S&P Capital IQ

CONTENTS

The Allstate Corporation NYSE:ALL

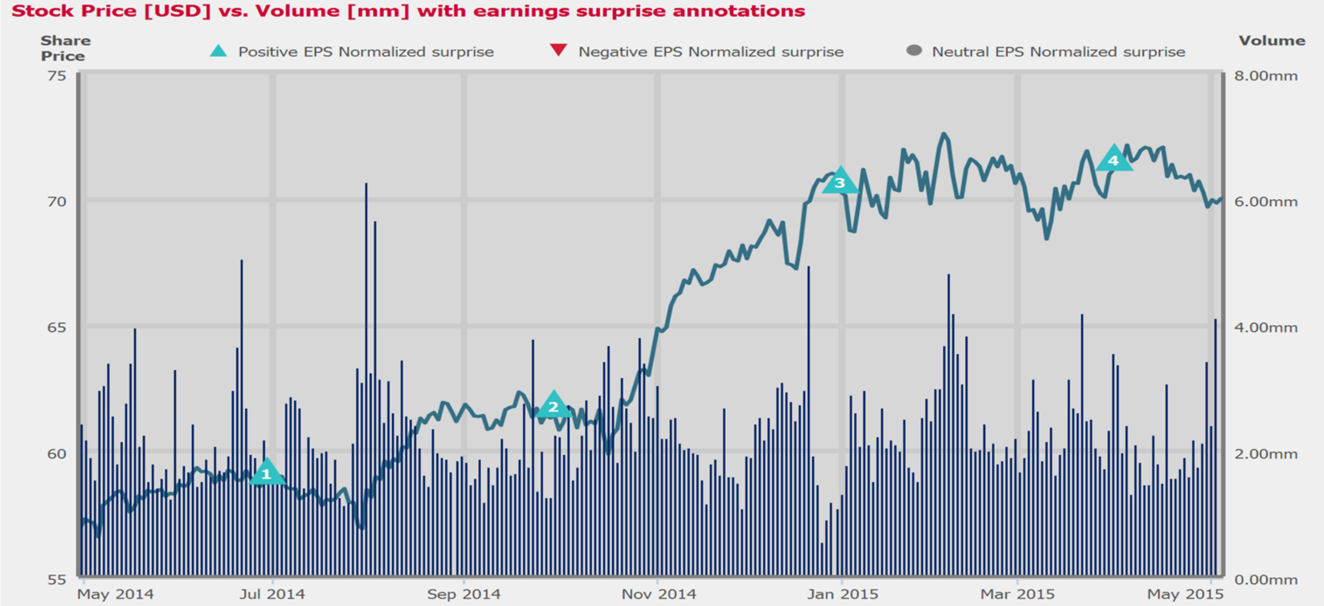
FQ2 2015 Earnings Call Transcripts

Tuesday, August 04, 2015 1:00 PM GMT

S&P Capital IQ Estimates

	-FQ2 2015-			-FQ3 2015-	-FY 2015-	-FY 2016-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	1.02	0.63	(38.24 %)	1.20	4.99	5.96
Revenue (mm)	7554.67	7549.00	(0.08 %)	7632.75	30616.29	31840.30

Currency: USD
Consensus as of Aug-04-2015 12:29 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ2 2014	0.68	1.01	1 48.53 %
FQ3 2014	1.32	1.39	2 5.30 %
FQ4 2014	1.68	1.72	3 2.38 %
FQ1 2015	1.42	1.46	4 2.82 %

Call Participants

EXECUTIVES

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Former Chief Investment Officer of Allstate Insurance Co. and EVP of Allstate Insurance Co.

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Presentation

Operator

Good day, ladies and gentlemen, and welcome to the Allstate Second Quarter 2015 Earnings Conference Call. [Operator Instructions] As a reminder, today's program is being recorded. I would now like to introduce your host for today's program, Pat Macellaro, Vice President of Investor Relations. Please go ahead.

Patrick Macellaro

Thanks, Jonathan. Good morning, and welcome, everyone, to Allstate Second Quarter 2015 Earnings Conference Call. After prepared remarks by Tom Wilson, Matt Winter, Steven Shebik and myself, we'll have a question-and-answer session.

Yesterday afternoon, we issued our news release, filed our 10-Q for the second quarter and posted the results presentation we'll use this morning, along with an update to our 2015 countrywide reinsurance program to reflect the placement of our Florida program. We also posted our second quarter 2015 investor supplement. We strive to provide transparency into our results and trends and to continuously get better. So to that end, you'll find a number of expanded disclosures in the investor supplement this quarter. For example, we now provide Allstate brand auto paid frequency in addition to the gross frequency statistics since paid frequency is more commonly disclosed and used in industry data reports.

The investors supplemental, along with the other documents I mentioned earlier, is available on our website at allstateinvestors.com. Our discussion today will contain forward-looking statements regarding Allstate's operations. Allstate's results may differ materially from these statements, so please refer to our 10-K for 2014, slides and our most recent news release for information on potential risks.

Also, this discussion will contain some non-GAAP measures, which they are reconciliations in our news release and in our investor supplement.

We're recording this call and a replay will be available following its conclusion, and I'll be available to answer any follow-up questions you may have after the call. And now I'll turn it over to Tom.

Thomas J. Wilson
Chairman & CEO

Good morning. Thank you for investing your time to keep current on all Allstate. I'll begin with an overview and then Pat, Matt and Steve will go through the results in detail. Also here with us are Don Civgin, the President of Emerging Businesses; Kathy Mabe, who leads our Business to Business Operations; Judy Greffin, our Chief Investment Officer; and Sam Pilch, our Corporate Controller.

If you turn to Slide 2, you can see the financial performance for second quarter 2015. The primary story for the quarter is that our proactive approach to running the business has accelerated the focus on quickly adapting to an increased auto insurance combined ratio. In addition, we continue to benefit from the repositioning in the homeowners business, make investment decisions that balance risk and return and invest in long-term growth. Net income of $326 million for the quarter and $974 million for the first 6 months of 2015, as you can see from the table on the bottom of the slide.

Operating profit was $262 million or $0.63 per share for the quarter, which brings the total for the first 6 months $878 million or $2.10 per share.

Second quarter profit was lower than the prior year driven by a deterioration in insurance margins, which was partially offset by strength in homeowners margin. Investment income in Allstate Financial income were slightly lower than the prior year quarter as expected. Auto insurance margins decreased as higher claim frequency and severity more than offset average auto insurance price increases.

The increase in auto frequency is broad-based across states, risk class, rating plans, and tenure of customer. And while the recent growth in Allstate brand auto policies did increase frequency since, of course, new business typically has higher relative frequency, this was not the primary driver of a higher combined ratio. Consequently, we believe this is primarily externally-driven and supports fast response to loss cost trends.

Now I know many of you have questions about if and how this will show up in competitors' results. We'll explain what our analysis shows, but as you know, each competitor has its own unique position. What is important to emphasize is that we've taken action, and we'll continue to take action to improve profits based on our data. If and when competitors react to their results, it does not change our commitment to profitable growth.

We're executing a comprehensive profit improvement plan for all 3 underwriting brands. It includes raising prices, tightening underwriting standards and lowering expenses. Matt will cover this in a few minutes.

The homeowners business continues to generate excellent underlying profitability and growth is accelerating. As a result of the auto profit actions and the strength of the homeowners business, we are not changing the goal of achieving an underlying combined ratio of 89 or less for the full year.

Progress was made on the other 4 operating priorities as well. Policies in force continue to grow in auto home and other property-casualty lines for both Allstate and Esurance brand. Encompass policies in force declined.

A combination of unit growth and price increases led to a $345 million increase in Property-Liability premiums earned for the quarter to $7.5 billion, which is a growth rate of 4.8% than the prior year quarter, which you can see on the table on the bottom. Operating income return on equity was 11.9% for the latest 12 months. We also continue to provide excellent cash returns on our common shareholders with total cash returns through dividends and share repurchases in the past 12 months of $3.1 billion.

The 5 2015 operating priorities are shown on the top of Slide 3, and the results for each brand and customer segment are shown below. At the bottom left, is the Allstate brand, which represents 90% of premiums. Our strategy here is to the increase the local advice provided by Allstate agencies, while profitably expanding the household relationships. We're making a good progress on implementing this plan and believe we can execute it while adapting to the broad-based increase in auto frequency.

Policy in force growth was 2.7% in total, auto policies continue to increase at slightly above 3%, homeowners growth accelerated to 1.2% and other personal lines grew by 2.9%, you can see that in the table on the lower left. Net written premium growth was 4.4%, is the largest driver which was a 4.9% increase in auto insurance premiums.

The combined ratio was 98.7 for the quarter, 101.4 auto combined ratio offset attractive results for homeowners and other personal lines. Homeowners insurance had a combined ratio of 92.3, despite $528 million of catastrophe losses in the second quarter. The underlying combined ratio for the Allstate brand was 87.7 for the quarter.

Moving to the second largest segment, Esurance in the lower right. Growth in policies in force has come down from the prior year to 6.4%, as we've tightened underwriting standards, reduced discounts, raised auto prices and reduced advertising expenses.

These actions were necessary to ensure that the doubling of the size of the business had appropriate pricing, particularly for preferred auto customers. Average auto prices increased by about 2%, which brought net written premium growth to 9.1%. The combined ratio declined by 2.1 to 110.2, reflecting a reduction in expenses.

Esurance also made good progress in expanding at the homeowners insurance and are now offering the product in 19 states. This will enable us to both better serve customers, while lowering acquisition cost per policy.

Encompass in the upper left competes in the independent agency channel which serves customers who want local advice but are brand neutral. As expected, policies in force have declined by 2.8% and in this price-sensitive channel, as we implemented a wide variety of profit improvement actions.

The profit improvement actions were initiated in response to our performance in the market before the upturn in auto frequency in the third quarter of 2014.

Average auto premium was 4.2% higher than the prior year quarter, which mitigated the impact of fewer policies in force. So the net written premiums declined by less than 1%. The combined ratio of 115.7 is lower than last year, but it's still too high at an underlying level of 96.5.

Answer Financial aggregated model has premium growth of 16% versus the prior-year quarter. Now across all brands, we continue to invest in 2 longer-term operating priorities. Modernize the operating model and build long-term growth platforms. The operating model is being modernized with the retirement of legacy technology platforms and expansion of continuous improvement practices. New growth platforms such as Drivewise and DriveSense, our 2 telematics offerings, are expanding, and between them now have 881,000 customers.

Now let me turn it back to Pat to go through our Property-Liability results.

Patrick Macellaro

Thanks, Tom. I'll start by taking a look at the Property-Liability P&L on Slide 4. Starting with the chart on the top of the slide, Property-Liability had net written premium of $7.9 billion in the second quarter of 2015, 4.4% higher than the second quarter of 2014. For the first 6 months of 2015, net written premium grew by 4.6% while protection policies in force grew by 2.6%.

Catastrophe losses of $797 million in the second quarter of 2015 were 14.9% lower than the prior-year quarter, but the impact was more than offset by deterioration in the underlying combined ratio resulting in a recorded combined ratio of 100.1 and a small underwriting loss for the quarter. Recorded combining ratio for the first 6 months of the year was 96.9, which was 0.8 worse than the first 6 months of 2014.

The underlying combined ratio for the second quarter and first 6 months of 2015 was 89.1, elevated over the levels we experienced in 2014. Net investment income of $292 million for the Property-Liability segment decreased 16.8% from the second quarter of 2014, due primarily to lower but still strong limited partnership returns in the quarter. As a result, Property-Liability operating income of $198 million in the second quarter of 2015 was significantly below the prior-year result, while the $753 million of operating income through the first 6 months of 2015 was 9.5% below the first 6 months of 2014.

The chart on upper right is to help orient you to the respective earned premium contribution of our 3 underwriting brands have for both auto and homeowners insurance.

Bottom of the slide contains growth trend information as well as a view of Property-Liability recorded and underlying combined ratio trends.

Protection premium and policy growth trends are in the chart on the bottom left. Red line represents policies in force growth and shows the continued positive policy growth trend that's being driven by the Allstate brand. Policies in force grew by 881,000 or 2.6% from the second quarter of 2014.

Net written premium represented by the blue line grew $330 million or 4.4% in the second quarter of 2015 compared with the same period last year, reflecting the combination of policy and average premium increases.

Exhibit on the bottom right displays the Property-Liability recorded and underlying combined ratios for the second quarter of 2015 along with some history. Both the recorded combined ratio of 100.1 and the underlying combined ratio of 89.1 were impacted by higher auto losses in the second quarter versus the prior year quarter.

Slide 5 highlights margin trends for Allstate brand auto and Allstate brand homeowners. Chart on the top left of the slide provides a historical view of quarterly recorded and underlying margin performance for Allstate brand auto. Echoing Tom's comments on auto profitability, you can see that the Allstate brand auto recorded combined ratio for the second quarter of 2015 deteriorated by 6 points compared to the quarter a year ago. The underlying combined ratio was 97.8 in the second quarter, also 6 points higher than the prior year quarter.

The chart on the right highlights the trends driving the deterioration in the underlying combined ratio. Annualized average earned premium per policy shown by the blue line continue to increase over the prior year in the second quarter, but at a slower rate than average underlying losses and expenses per policy, which is shown in red. Average underlying losses and expenses per policy increased 8.6% in the second quarter compared with the second quarter of 2014. While you can see the second quarter of last year was relatively low, the increase in the results in the second quarter of 2015 was not entirely driven by a low base. Now Matt will provide some color on what's driving these trends.

Similar information is shown for Allstate brand homeowners on the bottom of the slide. On the bottom left, you can see the impact of seasonally high catastrophes on the homeowners recorded combined ratio, which was 92.3 in the second quarter of 2015. The underlying combined ratio of 60.7 in the second quarter of 2015 was half a point higher than the prior year quarter, both well within its expected range. On a trailing 12-month basis, the underlying homeowners combined ratio was a strong 61.6.

Trends that drove the second quarter underlying combined ratio on homeowners are in the chart on the bottom right. As you can see, average earned premium per policy continued to increase over the prior year quarter, although at a slower rate than in the past given the achievement of target returns and the subsequent transition to more inflationary rate activity in this line of business. Underlying losses per policy increased 2.7% in the second quarter of 2015 compared to the second quarter of 2014. Allstate brand homeowners frequency was essentially flat to the prior year quarter, and paid severity increased within our expected range.

Now I'll turn it over to Matt to provide some further context on our auto results.

Matthew E. Winter
President and President of Allstate Insurance Company

Thanks, Pat. I'll start on Slide 6 by providing some context, what is driving our auto results, how we are thinking through the trends, and most importantly, how we are responding to them.

Last quarter, we said that increases in our auto claim frequency trends were evident broadly across geographies, risk classes and customer tenure. We noted that the trend appeared to be driven primarily by external factors. Most notably by the increase in miles driven and to a lesser extent, adverse weather in certain parts of the country.

What we've observed in the second quarter confirmed that. As you saw in our results, our bodily injury and property-damaged claim frequency trends were both significantly elevated compared to the second quarter of 2014.

As we have noted, frequency can be very volatile on a quarterly basis, and so year-over-year comparisons are difficult.

Some of the increase we've observed this past quarter was driven by the exceptionally strong performance last year.

But our absolute levels of frequency in the second quarter were at the high end of their 5-year expected range and were generally consistent with the elevated levels we experienced in the first quarter.

The largest difference in the second quarter was that there was not a material impact to auto claim frequency from whether. As a matter of fact, the northeast part of the country, which bore the brunt of the winter weather earlier this year, performed better than other parts of the country in the second quarter.

We continue to retest our hypothesis around the primary drivers of frequency and our analysis continues to support the conclusion that these trends are principally driven by external factors.

Miles driven and Allstate's auto claim frequency have historically been very tightly correlated with one another, particularly over shorter periods of time, as you can see from the chart on this slide.

While miles driven isn't the sole driver of our increased loss trends, it does explain a significant amount of the result.

And as you can see, miles driven have continued to increase rapidly over prior year as the year has progressed. The slope of the 3 lines is very consistent over the past few quarters.

With 3 additional months of elevated frequency trends, we continue to look for different ways to validate or disprove our preliminary conclusions. One of the more meaningful insights we were able to produce came from an additional analysis we conducted, looking at the loss experience of some of our most tenured customers, a block of business with a history of stable profitability. Many of these customers were written in underwriting companies that are not currently writing new risks and were written with a variety of rating plans.

What we found for the second quarter is that this group of customers also experienced significant increases in accident frequency, not dissimilar to the overall book of business. This reinforced our conclusion that the increases we're experiencing in auto claim frequency are primarily being driven by external factors that impact our auto book broadly. Frequency also tends to bounce around a bit. So quarterly trends and comparisons can be a bit volatile. When you look at PD and BI frequency over a 2-year period and compare the second quarter of 2015 with the same period in 2013, the annual increase is about 2%.

As you know, new business normally runs with a higher frequency level than renewable customers. We often refer to this as a new business penalty.

With that in mind, we want you to quantify this impact in our auto book, particularly, in light of the positive growth trends we've experienced over the past couple of years.

So we analyzed how the volume of new auto business we've written in the past 2 years has impacted our results. And our analysis indicated that the new business growth rate is having between half a point and a point impact on the auto loss ratio.

This impact was expected and manageable. It is, however, a contributing factor to the higher frequency we are seeing. We continue to monitor new to renewal trends across our 15 local market operating committees in the U.S. and Canada. So that's what we're experiencing.

Let's turn to slide 7 and I'll provide some insight into how we are adjusting to these trends.

My comments are going to be about Allstate brand auto, which is almost 90% of the auto business. Nevertheless, the actions we're taking in the Allstate brand are consistent with the actions taken by the teams in Esurance and Encompass.

We have a multifaceted plan underway to improve auto margins. First, we are broadly increasing rates to catch up and then keep pace with increased loss cost. Allstate brand auto approved rate increases in the second quarter were worth 1.5% of written premium, which is almost 4x the amount of rate increases that were approved in the first quarter.

We know this is number you are interested in and know that you turn to different sources to attempt to get a sense for what we and others are doing between quarters.

Unfortunately, it seems that there is a lot of inconsistency in how those sources identify and report on these rate increases. So I would encourage you to reach out to Pat if you have any questions on these.

In conjunction with our broad rate increases, we are also engaged in very targeted and segmented rate actions and the underwriting changes wherever we identify specific underperforming segments of business. Those rate actions and underwriting changes are taken in conjunction with our ongoing correct classification programs to ensure we are adequately matching price and risk.

We've also looked at our internal operations and are taking extensive proven actions across the company, including reductions in advertising, technology, professional services and employee-related costs. So that's our action plan to address the frequency pressure we have seen.

Let me talk for a minute now about severity. There were several trends we are watching that might influence severity in addition to normal inflationary pressures. Many of these trends are related to increasing vehicles complexity. First, there is an increase in newer cars on the road with expensive electronic components. Secondly, this growth in the average number of parts replaced per claim. And third, we have seen an increase in more labor hours per claim.

Additionally, the largest increase in miles driven has been on interstate roads, where accidents obviously occur at higher speeds.

So while most of our discussion today has been around increasing frequency, we are also concerned about and reacting to what we believe could be some additional pressure on loss severity. As a result, we will continue to focus on operational excellence in our claims operation to ensure maximum efficiency, rapid cycle time and the proactive management of loss cost.

Let's turn to Slide 8, and I'll help you understand what you should expect from all of these actions.

The chart on this slide gives you an idea of how much earned premium we would generate through 2016 if filed and approved rate increases had ceased on June 30, which, by the way, they did not. 2015 Allstate brand auto rate increase approved through June 30 will generate written premium of approximately $323 million. The rate at which this premium will be earned by months is shown by the gray bars on the chart. As a reminder, Allstate brand auto policies have 6-month terms, so they take on average a little over 12 months to fully earn in a rate increase.

Approximately $155 million of the rates approved through June 30 will be earned in the second half of 2015.

In addition, we continue to earn in premium from rates approved in 2014, which is shown by the blue bars in the chart. The total we expect to earn in calender year 2015 from rates approved last year is $243 million.

These actions in total will likely result in slower auto policy growth in the Allstate brand. We have already seen the impact of profitability actions on the auto policy growth rates in Esurance and Encompass.

So to summarize. Our action plans are based on a great deal of detailed analysis of both internal and external data surrounding the recent loss pressure we are experiencing. We will continue to refine our analysis and our understanding of the drivers of these frequency trends. Most importantly, however, is that while we continue to do this analysis, we are already taking swift and decisive action to address these trends and bring our auto profitability back to targeted levels. And now I'll turn it over to Steve, who will cover Allstate Financial investments and capital management.

Steven E. Shebik
CFO & Executive VP

Thanks, Matt. Slide 9 provides an overview of Allstate Financial's results. We have strategically repositioned Allstate Financial to become more integrated with the Allstate brand customer value proposition. Allstate Financial's results for the second quarter are highlighted on the left-hand side of the slide. Premiums and contract charges increased 3.5% when compared to second quarter 2014, as Allstate agencies have become more engaged in selling life and retirement products. Operating income for the second quarter was $139 million, 15.8% lower than the second quarter of 2014. This reduction in operating income was driven primarily by lower limited partnership income and higher life mortality than in the prior year second quarter.

As we did with the Property-Liability portfolio in prior periods, reducing the risk of rising interest rates in the Allstate Financial investment portfolio by selling longer-term fixed-income securities and investing the proceeds in shorter duration, fixed income and equity securities.

The chart on the right provides a view of the Allstate Financial fixed income portfolio by scheduled maturity date of June 30, 2015, and the 2 preceding year ends.

While reducing our interest rate risks and repositioning the portfolio maturity profile generates net realized capital gain, investment and operating income will reduce prospectively by the lower yield on the reinvested proceeds.

Moving to investments on the chart at the top of Slide 10. Following a strong first quarter, our portfolio total return will be negative 0.6% in the second quarter. The income yield has been stable while our valuations were reduced by higher interest rates and wider credit spreads in the quarter.

The bottom of the slide provides investment income and portfolio yield for the Property-Liability at Allstate Financial portfolios and illustrates the consistent earnings profile of the interest-bearing portfolio and the variability of our equity investments.

The Property-Liability yield reflects prior duration shortening and ongoing investments in low interest rate environment. The Allstate Financial yield is higher and has been more stable than the Property-Liability segment due to its longer duration and use of its cash flows largely to fund annuity reductions.

Slide 11 shows our capital position is strong with excellent cash returns to our shareholders in the quarter. Our deployable holding company assets totaled $3.4 billion at June 30, 2015.

During the quarter, we returned $642 million in cash to common shareholders through the combination of common dividends and common repurchases.

We repurchased 7.6 million common shares for $570 million in the open market and under the accelerated share repurchase agreement that settled on May 8, 2015. As of June 30, we had $1.9 billion remaining on our current repurchase authorization, which is expected to be completed by July 2016.
Now let's open up the call for your questions.

Question and Answer

Operator

[Operator Instructions] Our first question comes from the line of Jay Gelb from Barclays.

Jay H. Gelb
Barclays PLC, Research Division

Clearly, I think the main topic of the call beyond on auto insurance and how those margins can be improved. You outlined on Slide 8 the impact of the rate increases beginning to materialize in the third quarter, but I think there are some concern around how fast, overall, the margins can improve either from the combination of rate increases and also adjusting expenses. So perhaps you can give us a bit more clarity and outlook on that.

Thomas J. Wilson
Chairman & CEO

Jay, I'll start and then Matt can join in. First, we think this is very doable that we can get margins back to where they were. Obviously, you can do your own estimate of -- we try to provide some measure of how much dollars will come through the P&L on that slide that Matt showed. But also, you can look and know that we do disclose that we're increasing our price increases from where we've been so far this year. So you can factor that in. As it relates to expenses, I would say, what we're doing is tightening our belt, but we continue to invest in the future. So you will remember in 2011, when we had issues in homeowner profitability, we continued to invest in long-term stuff like advertising and continued to increase our expenses. Same thing is true this year. We're cutting some expenses, but we're continuing to invest heavily, for example, in things like Drivewise and DriveSense, which is the future for us. Matt can talk about both his prospects for rate increases and expense reductions.

Matthew E. Winter
President and President of Allstate Insurance Company

Sure. Thanks for the question, Jay. You mentioned rate increases and expense reductions, I'd also remind you that we consider the underwriting actions and correct class programs and things like that. A third lever that we're engaging in this effort, because we are, in fact, tightening some of our underwriting parameters, providing some increased focus on correct class programs and we'll continue to use underwriting in conjunction with that. On the expenses, I'd point you to Page 59 of the Q. We are clear there that the targeted expense reductions will represent approximately 0.4 on the annualized Allstate brand expense ratio. So you can factor that into your calculations as well. As Tom said, we are accelerating to the extent possible our rate taking. And so far, we've been quite successful with the states. We're not getting a great deal of pushback. Our acceptance and approval level is high. We are doing it on a micro-segmented basis. As I mentioned in my prepared remarks, we're attempting not to just take broad rate increases, but to focus them on the specific segments, where we're having underperformance or loss pressure. And so we feel good about our prospects for aggressively pursuing that. Obviously, on the slide I showed, on earning in the rate, I have to stop at the end of the second quarter, but you have to hypothetically add on to that what we might be able to take over the rest of this year and into next year. And it will compound and we feel comfortable that we will get back to auto -- to an appropriate targeted level of auto profitability as quickly as possible.

Jay H. Gelb
Barclays PLC, Research Division

Tom, with regard to the 87 to 89 underlying combined ratio target, given where we are in the first half, are you to essentially signaling you'll do whatever it takes to get it under 89?

Thomas J. Wilson
Chairman & CEO

We made a commitment because we believe we can get there. Yes, Jay.

Jay H. Gelb
Barclays PLC, Research Division

Okay. Can you give us any sense of what you're seeing in terms of auto profitability trends in July?

Thomas J. Wilson
Chairman & CEO

No. We -- given we just closed, no.

Operator

Your next question comes from the line of Ryan Tunis from Crédit Suisse.

Ryan James Tunis
Crédit Suisse AG, Research Division

I guess the first question is just on the 1.5% of rate that you've gotten on the book. Can we expect that number to be at least 1.5% for the remaining quarters of the year?

Thomas J. Wilson
Chairman & CEO

The 1.25%? I'm not...

Ryan James Tunis
Crédit Suisse AG, Research Division

For the Allstate brand auto, the rate increases as a percentage of the starting book.

Thomas J. Wilson
Chairman & CEO

Well, the rate increases -- it's 1.25, that's throwing me for a little bit. So it's a 1.5% for the quarter. And what we've indicated is, we would expect it to go up as we move throughout the rest of this year, up from the 1.5%.

Ryan James Tunis
Crédit Suisse AG, Research Division

Okay. That's helpful. And then just back to Matt, I guess, on the expense ratio reduction in Allstate brand, the 0.4 points, that's net of the investments you talked about. So we should think about the expense ratio getting 0.4 points better, correct?

Matthew E. Winter
President and President of Allstate Insurance Company

Yes.

Ryan James Tunis
Crédit Suisse AG, Research Division

Okay. And then I guess my last question is, just on I'm thinking about trend versus the location specific rate increases, I guess location-specific was 3.6%, which actually was a modest deceleration from the previous quarter. I'm just hearing you talk about view of frequency at sort of 2% and severity picking up. I guess I'm just wondering why the location-specific rate increases aren't greater than 3.6%?

Matthew E. Winter
President and President of Allstate Insurance Company

Yes. Ryan, the state specific is influenced heavily by mix, and that's not really a representative number to look at.

Thomas J. Wilson
Chairman & CEO

And as it relates to severity, I think Matt's point there was, we have of broad-based approach to making sure we're going to come in where we want to come in. And he's just referring to there's no stone unturned.

Operator

Your next question comes from the line of Kai Pan from Morgan Stanley.

Kai Pan
Morgan Stanley, Research Division

So just follow up on that. If you look at your frequency, up more than 6 points and severity like anywhere between 1 to 4 points. Add these together, you're close to a high single digits, so-called loss cost trend increase. So is that pricing increase you instituted right now enough to catch up for those? And do you expect these loss cost trends to continue at these levels that you would need more pricing increases to basically to improve your underwriting results?

Thomas J. Wilson
Chairman & CEO

Okay. Kai, let me just set the bar. So as Matt mentioned, it is up and your numbers are absolutely correct as it relates to second quarter. On one of the slides in the presentation, you can see that dip down in cost in Q2 of 2014. And what Matt has said is, of course, some of the up is -- that 6.9% is because of that down. But it's also just up higher than we would wanted. So we're doing everything we think we need to do to adjust that. Let me maybe make a -- so underneath that, perhaps it may be a question about did we react quickly enough. And I think Matt's team has reacted incredibly quickly and the system is fully aligned on improving profitability, just to provide some detail to that. When you look at total cost, that's the losses both expenses, which combined both to frequency and severity, as you point out. And you compare it to rate of increases, we're taking pricing, that is an appropriate analysis. If you look at 2014, the first quarter was up a lot because we had bad winter weather. Then it was about the same, as the price increases, the costs, were kind of moving along. So about 3 quarters of the way through 2014, everything looks fine. The fourth quarter, of course, as you know, went up and it exceeded our price increases. And then in the first quarter, they came down a little bit, but were still pretty high. So it was really towards the back end of last year and beginning this year that Matt's team began to accelerate price increases. As we saw things develop in April and May, they accelerated that. It increased their activity around profit improvement, which is the plan that Matt just took you through. So I think the system is working as planned. It is highly focused on making sure we earn an appropriate return and reacting quickly.

Kai Pan
Morgan Stanley, Research Division

Okay. Just a follow on to that. You mentioned about it, rising pricing could likely impact on your PIF growth. Just wondering, will that be a sort of lagging effect on the PIF growth and do you still expect for the full year we'll see some like positive growth in the auto PIF?

Thomas J. Wilson
Chairman & CEO

I'll let Matt comment in specific where he is working, but let me maybe set some historical context. So our unit growth in auto is over 3%, which is hard to tell whether you're picking up unit share, but it feels like we're picking up unit market share there. Homeowners, of course, accelerating at 1.2% and the other lines are increasing about 3% as well. The -- this is -- Matt mentioned this will have some impact on that auto growth line. But this is different than the results we're seeing in Encompass, where we're seeing a decline in PIF. And it's different than the reaction we had when we worked aggressively to adapt to other external conditions called homeowners and severe weather in 2009. So we do mention in the press release that we expect overall items in force to increase. Matt can talk specifically about the impact on growth, competition, what he's seeing even today as it relates to close rates.

Matthew E. Winter
President and President of Allstate Insurance Company

Yes. Thank you for the question. First of all, it's important to distinguish between impacting growth rate and impacting growth. So what we said was, we expect the rate of growth to dampen a bit as these profitability actions take effect. We have had 8 consecutive quarters of year-over-year growth in the auto business. We have been consistently improving that growth rate during all of that period. Retention has remained at fairly historic highs. New business has been exceptionally strong. And my only point in saying that the growth rate might decline is, we do think that at some point, taking all these rate and underwriting actions will dampen our ability to continue accelerating. That is not to say we expect not to grow. We will grow. And we've said multiple times, we intend to continue to add items in here. We just don't believe that we'll continue on the same trend line that we've been on.

Kai Pan
Morgan Stanley, Research Division

Great. Lastly, if I may, on capital management. Just this frequency issue with the delays on your capital management, how do you balance that? Because your operating earnings apparently is like down a little bit year-over-year. You still expect this current pace of buybacks or you'll take them back a little bit just to see how does it play out and how they balance also, of course, with your share price?

Thomas J. Wilson
Chairman & CEO

It has no impact on our capital plans.

Operator

Our next question comes from the line of Josh Shanker from Deutsche Bank.

Joshua David Shanker
Deutsche Bank AG, Research Division

So 2 questions. First one, if you can talk about the methodology behind paid severity versus incurred severity. And what are we seeing and how do those 2 things differ compared to what you publicly tell The Street?

Thomas J. Wilson
Chairman & CEO

Listen, we're struggling with what the question is, because between...

Joshua David Shanker
Deutsche Bank AG, Research Division

So in terms of your disclosures, when did you know -- is this representing paid loss here? Are these incurred losses? And trying to understand, when we see -- what are the chances that Allstate is being proactive in seeing a trend ahead of everybody else versus that Allstate is being reactive here?

Thomas J. Wilson
Chairman & CEO

Okay. Let me make a general comment and then Steve can fill in here. So of course, paid is just what we paid out and we don't report incurred. But when we do our reserving, we do it on a absolute claim reported basis. So we look at how many claims are reported and then we estimate what we think the incurred severity will be. We do that in a number of ways. We look at what's been paid out on claims. We look at field reserves. We adjust those field reserves for the fact that they develop upwards over time. And then we have, of course, claims that have been incurred but not reported. So as opposed to some people set their reserves based on a targeted loss ratio. So they'll say -- start the year off and say we're going to write $1,000 worth of business, we think the loss ratio will be 70. So they book $700 worth of losses. That's not the way we do it. I can't speak to whether that is how other people do their reserving. I'm sure they're accurate and highly focused on it as well. There's lot of actuarial science and lots of review that goes on for anybody that reports this stuff. So I can only tell you what we do, which is -- and so the reason we report paid is that it's a good clean number and its easy for people to understand. Incurred, of course, changes. Steve, I don't know if you want to add anything?

Steven E. Shebik
CFO & Executive VP

Yes. Really -- simply, our incurred, as Tom noted, is the accidents that we're aware that have happened. The paid is what we pay. So there's a lag, obviously, in that, but we do our reserving on a very real-time basis. And so that's how it runs to our financial statements and our paid just really catches up over time and you can see that in terms of the trends we have between those 2 lines.

Thomas J. Wilson
Chairman & CEO

And a couple of reasons that would do that. First, it gets into pricing fast when we do it that way. And secondly, as you look at pay though, you should also note, it bounces around a little bit as we change claim practices. So we're currently -- we've changed some of the claim practices on major medical expenses. And that's accelerate some of the payments of bigger claims. But we adjust for that when we estimate what we think the actual losses are for the quarter on which we report.

Joshua David Shanker
Deutsche Bank AG, Research Division

I realize that you don't disclose the incurred frequency number, but given the move in the quarterly combined ratio, is frequent -- is incurred frequency running ahead of paid frequency or are they the same or you just have no comment on that matter?

Thomas J. Wilson
Chairman & CEO

We base our profitability based on the number of claims that have been reported and adjusted for those that we think have not been reported. So the -- it's actually live what happens. So when we're closing July right now we know exactly how many claims we had in July and that's what runs through the P&L.

Joshua David Shanker
Deutsche Bank AG, Research Division

Okay. And then another question and I'll get off this topic. I'm sure someone else will pick it up. At 5 years ago, we said, let's just start over at Encompass. Because its not working and we need to take major actions. We have here 5 years later. Should I be thinking, even though I can't see it, Encompass is a better business than it was 5 years?

Thomas J. Wilson
Chairman & CEO

Yes, it's a good question, and one we work -- we talk a lot about. Let me maybe set the really long term context, and then talk about where we are today. Kathy can give you some specifics about the profit improvement programs. So first, we actually bought Esurance -- or Encompass in 1999. At the time, it had a combined ratio of a 117. We took it down into the low 90s, and -- which was a good thing because it obviously generated a lot of profit for us. But even better news was we didn't pay much for it. So generated a good return on our capital. And so it's -- even today, with its results, it looks like an acceptable return on capital. That said, this has been a difficult channel for us to maintain consistent profitability. In part, there's intense competition, of course, at the point of customer interaction and the customers tend to be highly price sensitive. We should be able to leverage both our auto and homeowners insurance expertise to compete effectively. That said, our current results aren't where we'd like them. So we have to continue to develop our capabilities to compete, as you point out, on a long-term basis. Kathy can talk about the things we're doing, specifically today, to get that combined ratio down both on a reported basis and underlying basis.

Katherine A. Mabe
Executive Vice President of Brand Distribution

Okay. Thank you, Tom. Well, as you know, in Encompass, we're focused on the mass affluent, and we're focused on -- strategically, on building core strength around pricing underwriting business, claims excellence and really good distribution management. And with regard to the profitability challenges we have -- we're experiencing and continue to experience in Encompass, we're using a three-pronged approach. So we're looking at the same things that Matt talked about, rate increases, underwriting actions and expense reductions. And you can see how we're leaning into rate. If you take a look at Page 14 of the investor supplement, you can see almost 10 points of rate that we are planning to take or have taken on the auto line, and it's broad-based. Its across 29 states, so 85% of the book is getting a significant rate increase in the auto line. And homeowners were also taking rates as well. And you can see that on Page 14 of the investor supplement. And you can see, its even more aggressive in location-specific rates. And we have a couple of really outlier states in terms of problematic performance where we're taking really strong action. And that's impacting that PIF number, that negative PIF number significantly. From an underwriting perspective, we're focused on agency level actions related to profit, correct class, that Matt talked about. Things like insurance to value, some of the things that we need to really strengthen to compete in this channel. And then across the country, we've strengthened our inspection standards on homeowners and looked at some of our payment practices around late pays and reinstates. From an expense perspective, you can see on Page 59 in the Q that we're down 6/10 in the quarter and 8/10 on a year-to-date basis. And that's from managing our technology expenses, our people expenses and our distribution cost. We've reduced commissions in our monoline auto line of business because, as you know, in this -- in Encompass, we're focused on package policy growth. Your question is a good one and it's a journey that we've been on for a while in Encompass. We're working aggressively across all those fronts. The strategy around mass affluent, strong disciplined pricing, excellence in claims and really skillful distribution management to reposition Encompass for long-term profitable growth.

Operator

Our next question comes from the line of Sarah DeWitt from JPMorgan.

Sarah Elizabeth DeWitt
JP Morgan Chase & Co, Research Division

On the Allstate brands auto underlying combined ratio of about 98%, how should we think about the trajectory of that going forward? Is it going to get worse before it gets better? Or are the rate actions you've taken so far enough to start to see an inflection point in that soon?

Thomas J. Wilson
Chairman & CEO

Sarah, we're not -- if you look -- you have to do your own estimate. But I think we would expect that if we're going to be at 89%, below 89%, we're obviously going to have to at least hold it because of where we are with -- we're at 89.1% for 6 months. So all the actions Matt talked about, the rate slide, all that shows it burning in. You can estimate -- you could calculate. That way, you would think it would be quarter like that. We think we've given enough information about the prices we've already had approved. You can factor in then at what prices you think we will try to get approved and when those roll in. And then you have the expense ratio number that Matt talked about. On top of that, you'll have to make an estimate of frequency and severity, obviously. And Matt gave some numbers as to what the longer-term trends are in frequency and severity. I would say, if you look at miles driven today, they're relatively high on a historical basis. And so frequency is up. Could frequency continue to go up? Of course, it could, which is why we always have a range and why we're adapting our pricing and not in profitability actions. So you have to just make your own estimate of that piece. But we're not giving a specific by quarter underlying combined ratio for auto insurance for the Allstate brand.

Sarah Elizabeth DeWitt
JP Morgan Chase & Co, Research Division

Okay. And does your guidance of 89% or better, does that contemplate the potential for deterioration in severity trends as well?

Thomas J. Wilson
Chairman & CEO

As you would expect, we've done all kinds of analysis around that. And we have a range of what the underlying combined ratio will be for this year, given that we're 6 months in and knowing what we know. But also knowing that there's a of things we don't know and can't predict. So there's a range around that, but we felt comfortable that we would be below 89% to stay committed to it.

Sarah Elizabeth DeWitt
JP Morgan Chase & Co, Research Division

Okay, great. And then if I can just get one more in. On the net investment income, how should we be thinking about the run rate there given some of the changes you made on the duration?

Thomas J. Wilson
Chairman & CEO

I'll let Judy talk about the specific net investment income, but I will point out just in terms of what we've done, right, so if you look at our investment position, we try to position the portfolios on the appropriate risk-adjusted return basis. We're not trying to be a hedge funded mark-to-market every quarter. We don't like the risk per unit of return than we make changes. And so the changes we started making 2 or 3 years ago was for higher interest rates. And so we shortened the duration on the Property-Liability portfolio. As we disclosed, we started to shorten that duration in the long-term payout annuity block in Allstate Financial and some of the capital accounts this year because we believe that the return per unit of risk per interest rate was not attractive to us. And then we began to shift into some idiosyncratic equity-like investments called performance-based, which generate higher long-term returns on a risk-adjusted basis but leads to more variability, as in Limited Partnership returns.

Judith Pepple Greffin
Former Chief Investment Officer of Allstate Insurance Co. and EVP of Allstate Insurance Co.

Sarah, thanks for the question. As Tom said, we're taking action in Allstate Financial to reduce our interest rate risk, to improve our expected return. As a result, you'll see some gains as well as some deterioration in net invested income. The -- as Tom also said, we're taking the actions in basically 2 places. In our long duration payout block and there, what we're looking to do, as Tom said, is reinvest primarily in equities. Initially, what you'll see is that we'll likely be in public equities. But over time, we're going to move it into more of that idiosyncratic risk that Tom just talked about. On the surplus side, we're shortening the duration and there, that surplus account is going to look more and more like a protection account that Tom just mentioned, where we shortened duration there and really kept it in fixed income for the most part, even though it's a balanced account. But that fixed income piece, so that surplus account is just going to be at a shorter duration. As Tom said, it's -- we look at the risk-adjusted return of interest rate risk and just don't feel that we're getting paid to be in the longer end of the curve.

Thomas J. Wilson
Chairman & CEO

I think the important thing to think about from a shareholder value creation is we believe in looking at long-term shareholder value creation. And so when we shorten the Property-Liability portfolio, we took a pretty significant hit to operating earnings per share, because we thought it was in our shareholders' best interest. You'll see, not as large, but also significant impact as it relates to Allstate Financial in the short term because we're harvesting gains and giving up operating income. But we believe that's in the right interest to shareholders and we don't run the place just on operating EPS on a quarterly basis.

Operator

Our next question comes from the line of Rob Glasspiegel of Janney.

Robert Ray Glasspiegel
Janney Montgomery Scott LLC, Research Division

Quick question on how we should think about -- on the first quarter call, you highlighted that you were seeing frequency kicking up and seeing the need to take decisive action. I was hoping to see that the PIF growth would slow. And in fact, the PIF accelerated against the tough comparison. Maybe you could talk to what the dynamics are that led to the acceleration. Is that something we should think is a good thing or a bad thing?

Matthew E. Winter
President and President of Allstate Insurance Company

Thanks for the question. We spent an awful lot of time and energy getting our agency force engaged, building up capacity, adding points of distribution, adding licensed SaaS professionals, entering markets where we had been geographically underpenetrated. And over time, that, along with some of the work we've done on the rating plans has improved quote -- close rates and quote rates and we have begun growing and the momentum has built on itself. And so while we have taken a bunch of rate actions and underwriting actions already, that growth momentum has been so strong and so systematic that it has still not shown up to dampen those growth rates. But as we said several times during the call, that has a limit. I don't know exactly when that's going to occur. A lot of it depends upon competitor actions as well and whether or not, competitors are taking rates as well or whether they're waiting this out. It will depend upon the mix in different areas and geographic concentrations of our competitors. So I think the growth is a good thing. Obviously, growth with targeted levels of profitability is our goal. And so right now I'm focused and the team is focused extensively on the profitability challenges to make sure we get that in line. And so that the growth yields shareholder value, long-term shareholder value in a long-term productive way.

Steven E. Shebik
CFO & Executive VP

Bob, let me share some analysis that Matt did as well, which gets to the question if your competitors have better pricing, where you're growing by being underpriced, which I think might be underlying your question there. And the data does not show that to be true. So he looked at one measure of competitiveness, of course, is your close rate and that's how many of your customers take the policy after they quote. A while price is not the only reason somebody would close, obviously, we think they close because we give them good local advice and have great service. But it is, obviously, very important. Those states where we have the highest close rate tend to have very low loss ratios, which would lead you to conclude, we're not underpriced as a way of driving that growth. If you look at the bigger states, they have lower close rates than some of the ones that have higher close rates, which are -- they're more competitive states. But the vast majority of those big states have loss ratios that are below our targets. So the conclusion then is we're winning through sophistication, not lower price.

Robert Ray Glasspiegel
Janney Montgomery Scott LLC, Research Division

Well, I have every conviction that you guys know how to do auto underwriting. The question is sort of what the timing is of getting to where you want to get to. And I think I'd have more conviction if you were shrinking rather than winning, doing -- due to your good franchise. So I appreciate the answer. Those were thoughtful responses. If I can have one other follow-up, your expense ratio cuts, you said, advertising. What other areas have you targeted as opportunities to cut expenses without getting to the bone?

Matthew E. Winter
President and President of Allstate Insurance Company

Yes. Bob, so it's advertising, technology, professional services and several employee-related costs. And that's what we've disclosed and that's the action that we're taking.

Thomas J. Wilson
Chairman & CEO

Bob, I think it's belt-tightening, not draconian.

Operator

Our final question comes from the line of Michael Nannizzi from Goldman Sachs.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Just I guess following up on Bob's question, if I could. When you guys had -- I'm not comparing magnitude, but like when the homeowners business went through a period of difficulty, and you guys pulled back from growth, I mean, it was no longer even on the table and you did what you needed to do to get the profitability of that book back where you wanted it to be and that was very successful. I guess my question is, what point do you take your foot off the pedal, the growth pedal, not just sort of partially and not just sort of tipping your hat to profitability, but entirely and sort of focus attention exclusively on getting the profitability back where you want it?

Matthew E. Winter
President and President of Allstate Insurance Company

It's Matt. Michael, let me make sure, because maybe I wasn't as clear as I should have been in my opening remarks. One of the bodies of work that we did was to go back and look at whether or not the loss ratio pressure and the frequency pressure was showing up in the growth areas and in the new business or whether or not it was showing up consistently across the books. And in fact, when we did that analysis, we saw those old blocks of historically profitable business, long-tenured customers unrelated to any of our recent growth, were experiencing significant frequency changes as well consistent with what the overall book is experiencing. So the pressure we're seeing is not specific to growth segments, it's not specific to growth geographies, it's not specific to anything related to growth. We're seeing it across the broad book. So slowing down growth. The only part that, that will impact is that what we refer to as the new business penalty, which is at differential with the normal new to renewal ratio. And as I said, we're monitoring that closely and we'll take appropriate action to ensure that we hit the targeted underlying combined ratio.

Thomas J. Wilson
Chairman & CEO

So let me just close. First, Allstate's operating philosophy is profitable growth. When you compete in an industry that has an overall return on capital below our targets, that means you have to have a guiding principle that profit is the biggest driver of shareholder value. Obviously, you have to be sophisticated and you have to react quickly, all of which we're doing. We've done this before, whether that's in homeowners or other businesses. We do -- are proactive in managing shareholder value on a long-term basis. So for example, in the investment portfolio, we're willing to give up operating earnings per share if we believe it creates long-term shareholder value. And we'll continue to operate with that philosophy of creating shareholder value. So we expect to continue to drive results, and we'll talk to you next quarter.

Operator
Thank you, ladies and gentlemen, for your participation in today's conference. This does conclude the program. You may now disconnect. Good day.