S&P Capital IQ

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Selective Insurance Group, Inc. NasdaqGS:SIGI

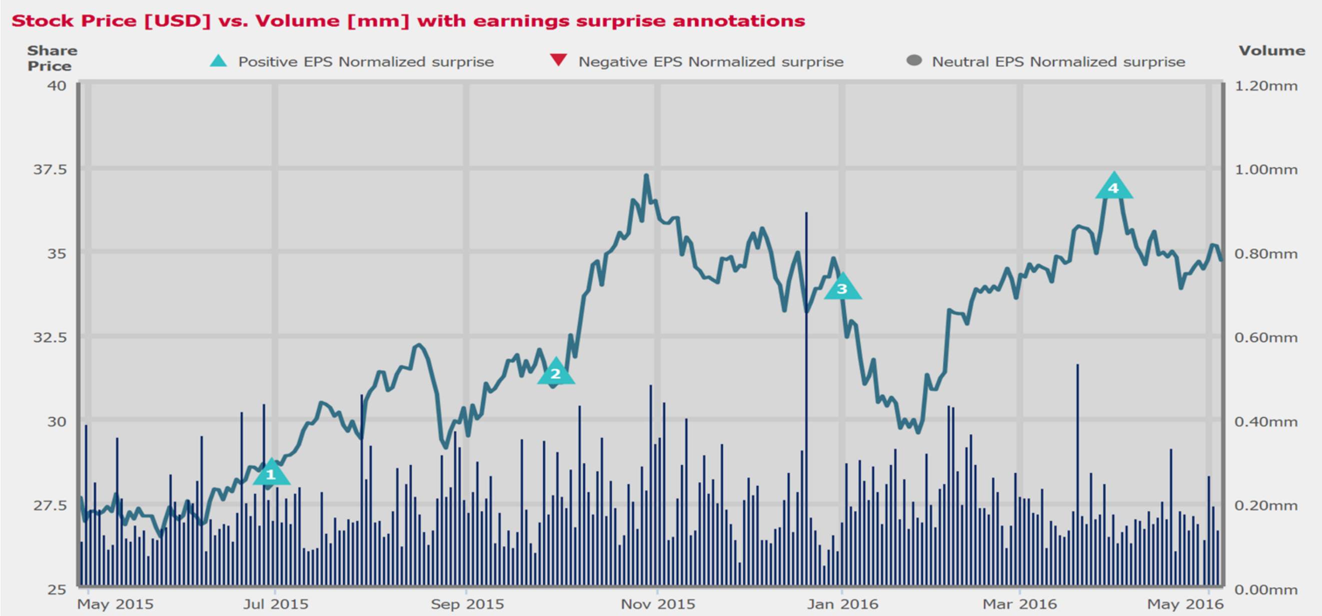
FQ2 2016 Earnings Call Transcripts

Thursday, July 28, 2016 12:30 PM GMT

S&P Capital IQ Estimates

	-FQ2 2016-			-FQ3 2016-	-FY 2016-	-FY 2017-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.61	0.72	▲18.03	0.70	2.78	2.71
Revenue (mm)	568.23	568.70	▲0.08	580.92	2291.50	2424.73

Currency: USD
Consensus as of Jul-28-2016 2:39 AM GMT



- EPS NORMALIZED -	CONSENSUS	ACTUAL	SURPRISE
FQ2 2015	0.58	0.62	▲1 6.90 %
FQ3 2015	0.68	0.81	▲2 19.12 %
FQ4 2015	0.68	0.81	▲3 17.39 %
FQ1 2016	0.58	0.66	▲4 13.79 %

Call Participants

EXECUTIVES

Dale A. Thatcher
Former Chief Financial Officer, Executive Vice President and Treasurer

Gregory E. Murphy
Chairman and Chief Executive Officer

John J. Marchioni
President and Chief Operating Officer

ANALYSTS

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Presentation

Operator

Good day, everyone. Welcome to the Selective Insurance Group's Second Quarter 2016 Earnings Call.

At this time, for opening remarks and introductions, I would like to turn the call over to Executive Vice President, Chief Financial Officer and Treasurer, Dale Thatcher.

Dale A. Thatcher
Former Chief Financial Officer, Executive Vice President and Treasurer

Thank you. Good morning, and welcome to my final Selective Insurance Group quarterly conference call. This call is being simulcast on our website, and a replay will be available through August 29, 2016. A supplemental investor package, which includes GAAP reconciliations of non-GAAP financial measures referred to on this call, is available on the Investors page of our website, www.selective.com.

Certain GAAP financial measures will be stated during my prepared remarks that will also be included in our quarterly report on Form 10-Q. To analyze trends in our operations, we use operating income, a non-GAAP measure that the investment community also uses, to evaluate performance of insurance operations. Operating income is net income excluding the after-tax impact of both net realized investment gains or losses and discontinued operations.

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

Joining me today on the call are the following members of Selective's executive management team: Greg Murphy, CEO; John Marchioni, President and Chief Operating Officer; and Ron Zaleski, Chief Actuary.

Now I'll turn the call over to Greg for introductory remarks.

Gregory E. Murphy
Chairman and Chief Executive Officer

Thank you, Dale, and good morning. The second quarter was a continuation of our ongoing effort to consistently generate an operating return on equity of 300 basis points above our weighted average cost of capital. 2015 was a record year for Selective since becoming listed on the NASDAQ both in terms of underwriting profit and net premiums written. And we reported an operating return on equity that was 310 basis points above our weighted average cost of capital.

In the first half of 2016, many key metrics across the organization improved, and we're ahead of last year's record pace as we focus on underwriting and claims improvements as well as achieving rate increases that match or exceed expected claim inflation. Year-to-date, our annualized operating return on equity was 11%, 310 -- 320, excuse me, basis points above our weighted average cost of capital as net premiums written grew 9%, and we delivered a 26% increase in operating earnings per share.

At Selective, we remain focused on leveraging competitive advantages to improve our position in the marketplace. Our first competitive advantage, true franchise value at Ivy League distribution partners has been the cornerstore of Selective's success.

One way we measure how distribution partners view their relationship with Selective is through an annual agency survey that measures overall satisfaction on a scale from 1 to 10. In the previous 3 surveys, Selective consistently received a score of 8.6, and we're pleased that in our most recent survey, the score improved to 8.8. In the quarter, we continue to engage with our distribution partners about the value of customer experience.

Our second competitive advantage, our unique field model, coupled with sophisticated underwriting and claims capabilities, has enabled us to implement underwriting and claims improvements, effectively balance rate and retention and improve profitability in most recent years.

Standard Commercial Lines' renewal price increases met or exceeded expected claim inflation in the last 27 consecutive quarters. During the 26 quarters that we have access to Willis Towers Watson Commercial Lines price monitoring survey data, we have exceeded industry pricing on a compounded cumulative basis by approximately 1,500 basis points.

Our field model and sophisticated pricing capabilities are also an important part of our ability to grow the organization going forward as we work closely with our distribution partners to underwrite new business and granually manage the renewal inventory. Over time, the goal is to increase our agent's combined state market share from 17% to 25% and our share of wallet of 7% to 12%.

Within our Commercial Lines of business, which, in total, represent about a $2.5 billion additional premium opportunity, both share of wallet and agency market share improved incrementally in 2015 as our market share increased from 1.1% to 1.2%, and we're currently ranked 41st in A.M. Best's annual ranking of top 200 carriers in the U.S. based on 2015 net premiums written.

As we think about growth, we prioritize opportunities in our current footprint, where we have established relationships and an operating history. However, we're evaluating opportunities for geographic expansion in our Standard Lines operation. Over time, we expect to add new footprint states to improve geographic diversification and grow the organization. We will provide more details on these efforts as they develop.

Our third competitive advantage, superior customer experience, delivered by best-in-class employees has been, and will continue to be, critical to our success. We tried a number of metrics related to customer experience, including Net Promoter Scores, Voice of the Customer survey results that are trending in a positive direction. Also we evaluated more than 20 key customer interactions that surface through our contact center, survey responses and an omni-channel assessment to pinpoint process disruptions that could negatively impact the customer experience. Through that evaluation, we identified the most significant friction points among customers, Selective and our distribution partners, and efforts are underway to eliminate that. These changes will help us increase efficiency and improve our first-call-response resolution of customer inquiries and overall customer satisfaction. In addition, we're investing in technology and employee development that support our strategic focus on customer experience.

With the first half of the year behind us, and having achieved better-than-expected results so far, we provide the following expectations for the full year 2016: a combined statutory ratio, excluding catastrophe losses, of approximately 89.5%, which is a 1.5 improvement from previous guidance of 91%. This assumes no additional prior year casualty reserve development; catastrophe losses of 3.5 points; after-tax investment income of approximately $95 million; and weighted average shares outstanding of $58.5 million.

Now I'll turn the call over to Dale to review the second quarter results.

Dale A. Thatcher
Former Chief Financial Officer, Executive Vice President and Treasurer

Thanks, Greg. For the quarter, we reported net income per diluted share of $0.74 and operating income per diluted share of $0.72, up from $0.58 and $0.62 a year ago. These increases were driven by superior performance within insurance operations. With 2 quarters completed, we are ahead of last year's pace when we achieved a record-setting statutory combined ratio. This is a result of ongoing renewal pure price increases, strong premium growth, favorable prior year casualty reserve development and lower CAT and non-CAT property losses in the first half of the year. Our statutory combined ratio in the quarter was 90.1%, a 3.4-point improvement from the same period last year. On an underlying basis, excluding catastrophes and prior year casualty reserve development, the combined ratio was 90.4%, which was 2.3 points better than the second quarter of 2015.

Catastrophe losses in the quarter added 1.6 points to the combined ratio, which is better than our full year expectation of 3.5 points and 3.3 points below the reported amount in the second quarter of 2015.

Also, non-catastrophe property losses were 2.3 points lower than the same period last year.

Our reserve position is strong, and we recorded favorable prior year casualty reserve development in the quarter of $10 million or 1.9 statutory combined ratio points. This compared to $20 million or 4.1 points a year ago. In the second quarter of 2016, favorable development was driven by improving claims trends within the general liability and Workers Compensation lines of business, which, respectively, reported $11 million and $9 million of favorable prior year casualty development. Partially offsetting this benefit was $8 million of unfavorable prior year casualty development in commercial auto, primarily in the 2011, 2013 and 2015 accident years as well as $2 million of unfavorable prior year casualty development in Excess and Surplus Lines from the 2014 accident year. As we've discussed in the past, given the size of our Excess and Surplus lines booked, we expect some volatility in reported results.

Top line growth was robust, and overall statutory net premiums written increased 9% in the quarter. This was driven by the renewal pure price increases, stable retention levels and higher new business. We continue to achieve pricing levels that exceed increases reported by the broader market while maintaining retention. We believe this is an indicator of our strong agency relationships and granular pricing capabilities.

In Standard Commercial Lines, renewal pure price for the quarter was 2.6%, which is in line with the level of expected claim inflation. Personal Lines in Excess and Surplus Lines are achieving greater levels of rate increases with homeowners' renewal pure price of 6.7%, personal auto renewal pure price at 3.6%, and Excess and Surplus Lines' overall rate at a 4.8% increase.

On the reinsurance front, excess of loss treaties were successfully placed on July 1, 2016, with the structure that remained largely the same. Our casualty excess of loss treaty covers $88 million in excess of a $2 million retention and renewed with stable rates and some improvement in terms. Our total property excess of loss coverage is currently $58 million in excess of $2 million, which includes a $20 million property excess of loss layer that was placed last January. This treaty experienced some loss activity in recent years, and as a result, rate increased at renewal.

Our investment portfolio contributed 6.2 points to operating ROE in the quarter as after-tax net income decreased 5% to $23.5 million from $24.8 million in the prior year period.

Fixed income, which represents 92% of our portfolio, experienced a 4% increase in pretax net investment income as a higher asset base helped to offset the effects of the continued low interest rate environment and lower returns from our alternative portfolio.

Alternative investments, which report on a 1-quarter lag, reported a pretax loss of $600,000 compared to income of $1.4 million in the second quarter of 2015. Over time, the market value of our alternative portfolio has declined into its maturity with many of our funds in the distribution phase of their life cycle.

In the quarter, after-tax new money yields on our fixed income portfolio averaged 2.4% as we invested in high-quality fixed income investments and also added a modest amount of high-yield products during the quarter. Our fixed income portfolio was highly rated with an average credit quality of AA- and a 3.7-year duration, and including short-term investments.

Given the sharp decline in treasury yields this year, our pretax unrealized gains position increased to $191 million at June 30 from $69 million at the end of 2015. As a result of the change in unrealized gains, the year-to-date ROE declined by approximately 30 basis points as the ratio of invested assets to stockholders' equity was reduced.

The pretax unrecognized gain position and the fixed income held to maturity portfolio was $7 million or $0.08 per share on an after-tax basis. Surplus in stockholders' equity were $1.5 billion and $1.6 billion, respectively, at the end of the second quarter. Book value per share increased 10% to $26.86 from year-end 2015 as our balance sheet benefited from strong profitability and a decline in interest rates. As Greg stated earlier, we achieved year-to-date annualized operating return on equity of 11%, 320 basis points above our quarter-end weighted average cost of capital of 7.8%.

Now I'll turn the call over to John to review insurance operations.

John J. Marchioni
President and Chief Operating Officer

Thanks, Dale. Our insurance operations are focused on delivering excellent growth and profitability. For the first 6 months, we achieved an overall statutory combined ratio of 90.4% and net premiums written growth of 9%. While we cannot control the headwinds that we face as an industry, such as moderating price or historically low investment yields, we are executing on our strategies and believe our results highlight the ongoing efforts of our employees and distribution partners.

Year-to-date growth in Standard Commercial Lines until June 30 was a strong 9%, driven by stable retention of 83%, new business growth and renewal pure price increases of 2.7%. Our Commercial Lines statutory combined ratio was 89.1%, a 0.8-point improvement from a year ago. On an underlying basis, year-to-date results improved 0.4 points compared to the prior year period.

In our renewal portfolio, we successfully balanced rate and retention through the use of our dynamic portfolio manager. For our highest quality Standard Commercial Lines accounts, which represent 50% of our premium, we achieved renewal pure rate of 1.5% and point of renewal retention of 91%.

On our lower-quality counts, which represent 10% of premium, we achieved pure rate of 7.2% and point of renewal retention of 77%.

Workers' Compensation continued to deliver strong results, driven by our focused underwriting and claims efforts and renewal pure price increases. Year-to-date, we achieved an 84.3% statutory combined ratio that included $21 million or 13.9 points of favorable prior year reserve development. This was driven by lower severities in accident years 2013 and prior due to the significant changes in our claims handling and outcome management as well as a lower prevailing loss cost inflation. This was the 10th consecutive quarter of the year with no development or favorable development in this line.

Our largest line of business, general liability, reported a year-to-date combined ratio of 83.4%, which included $22 million or 8.5 points of favorable prior year reserve development.

Commercial auto has presented challenges for the industry in recent years, and we have not been immune to this dynamic. Year-to-date, commercial auto reported a statutory combined ratio of 106% that included $13 million or 6.7 points of unfavorable prior year casualty reserve development. The increase in our commercial auto liability reserves related mainly to higher severities in accident years 2011 and '13 as well as higher frequencies in the 2015 accident year. To address profitability in commercial auto, we continue to achieve rate increases and are taking targeted underwriting actions. Through June 30, year-to-date renewal pure price in auto liability was 4.6%, and auto physical damage was 5.9%.

On the underwriting side, we are restricting new business and not renewing existing policies in certain challenged segments.

For the 6 months of 2016, the Excess and Surplus Lines statutory combined ratio was 100.6%. On an underlying basis, excluding catastrophes and prior year casualty reserve development, the statutory combined ratio was 94.4%, an improvement of 2.5 points compared to the prior year period.

Margin improvement in E&S is being addressed through a shift in mix of business, claims improvements and targeted price increases. In 2015, we move the E&S claims manager responsibility into our corporate claims group to implement our best practices across both property and liability. The team is in place, and we completed our review of the overall claims portfolio following our complex claims review at the end of 2015. Part of the transition includes the use of more robust monitoring tools to better manage the claims process and outcomes. These changes and aggressive pricing actions are expected to provide benefits, and we'll continue to focus on refining our E&S claims management practices to improve profitability.

Within Personal Lines, the statutory combined ratio improved 15.1 points to 90.1% through June 30. On an underlying basis, the statutory combined ratio improved 8.1 points and benefited from lower non-CAT property losses. Following a 5% decline in the first quarter, net premiums written in Personal Lines moderated in the second quarter and finished down 0.5% from a year ago. Last month, we launched a comprehensive marketing campaigns aimed at our distribution partners to emphasize our commitment to Personal Lines and our target customer, the consultative buyer.

Within homeowners, both the quarter and year-to-date underwriting results benefited from lower catastrophe and non-catastrophe property losses. We set a goal to achieve a 90% combined ratio in a normal catastrophe year and are implementing rate increases that move us to that goal.

In personal auto, the year-to-date statutory combined ratio improved by 2 points compared to the prior year period and benefited from rate increases that we've implemented in that book.

We work hard to create our position in the market and have no intention of slowing down. As an organization we remain focused on continuous improvement and outperforming the industry in terms of both growth and profitability.

Now I'll turn the call back to Greg.

Gregory E. Murphy
Chairman and Chief Executive Officer

Thanks, John. As you know, arithmetic has no mercy, and the industry will continue to be pressured to produce underwriting profits as we face the ongoing possibility of low for longer. Interest rates are already at or near historical low levels. We believe that the goalpost for acceptable industry returns should not be moved, and we are focused on consistently achieving an operating return on equity of 300 basis points above our weighted average cost of capital. As we move forward, franchise value and superior omni-channel experience with customers will be critical for success in the insurance industry, and we are strongly positioned to capitalize on our competitive advantages.

Before moving on to your questions, I'd like to take a moment to recognize and thank Dale. In March, Dale announced his retirement, and his last day at Selective will be September 1. Since joining Selective in 2000 as Chief Financial Officer, Dale has made significant contributions to our organization as we grew net premiums written 2.5x, increased total assets 2.7x and quadrupled our market capitalization as well as expanded into the E&S business with 2 acquisitions. We wish Dale well, and I thank him for his leadership and guidance.
With that, we'd be happy to take your questions. Operator?

Question and Answer

Operator

[Operator Instructions] Our first question is from Arash Soleimani of KBW.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

Dale, congrats on your final earnings call.

Dale A. Thatcher
Former Chief Financial Officer, Executive Vice President and Treasurer

Thank you.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

So just first question, can you provide a bit more color in terms of the new footprint states you're thinking about, what states you might be thinking of going into and perhaps how long you think it'll take to sort of get the agent traction there that you have in some of your existing states?

John J. Marchioni
President and Chief Operating Officer

Yes, thanks. Great question. This is John. And I could start, and Dale and Greg can certainly fill in. So I would say the focus of our expansion at this point would be the southwestern core part of the country, starting with Arizona, and building it out from there and building a regional operation there over time similar to the 5 regional operations we have in place in our existing footprint and using the same successful model we have used, which, as Greg indicated in his prepared comments, is around an empowered field model and deep relationships with a smaller group of high-powered agents. As we build out that footprint over time, we'll also continue to add contiguous states to our existing footprint where it makes sense and where we think there's opportunity to build out our existing regional structure as well, and we'll do this over a period of years. So the work has begun in earnest on the first couple of states. And generally speaking, we would expect to be operational there in the latter part of next year with the first 2 states, which means that we'll be shortly in the market for agents and employees in those territories to build them out and be able to hit the ground running. And then you would expect to see premium ramp up starting a little bit more slowly in the first year or 2 as we get our footing with our people and our agency partners and then building up from there.

Gregory E. Murphy
Chairman and Chief Executive Officer

Yes, the only thing that I would add to that, obviously, we'll be leveraging our existing relationships with our distribution partners that have footprints in -- existing footprints in those states. But also just to give you a sense, we're always out looking for opportunities in the marketplace. But because we're so unique as the way we distribute our product and our high franchise value, we just constantly come to the same point is that the only way we can do it is greenfield. And so that's the way we feel that we can successfully replicate our model. And I think you'll see us continue to build out. I don't think we'll be full-service everywhere, but -- and the rest of the country there probably about 10 states over a period of time that we would be full-service. The rest of the states the we'll enter, we'll enter because our agents have business opportunities in those states and it will give us a 50-state capability -- but that will take longer time, but we don't want to lose business that we have that rose up to a 50-state operation that we can't write because we can't service it. So we know we lose opportunities, particularly on the larger end for that. I think longer term, that's the problem that we're also trying to solve in this equation.

Dale A. Thatcher
Former Chief Financial Officer, Executive Vice President and Treasurer

The other color I'll add is, keep in mind, we're currently growing at 8% to 9% in our current existing footprint, well in excess of what the industry is able to achieve because of the capabilities that we've built here. So a steady measured approach in our new states, where the greenfield method is, to us, the appropriate way to maintain profitability for our shareholders and provide an opening-up of additional growth opportunity, which really is kind of the gravy on the overall scheme of things. So it's -- to me, it's an excellent way to continue to build this company.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

Right. On the commercial rate increases, not a big change, but it went from facing from 2.8% last year to 2.6% this quarter. Is there anything to read into there? Or would you consider that basically continuation of the status quo?

John J. Marchioni
President and Chief Operating Officer

We view those results as stable quarter-on-quarter. And when you look at our rate level relative to where the industry is, we're very happy with those results. Retentions remain strong. Rate level is pretty much in line with our expected claims inflation targets. And when you look at our Commercial Lines performance relative to our target returns, we want to make sure we continue to maintain those margins, and therefore, getting rate level on that -- in that amount is what we're striving to achieve.

Gregory E. Murphy
Chairman and Chief Executive Officer

And then just to understand that, that a fair amount of that rate also came in the commercial auto, which John prefaced in his comments, where our liability represents partial liability. Auto liability is about 76% of the auto premium, and that was up 4.3% in the quarter, and the physical damage, which represents about 24% of the commercial auto premium was up 6 spot, 4%. So good, healthy increases in that line, and we've pretty much always been ahead. Well, 1,500 basis points ahead of industry, 27 consecutive quarters of renewal price increases that equaled or exceeded expected claim inflation, in my mind, is quite a track record to stand on.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

And I guess, your expectation is still to keep pace at least with loss inflation this year.

Gregory E. Murphy
Chairman and Chief Executive Officer

Our goal -- here's how I would state it. We have the underwriting capability and vertically through the entire organization that our inside underwriters can sit across the table agency-by-agency 60 to 90 days out in advance with their renewals book, know which accounts they have to play hardball on and are able to do that. And because we have that relationship and knowledge base, we're able to scratch out premium increases where most of our competitors cannot.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

Right, right. And I know you mentioned in the prepared remarks that, obviously, you're not immune in commercial auto for some of the industry trends you're seeing. And obviously, you're getting good rate there. I guess my question is, I know a lot of competitors have mentioned that they're kind of staying away from commercial autos just because of what's going on. I guess, what give you a confidence to grow the way you've been growing in that line?

John J. Marchioni
President and Chief Operating Officer

Well, this is John again. I think if you look at our track record over a long period of time, our performance in commercial auto is very strong relative to the industry. We continue to believe we've got high-caliber underwriters with excellent tools to make good risk selection and pricing decisions. And those headwinds that we mentioned in our prepared comments that you're referring to certainly do affect everybody, whether it's the economic rebound and specifically, with contractors, the cost of gasoline coming down, unemployment coming down, which are driving up miles driven. But you've also got the continued impact of distracted driving as well as the cost to repair vehicles because of technology in vehicles that will continue to be on the rise. So we think there's sustained power to pricing in that segment because it is impacting the industry, but we still believe as an account underwriter -- again, we don't write a lot of monoline auto. We write account business, property, auto, GL, umbrella, Worker's Comp. We view it as an entirety, and not that we would have intentional subsidization between lines of business, but we think the stresses that are on that line are something we could manage going forward, bringing it to profitability, and our overall count base is continuing to compete effectively.

Gregory E. Murphy
Chairman and Chief Executive Officer

And you cannot be an account underwriter and not write commercial auto. And I think I must be -- this is the same issue everybody had several years ago with Workers' Comp. We're an account underwriter. We write the whole account, GL's our lead line in that. It's our biggest line, followed by commercial auto. Next is comp. When we had -- when our comp was running higher than we would've liked to, we had a concentrated effort to pull the combined ratio down, and the success of that has been phenomenal as our combined ratios have dropped substantially. And I think that we've got a very good grip on what it is we're doing. We're driving rate well above expected claim inflation. We're working around some of the underwriting and other claim improvements. So you can't operate that and expect to go in and get the rest of the account. So you've got to manage your way through a profitability on the line and get agents that are willing to work with you to make the improvements in the segmentations that need to be improved.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

Okay. That makes sense. My last question, just on E&S. I know you mentioned in the prepared remarks, that just due the size of the books, there'll be some volatility in there. But obviously, it seems like a line you're growing pretty strongly, and as we saw this quarter, does that imply that kind of, as those written premiums earn in, there's an expectation for those premiums to be at a combined ratio below 100% consistently? I guess, how do you look at that going forward?

John J. Marchioni
President and Chief Operating Officer

Yes. So we expect all 3 of our major segments to achieve our target returns over time and certainly consider E&S in that category. I think a couple of points I would make and reinforce. Number one, our ability to change the makeup of that book of business more quickly than we do in Standard Commercial Lines is there because retention rates in that segment are generally lower than they are in Standard Commercial Lines, usually in the 50 to 60 kind of range. So you're turning that inventory over a lot more quickly. The second thing is, and we've commented this on this in the past, we measure our pricing levels at a very specific segment -- on a very specific segment basis for new business, and we are actually acquiring new business at or above our targeted pricing levels. And again, that makes up a more significant portion of the book for this segment than it does in standard commercial, which we also think will contribute to improvement in performance going forward, and then going forward rather quickly. And then the final point I would highlight, which is also in the prepared comments, is we are just now starting to realize the expected benefits from migrating the claims management to our overall claims platform, and we think there's significant opportunity for improvement, both in terms of outcomes and loss adjustment expenses, and you haven't really seen that start to come through the numbers. So on an accident-year basis and an underlying basis, when you strip out the casualty development and CATs , we're seeing improvement. As we've said, we've got 2.5 points of improvement, the underlying combined ratio so far.

And we think we can continue that trend while we're growing it because we're so comfortable with the strength of new business pricing in that segment.

Operator

[Operator Instructions] Our next question is from Mark Dwelle of RBC Capital Markets.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

A few questions. In the Commercial Lines segment, the expense ratio had moved up about a point. Is there anything in particular behind that? Obviously, the overall combined ratio was good. So I was kind of surprised by that.

Gregory E. Murphy
Chairman and Chief Executive Officer

A little bit of supplemental commission as our profitability continues to improve, and it's actually better than we had expected it to be. We're adding more to the supplemental side. So that's the trade-off that -- you've got to remember that. In our -- we reward performance. We're a pay-for-performance organization. When our agents generate the results, they get more supplemental commission and, to some extent, even in our own annual cash incentive plan, which is, as you guys know, is heavily based on combined ratio performance and achieving very, very specific strategic initiatives. Both of those things are doing very well. That's not all of it, but that's a fair amount of it.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Okay. That makes sense. Second question is in the -- the alternative investments continue to kind of struggle. And I appreciate there's kind of a portfolio management aspect, but how are you thinking about that in terms of an allocation? It doesn't seem like it's something that's really rewarding you as much as the rest of the business is.

John J. Marchioni
President and Chief Operating Officer

Yes. I think it's important to note. So alternatives at our peak clear up around $160 million, $170 million of allocations in the alternative space. As things kind of blew up in the '07, '08 time frame, we really allowed kind of the alternatives to drift downward as we kind of retrenched and really get our arms around exactly what we had in there and where we wanted to go with that class of investments. We have since rebuilt our capabilities around being able to invest in the space, and we feel much better about that now, but you do have that ongoing drag from some of those legacy investments that are, if you think about it, towards the end of their normal life cycle. So they are the lower-performing of the overall alternatives. So until we get fully back ramped-up and fully allocated to the alternative space, the net income that you're going to see from those for a while is not going to be nearly as robust as we would expect. But once we achieve the right kind of diversification across vintage years and across classes of alternative investments, then our expectation is to have more consistent performance coming from that class of investment.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Okay. I guess, staying with the investments -- I hope this isn't my last question for you, Dale, but I fear, maybe. You just noted that the new money yields were above your book yields. Is that because you're shifting into more high-yield? Or -- that surprised me.

Dale A. Thatcher
Former Chief Financial Officer, Executive Vice President and Treasurer

That's really just what drove it this particular quarter is we moved a little bit in the high-yield. But as you can see, we didn't move so much in the high yield that it changed the overall credit quality of the portfolio, the AA-. It's been an area of investment allocation that, for us, has been 0 for a very long time. And as we look at comparing our portfolio to our peers, you can see that there's clearly a belief in allocating some level of the portfolio to a high-yield credit strategy, and we believe in that also. Again, it was an area that we didn't invest in because we didn't feel like we had all the right horses in place to be able to do that effectively, but we think that we have the right kind of strategy to be able to appropriately manage that. So it will not be a large allocation in the overall scheme of things, but just starting to ramp that up this quarter. And you see purchases with those kind of yields. That's really what drove the purchase yield just for this quarter.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Okay. That makes sense. I guess my last question is for John. The E&S -- the improvement in the E&S underwriting margin, the 2 points that you've mentioned a couple of times, is that driven by a change in the business mix? Or is that actually better pricing, better underwriting, better class of business, whatever you might want to call it? I'm just curious because the unit has had a number of fits and starts, and an improvement is obviously good. But I'm wondering if it's more driven by risk or through your selection there, or whether it's class.

John J. Marchioni
President and Chief Operating Officer

I would say it's actually been driven by both. There's a -- there are a couple of targeted segments that are geographic and industry vertical in nature that we have, in certain cases, gotten off of, in other cases, stop writing entirely. Or the third instance would be areas that we dramatically change our pricing structure to drive improvement. And if you were to look at our mix of business relative to a couple of those segments, it has, in fact, shifted quite a bit. So that's point number one. The second point is while the growth has been there, and new business has been strong, that new business pricing strength relative to target levels has been strong for the last couple of quarters, at least and the better part of the last 2 years. So as that new business makes its way into the renewal portfolio, that will also have a positive impact on loss ratios. So I would say, it's those 2 drivers. The claims improvements, to the extent they're in what we're seeing right now, will be probably slight, we would expect to see those really ramp up on a go-forward basis.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Okay. That's helpful.

Gregory E. Murphy
Chairman and Chief Executive Officer

Remember, there's a good size amount of turnover in this business every year. So to improve your performance, you've really got to look heavily at the new. John commented this earlier that on new business that we're writing is really at or above our target surcharge levels, and it's well in excess of what we wrote a year ago and also in excess of our renewal inventory. So we've seen improvement in our renewal inventory quarter-to-quarter. And -- but it's still -- our renewal inventory is still below our new business level, and it's something that we are trying to quickly close the gap on.

John J. Marchioni
President and Chief Operating Officer

And Mark, the other point I would add is, we've seen improvement on the renewal pricing side, but understand, the dynamic there is a little different than it is in the admitted business because you do have a wholesaler that's getting that business through a retailer. And they know that, that retailer would rather place that business on renewal in this admitted market if they can, so it does make it a little bit harder to achieve rate increases there based on that dynamic on your renewal portfolio. But the strength of our new business pricing were very comfortable with.

Mark Alan Dwelle

RBC Capital Markets, LLC, Research Division

Okay, that's very helpful. Good luck to you, Dale. Please continue to stay in touch.

Dale A. Thatcher
Former Chief Financial Officer, Executive Vice President and Treasurer

I will. Thank you.

Operator

[Operator Instructions] There are no more questions as of this time. I will turn the call back to Mr. Greg Murphy.

Gregory E. Murphy
Chairman and Chief Executive Officer

Well, thank you for participating on the call this morning. If you have any other additional questions please contact Dale. Thank you very much.

Operator
And that concludes today's conference. Thank you for your participation. You may now disconnect.