Selective Insurance Group, Inc. NasdaqGS:SIGI

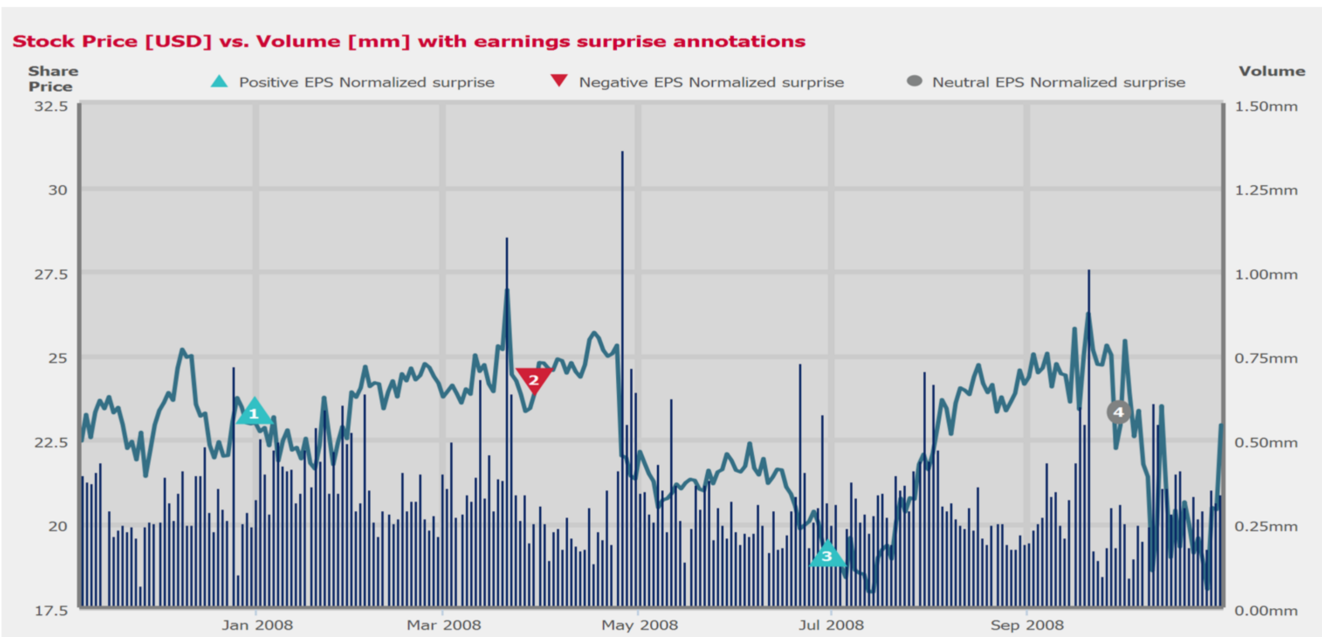
FQ4 2008 Earnings Call Transcripts

Thursday, January 29, 2009 1:30 PM GMT

S&P Global Market Intelligence Estimates

	-FQ4 2008-			-FQ1 2009-	-FY 2008-	
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	ACTUAL
EPS Normalized	0.48	0.10	(79.17 %)	0.38	1.81	1.42
Revenue	-	-	(13.64 %)	-	-	-
Revenue (mm)	440.48	380.40	-	436.17	1767.98	1695.98

Currency: USD
Consensus as of Jan-29-2009 12:32 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ4 2007	0.56	0.60	1 7.14 %
FQ1 2008	0.50	0.43	2 (14.00 %)
FQ2 2008	0.51	0.52	3 1.96 %
FQ3 2008	0.45	0.45	4 0.00 %

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Call Participants

EXECUTIVES

Dale Allen Thatcher
Former Executive VP, Treasurer & CFO

Gregory Edward Murphy
Chairman & CEO

Jennifer DiBerardino

John Marchione

Kerry Guthrie

ANALYSTS

Amit Kumar

Ben Hare

Mark Dwelle

Mike Grasher

Presentation

Operator

Good day everyone and welcome to the Selective Insurance Group fourth quarter 2008 earnings release conference call. At this time for opening remarks and introductions, I'd like to turn the call over to Vice President Investor Relations, Miss Jennifer DiBerardino.

Jennifer DiBerardino

Good morning and welcome to Selective Insurance Group's fourth quarter 2008 conference call. This call is being simulcast on our website and replay will be available through February 27, 2009.

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. Also this morning we posted on our website the fourth quarter GAAP income statement in the Investor package as it was inadvertently omitted yesterday.

Selective uses operating income and non-GAAP measure to analyze trends and operations. Operating income is net income excluding the after tax impact of net realized investment gains or losses. We believe that providing this non-GAAP measure makes it easier for investors to evaluate our insurance business.

As a reminder, some of the statements and projections that will be 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 filed with the US Securities and Exchange Commission for a detailed discussion of these risks and uncertainties. Please note that Selective undertakes no obligation to update or revise any forward-looking statements.

I'd like to take this opportunity to mention that we will be hosting an Investor Day on March 24, in New York City metropolitan area. Please watch for more details in February.

Joining me today on the call are the following members of Selective's executive management team; Greg Murphy, CEO; Dale Thatcher, CFO; John Marchione, Chief Underwriting and Field Operations Officer; Mary Porter, Chief Claims Officer; Ron Zaleski, Chief Actuary; and Kerry Guthrie, Chief Investment Officer.

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

Dale Allen Thatcher
Former Executive VP, Treasurer & CFO

Thanks Jennifer, good morning. As results indicate the fourth quarter was difficult largely due to the current volatility in the financial markets. As we indicated to you last quarter we expected fourth quarter reductions in alternative investment returns, dividend income, and the master limited partnership mark-to-market adjustments.

There were in fact the drivers of the fourth quarter earnings downside, however the magnitude was larger then we anticipated given the state of the financial markets and the fact that the majority of our alternative investments report on a one-quarter lag.

While we consider our investment portfolio to be conservative and well diversified nearly all asset classes became correlated in 2008 severely undermining the benefit of asset diversification efforts. Our portfolio including cash and short-term has a relatively short duration of 3.5 years and we maintain a laddered maturity structure in our highly rated AA+ average quality fixed income portfolio.

One hundred percent of our fixed income portfolio is performing according to contractual terms and less then 1% is below investment grade. We view these declines in value to be temporary given the high quality of our portfolio. That said, we have taken steps to limit portfolio volatility. Early in 2008 we trimmed about $50 million of equities from the portfolio. At year-end our total equity position stood at $132 million or 3.7% of invested assets limiting the potential downside of further equity declines but maintaining a commitment to this historically profitable asset class.

In the quarter we reduced our master limited partnership trading portfolio to minimize earnings volatility. Despite the negative impacts we experienced in 2008 our equity portfolio has outperformed the S&P 500 for the past nine years. We adopted our alternative investment strategy in 1997 to provide additional yield and an equity-like portfolio that was not correlated to the S&P 500.

This strategy has been very successful as it has outperformed the S&P 500 by approximately 1000 basis points on an annualized basis since inception. We employ six strategies within our $165 million alternative investment portfolio; $57 million in energy private equity, $30 million in distressed debt, $24 million in secondary market private equity, $23 million in real estate, $23 million in mezzanine financing, and $6 million in venture capital.

In the fourth quarter we sold our only hedge fund that provided near-term liquidity in which we had a capital balance of $14.5 million. Although the accounting for alternatives adds earnings volatility their continued outperformance of the S&P 500 builds more value for our shareholders over the long-term.

Another byproduct of the continued turmoil and illiquidity in the financial markets was a fourth quarter after-tax net realized loss in the investment portfolio of $19.7 million, including after-tax other then temporary impairments of $5.5 million. Certain equity investments were sold in the fourth quarter at a loss to take advantage of financial and tax planning strategies.

For the full year the non-cash pre-tax OTTI write-downs were $53.1 million or 1.5% of Selective total investment portfolio. Only one fixed income issuer in the OTTI was due to a bankruptcy. The rest were market valuation driven and may be amortized back into income in future periods.

The OTTI also included $6.6 million in equities and $4.8 million in alternative investments. It is also possible that future write-downs including securities that we believe has strong underlying fundamentals may be required in accordance with generally accepted accounting principals. As one would expect the severe pressure on investment valuations caused significant changes in our book value per share which was down 15% for the year to $16.84.

Book value per share reflected unrealized losses in our fixed income portfolio of $1.39, a decline in our equity portfolio’s unrealized gain position of $1.21 and a pension charge of $0.72. For the fourth quarter we reported operating income per diluted share of $0.10 compared to $0.60 in the fourth quarter of 2007.

The decline was mainly due to other investment income decline of $17.4 million after-tax or $0.34 per diluted share driven by our alternative portfolio, an after-tax underwriting loss of $3.1 million, a decline of $0.08 per diluted share from a year ago, an after-tax goodwill impairment charge of $2.6 million or $0.05 per diluted share for Selective HR solutions. As a result of a slowing economy near-term income expectations did not support Selective HR’s prior carrying value.

It is important to note that although the turmoil in the financial markets put extreme pressure on investment returns and earnings our core insurance operations continue to perform well. We are satisfied to report a profitable 99.2% statutory combined ratio for 2008 given the 104.8% industry estimate from Fitch Rating Service.

For the quarter our statutory combined ratio increased 0.8 points versus a year ago driven by higher non-cat property losses of $2.4 million or 1.2 points. Cat losses were flat compared to fourth quarter 2007. Overall prior year statutory loss and LAE favorable reserve development on a pre-tax basis for the quarter was $8.6 million or 2.3 points on the combined ratio compared to favorable development of $4.9 million or 1.3 points in the fourth quarter of 2007.

This quarter’s favorable development was primarily driven by accident years 2005 and 2006 partially offset by accident year 2007. For the full year favorable reserve development was $18 million. Our reserve position is strong at 54%, above the midpoint of the actuarial range.

As a result of the various expense saving initiatives we implemented in 2008 and despite the 4.5% decrease in statutory net premiums written, the statutory expense ratio for the year was relatively flat compared to a year ago at 31.7%. We acted early in 2008 to manage expenses with a workforce reduction, agent commission changes, and re-domestication of two insurance subsidiaries to Indiana.

These initiatives kept the expense ratio inline with 2007 but will also continue to benefit expenses going forward. For the fourth quarter the statutory commercial lines combined ratio increased to 102.4% from 99.4% driven by higher loss costs which were partially offset by the aforementioned expense savings. The impact on the combined ratio from catastrophe losses in the quarter was 0.5 points, 0.2 points higher then the fourth quarter of 2007.

Commercial lines statutory net premium written declined 6.5% in the quarter and 5.8% for the year reflecting our unwillingness to write aggressively in a soft pricing environment. New commercial lines business was down 6% in the quarter and 15% for the year. Despite the decline policy quotes were up approximately 2% compared to 2007. Audit and endorsement premium declined $38 million in 2008 due to the economic impact on our contractors book of business. However commercial lines renewal retention remains strong at 77%. Renewal pricing including exposure was down 2.6% for the quarter and just 1.5% for the full year.

Pure price was down 3% in the fourth quarter and 3.1% during 2008 compared to much deeper declines in the industry. This result in a difficult market reflects the underwriting tools and the discipline our underwriters employed throughout the year.

In the quarter the commercial property and Workers' Compensation lines performed well. We continue to see pressure in commercial auto due to pricing competition as well as rising severity trends. The general liability line saw pressure as we decreased audit premium accruals reflecting the weakening economy.

Personal lines excluding our flood operations posted a 110% statutory combined ratio for the fourth quarter. When comparing our combined ratio to the industry which generally includes flood in their personal lines results our combined ratio is 105.6%. We believe our underwriting improvement strategies are beginning to take effect and expect to significantly improve underwriting performance over the next year.

Personal lines premiums grew for the sixth consecutive quarter with $51 million in the fourth quarter, a 2.4% increase compared to 2007. We were successful in 2008 getting approval for personal lines rate increases and have plans to implement additional rate increases in 2009. We continue to see the impact of our rate actions on the old auto book. In New Jersey our agents have been rewriting our book into the new matrix program.

New Jersey auto count declined to approximately 65,000 cars at year end. The rollout of matrix for homeowners is on schedule. As we transition business into matrix our personal lines book could see some modest downward pressure on retention which currently stands at a strong 81%.

On January 1, 2009 we renewed three reinsurance treaties, the property capacity treaty, the surety excess of loss, and the national Workers' Compensation reinsurance pool quota share. We were extremely pleased with the solid diversification and overall pricing given the difficult market conditions.

The property capacity treaty came in at an increase of $1.3 million or 7.8%. The structure remained the same with 95% of $310 million in limit in excess of $40 million retention but the coverage improved to a one in 171 year event, up from a one in 159 year event based on last year's modeled losses.

This coverage improvement is directly due to our catastrophe strategy implemented in 2008 to reduce coastal exposure. Surety excess of loss treaty rates increased 5.4% in line with market conditions. We renewed our national Workers' Compensation reinsurance pool quota share with a net increase of $0.3 million in cost. This treaty now includes sessions for traditionally poorly performing New Jersey residual Workers' Comp business.

We are conservatively managing our liquidity position and ended the year with $60 million in cash at the holding company and $140 million in cash in the insurance subsidiaries. The holding company has access to a $50 million syndicated line of credit which expires in June, 2011. Operating cash flow in 2008 was $241 million and we maintain a conservative reinsurance program designed to preserve liquidity.

Additionally we maintain a laddered maturity schedule in our fixed income portfolio which provides predictable liquidity to operations. Capital preservation is paramount in the current environment. Despite the decline in equity over the course of the year, we feel that we are adequately capitalized with a premium to surplus ratio at 1.7x. The average life on our debt outstanding is 36 years and we have only $12 million in private placement debt maturing at the end of the next two years.

Our sustainable growth rate is approximately 5% and we believe we are well positioned to take advantage of any potential price hardening in the commercial lines market. If pricing conditions improve more dramatically then we anticipate we'll explore other contingencies to deploy such as an opportunistic equity issuance, or a [quarter] share arrangement.

Now I'll turn the call over to Gregory.

Gregory Edward Murphy
Chairman & CEO

Thank you Dale and good morning. In 2008 we experienced the most extreme confluence of economic and market events since the Great Depression. The investing world seemingly lost confidence in risk management and risk modeling as diversification efforts collapsed when nearly all asset classes became correlated.

We managed Selective to mitigate risk associated with the various financial market scenarios. We will however take prudent risks to enhance our overall long-term results while managing a conservative well diversified investment portfolio to support our underwriting activities.

We think that's the right way to manage the company, to maximize shareholder returns, while maintaining financial security. The [P&C] industry had challenges in 2008 beyond the financial market turmoil. Commercial lines pricing continued to soften, although there were early signs of rate stabilization as the year wore on.

While Selective has seen less rate decline then any pricing survey shows for the industry growth remains illusive. The cycle management tools that we have in place protected us from writing business that is sure to be unprofitable. While the short-term downside was a 5% decline in net premiums written, we believe we are in a better position to generate targeted return on equity levels over the long-term.

Underwriting profitability becomes even more critical focus for the industry given the low interest rate environment, higher catastrophe losses, investment portfolio write-downs, and closer rating agency scrutiny. While many of my industry peers are banging the table for higher pricing, we don't believe that's registered yet with the underwriters at the street level.

Within the context of the current interest rate environment pricing becomes fundamental to improving return on equity. When the pricing surveys are finally collected we believe you'll clearly see that in 2008 Selective gave up much [rate] less rate then our competitors. Pure commercial lines renewal pricing declined only 3.1%, a remarkable achievement in the current competitive environment.

We believe that's a direct result of the tangible evidence of Selective's successful strategy of maintaining close relationships with our agents and consistently giving them tools that enhance ease of doing business. Early in 2009 we expect commercial lines rates to become less negative and move into positive territory later in the year.

We are already driving higher prices on targeted sectors and have incorporated those efforts into company's performance goals for 2009. While this presents the possibility that we will drive away some business in the short-term we believe these actions will improve long-term profitability. In January of 2008 we rolled out our last predictive model for commercial automobile.

We now have a full compliment of models in use. Additionally we revised our first internal model for Workers' Compensation which is demonstrating a much better lift then the original model. In personal lines we achieved significant rate increases in 2008 that will generate an additional $15 million in annual premium, most of which will occur in 2009.

We have more rate increases planned in 2009 that will generate about an additional $9 million in premium. Reflecting the current competitive market environment commercial lines new business was down 6% in the fourth quarter and 15% for the year. New business growth by segment for the year is as follows.

[One and done] automated small business $69 million, up 7%, middle market our AMS generated business $176 million, down 17%, Selective risk managers, our large account unit $22 million, down 38%. Our cycle management efforts are best reflected in the large account arena. This is the segment of the market that continues to be the most competitive and where we've seen the steepest decline in new business.

However we are getting opportunities to quote as demonstrated by a 7% increase in 2008 new business submissions. We haven't been able to make sound actuarial pricing stick, so the business goes to lower priced competitors. We gave up only about four points of rate in 2008 on our large account business, less then we had budgeted.

Retention remains strong will renewal premium retention at 81% and customer retention at 87%. The middle market is still competitive but with our knowledge management tools in place we have the ability to identify business that can be priced for profitability. Our field underwriters have tools to make disciplined decisions even if it results in lower premium growth in the short-term.

We are pleased that we continue to grow small business with the expansion of our one and done platform to include more business classes and a broader appetite within each class. This will continue to be focused on in 2009. As we reflect on our accomplishments in 2008 we believe we've done the right things to generate growth and profitability for the long-term.

The short-term setbacks of 2008 financial markets may have slowed our progress but not stopped it by any means. We will continue to focus on growth opportunities and saw solid success in our state expansion efforts. We began operations in Tennessee which generated $6 million of premium in the first seven months of operations. Our successful 2008 entrance into Massachusetts generated $15 million of commercial lines premium growth in 2008.

We increased the number of agents relationships by 60 to approximately 940 agents at year end. We are providing our agents with business leads to help them work with our field underwriters to generate more business.

All of these initiatives are designed to take advantage of the market as it turns. We have an innovative experienced and energetic workforce and we leverage these strengths every day to serve our agents and insured's. Our relationship skills combined with ease of doing business is why we highly rank in overall satisfaction in our agency survey.

This year was no different with a strong 8.5 on a 10 point scale with 83% agency participation. Due to continued uncertain financial market conditions we've decided not to provide investment income and earnings guidance per share for 2009. However we are providing in the fourth quarter supplemental investor package an exhibit on page 11 that shows investment income by component for the fourth quarter and full year 2008 with the yields and effective tax rates for each class.

We believe this will allow you to build your 2009 models with your own assumptions on how the markets will behave. Although we gave up less rate in 2008 then many competitors we will still experience the impact of the 3.1% commercial lines rate decrease as premiums written in 2008 are earned in 2009.

The pricing impact combined with normal loss cost trends will push our 2009 combined ratios over 100, although we believe underwriting improvements will help offset some of these effects. That being said we are providing the following financial guidance for 2009; a GAAP combined ratio below 103.5, a statutory combined ratio below 102.5, [inaudible] losses of 1.4 points, and flat diversified insurance services revenue and a return on revenue of approximately 9%.

As you build your models I'd like to remind you that every one point of combined ratio represents approximately $0.18 per share on a diluted basis.

Although a tough year we are pleased with our core operations and the accomplishments we made in 2008. Our efforts will continue to actively manage investment volatility risks. We believe we are in a good competitive position to take advantage of a hardening market.
Now we are ready for your questions.

Question and Answer

Operator

(Operator Instructions) Your first question comes from the line of [Ben Hare] - Raymond James

Ben Hare

Can you talk a bit about how you're investing your new capital for 2009 and if its going to follow how your investment portfolio looks right now.

Gregory Edward Murphy
Chairman & CEO

I'd say generally you'll see some modification between on the fixed income side a slightly different allocation slightly away from muni bonds more into the taxable arena and then I think you'll continue to see a very guarded approach with respect to any increases in equity exposure or on the alternative side.

Kerry Guthrie

My only other addition to those comments probably are focused in this environment, our high quality corporate bonds and government and agency bonds. Those are two asset classes that we feel at this time offers pretty good risk adjusted returns.

Operator

Your next question comes from the line of Mike Grasher - Piper Jaffray

Mike Grasher

I wanted to ask on the alternative investments, you mentioned distressed debt about $30 million, is there any particular concentration within the distressed debt?

Dale Allen Thatcher
Former Executive VP, Treasurer & CFO

No, there's really no concentration within the distressed debt. Those are limited partnerships that we participate in that all have very diversified portfolios and I think what you're seeing there is a lot of due to FAS 157 a lot of kind of mark-to-market pressures as high yield bonds which they're using as comparables to value their portfolios have come down in price especially in the latter part of 2008.

Mike Grasher

Can you give us any further color on your exposures at the mezzanine level, the VC and the private equity.

Dale Allen Thatcher
Former Executive VP, Treasurer & CFO

Mezzanine similar story to distressed debt. That is for all intents and purposes private high yield. We feel that a lot of that is the same 157 pressure. We feel its temporary. These are loans that are made and now being marked to market during the interim part of the life of that loan and unless there's a credit event in which those loans aren't repaid, those values of those loans will gravitate back up towards par just like a bond does.

So a lot of these fluctuations we feel are temporary and mark-to-market in nature.

Mike Grasher

But in terms of the concentration of any specific industry, pretty diversified again.

Dale Allen Thatcher

Former Executive VP, Treasurer & CFO

Very diversified. Many many different, at the loan level, many different loans.

Gregory Edward Murphy
Chairman & CEO

When you look at our core fixed income portfolio less then 1% of it is below investment grade and several years when we sat back and looked at how we wanted to get a little more exposure into some other sectors, this is how we kind of got into the higher yield space. It's a very small segmentation of our portfolio on an overall basis.

So I think you have to have to look at the investment class relative to a $3.3 billion fixed income portfolio that's rated AA+ where 99 point something percent is all investment grade and so these are just some of the different strategies that have been deployed over time.

Mike Grasher

Did you happen to highlight what you thought the ceiling in terms of how high you could go on a risk to capital basis?

Dale Allen Thatcher
Former Executive VP, Treasurer & CFO

The point that we made was that we are at a 1.7 premium to surplus ratio. We've indicated for some time that we're comfortable up to a 1.8 to one. Obviously the capital is at a lower position then we started the year and there is pressure and we'll be having discussions obviously with the rating agencies but we still feel very comfortable with our capital position and comfortable that we are well within the appropriate rating ranges for AM Best which is the most important rating for us. So we feel pretty good where we are.

Mike Grasher

As you sit back and look at all this what is your biggest concern. We've got potential for more adverse investment results, we've got combined ratios going higher in 2009, there's a change in the market cycle going on, what of those is your biggest concern regarding your capital.

Gregory Edward Murphy
Chairman & CEO

In terms of our capital position in totality, what we've done to better insulate ourselves is we significantly sized down our equity exposure so obviously a large decline in market particularly, you have to understand there's statutory surplus and then there's GAAP equity and only the equity securities go through statutory surplus and GAAP equity versus fixed income only go through GAAP equity unless there's an OTTI charge and then that would go through surplus.

So really what we've done is we're looking at our statutory surplus position and Kerry has done a number of trades, sized down our exposure relative to the S&P 500. We've done two pretty good sized trades out of there, that portfolio now is only $135 million so obviously we've taken that exposure down quite a bit. We'll look at maybe other strategies maybe to better insulate any real significant downside exposure on that. That's just one issue as we look out.

There are other things with respect to GAAP equity that we explore in terms of our fixed income portfolio and the potential movement from securities out of an available for sale category into a held to maturity style account. Those are some issues that we look out and try to make sure that we reduce some of the heavy volatility as a result of what's going on.

So those are surplus issues but from a pure core pricing strategy I will tell you that John Marchione and his staff have clearly articulated a plan for 2009 that integrate the efforts that we've worked hard on from a predictive modeling and other efforts, (a) to grow the business in terms of better lead generation, better identification of high quality risk and added a lot to our agency and selling force to get us back into an organic growth mode but also trying to pick the classes that will be more profitable and while at the same time in an effort to limit some of the drag of the price reductions and normal loss cost trends, try to make sure we're going to be harder on the underperforming business.

And we feel we have a very good comfortable handle on what that business is and how we are transacting that business in 2008, so much so that it is dialed into our 2009 incentive plan that everyone in the company participates in.

Operator

Your next question comes from the line of Mark Dwelle - RBC Capital Markets

Mark Dwelle

In the general liability line it looked like there was a pretty significant combined ratio deterioration there compared to some of the recent quarters, was there, could you drill down into that line a bit and give us more sense of what's happening.

Dale Allen Thatcher
Former Executive VP, Treasurer & CFO

If you take a look at that line on just the quarter in the fourth quarter of 2007 we had significant favorable development that actually gave a benefit of about eight or nine points to that line. In addition to that in the fourth quarter of 2008 you had a drop in the accrual for audit premiums because obviously as we've seen the economy deteriorate you're seeing less frequency of additional premiums on audit and now you're starting to see return premiums on audit. So we had to drop our accrual there and then that comes straight through. That cost a couple of points in the quarter.

And then beyond that is with the fourth quarter just being a normally lower quarter in terms of premium volume you have statutory combined ratios float up because the expense ratios get higher as that's overwritten premium as opposed to earned premium. Again the biggest difference in comparison is just the favorable development that we had in 2007 and we had only minimal favorable development in 2008 on that particular line of business.

Mark Dwelle

So there was actually a little bit of favorable development, it sounds like its more of a numerator problem then a denominator problem.

Dale Allen Thatcher
Former Executive VP, Treasurer & CFO

Right if you look at fourth quarter 2007 we had $10 million of favorable development. The fourth quarter of 2008 we had $400,000 of favorable development.

Mark Dwelle

With respect to the investment portfolio I think this has been talked about in the past but I wanted to revisit the discussion in terms of the alternative investments and how those impact your results on a quarterly basis. Traditionally Selective's results have been very steady and very understandable but as a result of those investments now there's actually a significant amount of quarterly volatility built into your results and I would say that that level of volatility is not something that you're being paid for in your multiple. Have you as a company or has the Board revisited that as an investment class and taken any thoughts about how you want to continue to hold those in your overall portfolio.

Gregory Edward Murphy
Chairman & CEO

This is an asset class that we looked at. We liked the diversification, we liked the returns that it brings long-term. It significantly, we view this, if you step back and look at it at a high level, we view this as a subset of our equity exposure so we've taken an equity tolerance and then subdivided into equity and alt.

And then when we look at the alt performance significant outperformance on an annualized basis relative to the S&P 500.

So these have added an enormous amount of stockholders equity over the long-term. Unfortunately in, and its well diversified, uncorrelated so you figure that certain sectors are going to go down, some other sectors are going to go up and you get a lot of counterbalance. I think this quarter obviously tested the extremes where unless you were invested in gold, cash, and probably guns, everything went down and that's the, everything became correlated and everything went down at the same time.

So what we have discussed with the Board, what we have rethought is how can we protect maybe some extreme events to protect some of the volatility in our portfolio overall to protect some of the P&L portfolio more so then maybe the equity portfolio, more so then the stockholders equity aspect of it.

So that is something that we have discussed. We are looking at alternatives today in the marketplace but I will tell you that in some cases the frictional cost of those things are extremely expensive and but yet we are looking at other ways to protect more of the downside in there. I think that no one had really, when you look at the confluence of events these are absolutely the extreme events that you're seeing today.

Dale Allen Thatcher
Former Executive VP, Treasurer & CFO

Don't forget with FAS 157 that was adopted by most general partners in 2008 so that was a rule that was changed during the game as we built these long-term assets. Many of these strategies are private securities that are held for the long-term and now some of this volatility is coming through in the form of mark-to-market accounting in which you're forcing these managers to mark assets at let's say exit values that in the normal course they would never do.

Don't forget 157 was added kind of late in the game and it was a rule-changer so that's added some of the volatility that we prior to this have not seen.

Mark Dwelle

Your guidance for 2009 suggests some further slippage in terms of the combined ratio I don't know that that's tremendously surprising given the state of market prices over the last few years, the last time combined ratios were at this level in general was the 2001, 2002 time period, do you feel as though as you look into your marketplace and your potential to generate the price increases that were talked about in your opening comments, do you feel as though you'll have the ability to generate the same sort of increases over the next year or two to allow you to move back in the same sort of timeframe to being in a solid underwriting profit position again.

Gregory Edward Murphy
Chairman & CEO

Its difficult to say what will happen from a competitive standpoint because obviously your ability to move markets is limited by what happens in the competition because of the funds ability and the lack of switching costs in the core commercial lines product because it can easily be moved from company A to company B but what I will tell you what's different from our standpoint today versus the timeframe that you articulated, is the fact that now we have a lot more specificity of our business in terms of performance.

We have it relative by sector, relative by account, and this is where we are going to be much more aggressive in the underperforming aspect of the business so this is where we will have the capability and if our competitors are not moving price higher then we will lose those accounts. We will lose those accounts to competitors though that will be under pricing that business and they'll be further deteriorating their business then where they are today.

So that's the comment that I would share with you, maybe the difference between this market and that is the fact that the level of information that we have, the tools that our renewal underwriters have, and on a new business basis what they have to be able to go out and write the best performing business. So we will drive business out if we can't get the price increases that we feel are meritorious relative to what we need to do to generate the returns long-term.

That's the difference between today and then, now whether those prices stick will depend on what the rest of the world does in terms of competition.

Operator

Your next question comes from the line of Amit Kumar - Fox Pitt Kelton

Amit Kumar

Just going back to the discussion on the unrealized losses, and how much of it has lagged, I'm trying to figure out how much of the Q4 reversal in some markets will flow into Q1 2009 numbers, can you go back and refresh us on what is lagged and what is current as of Q4.

Dale Allen Thatcher
Former Executive VP, Treasurer & CFO

Most of the alternative investments report on a one quarter lag. There are a few that report to us monthly and therefore we don't have a lag but most of them are on a one quarter lag so you've got $165 million in alternative investments so fourth quarter activity is what will be reported to us during the first quarter and reported in our numbers in the first quarter.

Amit Kumar

Going back to the combined ratio guidance and if I go back and look at 2008 guidance that was 98%, you talked about a 3% rate pressure flowing into 2009, if I look at the delta that's roughly 5.5%, could you walk us through the components of the delta.

Gregory Edward Murphy
Chairman & CEO

We're saying that generally the combined ratio will be below that, so there's a tolerance band that we've put around that. If you were to dial down to more higher level of specificity in there, you've got three core moving parts in the overall performance. You've got a 3.1% pure price reduction in the 2008 year that will be substantially earned in 2009. So you've got that drag on a pure price basis.

In addition to that then you've got, if you're doing intellectually honest evaluations of where your year is going to be then you have normal loss cost trends, whether they be frequency, severity, and from our standpoint severity, frequencies continue to be down and severity is up a bit but at least its more in moderation relative to year-on-year so you have normal loss cost trends on your book of business that effect your performance.

And then third part of that entire process then are all of your underwriting activities that are deployed which include but are not limited to activities as a result of predicted modeling in the case that was mentioned before about our AAL strategy, what we're doing relative to the type of business that we're writing that might have been different before that may have a less new business penalty and then you go into the area of claims in terms of other initiatives that are going on in that aspect of the business and so that becomes really the third leg of the stool.

And then on top of that you've got what's generally happening year-on-year and just overall expense levels, how are you managing those expense levels relative to your premium growth and then, those are kind of the three kind of core aspects when you look at the delta. So when you're looking at the year to year we've got a collar around that ratio. I think it's the aspect of all of those things that you need to consider.

Amit Kumar

Could you just repeat the adverse development number and explain what line it came from.

Dale Allen Thatcher
Former Executive VP, Treasurer & CFO

For the quarter we had favorable development of $8.6 million. We didn’t articulate all the different lines. The only line we really talked about was on general liability, had $400,000 of favorable development.

Amit Kumar

There was no adverse in any of the lines, right?

Dale Allen Thatcher
Former Executive VP, Treasurer & CFO

The catch all, all other lines we did have some adverse development of $7.6 million.

Amit Kumar

And that came from?

Dale Allen Thatcher
Former Executive VP, Treasurer & CFO

Again its just a mixed bag of a bunch of different lines.

Operator

Your next question is a follow-up from the line of Mike Grasher - Piper Jaffray

Mike Grasher

Have you experienced any change in underwriting behavior out there so far here in the new year?

Gregory Edward Murphy
Chairman & CEO

Not as much as I’d like to see.

John Marchione

It certainly hasn’t firmed up as we would have either hoped or liked to see. I will tell you that our own pricing indications though did get more favorable as the fourth quarter went on in terms of lower reduction so no, has it firmed up at this point? Not as early as we’d like to see it but our indications are we’ve been able to give up a little bit less price later in the quarter then we did in prior quarters.

Unfortunately as long as you continue to have players out there on any given account willing to go lower then they should be on pricing, you are going to see a challenge in terms of market firming but not quite there yet. But our expectation is continued pressure in the first part of the year and then as the year goes on start to see it really start to firm up.

Gregory Edward Murphy
Chairman & CEO

When you look at, there’s four pricing surveys that we track and the two that we put the highest degree of creditability in are [Advison] and the [Telling House Clip] survey. If you look at those surveys quarter after quarter after quarter those price reductions are still in the 5%, 5.5% range and you sit there and go so when you look at the rest of the competitors, the drag on 2009 isn’t the 3.1 that we’re talking about, its 4, 4.5, 5 or whatever so you would think that at some point that has to manifest itself into the numbers and at that point then maybe you’ll see some change in philosophical approach to what happens at the street level where people are more disciplined.

I think you see a lot of grab for premium particularly in the early part of the year as companies try to help themselves get on the right track for growth to make their premium growth targets, and may not necessarily be as focused on profitability. We don't want to let ourselves fall into that trap and we're not based on the things that John and his folks are doing.

Operator

Your next question is a follow-up from the line of Amit Kumar - Fox Pitt Kelton

Amit Kumar

In terms of the pricing change we're talking about, obviously the offset is the general economic conditions and there is meaningful chatter out there that if we keep on seeing these recessionary forces a lot of the policy holders will trim the coverage and change the terms, what sort of impact are you seeing on that front.

Gregory Edward Murphy
Chairman & CEO

On the type of business that we write, I don't think you're going to see a lot of T&C changes. Our exposure is pretty much down the middle but what you will see in terms of economic ramifications is anything that's labor based for instance our Workers' Compensation book, a portion of our GL book, and other aspects that are labor sensitive, you'll see exposures drop and that will drop premium levels. As you know a good part of our commercial lines of business is in the contracting area. Its 43% of our business in total, it's well diversified in a whole host of different classes but I think you may not see a lot of top line growth per se, but you will see on an account by account basis that we are striving for price increases.

So the exposure aspect of what you're talking about will probably more manifest itself in less exposures and obviously when you drop labor it effects the comp and to some extent general liability and then it does have some overflow into the commercial auto space where an insured may have less power units. So if you've got 20 employees and 17 power units, you may have 15 employees and only 13 power units and obviously if you have less power units your exposure base is going to go down.

So I think that's more of the elements of the business that will effect our ability to grow premium in 2009.

Operator

There are no additional questions at this time; I would like to turn it back over to management for any additional or closing comments.

Gregory Edward Murphy
Chairman & CEO
Thank you very much for participating in our call. The market environment continues to be challenging but we'll weather this storm with the financial strength to further differentiate ourselves from the competition and if you have any questions or follow-up matters please contact Jennifer or Dale. Thank you very much.