S&P Global
Market Intelligence

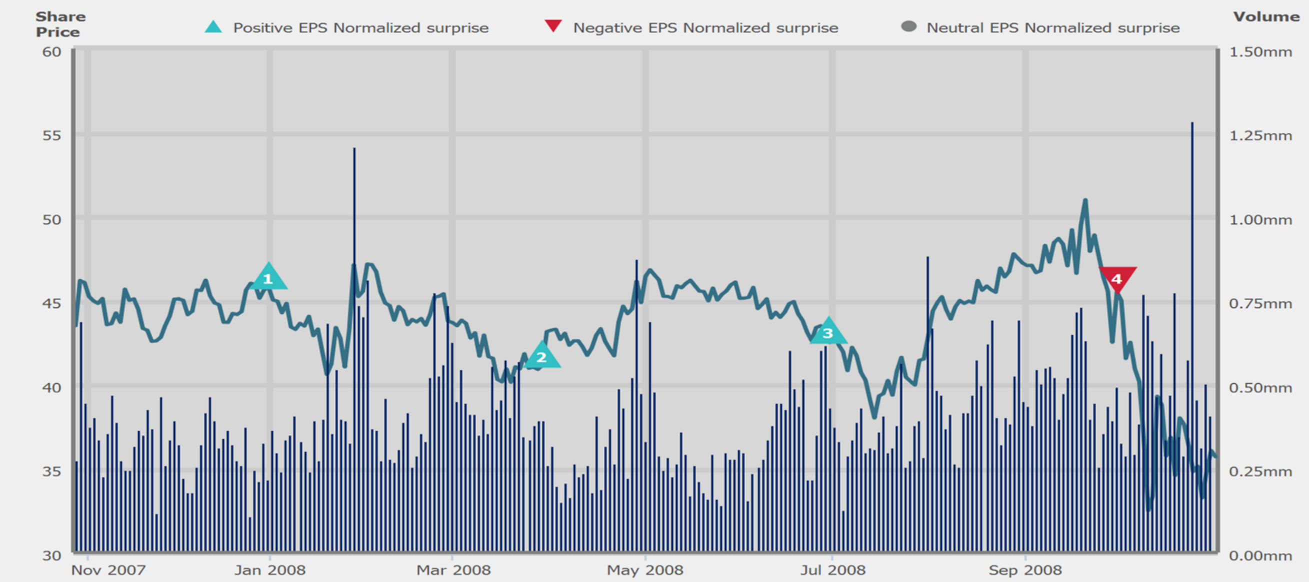
The Hanover Insurance Group, Inc.
NYSE:THG
FQ4 2008 Earnings Call Transcripts

Friday, February 06, 2009 4:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ4 2008-			-FQ1 2009-	-FY 2008-	
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	ACTUAL
EPS Normalized	1.13	1.16	2.65	1.06	3.39	3.40
Revenue	-	-	2.29	-	-	-
Revenue (mm)	583.90	597.30	-	651.65	2504.70	2518.00

Currency: USD
Consensus as of Feb-06-2009 2:27 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ4 2007	1.14	1.20	5.26 %
FQ1 2008	1.05	1.10	4.76 %
FQ2 2008	0.96	1.07	11.46 %
FQ3 2008	0.01	0.07	(58.82 %)

Table of Contents

Call Participants

EXECUTIVES

Eugene M. Bullis

Frederick Henry Eppinger
Former President & CEO

Marita Zuraitis
Executive VP, President of Property & Casualty Companies

Robert P. Myron

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Wayne Archambo
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Presentation

Operator

Good day ladies and gentlemen and welcome to the Fourth Quarter The Hanover Insurance Group Incorporated Earnings Conference Call. My name is Wayne and I will be your coordinator for today. At this time, all participants are in listen-only mode. We will be facilitating a question-and-answer session towards the end of this call. (Operator Instructions).

I would now like to turn this presentation over to your host for today's call, Mr. Bob Myron, Treasurer of The Hanover Insurance Group. You may proceed, sir.

Robert P. Myron

Thank you, operator. Good morning and thank you for joining us for our fourth quarter conference call. Participating in today's call are Fred Eppinger, our President and Chief Executive Officer; Gene Bullis, our Executive Vice President and CFO; and Marita Zuraitis, President of Property & Casualty Companies.

Before I turn the call over to Fred for a discussion of our results, let me note that our earnings press release and a current report on Form 8-K were issued last night. Our press release, statistical supplement, and a complete slide presentation for today's call are available in the Investors section of our website at www.hanover.com. After the presentation, we will answer questions in the Q&A session.

Our prepared remarks and responses to your questions today, other than statements of historical fact, include forward-looking statements. These include statements regarding expectations of earnings, pricing, accident year results, premiums, expenses and other projections for 2009.

There are certain factors that could cause actual results to differ materially from those anticipated by this press release, slide presentation and conference call. We caution you with respect to reliance on forward-looking statements and in this respect refer you to the forward-looking statements section in our press release, slide two of the presentation deck and our filings with the SEC.

Today's discussion will also reference certain non-GAAP financial measures, such as total segment income, segment results excluding the impact of catastrophes, X count loss ratios, book value excluding accumulated other comprehensive income and accident year loss ratios among others. A reconciliation of these non-GAAP financial measures to the closest GAAP measure on a historical basis can be found in the press release or the statistical supplement which are posted on our website as I mentioned earlier.

With those comments, I will now turn the call over to Fred.

Frederick Henry Eppinger
Former President & CEO

Good morning, everyone and thank you very much for joining the call. 2008 obviously was a challenging year for all financial services companies and that continued into the fourth quarter.

But given the ongoing turmoil in the financial markets and the severe weather we all experienced this year, I'm very pleased with our operating results. I'm even more pleased with the progress we've made in our efforts to position our company to create shareholder value by capitalizing on the growing turmoil and likely shake-out in our industry.

Given the ongoing disruption in the insurance and financial markets, I plan to take a few minutes this morning to comment on industry conditions in general as well as our own current position and prospects.

While our 2008 results were impacted by unusual weather and greater than expected write-downs in our investment portfolio, our core business fared very well as we continued to steadily increase the overall earnings power of our company. Even with difficult fourth quarter weather, we've generated a very solid segment earnings of 60 million compared to 61 million in 2007.

For the full year, segment income was 176 million compared to 229 million in the prior year, a decrease caused by significant increase in catastrophe losses. We generated P&C pretax ex-cat operating earnings of 471 million compared to 448 million in 2007, an increase of 5%.

We also were one of the very few companies to improve our accident year results in 2008. It's important to note that our catastrophe losses were in line with our market share and our pricing models reflecting the work we've done in recent years to strengthen our cat management program.

In addition, we continue to generate strong net premium growth for the year at 4.3%, and for the quarter at 6.4% in contrast to the industry as a whole and to most of our peers. This growth was in line with the guidance we gave early last year.

While Marita will provide details about the characteristics of this growth, I am very enthusiastic about its composition both now and prospectively, as it is driven by mix improvements and increasingly is in the higher margin segments of our business.

As we seek to grow both our Personal Lines and Commercial Lines business, we continue to apply a very disciplined underwriting approach, taking care enough to maintain sufficient margins and to manage to solid accident year loss ratio.

At the same time, we continue to be very thoughtful about balancing the investments we are making in people, products and services, investments that generate growth with a need to prudently manage expenses.

I would like to also comment on the overall strength of our balance sheet, our liquidity and our ability to capitalize on the market opportunities that we see.

Although our book value declined in the quarter specifically with respect to unrealized losses in our fixed income investments, we believe it is temporary consequence of an irrational market that is taking a broad brush to investment risks. As a result, we are optimistic that we will have significant growth in book value in future periods as these unrealized losses reverse.

More specifically, we are a very unique in that 98% of our investment portfolio is in cash and fixed income securities, and 94% of our fixed income is investment grade.

These characteristics not only give us one of the most transparent investment portfolios in the industry, it also makes us more confident that our company's unrealized positions will reverse as our bond portfolio seasons and the underlying credits mature at par in future periods. We think it is quite compelling and Gene will get into the details later in our call.

Our capital position remains strong, and we are very comfortable with our ratio of debt to total capital. We are also pleased with our liquidity position at both our operating company and our holding company, which now includes the proceeds of the FAFLIC sale.

The capital we are holding at the holding company post transaction of over 400 million is very significant for a company of our size. While the sale of the final piece of our life business FAFLIC which closed on the January 2nd of this year resulted in a charge, the divestiture of that business is very positive for our company and our organization.

It provides us with even more financial flexibility, reduces the last vestige (ph) of our contingent risks that others are now wrestling with, enables us to focus our attention in resources exclusively on the profitable growth for our P&C business.

This financial strength and flexibility is very important given what we see in the market around us. At some level, it's hard to believe the magnitude of change in disruption we've seen in recent months, and we now know it is far from over.

Without question, these events have caused more concern on more front than anything I've witnessed in 25 years in this business. And while these events will cause difficulties for all the companies, they will also create tremendous opportunities for companies that are well positioned both financially and operationally.

Many industry leaders are talking about the industry shrinking capital, the increasing cost of capital and the potential of pricing to turn.

We agree that we'll be -- that we will very likely see price improvements during the year, and you've already seen segments of the market improve. But the bigger question is the potential for good business, profit pool if you will, to move around the industry to stronger, less vulnerable competitors particularly where agents have concentration risks.

We've seen many companies just getting to the point where they are forced to react. Some property and casualty companies have significant exposure to equity and alternative investment markets and have seen material losses of the value in the last few months, the potential for more losses in 2009.

Storm losses have hurt others dramatically and access to capital is very limited, especially for underperforming companies. All of these factors have put pressure on company rating, their ability to grow or cause them to cut expenses and begin to shrink to support debt service.

In addition, the growing number of properties are or likely will be upsale. All this pressure is particularly present in the small companies that we compete with every day. While issues confronting the industry today is incredibly complex, our message is relatively simple.

The world in which we do business has changed dramatically. As access to capital remains limited, the degree of disruption in the insurance marketplace could be more severe than we have ever seen before. The stakes are high for carriers and agents alike, There absolutely will winners and losers. More than ever winning companies and winning agents need to rely on each other. Through partnerships are critical but over reliance on a few big carriers is dangerous. In this context, we believe that we have differentiated ourselves. And we've been saying... what we've been saying for the last five and half years is that we built an organization to capitalize on the disruption in the marketplace, just right in times like this.

Our partnership focused strategy will continue to serve both us and our agents extremely well. We view the turmoil in the industry as a tremendous opportunity. We have every confidence that we will gain ground through this period of disruption and when it does settle we will emerge as one of the winners in our industry.

Overall, I feel very good about our prospects. While we expect to face challenges like everyone else in this times, our company is well positioned to compete. We've established a strong financial foundation with our conservative approach to investment management. We have excess capital and a strong reserve position. We are building a strong track record with a broad and attractive mix of products. We do not write a lot of contractors and large workers comp business; we don't like large commercial accounts which have been adversely impacted from pricing perspective, more than small accounts; we don't like public company D&L and we don't do business in some of the most challenged markets; for example, Personal Lines in California or Homeowners in Florida.

While we feel pressure from the economic downturn, our franchise is very healthy today and we will continue to be, going forward. We have assembled one of the very best teams in our industry today, especially in the field, where our people work closely with our agent partners to identify and capitalize on growth opportunities that benefit our agents and our company.

We have also invested through building and buying product and service innovation. Our product portfolio and service capabilities represent distinct competitive advantage and enable our agent partners to meet more and more of our customers' needs and ultimately to grow their business.

At the end of this year, we ended up with a $500 billion specialty business, much different from our regional competitors. In December of last year, we held a meeting of our senior leadership team, our top 150 people to review our plans for the year. I came away from that meeting energized and more confident than ever.

While the economy and market turmoil presents challenges, it is very clear that the disruption in the market place creates tremendous opportunities for us and that our leadership team has the talent, the expertise and the commitment to carefully and fully capitalize on the opportunities at hand. I look forward to sharing our progress with you in the future on these and other areas.

With that, I'd like to turn over the call to Marita.

Marita Zuraitis
Executive VP, President of Property & Casualty Companies

Thanks, Fred. Good morning everybody and thanks for joining the call. I am also very satisfied with the company's top and bottom line performance in 2008, especially given where we are in the cycle as well as everything else that has occurred in the P&C insurance market and credit markets as Fred just discussed.

Although our overall results were somewhat hampered by the economic environment, our underlying underwriting performance is very strong. Our partner agent strategy and our laser focus on disciplined underwriting and pricing allowed us to produce results consistent with our expectations, with our 2008 investor guidance and with our objective of growing profitably.

I'd like to review our underwriting operations in that context, starting with a discussions of our overall P&C results. Today, I'll use the presentation deck that's published on the website and I trust that everyone has that available. So please refer to slide five.

For fourth quarter 2008, our P&C operations generated 97 million in pre-tax income, down from 98 million in the prior year quarter, primarily due to higher catastrophe losses in the fourth quarter of 2008. The comparison is also impacted by a one-time litigation benefit in the fourth quarter of 2007, offset by a pension related item in the same quarter. Note that our catastrophe losses for the current quarter include approximately 5 million of an increase in our reserve estimate pertaining to Hurricane Ike. Excluding catastrophes and the litigation benefit and pension item, pre-tax earnings were 111 million, compared to 105 million in the prior year quarter.

As you can see from the slide, similar trends existed for the full year, which was marked by high catastrophe losses from numerous hurricanes and storms, the largest of course, being Ike and Gustav in the third quarter of 2008. Excluding the impact of catastrophes, the one time litigation benefit and the pension items, our pre-tax earnings grew 30 million or 7% for the year, which I consider to be a very good result for this stage in the pricing cycle and the current economic climate.

I'd like to discuss the drivers underlying those results in more detail, starting first with Personal Lines.

Turning to slide six, our Personal Lines segment reported pre-tax earnings of 40 million in the current quarter, compared to 58 million in the prior year quarter. Excluding catastrophes, the litigation benefit mentioned earlier, Personal Lines segment income was 50 million in the current quarter compared to 51 million in the prior year quarter.

Favorable development of prior year loss and LAE reserves was 11 million in the current quarter compared to 15 million in the same quarter in 2007. Accident year ex-catastrophe margins also was lower in the quarter as compared to the prior year quarter, driven by an increase in frequency in the auto line, due to a large number of non-catastrophe weather storms predominantly in New England and in the Midwest.

Putting weather aside, the underlying trends in our auto line remained relatively stable. Underwriting expenses were lower in the quarter as compared to the same period in the prior year, driven in part by lower variable compensation.

Slide seven shows Personal Lines results for the full year of 2008, which were driven by the same items as the fourth quarter with catastrophes accounting for most of deterioration in underwriting margins. Excluding catastrophes, the full year combined ratio was 94.7 compared to 93.1 in the prior year. This increase is primarily attributable to non-catastrophe weather. Our underwriting margins are the best proof of our disciplined underwriting practices and proactive pricing approach. They also are a manifestation of our prudent growth strategies in Personal Lines.

On slide eight we provided you with our Personal Lines growth results for the fourth quarter and for the year. As expected, we recorded flat growth for the year with an improving trend of sequential quarterly growth with the fourth quarter growing at 3%. This is in line with our guidance and above the industry averages.

Although our written premiums were flat for the year, there was a lot of very important dynamics in our mix that occurred in 2008. First, we continued to manage our coastal exposures through our ongoing efforts to reduce our Louisiana exposure and by exiting the Florida homeowners market completely as of December 2008. Although these actions produced a drag on growth for the year of approximately 1%, they significantly improved our overall catastrophe exposure profile.

Second, in Michigan, where economic conditions are amongst the most challenging in the country, our PIP counts declined 1% for the quarter and 4% for the full year of 2008. While Michigan remains a challenging market, we're extremely proactive in terms of monitoring loss trends and taking rate action where and when appropriate. Obviously, we watch the political and regulatory climate in this state very closely.

Finally, in 2008 we continue to implement mix management initiatives in our Connections Auto book of business that we started in 2007; reducing our growth in less profitable auto segments as we focused on writing more multi-car and account business consistent with our strategy. These measures, while very beneficial to our bottom line and our risk profile, represented a meaningful drag on our net written premium. To counter this, we continue to grow premium and exposure in our targeted states, those outside of the four larger states and states with coastal exposures at a rate of 12% for the fourth quarter and 9% for the year.

We remain satisfied with the quality of our new business as an increasing part of our growth comes from our partner agents and from book consolidations. Many agents now put more weight than ever on balance sheet strength and stable ratings. More and more agents are making placement decisions based on strategic alignment with preferred markets and our new business pipeline is growing stronger, fueling that written premium growth.

Our new business premium growth improved steadily over the last four quarters, increasing 11% in the fourth quarter of 2008, compared to the prior year quarter. Also, we continue to remain proactive by constantly taking rate in excess of inflation. Excluding the 8% rate decrease in Massachusetts' Auto Line, our over all rate increased or the year in Personal Lines averaged 3%. And we have additional increases underway in 2009.

So, while premiums remained flat for the year, we were able to shift our book of business to more desirable risks and geographies thus improving the outlook for retention and the overall profitability of our book. And, in fact, we grew our policies in force in the quarter.

Now, turning to slide nine for a discussion of Commercial Lines; pretax segment income for the quarter was 56 million, compared to 43 million in the fourth quarter of 2007. Excluding catastrophe losses, which were relatively low in the current quarter, Commercial Lines segment income was 60 million or 11 million higher when compared to prior year quarter. This increase was primarily driven by improvement in ex-catastrophe accident year margins due to growth in our specialty lines which carry a lower loss ratio.

Most of our other Commercial Lines also had improved loss ratios for the quarter. The higher incidents of large property losses that we observed in the third quarter in the C&P line did not reoccur in the fourth quarter with full year large property losses actually decreasing. But as we've stated before this can be a lumpy statistic and we'll continue to monitor it closely.

Favorable development of prior year loss reserves continued with 14 million in the current quarter, compared to 20 million in the fourth quarter of 2007.

Our Commercial Lines underwriting expenses compared favorably to the prior year quarter. As in Personal Lines, lower expenses reflect a reduction in variable compensation in the second half of the year.

Finally, net investment income was up 3 million, compared to the prior year quarter. This is primarily due to the transfer of employee benefit related assets and liabilities from FAFLIC to Hanover Insurance, effective January 1, 2008.

As you can see from slide 10, our full year results were consistent with the trends of the fourth quarter of 2008. With improvement in ex-cat accident year loss margins being the major driver for the increase in ex-cat segment income, the ex-cat accident year combined ratio for 2008 was 96.8 or two points lower than the 99% in 2007 with loss ratio improvements seen in every line of business. As we have stated many times before, we prefer to take expense risk over underwriting risks and our results in Commercial Lines reflect the strategy.

Ex-cat underwriting margins in our Commercial Lines improved despite pricing declines in the market, macroeconomic conditions and the fast pace of our top line growth.

Slide 11 shows our Commercial Lines growth, which was 12% for the quarter and 11% for the year. This growth came primarily from our specialty businesses, which grew at a robust pace of 20% in this quarter and 27% for the year. The growth reflects our recent acquisitions; Hanover Specialty Property, Hanover Professionals and most recently AIX.

The new business production of our specialty property and professional lines of business that are coming from Hanover multi-line agent partners continues to ramp up, validating the synergies created by these recent acquisitions. We expect this trend to persist as we continue to install Hanover Professionals point of sales systems in our agents' offices in 2009.

Excluding recent acquisitions, our other specialty lines grew 6% in the quarter and 12% for the year, which we consider to be very strong at this point in the cycle. Most of the lift came from our niche businesses, specifically schools, religious institutions and athletic club programs which we have developed over the last two years to further broaden our product offering and to respond to our partner agents' needs.

Starting January 1, 2009 we've launched our new niche product offering, Social Services. A large number of our partner agents currently place these types of risks with competitive markets that have been weakened by balance sheet issues or have experienced disruption due to M&A activity. Early indications are that we hit the market on product design and as such we expect to make meaningful progress relatively fast in this niche, further improving our growth prospects for 2009.

In our bond business, we grew 16% for the quarter and 18% for the year, while at the same time maintained very strong margins and adherence to our conservative underwriting guidelines. I should note that our growth is coming from our target profile, which is weighed towards public works and expansion into new territories. A potential of increased government infrastructure spending in 2009 could help increase demand, allowing us to continue to grow this line with continued underwriting discipline.

Overall we will continue to push segmentation of business, making growth and specialty capabilities a focus for 2009. Our traditional lines continue to show improvement in growth, yielding 8% growth in the quarter and 5% for the year, benefiting from improved retention.

With respect to the state of markets, pricing, as you probably know, it's especially difficult to predict market behavior at an inflection point in the cycle. But we're encouraged by the overall slowing rate of decline in Commercial Lines pricing in recent months. So while we're not ready and prepared to call the bottom of the pricing cycle, we are optimistic that it will occur sometime in 2009.

Turning to slide 12, which provides a summary of property and casualty underwriting ratios for the quarter and the year; even with a growth rate substantially above the industry our P&C margins improved and remained stable compared to 2007 level. We will conclude by saying that with the overall P&C premium growth of 4% and no deterioration in the 2008 accident year underwriting results we have weathered very well the perfect insurance storm of 2008. And that we are even better equipped and balanced to continue our journey to outperform the market in 2009.

Before I turn the call over to Gene, let me give you an update on our reinsurance renewals. As you know our two largest reinsurance treaties, catastrophe and casualty, renewed on January 1st and overall I am pleased with the results of our placement. We believe our 2008 reinsurance structure of those treaties gave us the right balance of reinsurance protection and economic benefit. So these treaties were renewed at the same structure as the expiring program.

While our catastrophe renewal was challenging, we were able to achieve an exposure adjusted rate increase of just approximately 15%, which equates to approximately $5 million, which we believe is in line with the treaties of other statements who did not see losses to their reinsurers. For our casualty treaty, on an exposure adjusted basis, our renewal pricing was basically flat.

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

Eugene M. Bullis

Thank you Marita and good morning everyone.

Please turn to slide 14 which presents our consolidated results for the quarter. For the quarter we reported net income of $34 million or $0.66 per share compared to $76 million or $1.44 per share in the fourth quarter of 2007. Net income in the fourth quarter of 2008 reflects net realized losses on investments from our continuing operations of $37 million.

Included in this investment loss is a loss of $8 million that was reported in the third quarter of 2008 in discontinued operations, but was reclassified to continuing operations as a result of the underlying securities being purchased by Hanover Insurance Company from FAFLIC prior to the completion of the sale of FAFLIC on January 2nd.

We believe that these securities are likely to ultimately recover their value and thus we purchased them from FAFLIC to avoid the economic loss that would have resulted if they had been sold along with FAFLIC. Offsetting the $8 million loss in continuing operations is an $8 million gain in our FAFLIC discontinued operations

On slide 15, you can see our net income and segment results for the full year. Net income for the full year of 2008 was 21 million or $0.40 per share compared to net income of 253 million or $4.83 per share in 2007. Net income for the full year 2008 was impacted by substantially higher catastrophe losses than our property and casualty operations compared to the prior year; net realized investment loses of 98 million or $1.89 per share, and a loss of 85 million, or $1.64 per share related to the discontinued FAFLIC business.

Let's now turn to slide 16 for some information on the completion of the FAFLIC sale. On January 2, 2009 we completed the sale of FAFLIC to Commonwealth Annuity, a Goldman Sachs company. Hanover continues to retain FAFLIC's accident and health assumed pool business through a reinsurance agreement. This business has been in run-off since 1999 and its total net GAAP insurance loss reserves of approximately 130 million represented approximately 10% of the total net insurance liabilities of FAFLIC and now represent 3% of total Hanover policy liabilities. We will continue to account for these business as discontinued operations.

Total net proceeds from the sale of FAFLIC, including a pre-close dividend of approximately 130 million were 220 million, net of certain transaction costs and inter-company accounts settlements. The transaction resulted in a net after-tax loss on the sale of 77 million for the year ended December 31, 2008.

The total loss on discontinued FAFLIC operations for the full year 2008 of 85 million is comprised of a net after-tax loss on the sale of 77 million, net operating income of 7 million and realized losses on investments of 14 million.

Now turning to slide 17 for a quick review of our segment results. Segment income after-tax was 60 million for the quarter which is approximately equal to the fourth quarter of 2007.

The GAAP effective tax rate is 32% in the fourth quarter of 2008 compared to 31% in the prior year quarter. The current quarter's tax rate reflects increased low income housing tax credits. The full year effective rate of 33% is consistent with our expectation of our effective tax rate going forward.

Property and Casualty pre-tax segment earnings were 98 million in the fourth quarter of 2008, approximately equal to the fourth quarter of 2007. Our full year after-tax earnings of 176 million for 2008 and 228 million for 2007 reflect stable core underwriting results and much higher catastrophe losses for 2008.

Despite the high level of catastrophic losses, our P&C levered ROE was approximately 10% for the full year. Marita has already provided commentary on our P&C operations in detail. So, I will move on to a discussion of our investment portfolio beginning on slide 19.

The company holds 4.8 billion in cash and invested assets at December 31, 2008, excluding the assets related to FAFLIC.

Cash and fixed maturities represent 98% of our investment portfolio with a carrying value of 4.7 billion. 94% of our fixed income portfolio was rated investment grade. Our below investment grade securities are principally, actively managed high yield corporates with very few falling angels (ph).

With 98% of our total invested assets and fixed income in cash, our earned yield on total invested assets was 545 for the full year 2008 compared to 549 for the full year of 2007 and the book yield of our fixed income portfolio at December 31, 2008 is approximately 5.70.

Stable income provided by our bonds and government paper focus... our government paper focused portfolio provides good visibility into the stream of future stable earnings even in this disrupted financial environment. We continue to have no direct exposure to investments in subprime mortgages or sub-prime mortgage-backed securities, we have negligible derivative exposure and no activity in credit defaults swaps.

Skipping over to slide 21, we provide a breakdown of our corporate holdings, which represents 47% of our overall fixed income portfolio. Industrials constitute about 24% and about 14% or 594 million is invested in financial sector holdings.

Slide 22 describes our RMBS holdings. They constitute about a billion of our invested asset with approximately 16% held in non-agency prime securities. The market value for our RMBS portfolio improved from the end of last quarter and has only declined $3 million since December 31 2007.

We hold 258 million of commercial mortgage-backed securities, after the divestiture of FAFLIC which owned approximately 40% of overall TAQC (ph) MBS assets. The portfolio was well seasoned with 89% from pre-2005 vintages. It's also well diversified by geography and industry type.

About 21% of our CMBS portfolio are fully diffused securities. Weighted average loan to value on this portfolio was 66% and only 2% of the portfolio has a loan to value higher than 80%. Delinquency statistics on these securities are negligible. Net defaults under almost any possible default scenario would be absorbed by lower tranches prior to our last participation.

We believe the unrealized losses associated with our CMBS portfolio speak more to the overall market attitude and illiquidity and do not reflect the intrinsic value of these assets. Although in recent months, the spreads on non '06 and '07 paper have notably narrowed as the market has started to recognize the value of these issuances, contrasting them with the 2005 to 2007 issuances that were characterized by more aggressive underwriting practices.

On slide 24, we provide you with the credit rating profile of our CMBS securities along with the unrealized losses associated with each rating grade. As you can see from the slide, our non-AAA bonds are also characterized by a high level of subordination, strong diffusions and high occupancy ratios providing us with confidence that the marks on these assets will rebound once the market starts aligning quality with spreads.

Moving on to slide on municipal bonds at December 31, 2008 we held 717 million of municipal bonds with an overall rating of AA minus. Financial guarantor insurance enhanced municipals represent 335 million or 47% of this portfolio. The overall credit rating of our insured municipal bond portfolio giving no effect to the insurance enhancement is A minus.

On slide 26 we display changes in net unrealized losses for the quarter and for the year in our fixed income portfolio. The majority of the unrealized losses of $173 million for the year relate to our fixed income corporate holdings due to widened spreads and credit market liquidity contraction. As our disclosures indicate our holders -- our holdings are very diversified and high quality.

Again we believe that the loss of market value is temporary for this asset class. While... with our substantial liquidity position in light of duration structure in our fixed income portfolio, we have the ability and intent to hold these securities until recovery or maturity which will allow us to realize their anticipated long-term economic value.

It's important to note that because of our substantial balance of capital loss carry-forwards, increases in the balance of unrealized losses in our investment portfolio are not tax effected and thus tax benefits do not mitigate the impact of these decreases in our book value and book value per share amounts.

The positive offset of this is that when these losses recover the resulting increases in book value are not dampened by the release (ph) of tax assets.

Moving onto slide 27 for a discussion of our book value change. You see a contraction in the book value through December 31, 2008 which is impacted by losses in our discontinued FAFLIC business of approximately 85 million or $1.67 per share, and higher unrealized losses in our investment portfolio of 282 million or $5.53 per share for the full year.

The change in book value for the quarter also reflects a change in pension and post retirement related benefits of 81 million or $1.58 a share. As a result of the decline in the fair value of the assets held by our retirement plans, the funded status of the plan has changed from a liability of 87 million at December 31, 2007 to a net liability of approximately 195 million as of December 31, 2008.

The difference between actual and expected asset returns and minor changes in assumptions used to calculate the PBO resulted in pretax additions to accumulated other comprehensive losses for the year of approximately 128 million or 83 million after-tax as of December 31, 2008.

In slide 28, we have some key metrics that outline the strength of our balance sheet. Despite investment impairments and the impact of the FAFLIC sale per share book value excluding AOCI remains above $44 a share.

Our debt to total capital, including AOCI, is up slightly resulting from a lower capital base, still a 22% our financial leverage is conservative. Holding company liquidity made up of cash and investment assets was approximately 225 million at December 31, which reflects the use of approximately 100 million related to the November acquisition of AIX and will increase by about 220 million in the first quarter of 2009 as a result of the FAFLIC sale transaction on January 2, 2009.

Subsequent to December 31, 2008 we have contributed $70 million from the holding company to our Hanover Insurance subsidiary to maintain targeted capital levels in our growing and expanding insurance operations. This contribution is largely due to the statutory equivalent of the increased pension benefit obligation discussed previously.

Also as you know we are on positive outlook from A.M. Best with respect to our financial strength rating, and we intend to present a stronger case as possible for an upgrade this rating season.

Including the capital contribution, we have an RBC well in excess with 325% and a BCAR in excess with 200% in our P&C insurance company at year end.

In the fourth quarter, we did not repurchase any additional stock with respect to our outstanding $100 million stock repurchase program of which approximately 40 million remains unused.

We will likely maintain this cautious approach to share repurchases for the intermediate term. As always, our goal is to use our capital as effectively as possible to strengthen our organization, take advantage of growth opportunities to ensure that we're positioned to win in the long term.

Lastly, I would like to summarize our expectations for 2009. Our historical practice has been to provide an annual outlook at our Investor Day, typically in early March. We are now planning our Investor Day for the last week in May and accordingly we are providing outlook assumptions on this call.

Combining Personal Lines and Commercial Lines, we expect to achieve mid-single digit net written premium growth. We expect improved accident year loss ratios relative to actual 2008 results. We assume normal caps of 3.5% of net earned premium. We expect lower prior year development as compared to actual amounts for 2008, particularly in Q1 of 2009 because of the significance of the favorable development in last year's first quarter; an increase in the total expense ratio of half a point to a full point; pre-tax segment income which meets or modestly exceeds the current average First Call consensus of $360 million; an effective tax rate of 33% and average shares outstanding consistent with the fourth quarter 2008 of 51.4 million.

With that, I'll turn the call back over to Bob.

Robert P. Myron
Thank you, Gene. Operator that concludes our prepared remarks. Could you please open the line to questions.

Question and Answer

Operator

Sure. (Operator Instructions). Your first question that comes from the line of Mr. Michael Phillips from Stifel Nicolaus. You may proceed, sir.

Michael Phillips
Stifel Nicolaus & Company, Inc.

Thank you. Good morning everybody.

Frederick Eppinger

Hey Michael.

Michael Phillips
Stifel Nicolaus & Company, Inc.

Hey, couple of questions. I guess first and this is something I Marita passed on in her remarks and I would say that is going to hit on us a little bit with Michigan. I think a lot of your... a good amount of your growth I think in auto, I am talking personal auto now, has come from your pretty consistent rate stance. You guys always talk about trying to take rate changes a little bit ahead of inflation and you have done that pretty consistently.

And you got some good growth this quarter again. I guess I want to hear you talk a little bit more about how concerned you might be about that regulatory environment there and what that might mean for future actions in terms of rate increases given the significance you have in that state for personal auto?

Frederick Eppinger

Yeah, I mean, obviously we anticipated some of the conversations that are going in Michigan for a long time because we were involved, we have conversations with the Commissioner's Office there obviously and the administration. I actually feel relatively good about where I think it's going to unfold. I mean I believe that there is some issues in Michigan given the economy. But because we anticipated it... a lot of the rate increases we took just recently went in. So we basically just put in a number of rate increases in the last few weeks.

So financially it's fine. But more importantly I think that I believe that we can constructively work with Michigan on some issues. One of the interesting things about Michigan as you know is that it's had a recession for last two or three years. It's not something that just happened. So a lot of these issues we have been wrestling with them for a number of quarters. And one of the things obviously is the affordability there. And there are things about Michigan for instance, it's the only state of the union that mandates some limited medical projection. That makes policies more expensive there which I think we can now have the real conversation to change some of these.

So as we look at the proposals, they've made it already. We were working with them. But we're actually... we feel pretty good about where we think it's going to come out. I actually am not that worried that it's going to be too corny (ph) or anything like that. I think it's always been a difficult state, which you have to be working closely with the administration and I think it will continue that way. I feel pretty confident that we will get to some resolution about some of these issues and we'll be able to continue to get adequate rate to cover the loss cuts, although I am not overtly concerned.

Our strategy in Michigan has been since I've been here that we manage profitability carefully because again it's not something that just occurred and so, if that means that we'll continue to shrink a little bit there, we will. But I don't see anything that dramatic coming out of these latest proposals and I feel pretty confident in being able to address the ten items that the consumer advocate is proposing. I think most of those are things that we think we can work with or work with them to change a little bit to get where we need to go.

Marita Zuraitis
Executive VP, President of Property & Casualty Companies

And also keep in mind that we outlined in our comments that our growth isn't currently coming from Michigan now and the fact that we've positioned ourselves so well outside of Michigan with new product and new expertise. We feel good about our growth prospects outside of Michigan.

Frederick Eppinger

Yeah, the ironically thing ... the ironic thing about Michigan by the way is that Michigan has the highest percentage of probably of all the major states of regional companies. I think it is over 70,000 regional company employees for instance in the economy. I mean, it's a little bit ironic about what's happening there because it's an important part of economy.

The other thing that's interesting is that a lot of little regional companies are in deep trouble there, because of both; the economy and because of weather. We've had some very severe weather there. And so we actually see... we're pretty optimistic about our competitive position; our retention has gone up consistently, our ability to grow has gone up consistently in the last couple of quarter. What we see is the real have and have nots thing happening in Michigan. So, I'm actually more optimistic, frankly to say given your question about Michigan today then I've been in two years. A lot of the regional companies have not taken rate for a long time, they got killed by weather and the economy. And what're seeing is agents are going to quality. They're going to consistency, they're going to quality, they're going to balance sheet strength and again... so, I'm pretty darn optimistic about where we are in Michigan right now.

Marita Zuraitis
Executive VP, President of Property & Casualty Companies

Especially when you're considering the economy; over the last three years we've been able to hold steady, a lot of these issues aren't new for us. And we know the state level.

Michael Phillips
Stifel Nicolaus & Company, Inc.

Thank you. That's all very, very helpful. Last question centers around the expense ratio. This quarter it seems like it ticked up a bit, I guess, I wonder, overall, it ticked up a bit year-over-year. How much of that was the pension is that in there? And then secondly on the expense ratio, Gene's comments about the guidance. I guess to say it again, I didn't quite catch it, increase from a half point up to one point up, I think kind of .....

Frederick Eppinger

Yeah, also the pension increase did not increase this year. So, of the uptick that we are experiencing right now is almost exclusively trying to capitalize on the market disruption. Mike, I mentioned this in our third quarter. And I'm ready to talk about this social services program. We have hired a number of people, around some of our specialty areas because of the disruption. And we've also invested in some product development and accelerated some product development because of the availability of people.

So, as we look at guidance, the vast majority of the guidance that we're taking about from this half point to a point and the reason why it varies in my mind, is about how aggressive and when we would hire additional resources. But it's a 100% certain that we will continue to do this. Everyday, we find more opportunities to accelerate and expand what we're doing. And so, I just wanted to be... I feel good about our earnings. We're going to manage the earnings as we said.

But I also like always, I'm going to tell you, this is the time when I'm going to try to be very thoughtful while making sure that we invest in some talent and some areas of the expertise, because it's really there for us. I'll give an example; our segment, the niche business in commercial that Marita talked about was essentially zero, two year ago. It's $75 million of very profitable business for us today. That kind of opportunity is emerging all over the place, because it's not just the big companies that are struggling. A lot of these regional companies are very good at these niches. And, when they get in trouble, this is the place, they'd rather have that in their flow business, right? So, it got them in trouble.

So, for me, there is going to be an opportunity. And so, if you look at our expenses next year, that's really where the increase is. Now, we have efficiency in our core line that we talked about, that is a part of this. And so what you see is some increases in things like that in the pension et cetera, but decreases in core business. So, I would describe so much of the increase in personnel. I mean, it's ... you look at it down (ph) the technology and product that goes along with our decision to accelerate the social services, the private company P&L initiative we've got. There is a number of these things that we've accelerated all that development because we see opportunity that we think can fund it. That's just... it's always tricky because you don't know when the revenue is going to come and that's why we're being conservative about our forecast.

Marita Zuraitis
Executive VP, President of Property & Casualty Companies

Another thing, you mentioned that quarter-over-quarter comparisons, you have to remember that last year's litigation settlement drove two points of expense reduction in that quarter. So, it made the comparison a little wide. Actually, without that, the quarter-over-quarter comparison we actually improved by about a point.

Michael Phillips
Stifel Nicolaus & Company, Inc.

Yeah. Perfect. Thank you. Just clarification, the guidance for '09 was one point above '08, was that... is that what you said?

Unidentified Analyst

Half a point 2008 (ph).

Michael Phillips
Stifel Nicolaus & Company, Inc.

Okay. Perfect, thank you.

Unidentified Analyst

As I said... credit margin and what we'll do like we always do is we'll be very clear every quarter of about what's happening and what we see. That's one of those that's is going to be kind of what we give in the market.

Michael Phillips
Stifel Nicolaus & Company, Inc.

Great. Thank you very much and congrats on a great quarter.

Frederick Eppinger

Thank you.

Operator

(Operator Instructions). Our next question is coming from the line of Jay Gelb from Barclays Capital. You may proceed, sir.

Jay Gelb
Barclays Capital

Thanks. Good morning. I had a question on... actually couple of questions on guidance. First, I think there was a mention of one metric versus consensus that one passed me a little quickly. What was that again?

Eugene Bullis

Well, as we look at what's published in First Call today and we look at the underlying models, the average pretax segment income is 360 million. That's based on the published estimates that are out there. And we think that we can meet and/or modestly exceed that.

Jay Gelb
Barclays Capital

Okay. And that's driven by what versus the models?

Eugene Bullis

I'm not sure, I understand the question.

Jay Gelb
Barclays Capital

Is it underwriting income, investment income?

Eugene Bullis

Well, as we've said, we expect to improve accident year performance. I'm not sure what you are comparing it to.

Jay Gelb
Barclays Capital

Okay. So, just so I can square things out. What do you think is a reasonable expectation for investment income for the year?

Eugene Bullis

I think it will model very well off of this year. And given the fact that we have a portfolio rate that's slightly higher than our earned yield for the year, I think you can project that out, so it will be up a bit.

Jay Gelb
Barclays Capital

Up a bit in investment income. Okay. And, on the catastrophe loss expectation three points?

Eugene Bullis

3.5.

Jay Gelb
Barclays Capital

3.5. Okay. Is that a little light compared to what's -- what the results have been for the past few years?

Eugene Bullis

Very close to our five year average.

Jay Gelb
Barclays Capital

I see. Okay. And then Fed, I don't know if you can comment on the potential benefits for Hanover from Hartford's dislocation on the property casualty side?

Frederick Eppinger

I mean, I don't want to specifically talk to any competitor Jay. But what obviously is happening now is and again I would say that it's due to our some of the smaller companies. But obviously what we are seeing is that, there is almost all the major players that we compete against day-to-day are really managing expenses and capital pretty aggressively and therefore not investing.

And so their portfolio, what I see is that here we are agents worried about one or two companies that are struggling and they're trying to replace or move that business and a lot of the people on their shelf space are growing. They're doing the opposite, they're contracting there. And so they need some good partners to help them through the transition. And so what we're trying to do as I say is invest relatively aggressively to broaden our capabilities in some areas so that we can help the agents and take some of those profit pools for them.

Because it's really again, it's a combination of things, if you look at the number of companies that have been downgraded in the last 12 months, it's over the top right. And so what that maybe... it's not about them all going out of business, it's about the fact that they're not investing and growing. They're actually trying to shrink. You've seen people -- you'll start seeing a lot of co-share (ph) now. So now you can see that they're trying to preserve capital. That tells me that the likelihood that they can solve the problems of the couple obvious ones that are in trouble is limited. And so I think the opportunity is for us.

Now we don't play, as you know our mix is small commercial, and even our specialty business we focus small. But one of the things that I don't think people have really thought through completely is even though a lot of the issues are with the big accounts and some of these large specialty opportunities, what happens to agents is it's the second tier level impact which is, now there is some very strong companies right now. We all know who they are. They go to those folks to help them solve this problem. All of a sudden they have too much concentration with those very successful companies. And so they're going to look at things like small commercial and other places to spread their risks so they don't put too much in one basket.

So we see both an opportunity from small companies, but we also see an opportunity from this potential concentration risk with some of the obvious strong companies that are going to win because of the disruption. And I think both of those are relevant for us. And again, for me I don't think that stuff ever happens overnight, it always gets overstated, how quickly it happens. But it is inevitable that agents are going to have move a lot of their business on their shelf space over the next two years because of disruption and concentration and consolidation of some of these folks.

The other thing I would comment on is less visible to you guys is the mutuals. While the mutuals don't have earnings targets, they also have less access to capital. So one of the things we're seeing particularly in the Midwest where we have had some tough weather. This lack of access to capital makes them hunker down quicker and take rate quicker which really helps us, right. It gives us cover to when we take rate to meet adequate loss costs. Because historically the mutuals always hold back longer and they drag their feet about rate increases. You're not seeing that with a lot of folks now.

So even though lot of those guys have 'excess capital', what has happened in the investment portfolio, it is taking a lot of their excess capital away and this lack of access has scared them into taking more rate and hunkering down.

So both of those things are... again we look at that as... those are just as powerful to us as pricing opportunities. Because what that allows us to do we get profit pockets, book growth, book spending that have nice margins move to us without a new business penalty which is in our view just as important as price returns. And it's kind of what we have been living off of over the last three quarters.

Jay Gelb
Barclays Capital

Thanks very much.

Frederick Eppinger

You're welcome.

Operator

And our next question then comes from the line of Wayne Archambo from BlackRock. You may proceed, sir.

Wayne Archambo
BlackRock

Thank you. Fred, with the personal lines (ph) dislocation in the markets that you're in, it's clearly a buyers market. Would you expect to do any acquisitions upside that could move the dial in the next five?

Frederick Eppinger

It's a good question. I mean one of the obvious things that's happening right now and you guys can all feel is that when people can't get access to capital and have trouble they... it's not only just the sale of companies, it's the sale of divisions, it's the sale of geographies. There is lots of conversations out there right now, of pieces of teams or parts of companies or full companies we are seeing. And I will reiterate my philosophy.

Balance sheets are always the risk in our business, right? And companies that have operational troubles typically have them because they don't... they have something wrong with their book. So we're actually quite cautious. What's different today is that some of these problems are investment related. They are not underwriting related. So there will be opportunities.

Our strategy is the same, which is I'd must much rather do the small one that we can fold in, that we can leverage our distribution capability and then win at the agent level. And so if we did... some of the most likely scenario is to continue to do smallest capability kind of build-in teams because one of the things you've seen us do... sometimes I really don't care about the premium. I care about the team because we can quickly access to the premium because of our distribution strategy. So I think that's the most likely.

Could there be something bigger? I don't know. It may be, I do think you're going to see things move towards better pricing. I think dramatic... people if you remember the last cycle, the biggest prices were always paid just before the crashes. And I think we've seen that here too. And so I think the next deal is going to all be a lot cheaper. I think they have more renewal rights. I think you're going to have stuff a lot closer to tangible book than in the past. And so you could. But I think it's less likely for us. I think our opportunities are so significant, both organically and for smaller acquisitions that I think those are more, much more likely for us.

I will also comment on our rating, for me one of the most things for us is to demonstrate a track record of performances. So I look for all deals that warrant to be accretive quickly and I want to build a track record because we had a wonderful experience this year. We've been one of the very few companies in America frankly that have been upgraded by Moody's and S&P.

I feel good about where we are with the other rating agencies as well and I'm hopeful that we can continue to be upgraded more. And further that is just making sure that we're thoughtful and relatively conservative about how we approach the market and prove that we can continue to grow earnings and do it in a thoughtful way.

So, my greatest expectation is going to be more of the same. But again it's... the world is going to unfold in a bunch of interesting ways in the next year. And we're going to just try to be open to do the right thing, but I just can't imagine a scenario we're having a great balance sheet, excess capital, a terrific team, it doesn't get us up, which is where I think we are right now.

Wayne Archambo
BlackRock

Thanks, Fred.

Frederick Eppinger

Thanks.

Operator

And at this time we have no additional question. Actually, we have our next question from the line of Michael Phillips with Stifel Nicholas. You may proceed, sir.

Michael Phillips
Stifel Nicolaus & Company, Inc.

.Hey, thanks. Sorry, if I can just... something real quick.

Frederick Eppinger

It's okay. Mike.

Michael Phillips
Stifel Nicolaus & Company, Inc.

One thing, it's just one thing. Is any thing up with the workers' comp growth this quarter?

Frederick Eppinger

No, two things right, I think you're commenting on the fourth quarter which I think was over 6 million bucks. Which I think was...

Michael Phillips
Stifel Nicolaus & Company, Inc.

I know we're on small base there so...

Frederick Eppinger

Yeah. And that was actually a reversal with NAP.

Marita Zuraitis
Executive VP, President of Property & Casualty Companies

That's right.

Frederick Eppinger

So it is actually NAP coming through. But we did have a little bit of growth for the year. So let me answer that question, I think it was in the teens a little bit. If you recall what I did in insurance workers' dramatically.

Michael Phillips
Stifel Nicolaus & Company, Inc.

Fred, when you say a little growth and it's in the teens, that's pretty nice.

Frederick Eppinger

Mike, I'm sorry.

Michael Phillips
Stifel Nicolaus & Company, Inc.

Now you're saying a little growth and it's in the teens, that's not a bad little growth.

Frederick Eppinger

No, it is not. But we're hoping and I think the workers' comp to 120 million base.

Michael Phillips
Stifel Nicolaus & Company, Inc.

Yeah. Sure.

Frederick Eppinger

So, we're talking 8, $10 million here.

Michael Phillips
Stifel Nicolaus & Company, Inc.

Okay.

Frederick Eppinger

What happened is we after re-underwrote the book and kind of focused our team, we brought in the team as you know, we had an effort that started last year. I think we might have mentioned it in the Investor Day, rounding out our small accounts, because we wrote two single policy in our box and stuff. And so what we did this year is worked really hard with our partner agents at rounding out small comp.

So what we've got is... we've got growth in kind of that line of business. But it's still a small base value, a small percentage of our book, and we're excited about it.

Marita Zuraitis
Executive VP, President of Property & Casualty Companies

I mean, absolutely, we are very happy with our current mix. It's going to be a profit for us going forward. We intent to increase it when the price is there. And so we've positioned ourselves as Fred said, rounding accounts with partner agents, we've increased our appetite for small workers comp, we've increased our ease of doing business in our small commercial model and mechanization.

So if the price is there and it grows, it will grow, but we'll do it prudently and profitably because we really do understand the line and when the price is there, you'll see it grow.

Michael Phillips
Stifel Nicolaus & Company, Inc.

Okay. Thanks, guys. I'll see you at the Investor Day if not sooner.

Frederick Eppinger

Thank you.

Michael Phillips
Stifel Nicolaus & Company, Inc.

Thanks.

Operator

And at this time, we have no additional questions. So Mr. Myron, I'll hand the call back to you.

Robert Myron

All right. Thanks very much to everyone we look forward to speaking to you next quarter and at Investor Day in May.

Operator
And this concludes today's presentation. You may know disconnect. Thank you for joining us. Enjoy your day.