S&P Capital IQ

CONTENTS



# AXIS Capital Holdings Limited NYSE:AXS

*FQ3 2011 Earnings Call Transcripts*

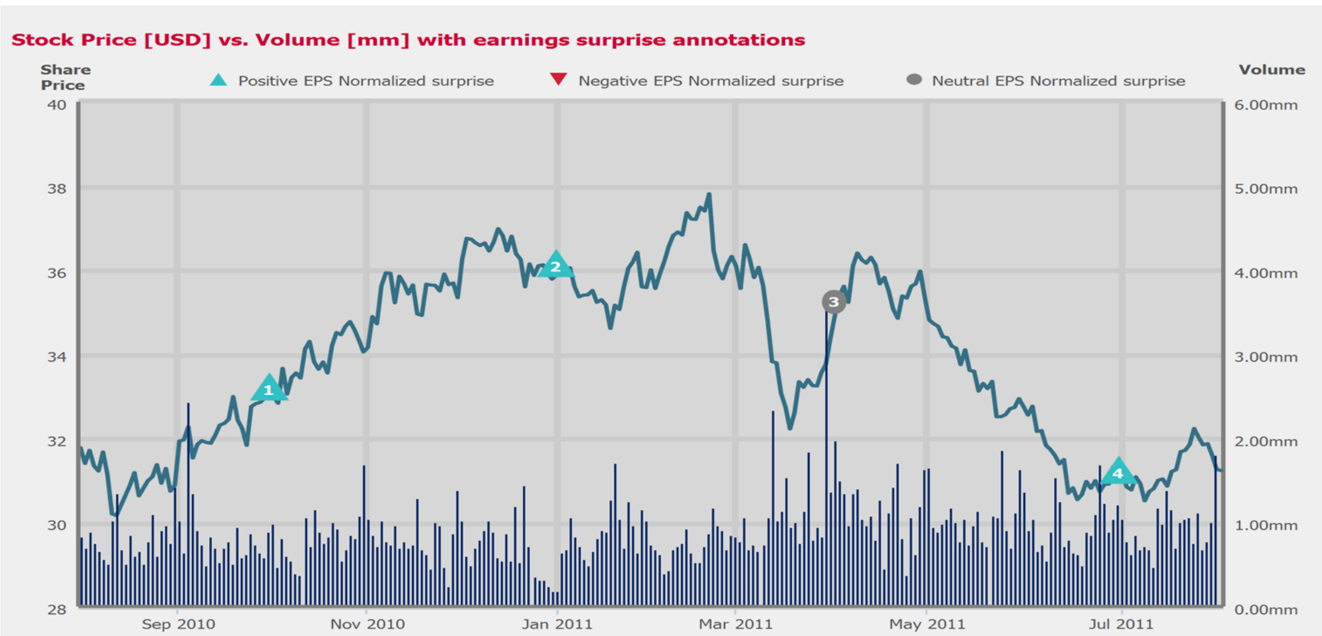
Wednesday, November 02, 2011 12:00 PM GMT

## S&P Capital IQ Estimates

| | -FQ3 2011- | | | -FQ4 2011- | -FY 2011- | -FY 2012- |
|---|---|---|---|---|---|---|
| | CONSENSUS | ACTUAL | SURPRISE | CONSENSUS | CONSENSUS | CONSENSUS |
| **EPS Normalized** | 0.78 | 0.74 | (5.13 %) | 1.10 | (0.64) | 3.85 |
| **Revenue (mm)** | 764.84 | 673.45 | (11.95 %) | 512.30 | 3518.05 | 3674.04 |

Currency: USD

Consensus as of Nov-02-2011 11:33 AM GMT




- EPS NORMALIZED -

| | CONSENSUS | ACTUAL | SURPRISE |
|---|---|---|---|
| **FQ3 2010** | 1.10 | 1.22 | 10.91 % |
| **FQ4 2010** | 1.20 | 1.41 | 17.50 % |
| **FQ1 2011** | (3.19) | (3.65) | NM |
| **FQ2 2011** | 0.48 | 0.65 | 35.42 % |

# Call Participants

## EXECUTIVES

**Albert A. Benchimol**
*President, Chief Executive Officer & Director*

**John R. Charman**
*Former Director, Chairman of Axis Re and Chairman of Axis Specialty Europe*

**Linda Ventresca**

## ANALYSTS

**Graham Yoshio Tanaka**
*Tanaka Capital Management, Inc.*

**Gregory Locraft**
*Morgan Stanley, Research Division*

**Ian Gutterman**
*Adage Capital Management, L.P.*

**Vinay Gerard Misquith**
*Evercore ISI, Research Division*

# Presentation

**Operator**

Good morning, and welcome to the Third Quarter of 2011 AXIS Capital Earnings Conference Call and Webcast. [Operator Instructions] Please note, this event is being recorded. I would now like to turn the conference over to Linda Ventresca, Executive Vice President. Ms. Ventresca, please go ahead.

**Linda Ventresca**

Thank you, Valerie, and good morning, ladies and gentlemen. I'm happy to welcome you to our conference call to discuss the financial results for AXIS Capital for the third quarter ended September 30, 2011. Our earnings press release and financial supplement were issued yesterday evening after the market closed. If you would like copies, please visit the Investor Information section of our website, www.axiscapital.com. We've set aside 1 hour for today's call, which is also available as an audio webcast through the Investor Information section of our website. A replay of the teleconference will be available by dialing (877) 344-7529 in the U.S. and the international number is (412) 317-0088. The conference code for both replay dial-in numbers is 10004922. With me on today's call are John Charman, our CEO and President; and Albert Benchimol, our CFO.

Before I turn the call over to John, I will remind everyone that statements made during this call, including the question-and-answer session, which are not historical facts, may be forward-looking statements within the meaning of U.S. federal securities laws. Forward-looking statements contained in this presentation include, but are not necessarily limited to, information regarding our estimate of losses related to catastrophes, policies and other loss events, general economic, capital and credit market conditions; future growth prospects, financial results and capital management initiatives; evaluation of losses and loss reserves; investment strategies, investment portfolio and market performance; impact to the marketplace with respect to changes in pricing model; and our expectations regarding pricing and other market conditions. These statements involve risks, uncertainties and assumptions, which could cause actual results to differ materially from our expectations. For a discussion of these matters, please refer to the Risk Factors section in our most recent Form 10-K on file with the Securities and Exchange Commission. We undertake no obligation to update or revise publicly any forward-looking statements, whether as a result of new information, future events or otherwise. In addition, this presentation contains information regarding operating income, which is a non-GAAP financial measure within the meaning of the U.S. federal securities laws. For a reconciliation of this item to the most directly comparable GAAP financial measure, please refer to our press release, which can be found on our website.

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

**John R. Charman**
*Former Director, Chairman of Axis Re and Chairman of Axis Specialty Europe*

Thank you, Linda, and good morning, ladies and gentlemen. I will start by providing a brief overview of our financial results for the quarter, and then leave it to Albert to provide more detail. Following that, I will discuss our underwriting operations and our view of the market outlook and then open the lines for questions.

The market continues to experience cycle change. Many foolishly expect instant gratification across the board. That is not what cycle change brings. I said 3 quarters ago that I absent a major market changing event, the insurance market was on the cusp of cycle change, characterized by a day-by-day battle, geography-by geography, product line-by-product line and account-by-account. This battle is being fought by underwriters to stem the overwhelming broad rate productions over the last 5 years and move towards much needed rate increases. Granted and deliberately, the shorter term and specialty lines are responding. There is still significant ground to be recovered in many professional and casualty lines.

Investment yields being at all-time lows are adding increased pressure for positive pricing change.
It is not a matter of if for these other lines, more of a matter of when. At AXIS, we are patient but

demanding. Our underwriters will not participate in what we consider to be underpriced product lines or individual accounts. Our underwriters are, however, responding appropriately in those lines where we see opportunity, as well as driving growth in newer lines, as well as new geographies.

On balance, this meant gross premiums were up 11% for the quarter and net premiums were up 8% for the quarter. Our third quarter underwriting results were very good in light of catastrophe activity, which we would consider higher than normal for the quarter. Our total net catastrophe losses, net of reinstatements in the quarter were $91 million. In addition to these catastrophe losses, our underwriting results for the quarter absorbed a high level of large property losses as a result of the cumulative impact of major and tragic weather disasters throughout the United States. U.S. events for the year-to-date are estimated to exceed $35 billion in economic losses, and are in addition to the highest insured earthquake losses in history.

Our prior year reserves continue to develop favorably, and during the quarter, we recorded a combined ratio of 91.5%, which we believe is a very healthy result considering the prevailing overall adverse market conditions. That investment income was under significant pressure in the quarter due to continued low interest rates and a reduction in the valuation of our Alternatives portfolio driven by the extreme volatility in the global financial markets.

For the quarter, our annualized return on average common equity was 17.5% on a reported basis, and our annualized operating return on average common equity was 7.8%. Our total return on our cash and invested assets including the effects of foreign exchange was a negative 0.4% for the quarter. As a result, our diluted book value per share for the quarter increased slightly from $36.78 per share to $37.06 per share.

And with that, I'd like to turn the call over to Albert to review our financial results in more detail.

**Albert A. Benchimol**
*President, Chief Executive Officer & Director*

Thank you, John, and good morning, everyone. As John noted, we reported a reasonably good quarter, given the high frequency and severity of property and cat losses, as well as the difficult financial market conditions. Of note are the good growth and promising lines in markets including A&H, Canada, Australia, Europe and renewable energy; a consolidated combined ratio of 91.5%; quarterly cash flow from operations of $399 million; quarterly operating income ROE of 7.8%; and quarterly net income ROE of 17.5%.

To put this quarter in context, both this year's third quarter and last year's had similar impacts from named large catastrophes. In this year's quarter, net catastrophe losses after related premium adjustments and taxes were $84 million or $0.66 per share. In the 2010 quarter, these aggregated $82 million or $0.61 per share. In both periods, cat losses added 10.8 points to the loss ratio. Likewise, prior year reserve releases subtracted about 9.5 points from the loss ratio. Yet our quarterly operating income was down $94 million from $189 million to $95 million. That difference can be attributed to the higher attritional property losses that John referred to in his introductory remarks, as well as lower investment income primarily due to the lower valuations of our alternative asset portfolio where the changes in market value is presented in operating investment income. We will discuss these in greater detail on this call, but essentially all other aspects of our operations are performing as well as could be expected under current market conditions.

Let's start with the income statement. Consolidated third quarter gross written premiums were up 11% to $835 million, while net premiums written were up 8% in the quarter. The lower growth rate reflects primarily a shift in business mix towards lines with high recession rates. Consolidated net premiums earned grew 11%, continuing to benefit from the reduction in our ceded reinsurance program affected in the second quarter of 2010. Our consolidated combined ratio for the quarter was 91.5% as compared to 85.6% in the prior year quarter.

Total third quarter named cat losses aggregated $65 million. The most significant major cat event impacting our results this quarter was Hurricane Irene. We recognized associated pretax net losses net of related reinstatement premiums of $20 million in our Insurance segment and $10 million in reinsurance. Tropical Storm Lee cost our insurance division $18 million, while the Danish flooding cost our reinsurance division a similar amount.

During the quarter, we also adjusted our estimates for the first half catastrophe events. We continue to be in regular communication with our clients and intermediaries and are actively monitoring available market information. As a result of which, we have added a net total of $26 million to our New Zealand and Japan losses net of reinstatements.

We increased our estimate of pretax net losses net of reinstatements from the February New Zealand earthquake and the June aftershocks by $38 million. Our ultimate net losses net of reinstatements now stand at $360 million and $32 million, respectively, for the February and June events in New Zealand.

With regards to the Japanese earthquake and tsunami, our estimated pretax net losses net of reinstatement decreased by $12 million this quarter to $189 million. We realize that many competitors have actually increased their estimates for Japan, and this reduction might, at first glance, appear counterintuitive. However, changes in the quarter must be viewed in the context of the original loss estimate. As I noted in our second quarter call, in retrospect, we were too conservative in our initial estimate for Japan. As new facts and indications came in, we have adjusted our estimates to what we believe is a more appropriate level. Even after this reduction, we remain confident in the prudence of our estimates for the Japanese earthquake.

That said, we recognize that conditions in New Zealand continue to evolve and significant loss adjustment work remains outstanding. In addition, we expect that there will be some difficulty allocating individual losses between the 3 major New Zealand earthquakes. Our estimated ultimate losses for New Zealand, Japan or any large catastrophe are subject to potentially significant changes on the basis of new facts or circumstances. We will continue to monitor development, and consistent with the reporting history, we'll keep you apprised of any significant developments.

In comparison to history, you'll recall that our third quarter 2010 results were impacted by the first New Zealand earthquake in September, which added $85 million to losses that quarter. Excluding the impact of catastrophe losses, our underwriting income was $180 million this quarter compared to $209 million for the third quarter of 2010. Ex cat, our accident year loss ratio was up 4.6 points from 54.3% in the third quarter of 2010 to 58.9% this quarter. The primary driver of the increase was a higher level and severity of large weather-related and other property losses that occurred throughout the year, the ultimate amount of which triggered a number of aggregate property reinsurance contracts for regional companies in the U.S. and this was booked in our Reinsurance segment.

To provide a little more detail by segment, insurance gross premiums written were up $60 million, led by our new Accident and Health units. Excluding A&H, gross premiums written for the Insurance segment were up 6% in the quarter. Consistent with last quarter, this growth was largely attributable to our recent geographic expansion and our renewable energy initiative. The growth in our professional lines business is largely related to smaller accounts and geographic expansion, including our European and Canadian operations where we are achieving very acceptable technical ratios on new and renewed business. As you know, our global reach and broad range of products in our Professional Lines business, addressing many industry segments and geographies, allow us the opportunity to find attractive pockets of business even in an overall difficult market.

Insurance net premiums written were up 7%, while net premiums earned increased 16% as a result of the changes in reinsurance purchases I discussed earlier that occurred in the second quarter of 2010.

Our Insurance segment reported third quarter combined ratio of 89.4%, and a loss ratio of 56%. This compares to a combined ratio of 79.3%, and a loss ratio of 47.1% in the prior year quarter. The difference is entirely driven by 10.7 points of cat losses in 2011 as compared to an absence of significant cats in the prior year. Prior year favorable development was essentially the same in both periods, with an 8.8 point benefit in the current year as compared to 8.7 points last year.

For the 9-month period, our Insurance segment reported 14% growth in net premiums written, 20% growth in net premiums earned and a combined ratio of 99% as compared to a 2010 9-month combined ratio of 84%. The year-over-year increase in the combined ratio is due to 11.9 points of cats in 2011 as opposed to no significant cats in 2010, a modestly lower benefit from prior period reserve releases and higher G&A.

For our Reinsurance segment, the 8% increase in gross premiums written for the third quarter primarily relates to our trade credit and bond business, as well as growth in Latin American surety business. Our Reinsurance combined ratio for the third quarter was 89.5% and the loss ratio was 63.8%, as compared to a combined ratio of 86.3% and a loss ratio of 61.8% in 2010.

Named cat in the third quarter of this year, including Hurricane Irene, the Danish flood and increases to first half events, contributed 10.8 points to the ratio as opposed from 19.3 points incurred in the first New Zealand earthquake in 2010. However, that lower cat expense was more than fully offset by new accruals for a number of aggregate excess of loss contracts as we discussed earlier.

Prior favorable development was flat year-over-year, with a 9.7 point benefit in 2011 as opposed to a 10 point benefit in the prior year.

For the 9-month period, our Reinsurance segment reported growth rates of 8% and 7%, respectively, for net premiums written and earned, and a combined ratio of 125 points too, as compared to a combined ratio of 89.8% in the prior 9-month period. This increase was driven by heavier cat loss of 47.3 points which was 27.6 points higher than the prior year, a lower benefit from prior year reserve releases and higher expenses.

Net investment income was $49 million for the quarter, down $63 million from the $112 million reported in the third quarter of 2010. And this reduction was the biggest driver for the decline in year-over-year third quarter operating income. Income from our fixed maturity portfolios, cash and short-term investments was $83 million for the quarter, down from $91 million in the second quarter of this year, as well as the third quarter of last year. This decline was to be expected due to the reinvestment of portfolio cash flows that yield below book yield, which declined again about 30 basis points during the quarter.

Other factors influencing interest income included the decline in the strength of the Euro, and therefore, European assets were converted to release smaller dollars, and a reduction in corporate debt holdings with proceeds invested in lower-yielding municipal bonds and U.S. Treasury bonds.

While this shift away from corporates cost us about $1 million in pretax investment income on a quarterly basis, we believe it was nevertheless, a good call in light of widening spreads in the quarter. But the largest factor on our investment income this quarter was the $30 million decline in the market value of our other investment portfolio given the turmoil in global capital markets. This reduction in value compares to an increase of $12 million in the second quarter of this year and an increase of $25 million in the third quarter of 2010. Our hedge funds fell $24 million and our credit funds lost $11 million. These declines were partially offset by improved valuation of our CLO equity holdings totaling $5 million.

While no one likes to report declines in portfolio values, the hedge fund portfolio did exactly what we expected it to do. It provided diversification from interest rate risks with volatility that is substantially better than that of equities. And while fixed income was indeed the best performing asset class this year, we continue to believe it is appropriate to have some diversification in our portfolio and to allocate prudent amounts to hedge funds, equities and high yield.

In aggregate, the total return on our cash and investment portfolio for the quarter was negative 0.4%. Excluding foreign exchange impact, which is largely offset on the liability side, the total return on cash and investments was essentially flat for the quarter.

During the quarter, we continue to realize gains in these portfolios, totaling $58 million, bringing our realized gains year-to-date to $125 million. Given the continued shift downward in the U.S. Treasury yield curve during the quarter, we expect net investment income will remain under pressure as the fixed maturity book yield of 3% converges closer towards the yielded market of 2.4%. Some of the decline in yield will be offset by our strong cash flow, which will lead to increases in invested assets. But the current interest rate environment remains a strong headwind.

We reported operating cash flow of $400 million for the quarter, actually an approximation for $399 million, and $992 million for the first 9 months of the year. The other income statement items are relatively straightforward. Total G&A expenses this quarter were largely consistent with each of the first 2 quarters of 2011, although higher than the third quarter of 2010, largely due to headcount increases commensurate with our growth initiatives and global expansion.

Our foreign exchange gains for the quarter relate to the revaluation of our insurance-related net liabilities. The amount was primarily driven by the depreciation of the euro, sterling, and Australian dollar against the U.S. dollar during the quarter. However, as I've mentioned in previous calls, since we invest in assets with currencies aligned to our liabilities, much of this gain was offset by reductions in the value in our investment portfolio, and thus, the net impact of FX movement on our book value during the quarter was insignificant. And this is why we determined to exclude FX from our calculation of operating income.

The net of all these items and preferred dividends was net income available to common shareholders of $212 million this quarter.

Moving on to the balance sheet, our assets grew 9% in the first 9 months of the year to $17.9 billion, consistent with our activities. Gross premiums written growth has resulted in increases for premium receivable, deferred acquisition costs and other premium, while cat losses affected our growth reserves and reinsurance recoverables.

Cash and invested assets totaled $13.4 billion at quarter end versus $13.2 billion at the end of the second quarter and $12.9 billion a year ago. Our fixed maturity portfolio continues to be our largest asset class, comprising 80% of cash and invested assets. We continue to maintain a high average credit quality of AA- with a 2.9-year duration for our fixed maturity portfolio. The strategy there is to continue to emphasize spread sectors, the largest being corporates, U.S. agency mortgage-backed securities and municipal issuers.

About $1 billion of our cash and invested assets is invested in non-U.S. government fixed income securities with an average rating of AA+ and an average maturity of 3.5 years. Our largest non-U.S. sovereign holdings are the U.K. and Germany, and we have no direct exposure to sovereign debt of Portugal, Italy, Ireland or Greece. Our holdings of Spain total $82 million.

Corporate debt holdings totaled $3.7 billion, down from $4.1 billion at the end of the second quarter. Corporate debt holdings of issuers with domiciles in the U.K. and Europe total $813 million. Included in that $813 million is a total of $302 million of bonds issued by U.K. and European banks. Subsequent to quarter end, in October, we have eliminated all fixed income exposures to U.K. eurozone banks at values approximating our quarter end values. Separately, we made a modest increase in our allocation to short duration high-yield portfolios in October given attractive valuations in this class. Equity has made up 4.3% of our portfolio at September 30, down from 4.9% at the end of the second quarter due to market value declines of our equity portfolios. As I noted earlier, we believe it is prudent and appropriate to diversify away from interest-rate risk in our portfolio. Equities and alternatives comprised 9% of our total invested assets and cash at the end of the quarter. We remain comfortable with our exposures and will likely make modest addition to this over the upcoming quarters, consistent with our diversification of risk management strategy and subject to supportive market conditions.

Gross reserves aggregate at $8.3 billion while net loss reserves are $6.6 billion, an increase of $1.1 billion from year end, as we booked approximately $797 million in catastrophe-related net losses. On a consolidated basis, we recognized $78 million of net favorable development this quarter and $180 million year-to-date.

Approximately 58% of the group's consolidated net favorable reserve development this quarter was generated from short-tail lines and reflected better-than-expected loss emergence. The remainder related primarily to our Professional Lines Insurance and Reinsurance business as we continue to incorporate our own experience into our ultimate expected loss ratios.

As with prior quarters, we have yet to do this in any meaningful way for our liability lines with longer development tails.

Our total capital at September 30 was $6.4 billion, down from $6.6 billion at year end, including $1 billion of long-term debt and $500 million of preferred equity. Book value per diluted share was $37.6 at September 30, up from $36.78 at June 30. We have not repurchased any stock in the third quarter. However, given the absence of unusually large cat events in the quarter and assuming that financial conditions remain the same, it is likely that we will resume stock purchases going forward.

While we are disappointed in the reduction of our common equity during the first 9 months of 2011 due to the frequency and severity of catastrophe activity, we are confident that we will resume our superior historical book value growth rate as we have in the past after unusually large loss events. Recall that since our IPO just over 8 years ago and through this quarter, our diluted book value per share has grown at a compound annual rate of more than 11%, and we've created value for our shareholders measured by diluted book value growth and dividends declared on a compound annual rate of more than 13% for the same period. We are confident that ours remains one of the strongest balance sheets in the industry, underpinned by high-quality liquid assets and prudent reserves.

Before I turn the call back to John, I would like to discuss our PML disclosures provided in our financial supplement. These quarterly PML updates will generally reflect the normal changes in our underwriting portfolio and reinsurance purchases in the period. This quarter's PML disclosure also reflects the incorporation of inputs from RMS version 11 in our cat modeling. You'll recall that we developed our PMLs using multiple commercially available vendor models, assigning various weights to each based on our own judgment and expertise, and also makes additional adjustments to supplement model shortcomings including those for unmodeled losses. We review, validate and incorporate model update on an ongoing basis.

During the quarter, we completed our validation of RMS 11, and our updated view of catastrophe risk is incorporated in the PMLs provided in our third quarter financial supplement. Our single zone, 1-in-250 years PML increased between 4% and 11% this quarter depending on the zone. The remaining PMLs remain within our tolerance and will -- and allow us the opportunity to increase exposures if we chose to do so under appropriate market conditions.

And with that, I'll return the call back to John.

**John R. Charman**
*Former Director, Chairman of Axis Re and Chairman of Axis Specialty Europe*

Thank you, Albert. I'll start by discussing market conditions faced by our Insurance segment, then followed by our Reinsurance segment.

In our Insurance segment, most lines of business continue to trend directionally upwards, either showing positive rate movements in absolute terms or less negative movements than previously. This is a very important statement, given that the market is in cycle change mode. Rate change for the segment overall was flat, indicative of the bottoming of the market we think we are seeing now, with improvement in the various lines pacing differently. Both our U.S. and International divisions experience very encouraging overall rate improvement in the quarter. Rate in our U.S. division, which is heavily weighted towards U.S. Property, was up 6% overall, ahead of the 12-month rolling average of minus 1%. In our International division, which is essentially comprised of our specialty designs, overall rate change was plus 3%, ahead of the rolling 12-month average of plus 2%.

Across AXIS Insurance, property and energy classes continue to show high single-digit rate increases. Specialty classes such as terrorism and aviation, which continue to be written by the market at inadequate pricing levels and are still subject to fierce competition and decreasing rates, do not feature meaningfully in our portfolio as our participations have already been substantially reduced over the last few years because of margin erosion.

In Professional Lines, which is suffering from heavy competition, rates on our portfolio continues to be down high single-digits overall. However, the gap between new and renewal pricing seems to be narrowing, and terms and conditions have been holding steady for some time. We are cautiously optimistic that we may be in the early stages of a transition in the Professional Lines market as well. The last cycle change in this line was at the beginning of the last decade and was not a quick correction, as was the case in some other specialty lines. Instead, it took 2 to 3 years to unfold. We have not been growing the core financial institution and commercial areas of our professional lines, which are predominantly large account-focused. Growth in this line is coming from our newer initiatives.

Moving on to our Reinsurance segment. As discussed in our second quarter call, rate improvement on the 1st of July renewals for property catastrophe exposed reinsurance business in the U.S. was in the order of 10% on average. This improvement was generally not sufficient to compensate us for the increased view of risk we believe the market needs to digest and act upon. Certainly, this increase was not enough to induce us to put more capital at risk. We expect to see rates increase at least that much at the upcoming 1st of January renewals. However, in our view, that is simply not good enough. And we will be pushing for substantially stronger pricing at the 1st of January renewal.

Our conservative and highly diversified U.S. casualty reinsurance portfolio, half of which is the Specialty Casualty reinsurance portfolio, currently comprises less than 20% of our annual reinsurance writings. For some time, the U.S. casualty reinsurance has been under pressure in line with underlying accounts. We are comfortable that we are beginning to see inflection points in pricing in many of the accounts underlying our portfolio.

Further, in our casualty reinsurance portfolio, there's no slippage in terms and conditions, and we are tightening contracts on a case-by-case basis. In our view, the tone in the reinsurance marketplace coming from the various industry gatherings of reinsurers with cedents over the last several weeks has been positive and bodes well for the 1st of January renewal date. Our insurance underwriters are observing the largest cedents pushing the hardest for rate increase, with cycle change gaining momentum primarily in North America.

We are optimistic that the positive momentum we've been seeing in the market over the last few quarters will continue. And as always, we'll continue to seek the very best opportunities available for our shareholders.

All of our business lines continue to perform within expectations and are appropriately positioned to continue to do so in the current market environment. New units established over the last several years are poised to deliver profitable growth. Overall, AXIS continues to be deliberately extremely underweight in the most competitive casualty lines. We have been very selective with respect to our participation in the longer tail lines since our inception, and we believe that our conservative reserving practices since inception and our strong capital base position us appropriately to deliver high-quality returns to shareholders as the market inevitably strengthens.

We have the capital, as well as the institutional experience in the breadth and depth, to strongly and nimbly address opportunities that present themselves if market pricing meets or exceeds levels commensurate with our view of risk. Simply put, we are there for the market if the market is there for us.

In line with our view of a gradual and deliberate cycle change, we expect underwriting opportunities will be available on a somewhat unpredictable basis as this cycle change unfolds. They will be there, and we are focused on preserving capital for the very best underwriting opportunities. Underwriting opportunities will be evaluated against our strong conviction that there is significant value available in our current stock price. Because of the mixed underwriting conditions we expect to face in the near term, we intend to balance deployment of capital and underwriting opportunities with share repurchase through organic earnings.

In summary, as we approach our 10th anniversary, our commitment to providing high-quality capacity to our clients at the same time that we deliver market-leading returns to our shareholders is as strong as ever, and we expect to deliver on this commitment. And with that, I'd like open the lines for questions.

# Question and Answer

**Operator**

[Operator Instructions] Our first question comes from Vinay Misquith of Evercore Partners.

**Vinay Gerard Misquith**
*Evercore ISI, Research Division*

John, on the cycle turn, just curious, there's been a lot of discussion, where do you think we are right now versus the last hard market? Are we in '99, in 2000 and what catalyst do you think will get us up to stronger pricing versus the low single-digit pricing right now?

**John R. Charman**
*Former Director, Chairman of Axis Re and Chairman of Axis Specialty Europe*

Well, I think the characteristics of the market are somewhat different from 2001 because -- which was the last hard market, because you had to go back to -- there were 3 main issues that caused the market to change then. Firstly was the fact of the reemergence of latent liability issues especially from asbestos rearing its ugly head again and cashing everybody out. And then secondly there was the most appalling losses being produced from the excessive competition in the marketplace between 1996 and 2001 that emerged in 2000 and was emerging again in 2001. And then on top of that, you had the unexpected and unmodeled World Trade Center tragedy loss, which at the time was being talked about between $50 billion and $80 billion. And I said at that time, it wasn't the straw that broke the camel's back, it was a haystack. And so I think the circumstances are very different. Even though that the market has assumed somewhere between $75 billion and $80 billion of large either cat losses or large individual losses this year, the market is still relatively sluggish in understanding the need to reprice its cat products. I've been very surprised as well that the non-cat products have still been under such fierce competition. But as I've said that we're now beginning to -- it's only in the last few months that people are now beginning to -- the balance sheets are now beginning to show the strain of some of the ridiculous competition we've seen throughout some of the lines of business over the last 4 or 5 years. I think, my instinct -- everything that my experience and instinct tells me that 2012 will be a fundamentally different marketplace from what it is today. But it's not going to be excessive. It is going to be a battle. And as I said, it's risk-by-risk and product-by-product and geography-by-geography. But it's there. And I can assure you, once that momentum changes and then the underwriting community have the confidence to charge rate increases as opposed to feeling that they're obliged to secede to rate decreases, once that confidence is within the marketplace, rating moves quite quickly. So I'm actually cautiously optimistic for next year, Vinay.

**Vinay Gerard Misquith**
*Evercore ISI, Research Division*

Okay, that's interesting. Also this time around, the capital position of the industry seems to be better than during the last cycle. Do you think that even if pricing increases that reinsurers will get more business or do you think that the primary insurers, because they're adequately capitalized, will keep the same amount of business net?

**John R. Charman**
*Former Director, Chairman of Axis Re and Chairman of Axis Specialty Europe*

Well, that assumes that the industry is properly reserved for casualty business and longer tail lines. So I suppose, when you talk about excessive capital -- I don't see evidence of excessive capital within the marketplace. I think people have been very prudent, and they're beginning to think about being much more careful about the way they deploy their capital. And the risk reward characteristics of the business that they're underwriting have to increase pretty dramatically over the next 2 to 3 years to be able to satisfy the demands of that capital base.

**Vinay Gerard Misquith**
*Evercore ISI, Research Division*

Okay, that's great. Just to follow up, this is for Albert, actually. How much of the increase in the reinsurance loss ratio ex-cats was due to the regional programs you've mentioned?

**Albert A. Benchimol**
*President, Chief Executive Officer & Director*

I have that information so bear with me. In the quarter it was approximately -- almost 6 -- sorry, almost 10 points. It was 10 points in terms of the aggregate ratings.

**Vinay Gerard Misquith**
*Evercore ISI, Research Division*

So the 10 points is just on the Reinsurance segment, correct?

**Albert A. Benchimol**
*President, Chief Executive Officer & Director*

That's correct.

**Vinay Gerard Misquith**
*Evercore ISI, Research Division*

Not on the aggregate...

**Albert A. Benchimol**
*President, Chief Executive Officer & Director*

Well, the average [indiscernible] were all paid out of the Reinsurance segment.

**Operator**

Your next question comes from Greg Locraft of Morgan Stanley.

**Gregory Locraft**
*Morgan Stanley, Research Division*

Wanted to just follow up on the buybacks. Obviously, you guys were very clear that they're attractive and have an increased appetite to do so at the current valuation. My other understanding, it seems like from the commentaries, should we be using operating earnings as kind of the governor for how much you might do this quarter and next? And can you maybe directly address whether you would start in the fourth quarter versus the first?

**Albert A. Benchimol**
*President, Chief Executive Officer & Director*

I think in the -- I think the second part of your question is now that we've announced it, we feel that we can do that starting today if we chose to. The second part is one where, as John had said, we really want to balance on a quarter-by-quarter basis where the opportunities are. So if we feel that we have opportunities to write business in the right markets, we will certainly buy less stocks. So -- and if we have less opportunities, we'll buy more. I'm uncomfortable giving you any guidance as to how much we will purchase in any quarter. It really will depend on the conditions as we see them on the ground.

**Gregory Locraft**
*Morgan Stanley, Research Division*

Okay, great, that's helpful. And then turning to the disclosure regarding PMLs and RMS 11, again, there's been a dramatic improvement, I think, as this year has progressed. And so I just wanted to once again understand, what -- how should we be thinking about your peak zone limit relative to capital in terms of as a capacity constraint on the business? Because that's been obviously a big perception issue in the marketplace in 2011.

**Albert A. Benchimol**

*President, Chief Executive Officer & Director*

Right. I think that -- I would start with 2 statements. The first is that our appetite in terms of an extreme event, in terms of exposing 25% of our capital to our 1-in-250 event remains. I think what you've heard from us pretty consistently since the beginning of the year is that, that appetite is not available at any price. And so we would be willing to use the top of our appetite if we were very well paid for it. If we are not well paid for it, there are a number of accounts that, if there aren't relationship or longer term profitability issues to consider, we may determine to get out of. And some of that is what you may have seen during this quarter or during the last 6 months. As we look to the renewals, and John had referred to it, significant reduction in Australasia in the January and March because we felt that notwithstanding some of the pricing increases, they did not meet our requirements. Same thing happened in the June, July. And I go back to John's point. We have the capacity, we are prepared to utilize it, but we are -- we have no intention to utilize all of it at any price.

**John R. Charman**
*Former Director, Chairman of Axis Re and Chairman of Axis Specialty Europe*

Greg, I just want to pick up on Albert's points, which are absolutely correct. We've spent -- I said in the last quarter of last year, we started really reflecting on the previous 3 or 4 years of cat and large losses, and look at the effect of climate change on these losses. And I really do believe that the cat market really needs to step back and rethink a great deal of the sort of structure that they're offering cedents in terms of retentions, in terms of pricing, in terms of reinstatements. It is not just the non-peak cat zones that you know I have a big issue about. It actually is the peak cat zones as well. And the market just thinks that it can -- if there's a loss, it can add 40% or 50% to a structure, and they feel that they've done very well. Instead of stepping back and looking to see whether the structure is realistic in the conditions that we're facing today. And I really do believe that the senior underwriters within the major cat writing businesses really ought to reflect more carefully on the scale of the losses as well as the frequency of the losses that we're seeing on a global basis and recalibrate the way that they look for their risk reward characteristics.

**Gregory Locraft**
*Morgan Stanley, Research Division*

Okay, great. And, I mean, again, given the updated disclosures and where book value is, I mean, you've got excess capacity now in every zone, so you can certainly go at it...

**John R. Charman**
*Former Director, Chairman of Axis Re and Chairman of Axis Specialty Europe*

Yes, [indiscernible], Greg. We're going to push price.

**Gregory Locraft**
*Morgan Stanley, Research Division*

Okay. Last one John, and then I'll jump back in the queue. It's just high flooding. Obviously, it's an issue that's cooking. I know it's too early to really gauge, but you tend to be closer to the markets than many, so how are you reading the situation from a loss perspective?

**John R. Charman**
*Former Director, Chairman of Axis Re and Chairman of Axis Specialty Europe*

Albert's our tide, flood expert.

**Albert A. Benchimol**
*President, Chief Executive Officer & Director*

That's only because I typed it last night. The -- we, as you might imagine, we've already gone through and looked at our various insureds. We looked at the -- we looked at our reinsurance contracts and obviously the water in some cases are still rising. But everything that we see right now makes us look that whatever were to happen would be well contained within our attritional expectations and normal large to lowest expectations. We don't see this as an unusual income-moving event.

**Operator**

Our next question comes from Graham Tanaka of Tanaka Capital.

**Graham Yoshio Tanaka**
*Tanaka Capital Management, Inc.*

I wonder if you can tell us a little bit more about your strategy on the asset side and how you're differing versus the industry? How that might be helping you in terms of whether you're taking a less aggressive or more aggressive stance. It appears you're being more conservative on moving risky assets off.

**Albert A. Benchimol**
*President, Chief Executive Officer & Director*

Let me start with the macro view and then we can talk about a couple of your comments. Fundamentally, we will always have a high-quality, fixed-maturity investment-grade portfolio. That is the core of what we do. But as I mentioned in my prepared remarks, the reality is that when you have interest rates in the low 2%, yes, they might stay down for a while, but after that, there's only one place for them to go, and that's up. And that's our single biggest balance sheet risk in terms of sensitivity. We've looked at a number of ways to try and mitigate interest-rate risk, and frankly, there aren't too many palatable ways to do that. And therefore, in our mind, the best way to mitigate interest-rate risk is to add diversification to asset classes that are less directly impacted or less negatively impacted in the interest rate movement. And as we've been discussing out for well over a year, we think it is appropriate to have allocations somewhere in the mid-teens area of hedge funds, equities, high yield, all of which have less of a direct relationship. And you know what? Everything that's happened has confirmed that. We've had quarters where the equities and the hedge funds have gone up very nicely and rates backed up and the value of the bond portfolio went down. So we offset that volatility. Likewise, what just happened in this third quarter, we had a significant improvement in the value of the bond portfolio as rates went down. And admittedly, that was modestly offset by the alternative. And so I think what we're doing is we're really aiming for stability in the portfolio and having asset classes that respond differently to economic development achieved that. The reason we have hedge funds, and the research would demonstrate this, is in fact it has less correlation to both equities and bonds. But more importantly, historically, we believe we can achieve equity, equity-like results on the hedge fund portfolio with volatility that is approximately half of what we expect. And again, this is what happened in the quarter. As you know, the MSCI was down almost 17% the S&P 500 almost 14% and, yes, we had a negative 5-ish percent return on the hedge fund. Again, nobody's happy with negative returns, but the portfolio did what it expects to do. So that's what we will do. So we think, again, somewhere in the 12% to 15% range. It's very diversified. We don't have any large commitments to any single hedge fund strategy, to any single equity manager, so we do get the benefit of diversification. The other thing that we look at is we don't believe that the investment portfolio is a place for distractions. And so we look for things that are reasonably predictable. We look for things that have relatively transparent reaction to economic development. And frankly, we just didn't want to deal with the heartache of waking up every morning and decided -- what the Greeks decided to do or what the Germans decided to do or whatever else. And so we decided, it's just not worth it. So we got out of all the European banks. We're not making a call on Europe. We're just thinking that that's not the right place for volatility in our balance sheet.

**Graham Yoshio Tanaka**
*Tanaka Capital Management, Inc.*

The cost of doing so, it sounds like it was little in terms of exit losses, that kind?

**Albert A. Benchimol**
*President, Chief Executive Officer & Director*

Actually, our unrealized losses on our bond portfolios were somewhere in the $4 million range at the end of the third quarter. We realized those losses in October, so no big deal. We were fortunate to sell the bonds in one of the weeks that was more exuberant and optimistic on the upside. So the timing of the exit, I think, made sense for us.

**Operator**

[Operator Instructions] Our next question comes from Ian Gutterman of Adage Capital.

**Ian Gutterman**
*Adage Capital Management, L.P.*

First, Albert, can I clarify a number on the cats? I think on the call, at the beginning, you said $82 million. I think the press release said $91 million. Is the difference $9 million, your reinstatements?

**Albert A. Benchimol**
*President, Chief Executive Officer & Director*

There's some taxes and some reinstatements, I can get you the exact numbers. But that's the issue. Yes, $91 million is the gross number.

**Ian Gutterman**
*Adage Capital Management, L.P.*

Okay. And I was just curious what the reinstatements are?

**Albert A. Benchimol**
*President, Chief Executive Officer & Director*

I can get you that number.

**Ian Gutterman**
*Adage Capital Management, L.P.*

Okay. And while you're looking, the other one on the cat side is the very large Japanese insurer that starts with a Z. Obviously, there was a lot of speculation in the trade press and other places that you were at the top of that layer and you were going to get hurt when they took their estimate up here, especially given that you released some last quarter. So can you give us any color on why that wasn't an issue for you?

**Albert A. Benchimol**
*President, Chief Executive Officer & Director*

Well, the first thing is you know that we can't control rumors. The second issue is that, as I told you earlier, we had assumed in our first estimate that pretty much all limits were blown. And we were clearly wrong. I will tell you that when we looked at our numbers in the second quarter, we could have made a very strong argument for a more significant reduction in the second quarter, but we thought that we should wait and see how things emerge, and if we had continuing good news, we would continue to do that. I can tell you that with regards to the largest mutual, although we are not fans of talking about individual accounts, I can tell you that whatever rumors are in the market with regards to what the losses are, they are well considered within our estimates.

**Ian Gutterman**
*Adage Capital Management, L.P.*

Fair enough, that's what I wanted to hear. John, can you talk...

**John R. Charman**
*Former Director, Chairman of Axis Re and Chairman of Axis Specialty Europe*

[indiscernible] till today.

**Ian Gutterman**
*Adage Capital Management, L.P.*

John, can you talk about trade credit and any concerns that, that portfolio heats up again given the events in Europe and while we're waiting for this [indiscernible] in Greece.

**John R. Charman**

*Former Director, Chairman of Axis Re and Chairman of Axis Specialty Europe*

Yes. Obviously, that -- when we were all in Monte Carlo, we spent a great deal of time with the 3 major trade credit underwriting businesses. They control over 70% of the marketplace. And that was a hot topic for discussion. Firstly, that leads us to give you a little bit of flavor about post-2008 where the losses were incurred on that portfolio and well within our expectations contrary to a lot of other people's views. The losses for 2008 are expected to be well-made back by the profitability of 2009 and 2010. 2010 is actually running at the lowest rates, loss rates after 18 months of any of the previous 8 to 10 years. And 2011 is trending similarly, although, it's very early days yet to 2010 but will be, I think, marginally, of deterioration over the numbers because 2010 appears to be an extremely good year, still some way to go yet. So when I talked to the 3 major companies, they said that they were not seeing any sign of stress on their portfolios. Don't forget, those companies rebalance their portfolios following the financial crisis. They look to the credit quality of their clients very carefully, send out their portfolios. They also took out a lot of the peak exposures they had, dramatically reduced them. So they -- we're looking at fundamentally rebalanced portfolios. And as of today, I have no undue concern for what the European crisis is doing with regard to that particular portfolio.

**Ian Gutterman**
*Adage Capital Management, L.P.*

Okay. So it sounds like then you would be comfortable renewing your book as is for next year if pricing is reasonably the same as this year?

**John R. Charman**
*Former Director, Chairman of Axis Re and Chairman of Axis Specialty Europe*

And subject to the information that being -- we go -- it's not just pricing, it's -- we'll take into account all the circumstances when it comes to the renewal season. But I'm fully optimistic about the portfolio.

**Ian Gutterman**
*Adage Capital Management, L.P.*

Okay. And what would make you more nervous, I guess, I mean, if we have -- if Greece defaults or Italy is close to defaulting, are those the type of events that will cause concern or is it really more...

**John R. Charman**
*Former Director, Chairman of Axis Re and Chairman of Axis Specialty Europe*

Let me just remind you, Ian, about the fact that I'm a big fan of the top 3 because they really do manage their businesses really well. And they're always a pretty good precursor to -- they're all a good litmus test to show whether there's a recession coming down the line. They started in 2006 and 2007 to be very concerned about the U.S. housing market. So what did they do? The first thing they did was to stop issuing credit to the manufacturers of tiles in Italy because the main export of the Italian tile manufacturers was the U.S. market. And they also pulled out -- dramatically reduced, not pulled out completely, the supply of credit to the automobile supplier network in the U.S. So if you remember what happened to Ford and GM and all that sort of stuff at the end of 2007 into 2008. They had already repositioned their portfolios. That's the way that this business reacts. And you could see that by the government criticism when businesses found it very difficult to obtain the previously high levels of credit they have been able to. So I have great faith in the -- in those major credit insurers managing their portfolios and carefully restricting credit where credit needs to be restricted.

**Ian Gutterman**
*Adage Capital Management, L.P.*

Great, that's very reassuring to hear. Albert, do you have those reinstatements ready before I pass on?

**Albert A. Benchimol**
*President, Chief Executive Officer & Director*

Two comments I will make just to follow up on the issue with regard to the trade credit is the fact that in any of these things, there are 2 issues. One is making sure that you underwrite it properly. The second is to make sure that you reserve it prudently so that you've made sure that if there's anything that is untoward there's already some recognition of that in the reserves. And as John has pointed out, 2010 may end up being one of the best years in history. And as part of our reserving, we're already expecting that there's going to be some deterioration from 2010 and 2011, but it's already there if you look at [ph] the way we view the business. And so we're not saying that there will not be an increase in loss ratios. What we're saying is that from where we started and where we're going to be reserving it, we're comfortable with all of that. Now with regards to your question, I would point you to Page 21 of the financial supplement where there is almost $7 million worth of tax benefits against the cats in the third quarter, mostly because as you'll recall, a lot of these are U.S.-based losses and we have the benefit of tax offsets in this quarter. And that's identified on Page 21 of the financial supplement.

**Operator**

And at this time, I'm showing no further questions. This concludes our question-and-answer session. And I would like to turn the conference back over to John Charman, CEO, for any closing remarks.

**John R. Charman**
*Former Director, Chairman of Axis Re and Chairman of Axis Specialty Europe*

Ladies and gentlemen, thank you as ever for taking the time to hear us today, and we look forward to meeting up with you early next year, when we will be 10 years old, by the way. And we will be celebrating our 10th anniversary next week. Thank you very much again.

**Operator**
The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.