flow business company and a middle-market company. If you look at how this organization arose, it arose by companies that had a focus on writing small-flow business and guaranteed-cost middle-market business.

So when you look at Select, or when you look at some of the other business insurance, or even in the commercial accounts, a lot of that really represents and affects small commercial business. And our experience consistently has been that the smaller end of the business is less price-sensitive and the largest end of the business is the most.

So, I think one way to put in context the comments about rate—and we watch everyone obviously—is to understand the mix of business that's being done. We are not a large-account casualty writer. I'm not saying you won't find any, but as a matter of the business that we do, we are not a large-account guaranteed-cost casualty writer. And I think that when you look at companies that do that, that you will find that the price sensitivity, both up and down, tends to be more dramatic.

We do write some large account national property business. That has a pricing dynamic that's really very much unto itself and acts almost like a market that's unique. I think if you look at the other companies that write small commercial kind of middle-market business that write—and we do compare it and it is now publicly available. I think you'll see that the rates look remarkably alike.

I think our advantage shows up--and we presented this information in the fourth quarter—in retention rates that have been historically higher than the companies that we would think about as competitors in those lines of business. And again, no one else has reported in the first quarter of the companies that I'm talking about so it's hard for me to comment about what they're going to say. I just, when I look at the rate experience that we've talked about over the last year, the rate looks very much like the companies against we compete in these various segments.

Brian W. MacLean

And with that said, Jay, we're not reading anything directionally into the quarter. It is clearly a little better than the last couple of quarters. As I said in my comments, it's marginally better than what we had expected for the quarter. We don't see it as a sign, though, of anything fundamental. Obviously if next quarter it's a little bit better we'll start thinking about that, but right now we think the market conditions are pretty much what we've been seeing for the last quarter or so.

Jay S. Fishman

Well, I think it can get confusing to think of first derivatives and second derivatives here. Our numbers in that first quarter of 2008 in pure rate are still down. They are not down more than they were in the fourth quarter, but they are still trending down. I think it's hard to declare, looking at this, that anything is bottoming out. I think that you could look at and speculate as to whether the rate of decline in this quarter has flattened out.

But I do come back to I think that the competitive advantages I spoke about earlier evidence themselves in higher retentions but that the rate arena in which we compete looks a great deal like the other best companies—the best companies—that we would consider the competitors in those segments.

Jay Cohen
Merrill Lynch

Great. Thanks a lot.

Operator

Your next question comes from the line of David Small with Bear Stearns. Please proceed.

David Small
Bear Stearns

Good morning. In terms of the reserve development, could you tell us which accident years that reserve development is coming from?

Jay S. Benet

The reserve development is actually spread out amongst a large number of our individual businesses and product lines. But it's probably concentrated in terms of more recent accident years—I don't mean the most recent—when it came to liability—but probably in the 2003, 2004, 2005 time frame. There is an amount that relates to property and property, of course, you see in a shorter time span, so there it's probably more like 2007.

David Small
Bear Stearns

Okay. And in your prepared comments and in your package here you talked about your liquidity. Given that liquidity, could you talk a little more about your M&A strategy and kind of where you would be looking to kind of build out your business?

Jay S. Fishman

I don't think we have an M&A strategy. We focus on our business strategy, which is growing our business and coming in each morning and doing what it is we do. I've said before, it would be irresponsible for management to say they wouldn't look or consider opportunities that come along and again, I've spoken previously about the fact that given the strength of this franchise and the breadth, that the focus in any transaction is creating shareholder value—and that's the only reason is that we're in business is to create shareholder value—then any transaction would have to overcome a very high hurdle of reserve risk and people risk and undisclosed liability risks and all the people risks and all that goes with it.

So I simply would like to say that we would look at things that would come along or be available, we would do very rigorous due diligence, we're not pig-n-poke kinds of people. We would do rigorous due diligence, we would evaluate the risk and the opportunity and that opportunity would have to compare very attractively against a very high hurdle of risks, because frankly, I just don't think we need much to build out our shareholder value. I think we have the products and the people; I think we've got what a company needs to fulfill it's mission and so you just keep doing it. That's as close of an answer that I can give you.

David Small
Bear Stearns

The one thing that I guess you left off in that answer is geographic diversity. I would agree with everything you said in the U.S. Would you be looking to, at all, expand internationally?

Jay S. Fishman

Well, we have operations right now in Canada and the UK and Ireland, and obviously at Lloyd's. And they're very good franchises and we're interested in growing them. And we have a real focus on growing them organically. And so when you say would we be interested in growing our business outside the U.S., I would love for our UK business to do more, and I would love for them to do it at profitable levels.

We disclosed that we are looking seriously about a joint venture opportunity in India, but it's obviously long-term in nature and if we're able to consummate it, it would be small and not particularly material. I just look over the next 20 years and fundamentally believe that there will be enormous opportunity there and now is the time to establish oneself, so we are actively engaged in that.

I think the notion of opening up, planting a flag, in continental Europe or elsewhere—these are over-insured areas where there are way too many companies and way too little demand and the notion of starting up an operation and sticking a flag in the ground just doesn't make at all sense. You may know that the St. Paul had operations in lots of countries around the world. We closed them down; closed most of them down.

And then when you get to the notion of an acquisition, I fall right back to my previous comment, which is that anything that we look at would have to be subject to due diligence and compare itself against a very high hurdle of risk and once you start talking about companies that conduct themselves in far-flung areas in different regulatory regimes in different time zones in different languages, that simply ramps that risk hurdle up even further.

So, we feel very good about what we've got and got plenty to do here in the U.S., in Canada and the UK and Ireland. We think we can create shareholder value with what's in front of us and we're off and running.

David Small
Bear Stearns

Great. Thank you very much.

Operator

Your final question comes from the line of Dan Johnson with Citadel. Please proceed.

Dan Johnson
Citadel

Thank you very much. Two questions, if we could, please. The first is can we talk a little bit about what you're seeing in terms of worker's comp pricing? I know it's very state-specific but assuming if your mix doesn't change maybe we can try to talk at a more national level.

Jay S. Fishman

Comp is obviously a line that's gotten some publicity lately. We are a significant player in comp, broadly. We do a lot in the loss-sensitive service and carrier business. On the guaranteed cost side—you know, again, it is state specific so it is hard to generalize. We feel pretty decent about comp opportunities around the country—and again, broadly speaking—particularly in the small commercial area. So, again, I'm hesitating because there are some areas that are such exceptions to that story that you have to be careful with the comment. But overall, comp pricing is we think fundamentally under control and loss trend has been relatively behaving.

We've done a lot of work on looking at loss trends, we spend a lot of time talking to CCI, we've looked at a lot of different medical trends that are going on and in the aggregate we feel pretty good that are some really good opportunities. There are also some other places where it's a real problem.

Dan Johnson
Citadel

I ask because it's the one place where you're still generating double-digit written premium growth and I [inaudible] even larger amount of unit growth. So if we could just spend a second there on some of why worker's comp [inaudible]

Jay S. Fishman

And again, just to summarize the other thing. I mean, rate is still shrinking and is a negative in comp. So it's in the aggregate, across all markets, across all states. Not unlike the rest of the products. You know, I think specifically for us as much as we have been a major player in loss-sensitive worker's comp, we have historically been a very conservative player in guaranteed-cost worker's comp. And I think there a couple of very focused opportunities for us; small commercial probably being at the head of that issue, of that line, but not exclusive, where we think we've got opportunities in different markets in different geographies to grow that business and we've been much more conscious of trying to do that thoughtfully. And actually leveraging our knowledge of the marketplace from our less sensitive book as opposed to not being as big a participant as we would be.

This is interesting because it's not—because it's loss-sensitive it's not visible in our financials as much as other business is, but we manage somewhere between $2 billion and $3 billion of claims for large companies that we manage on a fee-for-service basis and we hold ourselves out as experts in producing favorable worker's compensation outcomes. Our [inaudible] product that we market aggressively has been successful. So managing, in effect, other people's risks, with their money, we've been very successful.

We asked ourselves a couple of years ago, strategically, if we felt to good about handling other people's claims, why didn't we feel as good about managing in effect our own money's claims. And so we made a very conscious and dedicated effort to take the expertise from our loss-sensitive worker's comp business and move it down into the guaranteed-cost business and yet go at it selectively. And what we're seeing here is the by-product of that strategy as a result of it.

Dan Johnson
Citadel

When you think of the duration of those liabilities, obviously you can live with the higher targeted combined, can you give us a sense of where those targeted combines would be for that line of business?

Jay S. Fishman

We typically do—directionally, you're right. It's a longer tail business so it would have a higher target combined. We don't disclose those discretely, I would think, line by line. We hold all of our lines of business to the same ROE targets and that's a range, I think we've said in the past, 13%-18% return from our different products so it's clearly in there.

I just want to make sure I give you the right number on that. Our national account business I said is $2 billion-$3 billion—we've got the actual numbers here we can give you.

Dan Johnson
Citadel

The Katrina reserve relief, was that $65 million both in the reserve or do we figure as well as a [inaudible].

Jay S. Fishman

First of all, I'm not sure I heard you. It's 55. I don't know if that's what you said. It's in the reserve relief number, it's not a contra CAT in our CAT numbers for the quarter.

Dan Johnson
Citadel

I understood. Thank you very much.

Jay S. Fishman

And, Dan, I can confirm the [inaudible] under management are approximately $2.5 billion dollars.

Dan Johnson
Citadel

Very good. Thanks, again.

Operator
Ladies and gentlemen, this concludes our Q&A session and our conference call. Thank you for your participation. You may now disconnect.