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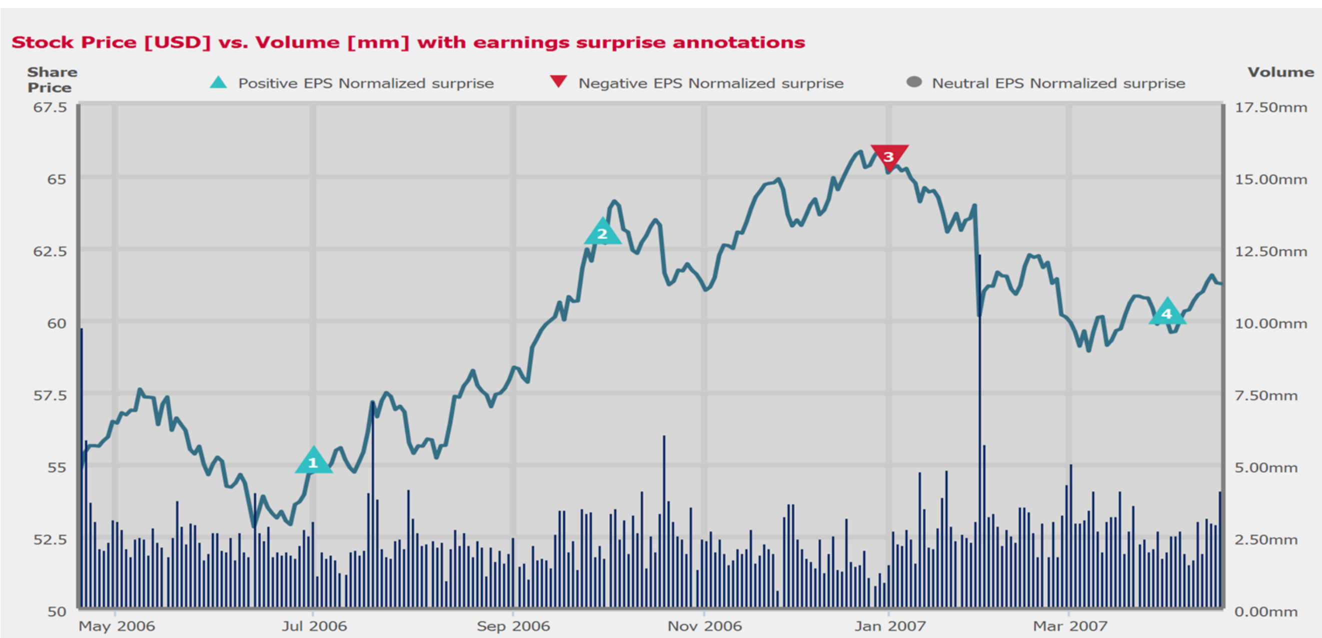
The Allstate Corporation NYSE:ALL
FQ2 2007 Earnings Call Transcripts
Thursday, July 19, 2007 1:00 PM GMT
S&P Global Market Intelligence Estimates

	-FQ2 2007-			-FQ3 2007-	-FY 2007-	-FY 2008-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	1.80	1.76	▲(2.22 %)	1.51	7.00	6.88
Revenue	-	-	▲6.26	-	-	-
Revenue (mm)	6847.43	7276.00	-	6889.57	27340.96	27496.27

Currency: USD
Consensus as of Jul-19-2007 11:27 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ2 2006	1.60	2.01	▲1 24.84 %
FQ3 2006	1.74	1.88	▲2 8.05 %
FQ4 2006	1.84	1.78	▼3 (3.26 %)
FQ1 2007	1.86	1.93	▲4 3.76 %

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Presentation

Operator

Good day ladies and gentlemen and welcome to the Allstate Corporation Second Quarter 2007 Earning Conference Call. At this time all participants are in a listen-only mode. Later we will conduct a question-and-answer session and instructions will be given at that time (Operator Instructions) As a reminder this conference call is being recorded.

I would now like to introduce your host for today's conference Mr. Robert Block, Vice President Investor Relations. Sir you may begin.

Robert Block

Thank you and good morning everyone. We appreciate you joining us for our second quarter 2007 earnings call. Yesterday, we issued our earnings press release, investor supplement covering our results through June 2007 as well as an update of our reinsurance program for this year.

If you have not seen these documents, they can be found on the I.R. portion of the Allstate website. Tom Wilson, Dan Hale and I will provide commentary on our progress through the second quarter. Following these comments we will hold a Q&A session.

In all we expect this call to last about one hour. Note that the following discussion may contain forward-looking statements regarding Allstate and its operations. Actual results may differ materially from those projected in these statements.

For information on important factors that could cause such differences, see the risk factor section in our 2006 10-K, our first quarter 2007 10-Q and yesterday's press release. We may discuss some non-GAAP measures, for which you will find reconciliation's in the press release and investor supplements available on our website.

This call is being recorded and your participation will constitute consent of any recording, publication, webcast, broadcast of your name voice and comments by Allstate. If you do not agree with these terms, please disconnect now.

A replay of this call will be available shortly after the call ends. All of our remarks are current only as of the date and time of the call. Finally, if you have any additional inquiries, investor relations will be available to handle those following the conclusion of this call. Now I'll turn the mike over to Tom Wilson. Tom?

Thomas Wilson

Good morning, and thank you for joining us. I'm happy to report that our second quarter results continued our record of delivering balanced results inline with our commitments. Once again, it confirms that our multi-faceted strategy continues to be the best way to compete in a tough market.

I'll begin with an overview our financial results and some strategic initiatives and then Bob and Dan will go through the financial results in greater detail and update you on our capital management initiatives.

And then of course we'll leave plenty of time for your questions since we find the dialogue helpful in continuing our record of adapting to a continually changing market. Let me begin with a summary of our financial results, revenues increased 6.5% over the second quarter of last year, continued growth in Allstate's standard auto premium.

Great investment income and a significant increase in realized capital gains. Net income rose 16% to $1.4 billion, which is a 21.7% increase on a per share basis over last year's second quarter.

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Operating income for the quarter declined 15.7% from Q2 of 2006, primarily due to lower favorable prior year reserve releases. We also had a modest increase in frequency in the auto and homeowner's lines in higher reinsurance costs.

Our return on equity was an outstanding 25%. Book value per share was $36.39 at the end of the quarter, which is 12.2% above the prior year. Allstate has generated great returns for our shareholders over the last decade, primarily by focusing on two key activities, operational excellence and capital management.

And as we look forward to the future, we must continue to deliver on both of those, but we must do more to continue our record of out performance. Consequently we'll more aggressively to pursue our strategy to be consumer centric by utilizing differentiated products and services. In addition our enterprise risk and return initiatives will be used to capture incremental sources of profit.

Allstate Protection had a strong quarter in what is a highly competitive market under the leadership of George Ruebenson, a differentiated consumer focus enables us to compete on value and relationships, not just price reductions or massive advertising expenditures.

We do have a very sophisticated pricing structure and we continue to invest heavily in highly effective marketing programs. But unlike our other competitors, we also offer differentiated products under the Your Choice platform, which gives us another competitive lever.

We're also hard at work improving the customer experience to drive retention. This multi-faceted approach is working for us and we'll continue to develop and introduce new products and services to drive long-term profitable growth.

The standard auto business continued to grow as our sophisticated pricing, effective marketing, and differentiated offer really does show proof that that strategy is working. Your Choice Auto continues to be an industry leader we now sold 2.4 million policies and as you saw from our press release that means revenues have reached about the $2 billion rate on an annual basis.

Our combined ratios were strong in all lines of business. And we had great performance with a combined ratio of 84.1, now that excludes catastrophes and prior year reserve re-estimates, and that's in comparison to our view that we would be in the range of 84 to 86 on that basis.

The auto business did have a moderate increase in physical damage frequency. It had a decline in bodily injury frequency and good severity results. The homeowners business generated a good combined ratio, but we need to aggressively manage both the price and cost in this line since both frequency and severity increases continue to be high.

At Allstate Financial, Jim Hohmann's teams made good progress in raising returns. The result, of course, is that sales continue to be below prior year in part reflecting just a different interest rate environment, but we've also set higher rate return targets for our fixed annuity business.

Operating income was $154 million, which is nearly the same as the first quarter of this year and slightly below last year's record second quarter. Enterprise risk and return includes a wide variety of initiatives, which are all designed to improve our risk and return profile.

We made additional strides in reducing our catastrophe exposure in the second quarter and Dan will take you through that. We had extremely strong results from our investment group under the leadership of Rick Simonson with investment income up 5.6% over last year's second quarter, and over $0.5 billion in realized capital gains, which is over $1 billion for the first 6 months.

Improved investment results that was really driven largely by expanding our investment activities into more partnerships and increasing our equity allocations over the last couple of years. On the capital side, we repurchased another $1.5 billion of stock, including shares under an accelerated share repurchase program.

So overall, this showed that the Allstate franchise and our multi-faceted strategy continued to deliver great results. So let me now turn it back to Bob.

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Robert Block

Thanks, Tom. I'm going to focus my comments on the trends within the property liability segment. Concentrating on our underwriting performance in Allstate Auto and Homeowners.

In total, we generated $6.9 billion in net premium written in the quarter, a decline of 1.9% from prior year. Excluding the cost of our reinsurance program, the net written premium was essentially flat.

Earned premium, excluding the cost of reinsurance posted a slight increase of 1.1% when compared to the second quarter of 2006. Underwriting income for the second quarter 2007 was $845 million, versus $1.2 billion last year.

The decline can be primarily attributed to increased reinsurance costs, which were $231 million this quarter compared to $116 million in the second quarter of 2006. And a $173 million unfavorable swing in prior year reserve re-estimates for prior year catastrophe losses of $50 million unfavorable in this quarter versus $123 million favorable in the second quarter of 2006.

The result in combined ratio in the quarter was 87.6% compared to 82.5% in the second quarter of 2006. However, as Tom said the underlying combined ratio that being the combined ratio excluding the effect of catastrophe losses and prior year reserve re-estimates remained at 84.1%.

The same level as it was in the first quarter this year. This result is at the favorable end of our expectation range of 84% to 86% that we provided in January and have reaffirmed today. Clearly, we are achieving our goal of profitable growth in a very challenging marketplace.

Now, taking a closer look at the auto business, we continue to grow the top line, generating $3.96 billion in Allstate Standard Auto net written premium an increase of 2.1% over the second quarter of 2006. Contributing to this result was our unit growth of 2%, strong retention levels at almost 90% and a slight increase in average premium.

On the downside, new business applications fell 4.8% in the quarter after increasing 7.3% in the first quarter. We believe our approach to the market offering choice to consumers, utilizing data and analytics to create sophisticated pricing structures, and leveraging effective marketing campaigns is appropriate and provides the best opportunity for profitable growth over the long-term. That said, we are constantly monitoring local markets, adjusting tactics to attract and retain profitable customers.

From an underwriting perspective, Allstate Standard Auto loss ratio of 63.5% was up slightly from the second quarter 2006, primarily due to a lesser amount of favorable reserve re-estimates in the quarter and flat to the first quarter of 2007. The underlying loss ratio was slightly better than last year. Loss cost trends were similar to the first quarter of 2007.

Gross frequency trends were slightly better in the quarter with property damage increasing 2.3% about half the rate of the increase in the first quarter of 2007 and bodily injury falling 2.2% in the quarter versus only a 1.1% decline in the first quarter of 2007. Importantly, on a paid frequency basis, property damage was up only slightly.

On a calendar year paid severity basis, the results for property damage were excellent. Up only 1.1%, even better than the 1.2% increase we experienced in the first quarter of this year. Bodily injury severity rose 6.2%, and that is admittedly higher than recently experienced.

However given the longer term nature of this coverage, you need to look at BI severity trend overtime. And on a 12-month moving basis, BI calendar year paid severity runs closer to 3%. The key take away here on severity is that these increases are well within our pricing expectations. Overall, we are maintaining margins while growing the business.

Turning to the homeowners' line, we continue to execute our strategy of reducing exposure to Mega-Cats. Allstate Brand homeowners' net written premium of $1.54 billion fell 4.8%. Excluding the cost of reinsurance, this result would have been an increase of six tenths of a percent.

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On an underwriting basis the recorded combined ratio remained profitable at 91% despite a significant rise in loss cost. Gross frequency and paid severity increased 12.9% and 9.8% respectively. While our loss trends remain better than the industries as measured by Fast Track, we're closely analyzing the results to see what improvements can be instituted to modify these trends.

With that, I'll turn the program over to Dan.

Danny Hale

Thanks, Bob. First a few comments about Allstate's financial results and then I'd like to talk a little bit more about our investment performance for the quarter. And finally, under the overall heading of enterprise risk and return management activities, I'll cover the status of our catastrophe management efforts, including recent reinsurance purchases as well as update you on our capital management actions.

Allstate Financial's topline growth for the quarter was curtailed as the business continues to focus on improving new business returns and a difficult economic environment for fixed annuities. Total premiums and deposits were down $1.3 billion for the quarter and fixed annuity sales were off $1.2 billion. However, Allstate's financial net income for the quarter was a record $200 million.

On top of strong operating income of $154 million, there were after tax capital gains totaling $45 million. Primarily as a result of favorable derivative evaluations related to the embedded equity and convertible securities and equity linked notes.

Operating income was $6 million less than for the second quarter last year, largely because our mortality experience last year was very favorable. And remember, that Allstate financial dividend is $725 million upstream last year. So they have to make up for lower capital account balances in which to earn investment income in addition to the loss of the variable annuity business.

Overall, the Allstate financial team is continuing to make progress on improving returns as they focus on ensuring that all new business is written at acceptable rates of return on aggressively managing expenses to provide funds for future growth initiatives and on reducing levels of required capital.

And a little more on the investment story. Net investment income totaled $1.6 billion for the quarter, an increase of 5.6%. For the property liability segment, investment income increased $56 million or 12% with about half of the increase coming from limited partnerships.

Total capital gains for the quarter, including both businesses amounted to $545 million on a pretax basis with $390 million coming from opportunistic equity trading and most of the balance from favorable derivative valuations that were equity related.

Now the subject of Enterprise Risk and Return Management or as we refer to it ER RM. As Tom mentioned, part of our strategic focus for the future includes greater emphasis on ER RM. On optimizing the returns on the risk we assume and the capital we employ.

Over the past five years, we've developed state-of-the-art Enterprise Risk Management evaluation, monitoring, and measurement processes as well as related governments' procedures. Our focus will turn much more now towards maximizing the returns we get on our enterprise portfolio of risk.

Obviously one of the most significant risks we assume is catastrophe risk. As you know, we've made significant progress with our homeowners' catastrophe management exposure strategies. We have many challenges in front of us, but many of the more difficult decisions have been made and plans have been and are continuing to be successfully executed.

We've eliminated optional earthquake coverage in most states and are pleased with the excellent progress we're making in reducing our exposure to hurricanes. An important part of that continued progress was the completion of our 2007 catastrophe reinsurance program, which will provide us with a significant protection from hurricane, earthquake, and fire following earthquake catastrophe losses.

We not only completed our Florida agreements, we also executed an agreement for index based collateralized reinsurance coverage for hurricane losses in New York, New Jersey, and Connecticut over a

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three-year period. The agreement was placed with the collateralized entity, which issued $250 million of catastrophe bonds for unrelated investors.

Four separate one-year agreements were completed by Allstate Floridian Insurance Company and its subsidiaries in coordination with the coverage from the Florida hurricane catastrophe fund. Details of the Florida and northeast agreements as well as all of our other reinsurance agreements are available on our Allstate website and as in the past we have included examples of the expected recoveries from these agreements as a result of a variety of potential catastrophes.

Our estimated total annualized costs of all reinsurance programs will be approximately $900 million or about $225 million per quarter. That's about $100 million more than the annualized cost for 2006 and $130 million more than this year's estimate that we provided on our last call. The principal differences from our previous estimate relate to a greater amount of coverage purchase for Florida as well as our decision to add the northeast categories.

Increased Florida coverage was largely a result of a change in reinsurance related to our second Royal Palm transaction, the results of some additional costs due to the impact of Florida regulatory changes, rating agency requirements, and modeling changes. But the most notable change occurred because we had assumed in our previous estimate that we would enter into a quota share reinsurance agreement with Royal Palm for 106,000 policies, which is what we did on our first Royal Palm transaction.

However, we retained those policies together with an estimated $86 million in earned premium and underwriting results on the policies and purchased additional cat reinsurance to protect incremental exposure.

On a calendar basis, 2007 reinsurance costs will be about $285 million more than for 2006, primarily because the annual aggregate and Southeast agreements were not in place during the first half of the last year. So about $260 million of the additional $285 million has already been realized in the first half of 2007, leaving about $25 million as the increase in reinsurance costs for the last half of this year.

We should also point out that we expanded reinsurance coverage this year compared to last year, in addition to placing 80% of our aggregate excess agreement for a second year. So we have more coverage and more coverage for multiple years.

Now, turning to the capital management portion of our Enterprise Risk and Return Management discussion. As outlined in our last call, we did issue $1 billion of hybrid securities during the quarter and designated the proceeds to be used to purchase an additional $1 billion of our stock.

It was essentially a hybrid for equity swap, which will be accretive to earnings per share, will increase our return on equity, and will reduce our overall cost of capital. In connection with the hybrid transaction, we accelerated our share repurchases during the quarter buying 24.3 million shares at a cost of $1.5 billion or $61.64 per share.

Included in that amount as described in the 8-K we filed on June the 27th, we entered into an accelerated share repurchase program for $500 million at the end of the quarter. The forward sale contract with an investment bank involves an initial share retirement at the end of the second quarter with final settlement over the next four months.

We will also be continuing our open market repurchases during that period. As we mentioned on our last call, we intend to complete both the $1 billion of repurchases funded by the hybrid issuance and our $3 billion program announced last November to complete the combined $4 billion program by the end of the first quarter of next year.

Finally, our operating income ROE for the last 12 months was 23.1%. Despite repurchasing $1.5 billion of stock and despite the negative impact of higher interest rates on unrealized gains, we maintained our book value at about the same level at quarter's end as it was at the beginning.

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Compared with the end of the second quarter of '06, book value increased 12% to $3.96 over the past year up to $36.39 per share. Excluding the impact of unrealized net capital gains and fixed income securities, book value grew better than 2% from the end of the first quarter and 7% from the year end.

Now Bob, with that I think we're ready for questions.

Robert Block
Matthew, if you'd start the Q&A session.

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Question and Answer

Operator

(Operator Instructions) Our first question is from Charlie Gates of Credit Suisse. Your question please.

Charlie Gates
Credit Suisse

Hi. Good morning. My first question, do you have any assessment of the changes in the Massachusetts auto insurance regulatory environment and what that would mean for Allstate?

Thomas Wilson

Charlie, it's Tom. Well, of course as you know, they're just talking about changes. They haven’t actually made any changes. A couple of years ago, I went out and met with Governor Romney.

Suggested that if there was a good market, 2 or 3% of the U.S. population, you got a lot of good drivers there. That we would love to be back in that market but that they had to create a regulatory environment, which really enabled people to compete on their skills and capabilities as opposed to working the regulatory system, which meant the ability to use sophisticated pricing models, the ability to have freedom as to how you move prices around, with some degree of oversight.

We're not asking for, we’ll just leave us alone. They were receptive at that time and then it kind of died for a while. I understand it's back on the table now. We'd be happy to be able to expand our business there.

We do a little bit of business with encompass there. But nothing under the Allstate brand. We pulled out of that over a decade ago. Maybe almost two decades ago. And so, we'd love to go back in, but it's got to be the right environment.

Charlie Gates
Credit Suisse

My second or follow-up question, new standard auto applications, I believe rose 7.3% in the first quarter of this year, fell 4.8% in the second quarter, could someone explain that?

Thomas Wilson

Well, let me give you a sense for what it is we're doing and how we compete and you, of course, Charlie, I know you've seen the numbers and you can tell where it's come from and that sort of stuff.

Let me give you a really a tale of maybe two markets to give you a sense for how our multi-faceted strategy works overtime. And I'll use Florida, which of course we spike out and had a large decrease. And then I'll come and talk to you for a few minutes about New Jersey.

And you'll see each market is different, obviously you need a balance of tools to enable you to compete. But in Florida, of course, our new business is way up last year. We had a great new business year last year.

Our total items in force are still headed up, although that's because of the work we did last year. And our new business is way off this year as you can see from the tables in the press release.

Competitive situation there is pretty tough. Both State Farm and GEICO have taken a couple of decreases this year, we took a small increase in November of last year. So, that's slightly lower the amount of new business we get from them. It's also made us a little less competitive for that business we compete, all compete for that comes from the small carriers.

But if you look at our overall pricing position, we still feel very good about where we are in the high lifetime value customers. It's more in the middle of the range in terms of the risk profile and retention profile, customers where, we're not as competitive.

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So we feel good still about the high lifetime value customers. At the same time, we have a challenge of our catastrophe management efforts going on down there. We are offering customers coverage with Royal Palm so that we can protect our relationship with them.

But I think the thing that gets -- and that's working pretty well. The thing sometimes people don't focus on, it takes a long time to do that. And so, our agencies are spending time writing policies to a new company and it's not as efficient as we do it and you've got to talk to the customers.

So that takes aging capacity offline as you're trying to do that. And at the same time, that whole market's kind of in a meltdown right now and the only person you can sell through is citizens. So we're not writing much new business down there and in fact no new business hardly and that gives you less opportunity to capture the cross line sales on the auto business.

So, that's kind of the situation. So, you say okay, what are you doing about it? We're getting ready to launch Your Choice auto down in Florida. We've had some issues with the Department of Insurance on getting that approved. It is approved. We'll be launching, I believe, its next week, I know it's this month sometime.

And we're, of course, always looking at our pricing. But we still feel pretty good about where we are in high lifetime value. We're going to up our marketing spend around the your choice auto stuff, push on differentiation on prices. We do sell something different than other people.

And the policy transfers will start declining here. So, we expect some of that capacity to come back online. And so that's kind of where we are in Florida and that would be how I would describe that situation from sort of the competitive situation.

If you go to New Jersey, you remember it was in late '04 that GEICO came into that market. Our business dropped a little bit because, in fact, a new business dropped a lot in New Jersey because we weren't willing to chase where they were in pricing.

Our new business in New Jersey is way up and we launched a new pricing plan last year and we also introduced Your Choice auto in New Jersey last year. And now, the competitive situation, still pretty competitive there, you know 21st Century came into that market. We don't quite understand their pricing. They recently took a small increase.

So, we're trying to -- but they still don't seem well-priced to us in some particular categories. GEICO of course is very aggressive. Their loss ratio in New Jersey is higher than it is in other parts of the country. I don't know what they'll do with pricing. There's rumors out they might lower, they might raise, we'll have to see. They've been moving it around.

Travelers recently took some rate increases. We took a small increase on one block of our business already this year. But despite all that situation, our business is still growing quite rapidly on a new business front.

Same pricing situation, I would say, we're really well-priced on the high lifetime value customers. With that changes there, we're not as well priced in the slightly higher risk, not that I am talking about the highest risk kind of slight.

On the marketing side, of course, you all, some of you anyway would spend time on the east coast there and you can't drive down the turnpike out there without seeing about, it seems like probably every other bill hoards insurance. And we spent a lot of time getting our marketing going, tying it together, shifting our mix around.

We did change our comp plans there with agencies to try to drive value. And from a PML standpoint, we've been adding higher deductibles there, not really much noise around that.

But here, we have an expanded market solution. So we're not writing a whole lot of new business under the Allstate brand. But we're able to offer customers, homeowners from other people and capture that auto sale. So, that's a little different than Florida. And we're getting ready to launch a new version of Your Choice auto in New Jersey.

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So we're feeling good about New Jersey. So I think when you kind of look at those markets. The point I'm really trying to make Charlie is, every market's different, but you got to have sophisticated pricing, you got to have great marketing. We think differentiated products makes you different, we think you can leverage at local presence.

So you compete and having all of those levers helps you move. That doesn't mean we can guarantee that every quarter the number's not going to bounce around a little bit. So we look at really the items in force and say are we growing items in force? Obviously, new business is a trend and indicator. But that's something you react to with your levers as opposed to changing your strategy. Is that helpful?

Charlie Gates
Credit Suisse

Yes, sir, thank you.

Operator

Our next question is from Joshua Shanker of Citi. Your question, please?

Joshua Shanker
Citigroup

Thank you, good morning.

Thomas Wilson

Hi, Josh.

Joshua Shanker
Citigroup

Hi. In terms of your last answer, Charlie spoke about a lot of pricing changes you see going on. And we've gotten the recent CPI data that says, the auto pricing is down on the margin from where it was a year ago. But it doesn’t smack of price or like we had seven, eight, nine years ago. Are there any leading indicators that concern you in terms of where the direction of pricing is going overall? And given the change that you've made in the successes you've had, have you seen any competitive changes over at State Farm?

Thomas Wilson

Well, I'm always concerned when I see people lowering prices, when we don't think they have a reason to do it, and we don't think it doesn’t generates good long-term value because, customers don't like the prices reduced and then raised, it drives them all nuts. So, that said, I don't think there is a price war out there. I think people are competing on a broader basis today, than in the past. Most people are competing on sophisticated pricing and massive advertising.

We've tried to add -- we have added product differentiation to that, which makes our advertising and more effective and makes us less price sensitive. State Farm, of course, is launching new plans. They're seems they’re pretty good planned and sophisticated, they are smart group of people, they've also dialed up their advertising, which will make the environment a little more competitive. GEICO of course continues to just hammer away on advertising, and the theme of low price. And progressive is kind of caught in between there, but also very aggressive in trying to move forward and grow.

That may -- I think sometimes, though, we all get focused -- everybody including us gets focused on the big four or five carriers. But recognize that there is about half of the market is with bunch of small carriers, and a lot of the business comes from them too. So, and they're not making the kind of moves with the kind of speed and dramatic impact that the bigger carriers are making.

So, Josh, I'm feeling okay about the market. It's a tough market. We're out there slugging it out each and every day in every local market. And Phil Lawson runs Florida for us, Bill Ballinger runs New Jersey,

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they're focused on not only what are doing in their state, but what are do they doing in specific parts of their state?

How they pull various levers to compete. So, ours is about achieving profitable growth with a variety of levers rather than just riding one thing. You won't see us say, the only thing we're going to do is cut prices by 10% across the board to drive growth. That's not our strategy, and we have no intention doing that.

Joshua Shanker
Citigroup

Well, thank you and congratulations on the quarter.

Thomas Wilson

Thank you.

Danny Hale

Thanks, Josh.

Operator</TAG>

Our next question is from David Lewis from Raymond James. Your question, please

David Lewis
Raymond James

Thank you, and good morning.

Thomas Wilson

Hi, David.

David Lewis
Raymond James

Couple three questions. First, may be show us a little bit more light on the frequency trends. And the homeowners' bit higher than what you'd like to see, is some of that just more difficult comparisons with the year ago? And how do you deal with that particularly on the homeowners' pricing side? And do you have any assumptions for the second half of '07 in your 84 to 86 non-GAAP combined ratio? That's one.

Two; and try to help us figure out the net investment income run rate? How much greater was the second quarter alternative investment income versus what you'd see as normalized levels?

Thomas Wilson

Okay. Let me may be make a comment about. Was your question on frequency on auto and homeowners, or just homeowners?

David Lewis
Raymond James

Well, I think more specifically to homeowners, but you can touch on both.

Thomas Wilson

Let me make a general comment about homeowners, which is frequency is up, severity is up, and we're focused on it. And we intend to make sure we continue to make that a profitable item. I'm looking down at my friend George, who is shaking his head yes. And, so that's something we're focused on. It's not a run away train, but we just don't like the trends. And so we're working hard and getting behind it. Bob may be you want to take auto frequency. You might want to talk about sort of '05 and '04. And Dan, do you want to take investment income? Does that make sense?

Robert Block

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David, the auto frequency trends as we look at them, the first half of '06 trends were incredibly good. So, from a year-over-year comparison, the first two quarters of this year are tougher comparisons, plus we had some weather obviously in the first quarter. But, when we look at our trends, they're very, very similar their levels of frequency are very, very similar to what we produced in 2004-2005.

So, while they are up, we also look at them on a net basis and their paid basis. And the paid trends are actually increasing less than what the gross frequency trends are. So, those look pretty good.

Danny Hale

And as far as net investment income, again, as you noted correctly while property liability net investment income was up about 12%, about half of that was due to partnership income. There was about $65 million in partnership income. As you know, that line item, that segment bounces around some with $65 million this quarter. Last quarter's $54 million, some previous quarters is in the 20s.

We have over the past few years done more in terms of investing in that type of security. But being able to predict the income pattern from it is very difficult. So, again, that underlying 5%, 6% you saw for property liability and bumped to 12% was the increase from partnership income.

I think you can look at the underlying rates and then use your judgment to just as good as ours to what partnership income might be quarter to quarter.

Thomas Wilson

Okay. I occasionally have to manage this call on your behalf. So if you could pick your top question and hope that somebody else has their top question as their number two question, I can make sure we can get through our group, longer group questions. And I did take a little longer on that first question because I wanted you to understand that competitive environment. Okay. Who's next?

Operator

Your next question is from Jay Gelb of Lehman Brothers, your question please.

Jay Gelb
Lehman Brothers

Thank you. Could you update or give us a sense from the reinsurance coverage you purchased for 2007? Where does that get you from a long-term perspective of where you want to be in managing megacat exposures? And then if you could also update us on your estimated PMLs for 2007, say compared to 2005?

Danny Hale

Well, the program that we just completed for '07 that is indicated about $900 million. We would expect over time, particularly in Florida as you saw as we discussed the Royal Palm transactions and the couple of transactions we've done, which are running off of our books that we would have less exposure there and therefore you would expect that we would be able to buy less reinsurance.

I say that with a caveat that you never know what might happen the balance of the year as far as catastrophes and the impact on pricing in the industry and pricing and availability, but all things being equal, we would expect over time that there should be some opportunity to reduce the overall amount of reinsurance that we buy.

At the same time, from a tail risk point of view, I think you asking that question, as well. As you saw we did enter into participating into cat bond transaction, particularly in the northeast, we are as with that transaction continuing to look at ways from a capital market solution perspective to find ways to improve our overall position.

We don't give out, as you know PML numbers, but there has been as I indicated in my remarks significant improvement in the '07 and forward time frame for our overall cat exposure versus where it was a couple of years ago.

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Jay Gelb
Lehman Brothers

Can you give an order of magnitude of reduction if not the specific PML?

Danny Hale

Not really. We're not giving out numbers on either side, either the GAAP or the absolute numbers. But significant reduction, you can see for yourself as you look at the various areas and the cutbacks we have made. The Royal Palm transaction universal, etc., that the significant amounts have been taken off our books in addition to some of the reinsurance or the re-underwriting activities that have taken place. So the exposure is clearly being significantly reduced.

Thomas Wilson

Hey Jay, It's not that we have any great secrets or anything like that. As you know from Bob and Sam and our group, we have a lot of transparency. It's just that the growth number keep changing on that one. Every time they put a new model out, you've got a different number and you've got to explain something, which you didn't even calculate. It's headed down Dan and George and our teams are doing a good job of banging it out and we're going to continue that.

Danny Hale

I think a good way of getting a feel for particularly effectiveness reinsurance is to look at those examples on our website, which would give you a feel for another Katrina. And similar situations over the last several years of hurricane patterns and what the recoveries would be. Therefore the impact on our bottom line.

Jay Gelb
Lehman Brothers

Fair enough. And then just another quick one. Can you update us on exposure to the investment portfolio for subprime and CDOs?

Thomas Wilson

Well, Jay, we'll do that because I suspect that somebody else's top question too. Dan, you want to do that?

Danny Hale

Pardon me, Jay. We have about $4.8 billion of subprime mortgage back securities. Fortunately we've positioned ourselves defensively in this market segment several years ago. We're comfortable with our holdings there, we've experienced virtually no rating activity on our portfolio to-date.

We don't own any of the classes of transactions that were downgraded or put on watch as part of S & P's and Moody's ratings announcements back a few weeks ago. We do expect continued ratings pressure for these types of securities going forward. But at this time, don't expect widespread downgrades across our portfolio, particularly since about 73% of ours is currently rated AAA.

We also have about 164 million in ABS CDOs. And to date the valuation impact on that portfolio has not been as severe as some of the levels we've been anecdotally hearing in the market. I think that reflects our position on the capital structure about a 93 million of those are rated AAA, 93 of the 164. And also reflects the diversification of the type of underlying collateral supporting the transaction.

And again, although we're comfortable with our holdings, given the current market environment we expect continued downward pressure on the market valuations. But to date none of them have been downgraded or put on negative watch. We'll continue to monitor the subprime market developments and make the appropriate valuation adjustments going forward.

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In the meantime, we are very pleased that our investment team took actions to reduce our exposure to the speculative high risk subprime projects several years ago.

Jay Gelb
Lehman Brothers

Thanks for the answers.

Operator

Our next question comes from Bob Glasspiegel of Langen McAlenney. Your question please.

Bob Glasspiegel
Langen McAlenney

Good morning. I was wondering if you could give us a little bit more color on the modest wiggle of prior year cats and specifically how Mississippi fed into the recent Mississippi settlement fed into that number?

Thomas Wilson

Well, Bob, you could see a lot of it came from a wide variety. It came from '05 '06 storms. It's not a big piece was due to that. We were happy that we settled that suit customers are now off rebuilding their lives. We've moved on. We're feeling pretty good about the whole situation. And it's just sort of our normal reserve changes.

Bob Glasspiegel
Langen McAlenney

Okay. Thank you.

Operator

Next question is from Dan Johnson from Citadel. Your question, please.

Dan Johnson
Citadel

Great. Thank you. I'd like to talk a little bit about the new auto application trends in the quarter. Obviously in the first quarter, we saw some -- I guess higher numbers, I guess they were positive, I don't have the exact number right in front of me.

But your data you put out in the press release would show negative app trends sort of in all three traunchs of classification, the hurricanes, hurricane exposed states, California, and everyone else. Would you mind just putting a little light on that trend in light of the what has been, I think decent trends over the last 5 or 6 quarters prior?

Thomas Wilson

Yeah, I'd be happy to, Dan. Is there anything that in terms of the example I gave between Florida and New Jersey in what's going on in new business I can build on? Or.

Dan Johnson
Citadel

Just in, well, frankly, let's go right to the heart. This quarter was down, call it 5 the last couple quarters were up 6 or 7, I believe. Which one do you think more likely to be persistent going forward?

Thomas Wilson

Well, it's always a crapshoot as to what new business you're going to be. You're out there working, driving quotes, you don't know what your competitors are going to do in terms of price. Maybe take a different place is new business is down, it's clearly a very competitive market.

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Some of that is due to price decreases other people have taken, which we've chosen not to take. Although we are still very competitive in the high lifetime value customers. So we're feeling good about that and don't feel we need to chase it on price.

We do have Your Choice Auto out there, which is a differentiated product and drives average premium up on an apples-to-apples basis and we do have our marketing is all working. So we're feeling good about our strategy. It changes by individual state. But it's clearly more competitive now that and it was last year. We'll adapt and try to drive more change just as our competitors will. I don't see that piece on new business changing a lot.

We are also spending a bunch of time on retention, which as you know is 80% of the volume. So we also look at items in force and just the pit growth. And so driving both of those is what will help us grow, which is I know what you want rather than just writing a bunch of new business and having to cycle out a quarter or two quarters later.

More competitive, we're competing with a variety of tools called pricing, advertising, differentiated products, and we expect to continue on that path. Don't see any need to change dramatically our mix on any of those. So we should not expect to see us feel like we have to substantially reduce price to grow.

You shouldn't expect to see us dramatically change our marketing stuff. And you should expect to see us continue to do more on differentiated products. And to the extent that bounces new business around a little bit, we're willing to take that as long as we're growing overall.

Dan Johnson
Citadel

Thanks. Great. I'll get in the queue for number two.

Thomas Wilson

Okay. Thank you. Thank you for helping.

Operator

Our next question is from Matthew Heimermann of JPMorgan. Your question, please.

Matthew Heimermann
J. P. Morgan

Hi, Good morning, everyone. Hoping I can get by with a two-part question. But follow-up on lost cost.

Thomas Wilson

I'm starting to feel like Attila the Hun here. I was trying to do it on your behalf.

Matthew Heimermann
J. P. Morgan

Hopefully I'll be quick. They are just a follow up on lost cost trends. One was on the auto side, I guess is there a portion of the loss -- of lost cost trend that was related to kind of the higher average premium related, which is a function of your choice? That's kind of part A?

Thomas Wilson

No the, margin look is good on your choice.

Matthew Heimermann
J. P. Morgan

I didn't know if there was maybe some creep on the overall book as average premium was going up just mathematically. I know that margins are the same. I was wondering as we're looking at the data given the stability in the margins themselves.

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Thomas Wilson

No.

Matthew Heimermann
J. P. Morgan

Okay. The other thing was on homeowners and the frequent severity there. I guess you spoke to a little bit earlier, but I guess what I'm surprised by is there's no change in kind of the underlying accident year loss ratio excap despite two quarters of pretty significant loss cost trend increases. I was hoping you could reconcile that.

Thomas Wilson

Try to do the reconciliation in my head. You know what I would suggest is, Bob, do you have?

Robert Block

Yes, well, I'm trying to remember the numbers and I believe the underlying accident year loss ratio did go up several points, not as much as the recorded. We'd have to go back and sort through all the numbers.

And it gets particularly confusing when you -- when we have the prior year reserve re-estimates affecting both that number and affecting cats. So, to try to get to the right numbers. I think the underlying accident year to my recollection in the quarter was up.

Matthew Heimermann
J. P. Morgan

I had it down, but I'll follow-up with you offline on that.

Robert Block

Thanks.

Thomas Wilson

Thanks. I'd be happy if it was going down.

Danny Hale

We like your numbers.

Operator

Our next question is from Gary Ransom of Fox-Pitt Kelton. Your question, please.

Gary Ransom
Fox-Pitt Kelton

Yes, good morning. I had a question related to the price increases and how that compares to the loss trends. If you look at the information, you've been incrementally raising rates despite the market, which is probably down. And then the loss trends on the other side, if I look at the last few quarters and maybe mingle BI and PD, it looks like the trends overall pure premium trends up 2 or 3 points.

The question is maybe there's an A and B part to this question, but one is, are the rate increases, are you specifically reacting to what you see on the trends? Or are you reacting more to what you see competitors doing in the market? And if these trends, the loss trends continue at say a 2% or 3% pace on pure premium, would we -- would you continue to raise rates in reacting to that going forward despite what the market might do?

Thomas Wilson

Simple but complicated question. We do our pricing looking both at our trends and the competitive situation. And we might move prices around, even without a trend up or down because of the competitive

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situation. And we might do it no matter what the competition does because we might raise if other people are going down because we don't like to trend.

So we -- ours is about having profitable growth, making sure we generate good returns for our shareholders. And thinking about those changes as it relates to other things. I was talking to one of our field vice presidents the other day.

He was saying well, I have to decide whether I want to take a price decrease, or I'd rather invest that money in marketing or I can launch a new agency. So we think about it holistically. You are correct in that there has been a slight decrease in margin as loss costs have drifted up with inflation. And prices in total have stayed relatively flat. And that's in our 84-86 -- I don't see that changing much, but it's about -- we're still getting a really high return on equity in that business. So, we're generating 25% return overall, and we're growing. So, it's about managing your way through it carefully as opposed to just pushing one lever. Is that helpful?

Gary Ransom
Fox-Pitt Kelton

Yeah. That is helpful. Yes, but if I just look at it in the context of what everyone else is doing, there certainly are some companies as you mentioned, competitors that are reducing price. The changes you're making, you're still comfortable with where you are versus the competition as of right now?

Thomas Wilson

Yeah. I mean, well as I said, we're very competitive in the high lifetime value customers. We just launched Allstate Blue and we're in four states and then the volume is really kicking up. Now, it's off a small base and we're nowhere close to where we used to be, but that gives me a hope, not concern.

If you look that in Encompass, we've launched a new product there called Edge in four states and the volume has really jumped up in there and it's good, profitable business. We like the way we got the plans tiered. So we're constantly looking at how do we drive growth and change it? But it always has the underlying premise, it’s about profitable growth, not about just driving growth.

I do not want to be sitting here with you saying, yeah, new business is up 15% and combined ratios were way up either. It’s about -- we'll have to deal with the general margin compression. We're working hard on that. We have things like next gen and other things we’re doing to keep our costs in line on a long-term basis.

But we're not going to trade off profits for growth. We're going to try to get both. Which means it'll be a bumpier on new business than just a single point solution, but also means it'll be more stable over the long-term.

Danny Hale

I might add a couple of more comments there. When we talk about lost cost trends, that 84.1 was 84.1 last quarter, as well and about the same as the fourth quarter last year. As we’ve talked about we've been in a mid 80s to low 80s range for 3 years now. And we look at some individual changes like frequency being a little higher.

If you compare it with how unusually low it was in 2006, then the first half of 2006 was dramatically low. If we look at second quarter, first quarter of '07 versus '04 and '05, it's actually better than those years. The severity numbers are very good. I think people look at just that one page, 6.1 on the BI, as Bob said, on a rolling 12 month basis, that's very, very small in terms of lost cost trend increases and is well within our pricing parameters.

So we're not seeing that kind of pressure that maybe somebody -- some of those who are looking at the numbers are thinking may be occurring, just because of individual increases in frequency of severity. Overall, the 84.1 is excellent.

Gary Ransom

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Fox-Pitt Kelton

That's very helpful. Thank you.

Operator

Our next question is from Brian Meredith of UBS. Your question, please.

Brian Meredith
UBS

Yeah. Good morning. One questions here. If you're generating massive amounts of excess capital right now, Tom, and you're doing a great job and you're buying back the bunch of stock, but not sure if that's the best long-term strategy as to generate excess capital and buy back stock, as far as getting a really good multiple on your stock.

I'm wondering if you think about what other areas do you deploy that capital to maybe kind of grow internal rates of return. I mean actually get the company bigger and just kind of talk about that a little bit.

Thomas Wilson

I will, Brian. Thank you. I'd like to see us grow our emerging businesses, which is motorcycles, boats, motor homes, our market share there is small and it should be a lot bigger. And so I'd like to see us grow there. I'd like to see us grow in the higher risk nonstandard business of Allstate Blue. We're starting to roll that out. We ought to be able to hit that harder.

I think that the work we've been doing on our direct channel and getting its effectiveness up in serving customers in a different way should be helpful there. I think at Allstate Financial, coming up with a product, some product differentiation, that's really consumer-based in the retirement space.

It's kind of like a your-choice-retirement kind of deal, would be a place we could deploy capital and get good returns on it as opposed to selling the same product everybody else sells through the highly competitive bank channel and bashing each other over the head as to how do we get decent rates of return.

So, those are the things that we're focused on. Sometimes people ask about acquisitions. We look at a lot of stuff. We look at it relative to the things I just listed. We look at it relative to share repurchase. We're pretty picky, and so we haven't done much.

Brian Meredith
UBS

Great. Thanks.

Operator

Our next question is from Meyer Shields of Stifel Nicolaus. Your question, please.

Meyer Shields
Stifel Nicolaus

Yes, thanks. Good morning. I just wanted to clarify one comment Dan made because I think I misunderstood it. With the higher reinsurance costs, I think Dan said that it was reflective of the fact that you're retaining the Royal Palm Two policies instead of quota-share reinsuring them with Royal Palm. Would that impact the net premium runoff for these policies? Or did I just get the whole thing wrong?

Danny Hale

Well, we quota-shared on the first transaction that we have not been able or did not choose to do so on the second one, so we keep the premium. These policies will still be running off. I know that's one of the issues. We bought reinsurance for policies that would be running off over the period that the reinsurance covers. But on a quota-share basis, we obviously keep the premium and the underwriting results.

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Meyer Shields
Stifel Nicolaus

Okay. Is it now -- it's the reason that the expected runoff patterns haven't changed because you're running them off instead of transferring them to Royal Palm?

Danny Hale

We will be transferring to Royal Palm.

Thomas Wilson

Just later than we thought.

Danny Hale

A little later because of what happened with the regulatory environment in Florida. Much of those transfers had to be delayed.

Meyer Shields
Stifel Nicolaus

Okay. That's fine. Thanks so much.

Thomas Wilson

Okay.

Operator

Our next question is from David Small of Bear Stearns. Your question, please.

David Small
Bear Stearns

Yeah, just on the homeowners' book. I guess you -- if I look at new issued application, hurricane exposed states down 20% in the quarter, how far along are you guys in your process of reducing Cat exposure along the East Coast? I guess we've talked a lot about Florida, but maybe you could talk about the other states?

Thomas Wilson

We're making a fair amount of progress. During that time of the year, we stated you, but I am feeling very good about our efforts whether that South Caroline and North Caroline, work here all the way up to New York, New Jersey, Connecticut.

And of course, we're doing it in part to reinsurance, in part to not offering new businesses as you point out, and at some places, by not offering continuing coverage to the people.

We made a lot of process. We're not done, and it will take us a while to get there, but we are to the point of where George and his team will start to think about how do we -- when we have extra capacity, how do we want to actively utilize that?

David Small
Bear Stearns

So, then that's the number that we would start to see flatten out over the next two quarters?

Thomas Wilson

Now you have ask for two important thing, I'd avoid giving, we moved away from the guidance things, I don't want get into specific line item guidance either, I wouldn't want to give you that number.

David Small

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Bear Stearns

I just have few -- okay. Thanks.

Operator

Our next question comes from Bill Wilt of Morgan Stanley. Your question please.

Bill Wilt
Morgan Stanley

Hi, good morning. Question that may or may not be related to the new business, auto new business applications and back to State Farms, so it appears that they’ve not only increased their volume of their advertising, but seem to have pretty meaningfully shifted their strategy, I guess the mediums through which they advertise.

So wondering if you begun to see these factors out or you feel like you begun to see the effect of that or expect to in the upcoming quarters? Thanks.

Thomas Wilson

Well, you’re right. They have started to advertise more. One never knows whether you can annualize at quarter or not. But they have spent lot more in the first quarter. I haven't seen their second quarter spend numbers yet.

They have changed their advertising a little bit, they’re driving more on to the Internet. The question will be how effective is that, and how much it will actually, can they handle and drive to their website as they click right through.

But they’re clearly out in the advertising game, you know play more aggressively. I am feeling good about our advertising though, because if you look at our ads the effectiveness, they are getting people attention, they are getting them willing to consider us and motivating them to actually call us is really high.

So, not only that the amount of money you throw at something is how good, that is, which you throw through the media and we're liking what we have there and I think State Farm will obviously have an impact on the marketplace that.

But we are not backing down from our program. We like what we got, nor do we feel like we have to dramatically increase it at this point.

Operator

Our next question is from Richard Sbaschnig of Oppenheimer. Your question, please.

Richard Sbaschnig
Oppenheimer

Good morning, thanks for taking my call. Just wanted to know, what trends are you seeing out in the West Coast market, specifically California now that the recent regulatory changes that they implemented last year are now starting to have more of an effect?

Thomas Wilson

Well you are seeing a number of people come up with new territories, new pricing out in California and our new business is down in auto in California. Some of which is due to that, some of which is due to the fact that we're not selling homeowners out in California at this point because of the earthquake exposure issue.

And as I point out, sometimes homeowners is a nice lead line for you because it gives you an opportunity to capture somebody's auto. Those two things have hurt some of our volume in California.

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We'd like to introduce Your Choice Auto in California, it's the one big state other than Florida that we haven't been in. We're having some regulatory issues trying to get that through. But we're still, again, I think well-priced in the high lifetime value segment. So when you look on a long-term basis driving long-term profitable growth, we're still okay by it.

Richard Sbaschnig
Oppenheimer

Thanks a lot.

Operator

Our next question is from Hani Sabbagh of Viking Global. Your question please.

Hani Sabbagh
Viking Global

Thank you very much. Just a very quick question. Could you please give us the vintages of your subprime exposure?

Thomas Wilson

The vintages?

Hani Sabbagh
Viking Global

Yeah, in terms of the years.

Thomas Wilson

Of the $4.9 billion how much is from various years?

Hani Sabbagh
Viking Global

Yeah.

Thomas Wilson

I think we could have Bob get you whatever we publicly disclose. I will tell you that in the end of 2005 and all through 2006, those vintages we changed which originators and servicers we were willing to buy business from to high grade our portfolio.

The question is really not only which years did you buy from, but who did you buy from in those years. And we defensively postured our business and we feel pretty good about. In fact, we're looking at it we're going the wait for this thing to cycle down a little bit.

We've been working for the last 3 or 4 months to figure out how we can make money on this meltdown as opposed to worrying about how we protect ourselves.

Hani Sabbagh
Viking Global

All right.

Thomas Wilson

So, Bob, you can talk to Bob on that specific vintage. Is that the end of our questions? Okay. It's about time anyways end at this time. Let me close with this couple of comments. First, our multi-faceted strategy, we believe working in what is a highly competitive market?

But we compete with a wide range of tools that are appropriate for each local market. Secondly, focusing on the customer and on the consumer is differentiating and it's a key part of our strategy.

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And lastly, our outlook for overall results for the year hasn't changed. We have the brand, we have a great market position, we have the people and the resources to continue to drive profitable growth. Thank you, all. And we look forward to talking to you again next quarter.

Operator
Ladies and gentlemen, thank you for participating in today's conference. This concludes the program. You may now disconnect. Have a good day.

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