

Travelers Companies Inc (TRV) Management Discusses Q2 2013 Results - Earnings Call Transcript

Executives

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Jay S. Fishman - Chairman, Chief Executive Officer, Chairman of Executive Committee and Member of Operating Committee

Jay S. Benet - Vice Chairman, Chief Financial Officer and Member of Operating Committee

Brian W. MacLean - President, Chief Operating Officer and Member of Operating Committee

Alan D. Schnitzer - Chief Legal Officer, Vice Chairman of Financial, Professional, International Insurance & Field Management and Member of Operating Committee

William H. Heyman - Vice Chairman, Chief Investment Officer and Member of Operating Committee

Analysts

Amit Kumar - Macquarie Research

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Josh Stirling - Sanford C. Bernstein & Co., LLC., Research Division

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The Travelers Companies ([TRV](#)) Q2 2013 Earnings Call July 23, 2013 9:00 AM ET

Operator

Good morning, ladies and gentlemen. Welcome to the Second Quarter Results Teleconference for Travelers. [Operator Instructions] As a reminder, this conference is being recorded on Tuesday, July 23, 2013. At this time, I would like to turn the conference over to Ms. Gabriella Nawi, Senior Vice President of Investor Relations. Ms. Nawi, you may begin.

Gabriella Nawi

Thank you, Andre. Good morning, and welcome to Travelers' discussion of our second quarter 2013 results. Hopefully, all of you have seen our press release, financial supplement and webcast presentation released earlier this morning. All of these materials can be found on our website at www.travelers.com under the Investors section.

Speaking today will be Jay Fishman, Chairman and CEO; Jay Benet, Vice Chairman and Chief Financial Officer; and

Brian MacLean, President and Chief Operating Officer. Other members of senior management are also available for the question-and-answer period. They will discuss the financial results of our business and the current market environment. They will refer to the webcast presentation as they go through prepared remarks, and then we will open it up for questions.

Before I turn it over to Jay, I would like to draw your attention to the explanatory note included at the end of the webcast. Our presentation today includes forward-looking statements. The company cautions investors that any forward-looking statement involves risks and uncertainties and is not a guarantee of future performance. Actual results may differ materially from those projected in the forward-looking statements due to a variety of factors. These factors are described in our earnings press release and in our most recent 10-Q and 10-K filed with the SEC. We do not undertake any obligation to update forward-looking statements. Also, in our remarks or responses to questions, we may mention some non-GAAP financial measures. Reconciliations are included in our recent earnings press release, financial supplement and other materials that are available in the Investors section on our website.

And now, Jay Fishman.

Jay S. Fishman

Thank you, Gabby. Good morning, everyone, and thank you for joining us today.

We're very pleased with our results this quarter, posting record net income per share of \$2.41. We are particularly gratified that this is another quarter which demonstrates the very successful execution of the pricing strategy in commercial lines, which we embarked on nearly 3 years ago. Our granular active approach to improving profitability has been very successful. The aggregate rate and retention data that we showed -- that we show you for our commercial businesses demonstrate the success, but the data underneath tells an even more powerful story of improvement in profitability. This is important, and Brian will take you through that in more detail.

But let me share with you that underlying margin improvement in our commercial businesses since 2011, which we achieved primarily through earned rate, our renewal business exceeding loss trend has, as of now, generated an increase in after-tax operating income of \$650 million on an annualized basis. If we include Personal Insurance, and more to say on personal lines in a minute, the increase is more than \$1 billion.

Importantly, we have done so without disruption to our agents or customers. The relevant question now is where do we go from here?

Since 2005, we have maintained a financial goal of producing a mid-teens operating return on equity over time. The over time aspect of the goal allows us to maintain the objective even when conditions are such that returns at that level are not immediately achievable on an accident year basis such as now. If you adjust our year-to-date operating return on equity of 15% to more of an accident year look by excluding the impact of net favorable prior year development, as well as the impacts of the favorable tax and legal resolutions, the adjusted ROE is approximately 8.5%.

Also, to achieve a mid-teens operating ROE over time, there will be years where we must exceed the target because there will be other years when, due to any number of factors, we will fall below. So it is clear that we have more work to do to achieve our objective, and as a consequence, our strategy remains intact. We will continue to execute for improved returns, just as we have been doing.

In Personal Insurance, we have also had a strategy of improving profitability through higher pricing. What has become apparent to us in the auto insurance line is that the combination of the rapid adoption of the comparative rater technology in independent agents offices, which now is the source of the substantial amount of the quotes that we issue and changing consumer expectations for this product have impacted our new business volume meaningfully.

Consequently, we have concluded that to improve profitability and to create long-term value, we must have a more competitively priced product. By leveraging technology and taking other actions, we will make substantive changes to our business processes that we expect will allow us to meaningfully reduce costs without impacting service or quality.

Brian will take you through the details, but through these actions we expect to be able to more competitively price our product and improve our profitability. Before I hand it over to Jay, I'd like to comment on our announcement in June that we agreed to acquire the Dominion of Canada. This was a strategic move, providing us with meaningful scale and market position in Canada. We are enthusiastic about the opportunity and are looking forward to welcoming the Dominion employees to Travelers.

With that, let me turn it over to Jay.

Jay S. Benet

Thanks very much, Jay. Let me start by saying how pleased we all are with the second quarter and year-to-date results. And I do want to correct one thing Jay said, on Page 21 of the webcast, we do have a reconciliation of the operating return on equity year-to-date as reported of 15%. And when you do adjustment in net favorable prior year development and the favorable tax and legal settlements, it's actually 11.5%, would be -- what we consider to be the accident year kind of run rate of that. But with that, our liquidity and capital positions remain very strong, and we continue to generate capital in excess of what we need to support our businesses. Operating cash flows of approximately \$722 million for the quarter and \$1.3 billion year-to-date were also very strong, notwithstanding the cat losses that remain very high relative to historical standards although it's significantly below the corresponding prior year periods.

We maintained our strong cash position, ending the quarter with holding company liquidity of just over \$2 billion, after returning \$491 million of excess capital to our shareholders through dividends of \$191 million and common share repurchases of \$300 million. Our strategy of returning excess capital to our shareholders remains unchanged. As we've stated in the past, the combination of dividends to common shareholders and common share repurchases will likely not exceed operating income over time. And in any given period, the difference between operating income and the level of dividends and share repurchases will also be a matter of timing. I'd remind you also the amount of common share repurchases will also depend on a variety of additional factors, including corporate and regulatory requirements, maintaining capital levels commensurate with the company's ratings, our share price, pension funding needs, strategic initiatives and other market conditions.

We've included an overview of our cat reinsurance coverage on Page 20 of the webcast, which has been structured in a way that is generally consistent with the prior year.

Effective May 16, we entered into another 3-year reinsurance agreement with long-term -- Long Point Re III in which they issued \$300 million of cat bonds, providing us with Northeast hurricane coverage on a specified -- on specified lines of business subject to a \$1.25 billion retention, after which we can recover up to \$300 million on a proportional basis until covered losses reach \$1.8 billion.

Effective July 1, we renewed our gen cat treaty with terms that look similar to last year, an attachment point of \$1.5 billion and with covered losses of up to \$400 million within the \$1.5 billion to \$2.25 billion level -- layer.

Also effective July 1, we renewed our \$600 million Northeast gen cat treaty with the same \$2.25 billion attachment point as in the prior year. Given the current reinsurance pricing environment, all of this was accomplished at a cost that was lower than the prior year. A more complete description of our cat reinsurance coverage, which also includes a description of our gen cat aggregate excess of loss treaty that covers an accumulation of certain property losses arising from multiple occurrences, is included on our second quarter 10-Q, which we filed earlier today, as well as in our 10-K. All of our capital ratios remained at or better than our target levels, and we ended the quarter with a debt-to-total capital ratio of 20.1%. Due to the recent rise in interest rates, net unrealized investment gains decreased by \$1.2 billion after-tax in the quarter, driving a 2% reduction in book value per share in the quarter or 1% year-to-date.

This impact of higher interest rates more than offset the very positive impact on book value per share of our strong earnings, which was the major driver of the change in adjusted book value per share. Adjusted book value per share, which excludes unrealized investment gains and losses, increased 3% during the quarter and 5% year-to-date. I would note that the rise in interest rate does have a positive side. Going forward, if interest rates stay at their current levels, we'll be able to reinvest proceeds from maturing bonds at higher yields than we were previously assuming. I would point out though that at current interest rate levels, this will still result in a reduction in future net investment income, just not as much. The rise in interest rates also led to an \$87 million after-tax realized investment gain this quarter due to our use of U.S. Treasury futures to shorten the duration of the investment portfolio. At the beginning of the year, given the interest rate environment and the economic outlook, we decided to increase our short position from its then nominal amount of \$800 million. The position was increased to \$2 billion by the end of the first quarter and further increased to as much as \$2.7 billion before the position was closed by the end of the second quarter due to our outlook for interest rates versus the carrying cost of this strategy.

Lastly, I'd also like to point out that the rise in interest rates has not been significant enough to impact our pricing strategy in any meaningful way.

So Brian is now going to provide some further comments on operating results.

Jay S. Fishman

Jay, just let me interrupt one second, if I may. I understand I misspoke and I know you corrected it, but because it is so important, please just let me reiterate that the adjusted ROE on what I described as the more of an accident look is 11.5%. If I said 8.5%, it was indeed just simply an error on my part. It's 11.5%. Thank you. Brian, I apologize.

Brian W. MacLean

No problem. Thanks, Jay. I'll go right to the segment results, beginning with Business Insurance, where we continue to be extremely pleased with the fundamentals of the business.

The combined ratio for the quarter of 96.2% improved nearly 7 points versus the prior year, while the underlying combined ratio, which excludes the impact of cats and prior year development, improved over 3 points.

Looking at production results for the segment on Page 9, retention and renewal premium change were both strong and in line with recent periods at 80% and nearly 9%, respectively, while new business volume was down slightly from the first quarter. Over the last 6 quarters, the production trends have been remarkably stable with retention running consistently around 80%, renewal price change between 8 and 10 points and rate around 7% to 8%.

Slides 10 through 12 show a basically similar story of consistency for each of the businesses within the segment, and in each case, the compounding effect of rate increases is driving a meaningful improvement in our combined ratios. So the aggregate production results remain strong but as we've mentioned many times, the aggregate numbers alone don't tell the entire story. In fact, the detail of where we are getting the rate and what accounts we are retaining is key to evaluating the success of our pricing strategy.

On Slide 13, we show our commercial accounts rate change and retention data for the second quarter of 2013 as compared to the second quarter of 2012. The data is segmented by the individual account's long-term loss ratios, with the bars on the left representing our best-performing accounts and the bars on the right representing our worst performing accounts.

We've shown this data before and I want to emphasize that it's a summarized version and the analytics we actually used to manage the business are at a much more granular level. The results show that for our better accounts, retention was very strong and rate change was solid and consistent with the year ago. For our core performing business, rate increases were up significantly year-over-year while retention was down meaningfully.

Additionally, as you evaluate our results, keep in mind that our rate actions over the past 3 years have improved the returns in each of these loss ratio bands. So in fact, although the aggregate pricing improvements are very consistent over the past 6 quarters, an analysis of the underlying data reveals that our execution has, in fact, improved over time and is contributing to higher levels of profitability. So overall, in Business Insurance, very encouraging picture. The earned impact of these rate gains, along with loss trend across the segment that continues to run at about 4%, drove meaningful margin expansion. Going forward, our emphasis is continue to improve returns through maximizing the rate and retention trade-off at a very granular level.

In Financial, Professional & International Insurance, operating income for the quarter was down 15% year-over-year due to higher catastrophe losses and less favorable prior year development. The cat losses in the quarter were primarily due to the unprecedented flooding in Alberta, Canada. Excluding cats and prior year development, the underlying combined ratio of 89.9% for the segment was strong and improved more than 2 points year-over-year. This improvement was driven largely by expanding margins in our Management Liability business, along with the impact of recent underwriting initiatives across the segment. Written premium was up slightly compared to the prior year quarter, driven by strong surety results, continued favorable rate in Management Liability and new business in international, partially offset by higher levels of written [ph] premiums.

In June, we were pleased to announce our agreement to acquire the Dominion of Canada. The combined business will benefit from Travelers' sophistication in the use of data and analytics, as well as claim and risk control capabilities. The Dominion's extensive distribution network provides us with an exceptional platform for expanding our commercial lines business in Canada. In combining Travelers of Canada surety, Management Liability and commercial middle market products with the Dominion's commercial and personal portfolios, we'll create an organization with significant product breadth and a balanced mix of business. The transaction is expected to close in the fourth quarter of 2013, subject to regulatory approvals and other customary closing conditions.

In Personal Insurance, operating income was up significantly versus the second quarter of 2012 due to lower levels of catastrophe losses and higher underlying underwriting margins. The underlying combined ratio for the quarter showed a 3-point improvement year-over-year with about 2 points driven by earned rate increases that exceeded loss cost trends.

Looking specifically at Auto production trends, retention of 80% and renewal premium change of over 8% were both in line with recent periods. Net written premium and new business volumes were down year-over-year as a result of our pricing actions.

Turning to Auto profitability. The underlying combined ratio of 96.4% was an improvement of over 1 point versus the prior year quarter, primarily reflecting the earned impact of the rate -- written rate gains we have achieved over the past several quarters. Loss cost trends for Auto remain consistent with recent quarters, with mix adjusted frequency continuing to be benign and severity stable at a slightly elevated level. Specifically, bodily injury severity this quarter remained in line with what we've seen in the previous 3 quarters.

In Homeowners, pricing was also very strong, with renewal premium change coming in at over 11%. Retention was consistent at 83%, while new business volume was down slightly from the prior year quarter. The underlying combined ratio for Home was 81.5% in the quarter, an improvement of over 3 points year-over-year. The improvement was driven by a lower level of non-cat weather losses, along with earned rate increases that exceeded loss cost trends. So a very strong underwriting result, and we are beginning to see the positive impact of our underwriting and pricing actions.

So overall, a very good quarter. But as Jay mentioned in his opening comments, the personal auto marketplace is changing. We remain committed to offering a product that is both competitively priced and delivers an appropriate return for our shareholders. And accordingly, we are taking expense reduction actions that will allow us to improve both pricing competitiveness and product returns.

Specifically, we expect to reduce our claim and other insurance expenses, such that we realize a savings of \$140 million pretax when fully implemented. This represents about a 10% reduction in our unallocated claim and other insurance expense base in Personal Insurance. We will begin realizing some of these savings immediately and they will be fully realized in 2015. The savings will be achieved through the consolidation of certain operations, along with other efficiency gains throughout the business.

The majority of the savings will be driven by staff reductions, primarily through attrition, but we will also be giving notice to approximately 450 employees this week. We expect to take a restructuring charge of about \$16 million, \$10 million of which is expected to be incurred in the third quarter of 2013. While some of these savings will be realized in our Homeowners business, the majority of the impact will be in Auto, and these actions are clearly aimed at improving our strategic position in that line. We are pleased with the progress we've made in the personal lines business and we believe these actions will allow us to offer an even more competitive product in a challenging marketplace.

I'll now turn it over to Gabby.

Gabriella Nawi

Thank you, Brian. Before we open it for questions, I'd like to note that the management team is participating from several different locations this morning, so please bear with us as we coordinate our responses. With that, Andre, can we open it up for questions, please?

Question-and-Answer Session

Operator

[Operator Instructions] Our first question comes from the line of Amit Kumar with Macquarie.

Amit Kumar - Macquarie Research

Two quick questions. First, it relates to pricing. In terms of the Business Insurance pricing trends, I'm looking at the renewal rate change. Do you think, based on where we are and what rates we have achieved in the past, does the RRC and Business Insurance, does it stay somewhat flattish from here? Or does it change meaningfully from here?

Brian W. MacLean

So let me start. This is Brian MacLean. Let me start with an answer and then, Jay or Jay, chime in. I -- the first observation I'd make is when we look at the actual results, so we're not going to go far out in the crystal ball world, but if we look at the actual results over the last 6 quarters, from Page 10, it's incredibly stable. The red line there of renewal rate change is basically rounding off of 7.5% for all of those quarters. So what we saw in the quarter was very consistent with where we've been. Our view about it -- I would want to emphasize what we said in the presentation, that we don't have a target and it's not necessarily about attaining a specific level of rate gain, it's about achieving

returns. So we're looking very granularly and obviously trying to retain the best business and drive the price increases on the weaker stuff. There can be a -- next quarter, a rate change number identical to the one that we just have, which might be generating much better returns or much worse, depending on where you get it. So we're very focused on the segmentation. As far out as we're going to go is what we saw in the quarter was very consistent. June was a pretty strong month. July looks like it's trending pretty consistently, but where the market's going to be in 3, 4, 5 months, we'll all see. But we haven't seen anything in our results that would say that the market is about to shift dramatically and the fundamental situation with interest rates and weather volatility continues.

Jay S. Fishman

Brian, would you agree that over the last 3 years as more of the Commercial Business has moved from the right side to the left side, and as a consequence, more as in the higher margin rather than the lower margin business? That achieving a flat rate in that same environment is actually net underneath an actual improvement.

Brian W. MacLean

Yes. And what you mean by flat rate is 7.5% round number rate increase?

Jay S. Fishman

Correct. It's really the rate applied to the mix that is the important factor here.

Brian W. MacLean

Right. When we look at our granular execution and the impact of now a couple of years of rate increases on the portfolio, we feel the round numbers, 80% retention, 7.5% rate we're getting today, is producing a much better result than the 80% and 7.5% renewal rate change we were getting 1.5 years ago. So we feel very good about it.

Amit Kumar - Macquarie Research

Got it. That's helpful. I'm sorry, go ahead.

Brian W. MacLean

I was just going to say, but don't see any major shifts in what's going on in the market.

Amit Kumar - Macquarie Research

Yes. One quarter does not make a trend, but we'll see. The only other question I had is on...

Jay S. Fishman

I will just make an observation. It's not one quarter. It's been a lot of quarters. And just an observation as to the data. That's all.

Amit Kumar - Macquarie Research

Yes. The other question was on Dominion, Dominion's business mix and a combined ratio. And I know it's a bit too early. Just looking at their business mix and their combined ratios, could you just sort of broadly talk about what your strategy might be and how it might differ versus the current strategy?

Alan D. Schnitzer

Sure. Amit, it's Alan Schnitzer. But when you're talking about the current strategy, I'm not sure exactly which one you're asking.

Amit Kumar - Macquarie Research

I'm talking about the combined ratios, 106.1% for 2012, and their top line is \$1.2 billion. Just sort of broader thoughts on that going forward. How does that change? Does it change near term? Or does it take somewhat longer to turn that around?

Alan D. Schnitzer

Sure. Let me take a stab at that. So stepping back, the transaction really is a strategic transaction for us. It gives us important scale and competitive position in a big market that currently we're -- we don't have either in. So from a strategic perspective, we think it's important. In terms of what's driving that combined ratio, a lot of that is their personal lines Auto business. And we think that when we bring our data and analytics and claim expertise to that marketplace, we can -- and it'll take some time, but we think we can substantially improve that result. Also, they've got a small commercial platform that we like a lot. We think we can bring our expertise and analytics from that business into that marketplace. And one of the real benefits for us in this transaction is that they've got a terrific distribution platform in Canada, and we like the opportunity to expand our commercial middle market products through their distribution. So we think that there is good premium growth in the platform from that. So -- and looking overall in international, we've been, certainly over the last couple of years, focused on investing in that business and managing the loss side, which we've done very effectively over the last couple of years. So we're very confident that when we apply that same expertise to the Dominion, we'll be able to have positive effects on that. One of the impacts of what we've been doing for a couple of years is the expense ratio has ticked up, both from investing in people and data and analytics and also from, over the years, having shed some premium that didn't meet the risk and reward calculation for us. So the additional volume that comes on from Dominion really helps us from the expense side as well. So that's really sort of the outlook and the strategic positioning of the transaction.

Operator

Our next question comes from the line of Mike Zaremski with Crédit Suisse.

Michael Zaremski - Crédit Suisse AG, Research Division

In regards to margins, in the press release, I noticed that low levels of large losses were cited at -- within the international segment. And I also noticed that lower levels of non-catastrophe weather-related losses were cited in personal lines. So I guess, does that mean we should build some margin cushion into our forward estimates given non-cat level large losses have been running below historical averages? Or am I thinking about that wrong -- the wrong way?

Jay S. Benet

Yes. This is Jay Benet. As we've said in previous quarters, any individual quarter is going to be impacted by things that go well beyond the general flow of earned rate versus what you'd consider to be the underlying loss trend. Now we spike out at least verbally because that's probably as good as it's going to get. We have things like large loss activity and some view as to, with the non-cat weather, favorable or unfavorable relative to the prior year and we try to give you that perspective. What we always suggest you do is look at the longer-term view as to what the combined ratio looks like x cat and few ID [ph], and with those words around and what others say, try to get a view as to what the weather looks like and build that into your models. I hope that's helpful because that's probably as granular as we can get with it.

Michael Zaremski - Crédit Suisse AG, Research Division

Okay. Yes, it just stood out because I know in 2Q of last year, you also cited lower levels of large losses.

Jay S. Benet

Yes, because the other thing you could do is we wrestle with this as well. So we try to put some words into the outlook within the 10-Q that might also be helpful.

Michael Zaremski - Crédit Suisse AG, Research Division

Okay, great. Last question, in regards to investment income levels. I noticed the portfolio's average pretax yield actually rose a bit sequentially to 3.9%. And I think you cited duration increasing. Can you comment on how we should perspectively think about those dynamics, given the recent increases in new money rates?

William H. Heyman

Well, I think what -- it's Bill Heyman. I'd go first to what Jay said earlier and that is the recent increase in market rates obviously permits us to put new money out at better rate than we were before, but still at rates below the book yields on maturing securities. So I think I would simply take the projections which Jay has made in the past of net investment income going out 2, 3, 4 years and tweak them for this increase in rates, and frankly, I wouldn't tweak them much. If this is -- if what we have seen in June is all we're going to see in 2013 and some will think that may be the case, I

wouldn't make major changes in projections.

Jay S. Benet

Yes, if I could add a couple of things. The -- we talked about the short position in treasury futures. And by eliminating that at the end of the quarter, that had an impact of slightly expanding the duration of the portfolio. Having said that, too the rise in interest rates also expands the duration of the portfolio, given the expected impact on bonds that would be called or not called under that circumstance. So the change in duration is really not a structural change at all in the portfolio. And as Bill just said, the rise in interest rates would have a fairly moderate impact on the reinvestment yields so -- given how much is rolling over versus what's enforced. And in our 10-Q, in the outlook section, we talk about all of this having an impact that would suggest about \$25 million less in after-tax net investment income off of the fixed income portfolio per quarter going forward, if interest rates stay where they are, and I think before we said the out number was about \$30 million. So it's a relatively modest impact.

Jay S. Fishman

And Jay, I would just make some one observation. You just -- you mentioned in passing that the gain was attributable to closing the position. That's actually not completely correct because it's a mark-to-market position, so whether we had closed it or not closed it, the gain would have been there. We closed it because of our expectations of interest rates and the relative cost of carrying the position. But the position is a daily mark-to-market position.

Jay S. Benet

That's entirely right. Thanks for correcting that, Jay.

Operator

Our next question comes from the line of Josh Stirling with Sanford Bernstein.

Josh Stirling - Sanford C. Bernstein & Co., LLC., Research Division

So obviously, we've all been very impressed for the past couple of years with your pricing leadership, pricing approaching, I guess, 20% at this point. You've helpfully done the math for us in 11% or 12% x your ROE. And there's obviously still some pricing yet to earn in and rates are moving higher and so I think we're all sort of sitting out here just scratching our heads, trying to figure out how much longer pricing will continue. You've given us some guidance, which is helpful in your Q. And I'm wondering if you can just expand the math a bit and give us a sense when you've actually worked with your actuaries and meet with your insurance regulators, and share them with your indications, how much more rate in some of your major segments do you actually need to take at these levels?

Jay S. Benet

Jay, you want to start or...

Jay S. Fishman

Yes, I was just taking about how to do that. First, I -- we've always said that one of the things we can't do is to, in any way, is to project or speculate competitive reactions. So just because we articulate pretty clearly what we intend to do, it certainly doesn't mean that it's going to happen or that we approach it with that certainty. But nonetheless, we continue to have a space to go. We've been saying for the longest time, and I take some pride in the fact that the objective, the financial objective, that we articulated now some 8 years ago is one that we stayed with consistently. It's not been remanufactured to be convenient to the environment. It is what we think long-term returns in our business should be and hopefully can be again. But our goal is to get back to the mid-teens return on equity over time, and at 11.5% now on an accident year basis, round numbers, we still have a ways to go. Not all products are the same, very important. Not all businesses are the same. And as a consequence, not all pricing strategies are the same. We talk all the time about the analytic grid that demonstrates high to low returns and our emphasis on pricing relative to that. But every time you take a step up, it changes, whether you're talking about an individual product line like Workers' Comp or property or whether you're talking about a particular business like construction versus our surety business. So the strategies are all quite different and they are all return-driven. But in the aggregate, we are going to continue to push as long as we can, until such time as we bring ourselves back to the long-term objective. And I think that's probably about as clear as we can be. I -- we've resisted, even internally setting artificial goals or targets or budgets, and rather always look at what we've always articulated as our long-term goals to be.

Brian W. MacLean

Yes. So 2 things that I would add because, Josh, in your question, you put in there rates moving. I would just point out that the rate movement that we just saw in interest rate has really had virtually no impact on our pricing, and to some degree, because it was a relatively small move in rates. But even the 100 basis points, at one point in time, at the 10 year got a lot of play. The duration of our liability is significantly shorter than that. So you have to look at the whole yield curve and see where rates are moving. So that has had minimal impact. And we'd need quite a bit of movement in interest rates before started changing pricing significantly. And the other...

Jay S. Fishman

We -- actually, Brian, just in that regard, we asked, and I do think these 2 comments are important, most of our, call it, free cash, I don't mean to define that term, but most of our free cash is used in buying back share. So if you look at our portfolio position over the last several years, it's actually been relatively flat. And most of our investing is reinvesting. And so we're not -- it's not as if we're deploying significant amounts of new cash, we've been deploying it in buying back shares. We did ask our actuaries to make an estimate of what a 100 basis point increase would be in the entire curve if there was a shift because, of course, every product is invested -- the underlying products have a duration philosophy is tied to the -- that's tied to the asset. They're not directly matched but it's very much a philosophical match. And this is just an estimate and I perhaps even would call it a guesstimate. But in terms of returns, the equivalent of 100 basis point move in the yield curve would be about 2 to 3 points in pricing rate. So 2 to 3 points in price would be equivalent in returns to 100 basis point move in the entire yield curve. Brian, am I recalling that correctly?

Brian W. MacLean

Yes, that's correct.

Jay S. Fishman

Yes.

Brian W. MacLean

Yes. The other quick thing I'd point out is that weather volatility is still there. And although our second quarter cat number was dramatically less than what we have seen the last 2 years, it is dramatically higher than what 3 years ago we would have said was historical second quarter norms. So that is still out there and the marketplace needs to deal with it. So that's kind of our view.

Josh Stirling - Sanford C. Bernstein & Co., LLC., Research Division

That's very helpful, Jay, Brian. Just one other question on strategy and distribution evolution. So your comments about the evolution of comparative raters, agents starting to use them for renewal business as well start to get sort of -- raise a whole bunch of questions and it's not obviously as good for the agents or -- and certainly more challenging for the company. I'm wondering if you can talk about how you think that your sort of broader sort of agency strategy evolves more if there's going to be changes in commissions or if you fundamentally try to change your position or approach to that market? And then just more broadly related to that same point, is this something that sort of starts in Auto and then moves to Home and moves the Select and ultimately as sort of a Pandora's box once it's opened?

Brian W. MacLean

So let me -- this is Brian. Let me start with a couple of comments, and then Jay. And I'll go to your last comment first, Josh, which is, clearly, we look at this and say it doesn't have to be just a personal auto dynamic, but complexity of product is really significant in being able to build an efficient rater technology and business process. So even Homeowners is fairly more complicated than Auto and you get into the commercial products and much more complicated than Auto. So we watch it closely but we don't think we're on the verge of comparative raters everywhere. And then I'd say the big backdrop to the question is we're not looking at a fundamental shift across the board of how we deal with independent agents. One of the great strengths of our franchise is the position that we have with agents, and we have a lot of products and we have a lot of breadth and we're going to continue to leverage that, working with them closely on what their business process is and how we continue to together bring a value proposition to the customers is important. With that said, everything is on the table where we're constantly looking it all, the dimensions of it, but we feel good about where we are with agents. Jay?

Jay S. Fishman

Yes, I know, I'd -- just an observation. I think we have a well-deserved and well-earned reputation for being a low-cost-oriented company. We know from experience, I think, how to do that thoughtfully and in the best interest of the business. I think Brian's comment is right. We're determined to be successful in the business. We have an \$8 billion premium combined personal lines business, and in fact, everything is on the table. But we do know how to do this. And the comparative rating technology, I get asked all the time, is the product becoming a commodity? And I'm always quick to answer, no. A commodity is a product where the only thing that doesn't matter is the price because all the prices are the same. Every -- oil, the price is the same. And that's not the case here. There are value differentiations and value perceptions and strength to agents and strength to customers, and there are differentiations. What the rater is doing, though, clearly, is increasing price competitiveness at the point-of-sale. The technology has introduced the ability of agents to see greater multiples of prices much more easily. And we do think that the onslaught of advertising over the last, and this is just an opinion, I can't prove it as a fact, but the onslaught of advertising in the space over the last 10 years has brought customers to the view that value is a more important component value dollars of the purchase than perhaps it was previously. So it's going to force a greater level of price competition and I think we're up to the task. And that's what we're going to do.

Operator

Our next question comes from the line of Michael Nannizzi with Goldman Sachs.

Michael Nannizzi - Goldman Sachs Group Inc., Research Division

So one question I had for, I guess, maybe for Brian first is, just looking -- I know we look at this on a year-over-year basis but sequentially, the combined -- the underlying combined in business was up a bit. And then -- and even going back and looking at 1Q to 2Q, it's not clear that the second quarter is always higher than the first. And even if we'd look at year-over-year, I mean, you're 400 basis points better in the first quarter, 300 basis points-ish better here in the second. Just trying to understand that -- was non-cat weather an element of that comparison? Or any color there on kind of the margin in Business Insurance?

Brian W. MacLean

Yes, Mike. I think there's always -- as Jay Benet was saying before, there's always volatility in the individual quarters. Nothing fundamental with the trend has changed over where we were with first quarter. And I know deltas have shifted a little bit. If you look at our data on Page 9, 3.1 points of underlying combined ratio better than last year and the first quarter was better than that. That was the movement in those other things. So we're going to have large losses go up or down or non-cat weather go up or down relative to the previous quarter. I think that we're still in the same place we were in the first quarter, where we think the core underlying margins here in BI are improving somewhere between 2.5 and 3 points for the business. And that is unchanged from where we were in first quarter. And everything has been, as I said before, pretty stable, both rate and loss trend there. So we don't see any fundamental shift. I know the numbers do move around a little bit.

Michael Nannizzi - Goldman Sachs Group Inc., Research Division

Yes. And I'm just trying to understand given -- so that's great. So the 2.5 to 3 points remain so you had some noise maybe in second quarter. But is it possible to just give some parentheses around the rate-driven margin expansion that you saw in the first quarter versus the second quarter? Just because -- again, I mean, this is the first -- I mean, we've had 1, 2, 3, 4, 5, 6, 7 consecutive quarters of sequential improvement in that underlying combined...

Brian W. MacLean

Yes, that's -- I think what I was trying to say, Mike, is the rate-driven margin improvement is the 2.5 to 3. When we try to back out the quarterly periodic volatility and what's the impact of the rate we're earning in versus the core loss trend, that continues to run at 2.5, 3 combined ratio points. And again, you have to do the arithmetic to get the -- just bring it through the combined ratio to get the math to work.

Michael Nannizzi - Goldman Sachs Group Inc., Research Division

Got it. Okay, great. And then, I guess, one question on the actions in personal lines. Any thought around in this process, the direct business, and kind of cost rationalization or continued investment on that front?

Jay S. Fishman

The decision is certainly not being driven by the direct business, but the direct business will most certainly benefit from a lower priced product. So it will certainly help in that regard. I do want to reemphasize, so that everyone understands clearly, that the intention here is to lower cost and increase profitability. So the reduction in cost will, in effect, not be passed on entirely to the price of the product. Some of it will be retained in the form of improved profit. At least that's the plan. So it'll help. It'll certainly help the direct business.

Operator

Our next question comes from the line of Greg Locraft with Morgan Stanley.

Gregory Locraft - Morgan Stanley, Research Division

Just wanted to follow up on the personal lines segment. The policy counts are -- and I mean, you've admitted the policy count declines are pretty stunning and accelerating, it seems, at least this year. Homeowners back to 2006 levels, personal auto back to '04 levels, the direct initiative seems to have stalled. So you guys are losing a lot of share. You've admitted that. What I'm wondering is, is the cost plan enough? In other words, is there -- there's clearly a pricing problem in the marketplace with this segment. So is the cost plan enough such as you can cut your pricing or get more competitive to begin to stem the share losses? And then second is, what's the timing around when we'll see the tangible actions in the P&L from a PIF perspective? I'm sort of wrestling with how long to take the share losses down in my model?

Brian W. MacLean

Yes. Let me start, Jay, and then throw it to you and so I'd -- several comments there. And maybe one of the things I'd say right at the front is that the actions we're taking today are somewhat -- the expense actions are somewhat a reaction to what's going on in our top line but more focused on reacting longer term to some changing dynamics in the marketplace. So it's not just a -- because the PIF is down 12%. I would look at -- so a couple of things, number one is...

Jay S. Fishman

Brian, can I also ask you to speak because Greg asked the question with Home, Auto, direct, and I think there is a distinction to be made there as well.

Brian W. MacLean

Yes, so let me start with Auto where we -- on the retail auto business through our agent channel. For starters, retentions remain pretty solid and that's been a positive. So although it's down a couple of points, it's still running at a solid level and the shortfall has been in new business. And as we've said and maybe has been obvious, that's clearly been impacted by our pricing action. We feel good that returns have improved, that the -- and 6 months are consistent with our expectations. And our price changes, independent of the expense actions, would -- will be mitigating, as you've seen in the last couple of quarters with the Auto business. So hopefully, that will bring the us back in line. The industry did post the 104.5% combined ratio last year. So it is a product that is needed rate and we feel good about the actions we take. We've taken, we think, the expense actions. And as we said before, anything else that we need to do in this business, everything is on the table, is really -- are really focused on improving that and helping us deal with the changing marketplace. So the Homeowners business, we view as fundamentally different there. We think there are some real capacity issues. That was, I think, much more of a focused weather exposure kind of actions. And so it's not just the pricing we've been driving there, which has fundamentally been driven by the losses, the weather losses, that has been come through. But it's also other actions we've taken from underwriting, deductibles, terms and conditions that have really, really driven us. So we feel very good about where our Homeowners business is right now and feel like we're in a position to move forward. The tricky part of your question is, where do we think the impacts -- well, what's the time horizon? We don't really forecast that out. We're looking at, clearly, a different PIF situation for 2014. But we'll see what that is, okay?

Jay S. Fishman

And just a closing comment on the direct because, Brian, I think you got both of those just right. The dynamic in direct is very much what we've been intending to do. We've been doing a test, a test of pricing sensitivity. And so our -- and people have asked you, your advertising is down. Yes, our advertising is down very intentionally because we've been focused on testing price elasticity in a very limited number of markets and gaining some insight into what that means. So I would just observe that there isn't anything in our direct channel other than also seeing and observing, of course,

that pricing really matters, great shock, pricing really matters. And so again, what we're going to do in the personal space here will most -- we hope, we believe, will certainly help the direct channel as well.

Gregory Locraft - Morgan Stanley, Research Division

Okay. And I guess, just to follow up on this because the answer is very thorough, but what I'm wrestling with is I love that you're getting good price in the business and the retentions are holding in. So clearly, the core client base is sticking with the Travelers once in the umbrella. Direct is so small. It just seems like -- it's like an experiment, in a way, in the P&L. But really, in the agency side of Homeowners and Auto, it's the lack of the ability to attract new clients in. And I'm wondering if it's more than just the expense side. I'm wondering if it's actually you need to start to ramp advertising a lot more. You need to re-architect the product which you mentioned. I don't know if that costs money. I don't know if that's technology. In other words, I'm just -- I'm trying to wrestle with the cost to fix the new business acquisition engine in the Auto segment and...

Jay S. Fishman

The analytics that we have indicate, maybe even more than indicate, that pricing sensitivity for new business through comparative raters is just significantly different than it was in the past. And we have all sorts of data that shows when you're lowest in the comparative raters space, when you're second lowest and when you're third lowest. And so we know what it takes to be successful. And so I -- we don't believe that there's anything, with respect to our product, that needs to be reengineered or -- I mean, we're always filing changes. We're always filing changes in pricing. We're always filing changes in underwriting and claimants. So there's always changes going on. But we believe this is the issue in the new business front. And you're right, the renewal business has been quite stable, and that is very encouraging. So we think we're on the right path here.

Operator

Our next question comes from the line of Brian Meredith with UBS.

Brian Meredith - UBS Investment Bank, Research Division

I have 2 questions here for you. First, Jay, I'm just curious, the acquisition of Dominion, nice, opportunistic acquisition. But given where your stock price now is trading on a price-to-book multiple, does it change at all your thought process with respect to capital allocation? Are acquisitions here potentially more attractive than share buyback?

Jay S. Fishman

No, I don't believe so. This was -- there were a couple of things about the Dominion transaction that were really appealing to us. One, is it gave us some real size and scale in a market where we just were lacking badly; two, there were some scarcity value up there. There are precious few companies to be acquired. They're either mutuals or subsidiaries of larger companies or very large companies themselves. So there is a scarcity value. And it provided a first-rate management team, we think, and a terrific systems and technology and a platform to do business. So it had several compelling reasons that really just had us think about it as a special opportunity but not thinking about it differently in the context of capital management, no.

Brian Meredith - UBS Investment Bank, Research Division

Great. And then the second question, I wonder if you could chat a little bit about the small commercial business. It seems to continue to be a little sluggish there. Is that because of the economic environment? Is it because that there's maybe more competitive down there? Why is it tending to be a little bit slower from a growth standpoint, actually declining this quarter on a written premium basis than some of the other lines?

Brian W. MacLean

Yes, Brian, this is Brian MacLean. I'll start. There's several things that going on there. We've talked a while back about what was going on in the larger end, plus we talked a little bit about Auto trends that we were seeing in commercial and specifically in the Select world. So there were some targeted underwriting actions that we were taking, which we have now pretty much worked through. And it was a business, if you think of -- it's almost a great example of the segmentation concept that I was talking about in commercial accounts. If you looked across our spectrum of businesses in Business Insurance a couple of years ago, Select would've been one that, from a return perspective, we were struggling with more than others. So it would've been on the writer side of the graph of our businesses. And if you look at the pricing that we've gotten there, and in that business, RPC is really driving to the bottom line, we've gone to

the point where we feel pretty good. We've worked through some underwriting actions, and that's one that we would be hopeful expecting that as the return picture has improved, we're going to be retaining more of that business going forward. So it is -- it's -- we feel good about how we've executed but we think the trajectory there should be changing in the future.

Operator

Our next question comes from the line of Jay Cohen with Bank of America Merrill Lynch.

Jay Adam Cohen - BofA Merrill Lynch, Research Division

I guess, a couple of things. First, I guess 2 questions on pricing. The first is, the good news on pricing was, on the international side, it looks like there was an inflection point to the positive side. Can you talk about what's happening there?

Alan D. Schnitzer

Yes, Jay, it's Alan Schnitzer. Certainly, it did pick up a little bit. I wouldn't call it an inflection point. And I'd say that the pricing dynamics outside of the United States continue to be very different than what we see in the United States. I think what you're seeing in our results, in particular, come from our efforts recently to increase our use of data and analytics and manage the portfolio and profitability. I wouldn't say there's an overall shift in the market though.

Jay Adam Cohen - BofA Merrill Lynch, Research Division

Got it. And I guess getting back to Business Insurance. You described the pricing environment over the past several years as quite stable, and clearly, that shows up in the graph. This deceleration that you've seen, modest as it is in the second quarter, investors are very sensitive to this. And I'm wondering -- I think, Brian, you had mentioned July being reasonably good. If you could give us some indication of where July stood relative to June or relative to the 2Q that would be helpful because, again, people are very sensitive to this issue. Your stock is up 2.3%. Any color would definitely be helpful.

Brian W. MacLean

Yes, and I think -- so I completely get it. I'll, on one hand, admit that we obsess over fractional movements in these things, but I think we and the marketplace are obsessing a little too much. And I know, we've got a better window into the detail than you do. So if you look at -- we ticked down a little bit from last quarter, literally rounding off of 7.5%, which had ticked up a little bit from the fourth quarter. So the numbers have really been about, in the aggregate, 7.5%. Within Business Insurance, June was the strongest of the 3 months in the quarters. But again, I'm talking about fractions of a point here, of the difference between 7.2% and 7.4% in total rate. And July looks like -- right now, our look of July looks like it might be a little bit better than June. But again, I'm talking about rounding a couple of cents of a point. So I don't mean to overemphasize it. We get the sensitivity. I think we're all watching the market closely. But it's been about where it's been for a while. And then the last point I'd make is we're really actively managing the business. We're trying to make sure we're getting it in the right places and...

Jay S. Fishman

Yes. Brian, I was actually just going to interrupt because I do think that's so important. These conversations, there's almost a backdrop as if somehow pricing is magically obtained from a third-party source from somewhere. What we're getting is what we're trying to get. I ask the question all the time, are we trying to get 12% and we're getting 7%? And the answer is no. We're managing this process very thoughtfully, always with a focus to not having disruption to agents or customers. We're in the business for the long term. We look at returns over time and will continue to march in improving returns. And as long as we're moving that way, we feel pretty good. And by the way, the retention remains as solid as it has and you can see from the more detailed graph how strong that really is.

Jay Adam Cohen - BofA Merrill Lynch, Research Division

So I guess, really, the main point based on this conversation is that the monthly data trend does not suggest any sort of slip-off, any notable slip-off? And what you're saying is the market to you does not feel like it is softening at this point despite this modest deceleration in the 2Q?

Jay S. Fishman

Well, first, it's only July 23, I think, so it's a little -- always a little reluctant to declare anything. We're only 3 quarters of the way through the month. So what we're getting is, to some extent, anecdotal with some data around it. So it's early. It's early. But if you -- on a more anecdotal basis, if you speak to people in the field, you don't get the comment back that there's any substantive change or receptiveness to our strategy. Brian, would you agree with that?

Brian W. MacLean

Yes -- no, I completely agree. And Jay, basically, I think the way you asked the question, yes, we'd agree with that, that what we've seen in our results and what we see and what were out in the marketplace quoting on, the market looks the same to us as it's been for a number of quarters now. We hear the same rhetoric but what we see and what we hear from our people is that it's continuing to move at about the same pace.

Operator

Our final question comes from the line of Clifford Gallant with Nomura.

Clifford H. Gallant - Nomura Securities Co. Ltd., Research Division

There's been talk in the reinsurance marketplace that some of the new capacity that's come in has perhaps structurally changed the business, maybe made reinsurance permanently cheaper or at least more stable. I'm curious, how do you -- how will that affect your business over time and how you manage things?

Jay S. Benet

Yes, this is Jay Benet. Well, first of all, as we've said in the past, we operate the business as a gross under -- gross lines underwriter. We don't rely on reinsurance to be in a particular marketplace. And when we do have reinsurance, it's generally in the larger risk or certainly in the cat area. As it relates to our view of the market, and I'm sure there are others who have a more intense view with their utilizing the market a lot more than we are, but given our view of the market, it would seem like there's a lot of capacity that's come in on the upper level cat kind of coverages. And that's helped drive prices down. And as I mentioned, the cost that we had this July of renewing our coverages were favorable, so it costs us less. How that's going to translate or if it will translate into the working layer-type benefits to companies that rely on that, we don't have any great insight, but it would seem, to us at least, unlikely that that's going to be where this capacity would want to play. So it's not a big impact on our business for sure and we'll see what happens going forward in the marketplace. But it seems like most of this capacity would be for higher-level cat coverage where the expectation of loss -- of actual losses taking place would be very, very low.

Operator

This does conclude our Q&A session for today. I would now like to turn the conference back over to Ms. Nawi.

Gabriella Nawi

Very good. Thank you for joining us today, and always, in Investor Relations, we are available for questions and answers. Have a great day.

Operator

Ladies and gentlemen, this does conclude the conference for today. We thank you for your participation and ask that you please disconnect your lines.

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Executives

Gabriella Nawi - Senior Vice President of Investor Relations and Member of Operating Committee

Jay S. Fishman - Chairman, Chief Executive Officer, Chairman of Executive Committee and Member of Operating Committee

Jay S. Benet - Vice Chairman, Chief Financial Officer and Member of Operating Committee

Brian W. MacLean - President, Chief Operating Officer and Member of Operating Committee

Alan D. Schnitzer - Chief Legal Officer, Vice Chairman of Financial, Professional, International Insurance & Field Management and Member of Operating Committee

William H. Heyman - Vice Chairman, Chief Investment Officer and Member of Operating Committee

Analysts

Amit Kumar - Macquarie Research

Michael Zaremski - Crédit Suisse AG, Research Division

Josh Stirling - Sanford C. Bernstein & Co., LLC., Research Division

Michael Nannizzi - Goldman Sachs Group Inc., Research Division

Gregory Locraft - Morgan Stanley, Research Division

Brian Meredith - UBS Investment Bank, Research Division

Jay Adam Cohen - BofA Merrill Lynch, Research Division

Clifford H. Gallant - Nomura Securities Co. Ltd., Research Division

The Travelers Companies ([TRV](#)) Q2 2013 Earnings Call July 23, 2013 9:00 AM ET

Operator

Good morning, ladies and gentlemen. Welcome to the Second Quarter Results Teleconference for Travelers. [Operator Instructions] As a reminder, this conference is being recorded on Tuesday, July 23, 2013. At this time, I would like to turn the conference over to Ms. Gabriella Nawi, Senior Vice President of Investor Relations. Ms. Nawi, you may begin.

[Gabriella Nawi](#) - Senior Vice President of Investor Relations and Member of Operating Committee

Thank you, Andre. Good morning, and welcome to Travelers' discussion of our second quarter 2013 results. Hopefully, all of you have seen our press release, financial supplement and webcast presentation released earlier this morning. All of these materials can be found on our website at www.travelers.com under the Investors section.

Speaking today will be Jay Fishman, Chairman and CEO; Jay Benet, Vice Chairman and Chief Financial Officer; and Brian MacLean, President and Chief Operating Officer. Other members of senior management are also available for the question-and-answer period. They will discuss the financial results of our business and the current market environment. They will refer to the webcast presentation as they go through prepared remarks, and then we will open it up for questions.

Before I turn it over to Jay, I would like to draw your attention to the explanatory note included at the end of the

webcast. Our presentation today includes forward-looking statements. The company cautions investors that any forward-looking statement involves risks and uncertainties and is not a guarantee of future performance. Actual results may differ materially from those projected in the forward-looking statements due to a variety of factors. These factors are described in our earnings press release and in our most recent 10-Q and 10-K filed with the SEC. We do not undertake any obligation to update forward-looking statements. Also, in our remarks or responses to questions, we may mention some non-GAAP financial measures. Reconciliations are included in our recent earnings press release, financial supplement and other materials that are available in the Investors section on our website.

And now, Jay Fishman.

Jay S. Fishman - Chairman, Chief Executive Officer, Chairman of Executive Committee and Member of Operating Committee

Thank you, Gabby. Good morning, everyone, and thank you for joining us today.

We're very pleased with our results this quarter, posting record net income per share of \$2.41. We are particularly gratified that this is another quarter which demonstrates the very successful execution of the pricing strategy in commercial lines, which we embarked on nearly 3 years ago. Our granular active approach to improving profitability has been very successful. The aggregate rate and retention data that we showed -- that we show you for our commercial businesses demonstrate the success, but the data underneath tells an even more powerful story of improvement in profitability. This is important, and Brian will take you through that in more detail.

But let me share with you that underlying margin improvement in our commercial businesses since 2011, which we achieved primarily through earned rate, our renewal business exceeding loss trend has, as of now, generated an increase in after-tax operating income of \$650 million on an annualized basis. If we include Personal Insurance, and more to say on personal lines in a minute, the increase is more than \$1 billion.

Importantly, we have done so without disruption to our agents or customers. The relevant question now is where do we go from here?

Since 2005, we have maintained a financial goal of producing a mid-teens operating return on equity over time. The over time aspect of the goal allows us to maintain the objective even when conditions are such that returns at that level are not immediately achievable on an accident year basis such as now. If you adjust our year-to-date operating return on equity of 15% to more of an accident year look by excluding the impact of net favorable prior year development, as well as the impacts of the favorable tax and legal resolutions, the adjusted ROE is approximately 8.5%.

Also, to achieve a mid-teens operating ROE over time, there will be years where we must exceed the target because there will be other years when, due to any number of factors, we will fall below. So it is clear that we have more work to do to achieve our objective, and as a consequence, our strategy remains intact. We will continue to execute for improved returns, just as we have been doing.

In Personal Insurance, we have also had a strategy of improving profitability through higher pricing. What has become apparent to us in the auto insurance line is that the combination of the rapid adoption of the comparative rater technology in independent agents offices, which now is the source of the substantial amount of the quotes that we issue and changing consumer expectations for this product have impacted our new business volume meaningfully.

Consequently, we have concluded that to improve profitability and to create long-term value, we must have a more competitively priced product. By leveraging technology and taking other actions, we will make substantive changes to our business processes that we expect will allow us to meaningfully reduce costs without impacting service or quality.

Brian will take you through the details, but through these actions we expect to be able to more competitively price our product and improve our profitability. Before I hand it over to Jay, I'd like to comment on our announcement in June that we agreed to acquire the Dominion of Canada. This was a strategic move, providing us with meaningful scale and market position in Canada. We are enthusiastic about the opportunity and are looking forward to welcoming the Dominion employees to Travelers.

With that, let me turn it over to Jay.

Jay S. Benet - Vice Chairman, Chief Financial Officer and Member of Operating Committee

Thanks very much, Jay. Let me start by saying how pleased we all are with the second quarter and year-to-date results. And I do want to correct one thing Jay said, on Page 21 of the webcast, we do have a reconciliation of the operating

return on equity year-to-date as reported of 15%. And when you do adjustment in net favorable prior year development and the favorable tax and legal settlements, it's actually 11.5%, would be -- what we consider to be the accident year kind of run rate of that. But with that, our liquidity and capital positions remain very strong, and we continue to generate capital in excess of what we need to support our businesses. Operating cash flows of approximately \$722 million for the quarter and \$1.3 billion year-to-date were also very strong, notwithstanding the cat losses that remain very high relative to historical standards although it's significantly below the corresponding prior year periods.

We maintained our strong cash position, ending the quarter with holding company liquidity of just over \$2 billion, after returning \$491 million of excess capital to our shareholders through dividends of \$191 million and common share repurchases of \$300 million. Our strategy of returning excess capital to our shareholders remains unchanged. As we've stated in the past, the combination of dividends to common shareholders and common share repurchases will likely not exceed operating income over time. And in any given period, the difference between operating income and the level of dividends and share repurchases will also be a matter of timing. I'd remind you also the amount of common share repurchases will also depend on a variety of additional factors, including corporate and regulatory requirements, maintaining capital levels commensurate with the company's ratings, our share price, pension funding needs, strategic initiatives and other market conditions.

We've included an overview of our cat reinsurance coverage on Page 20 of the webcast, which has been structured in a way that is generally consistent with the prior year.

Effective May 16, we entered into another 3-year reinsurance agreement with long-term -- Long Point Re III in which they issued \$300 million of cat bonds, providing us with Northeast hurricane coverage on a specified -- on specified lines of business subject to a \$1.25 billion retention, after which we can recover up to \$300 million on a proportional basis until covered losses reach \$1.8 billion.

Effective July 1, we renewed our gen cat treaty with terms that look similar to last year, an attachment point of \$1.5 billion and with covered losses of up to \$400 million within the \$1.5 billion to \$2.25 billion level -- layer.

Also effective July 1, we renewed our \$600 million Northeast gen cat treaty with the same \$2.25 billion attachment point as in the prior year. Given the current reinsurance pricing environment, all of this was accomplished at a cost that was lower than the prior year. A more complete description of our cat reinsurance coverage, which also includes a description of our gen cat aggregate excess of loss treaty that covers an accumulation of certain property losses arising from multiple occurrences, is included on our second quarter 10-Q, which we filed earlier today, as well as in our 10-K. All of our capital ratios remained at or better than our target levels, and we ended the quarter with a debt-to-total capital ratio of 20.1%. Due to the recent rise in interest rates, net unrealized investment gains decreased by \$1.2 billion after-tax in the quarter, driving a 2% reduction in book value per share in the quarter or 1% year-to-date.

This impact of higher interest rates more than offset the very positive impact on book value per share of our strong earnings, which was the major driver of the change in adjusted book value per share. Adjusted book value per share, which excludes unrealized investment gains and losses, increased 3% during the quarter and 5% year-to-date. I would note that the rise in interest rate does have a positive side. Going forward, if interest rates stay at their current levels, we'll be able to reinvest proceeds from maturing bonds at higher yields than we were previously assuming. I would point out though that at current interest rate levels, this will still result in a reduction in future net investment income, just not as much. The rise in interest rates also led to an \$87 million after-tax realized investment gain this quarter due to our use of U.S. Treasury futures to shorten the duration of the investment portfolio. At the beginning of the year, given the interest rate environment and the economic outlook, we decided to increase our short position from its then nominal amount of \$800 million. The position was increased to \$2 billion by the end of the first quarter and further increased to as much as \$2.7 billion before the position was closed by the end of the second quarter due to our outlook for interest rates versus the carrying cost of this strategy.

Lastly, I'd also like to point out that the rise in interest rates has not been significant enough to impact our pricing strategy in any meaningful way.

So Brian is now going to provide some further comments on operating results.

Jay S. Fishman - Chairman, Chief Executive Officer, Chairman of Executive Committee and Member of Operating Committee

Jay, just let me interrupt one second, if I may. I understand I misspoke and I know you corrected it, but because it is so important, please just let me reiterate that the adjusted ROE on what I described as the more of an accident look is 11.5%. If I said 8.5%, it was indeed just simply an error on my part. It's 11.5%. Thank you. Brian, I apologize.

[Brian W. MacLean](#) - President, Chief Operating Officer and Member of Operating Committee

No problem. Thanks, Jay. I'll go right to the segment results, beginning with Business Insurance, where we continue to be extremely pleased with the fundamentals of the business.

The combined ratio for the quarter of 96.2% improved nearly 7 points versus the prior year, while the underlying combined ratio, which excludes the impact of cats and prior year development, improved over 3 points.

Looking at production results for the segment on Page 9, retention and renewal premium change were both strong and in line with recent periods at 80% and nearly 9%, respectively, while new business volume was down slightly from the first quarter. Over the last 6 quarters, the production trends have been remarkably stable with retention running consistently around 80%, renewal price change between 8 and 10 points and rate around 7% to 8%.

Slides 10 through 12 show a basically similar story of consistency for each of the businesses within the segment, and in each case, the compounding effect of rate increases is driving a meaningful improvement in our combined ratios. So the aggregate production results remain strong but as we've mentioned many times, the aggregate numbers alone don't tell the entire story. In fact, the detail of where we are getting the rate and what accounts we are retaining is key to evaluating the success of our pricing strategy.

On Slide 13, we show our commercial accounts rate change and retention data for the second quarter of 2013 as compared to the second quarter of 2012. The data is segmented by the individual account's long-term loss ratios, with the bars on the left representing our best-performing accounts and the bars on the right representing our worst performing accounts.

We've shown this data before and I want to emphasize that it's a summarized version and the analytics we actually used to manage the business are at a much more granular level. The results show that for our better accounts, retention was very strong and rate change was solid and consistent with the year ago. For our core performing business, rate increases were up significantly year-over-year while retention was down meaningfully.

Additionally, as you evaluate our results, keep in mind that our rate actions over the past 3 years have improved the returns in each of these loss ratio bands. So in fact, although the aggregate pricing improvements are very consistent over the past 6 quarters, an analysis of the underlying data reveals that our execution has, in fact, improved over time and is contributing to higher levels of profitability. So overall, in Business Insurance, very encouraging picture. The earned impact of these rate gains, along with loss trend across the segment that continues to run at about 4%, drove meaningful margin expansion. Going forward, our emphasis is continue to improve returns through maximizing the rate and retention trade-off at a very granular level.

In Financial, Professional & International Insurance, operating income for the quarter was down 15% year-over-year due to higher catastrophe losses and less favorable prior year development. The cat losses in the quarter were primarily due to the unprecedented flooding in Alberta, Canada. Excluding cats and prior year development, the underlying combined ratio of 89.9% for the segment was strong and improved more than 2 points year-over-year. This improvement was driven largely by expanding margins in our Management Liability business, along with the impact of recent underwriting initiatives across the segment. Written premium was up slightly compared to the prior year quarter, driven by strong surety results, continued favorable rate in Management Liability and new business in international, partially offset by higher levels of written [ph] premiums.

In June, we were pleased to announce our agreement to acquire the Dominion of Canada. The combined business will benefit from Travelers' sophistication in the use of data and analytics, as well as claim and risk control capabilities. The Dominion's extensive distribution network provides us with an exceptional platform for expanding our commercial lines business in Canada. In combining Travelers of Canada surety, Management Liability and commercial middle market products with the Dominion's commercial and personal portfolios, we'll create an organization with significant product breadth and a balanced mix of business. The transaction is expected to close in the fourth quarter of 2013, subject to regulatory approvals and other customary closing conditions.

In Personal Insurance, operating income was up significantly versus the second quarter of 2012 due to lower levels of catastrophe losses and higher underlying underwriting margins. The underlying combined ratio for the quarter showed a 3-point improvement year-over-year with about 2 points driven by earned rate increases that exceeded loss cost trends.

Looking specifically at Auto production trends, retention of 80% and renewal premium change of over 8% were both in line with recent periods. Net written premium and new business volumes were down year-over-year as a result of our pricing actions.

Turning to Auto profitability. The underlying combined ratio of 96.4% was an improvement of over 1 point versus the prior year quarter, primarily reflecting the earned impact of the rate -- written rate gains we have achieved over the past several quarters. Loss cost trends for Auto remain consistent with recent quarters, with mix adjusted frequency continuing to be benign and severity stable at a slightly elevated level. Specifically, bodily injury severity this quarter remained in line with what we've seen in the previous 3 quarters.

In Homeowners, pricing was also very strong, with renewal premium change coming in at over 11%. Retention was consistent at 83%, while new business volume was down slightly from the prior year quarter. The underlying combined ratio for Home was 81.5% in the quarter, an improvement of over 3 points year-over-year. The improvement was driven by a lower level of non-cat weather losses, along with earned rate increases that exceeded loss cost trends. So a very strong underwriting result, and we are beginning to see the positive impact of our underwriting and pricing actions.

So overall, a very good quarter. But as Jay mentioned in his opening comments, the personal auto marketplace is changing. We remain committed to offering a product that is both competitively priced and delivers an appropriate return for our shareholders. And accordingly, we are taking expense reduction actions that will allow us to improve both pricing competitiveness and product returns.

Specifically, we expect to reduce our claim and other insurance expenses, such that we realize a savings of \$140 million pretax when fully implemented. This represents about a 10% reduction in our unallocated claim and other insurance expense base in Personal Insurance. We will begin realizing some of these savings immediately and they will be fully realized in 2015. The savings will be achieved through the consolidation of certain operations, along with other efficiency gains throughout the business.

The majority of the savings will be driven by staff reductions, primarily through attrition, but we will also be giving notice to approximately 450 employees this week. We expect to take a restructuring charge of about \$16 million, \$10 million of which is expected to be incurred in the third quarter of 2013. While some of these savings will be realized in our Homeowners business, the majority of the impact will be in Auto, and these actions are clearly aimed at improving our strategic position in that line. We are pleased with the progress we've made in the personal lines business and we believe these actions will allow us to offer an even more competitive product in a challenging marketplace.

I'll now turn it over to Gabby.

[Gabriella Nawi](#) - Senior Vice President of Investor Relations and Member of Operating Committee

Thank you, Brian. Before we open it for questions, I'd like to note that the management team is participating from several different locations this morning, so please bear with us as we coordinate our responses. With that, Andre, can we open it up for questions, please?

Question-and-Answer Session

Operator

[Operator Instructions] Our first question comes from the line of Amit Kumar with Macquarie.

[Amit Kumar](#) - Macquarie Research

Two quick questions. First, it relates to pricing. In terms of the Business Insurance pricing trends, I'm looking at the renewal rate change. Do you think, based on where we are and what rates we have achieved in the past, does the RRC and Business Insurance, does it stay somewhat flattish from here? Or does it change meaningfully from here?

[Brian W. MacLean](#) - President, Chief Operating Officer and Member of Operating Committee

So let me start. This is Brian MacLean. Let me start with an answer and then, Jay or Jay, chime in. I -- the first observation I'd make is when we look at the actual results, so we're not going to go far out in the crystal ball world, but if we look at the actual results over the last 6 quarters, from Page 10, it's incredibly stable. The red line there of renewal rate change is basically rounding off of 7.5% for all of those quarters. So what we saw in the quarter was very consistent with where we've been. Our view about it -- I would want to emphasize what we said in the presentation, that we don't have a target and it's not necessarily about attaining a specific level of rate gain, it's about achieving returns. So we're looking very granularly and obviously trying to retain the best business and drive the price increases on the weaker stuff. There can be a -- next quarter, a rate change number identical to the one that we just have, which might be generating much better returns or much worse, depending on where you get it. So we're very focused on the segmentation. As far out as we're going to go is what we saw in the quarter was very consistent. June was a pretty

strong month. July looks like it's trending pretty consistently, but where the market's going to be in 3, 4, 5 months, we'll all see. But we haven't seen anything in our results that would say that the market is about to shift dramatically and the fundamental situation with interest rates and weather volatility continues.

[Jay S. Fishman](#) - Chairman, Chief Executive Officer, Chairman of Executive Committee and Member of Operating Committee

Brian, would you agree that over the last 3 years as more of the Commercial Business has moved from the right side to the left side, and as a consequence, more as in the higher margin rather than the lower margin business? That achieving a flat rate in that same environment is actually net underneath an actual improvement.

[Brian W. MacLean](#) - President, Chief Operating Officer and Member of Operating Committee

Yes. And what you mean by flat rate is 7.5% round number rate increase?

[Jay S. Fishman](#) - Chairman, Chief Executive Officer, Chairman of Executive Committee and Member of Operating Committee

Correct. It's really the rate applied to the mix that is the important factor here.

[Brian W. MacLean](#) - President, Chief Operating Officer and Member of Operating Committee

Right. When we look at our granular execution and the impact of now a couple of years of rate increases on the portfolio, we feel the round numbers, 80% retention, 7.5% rate we're getting today, is producing a much better result than the 80% and 7.5% renewal rate change we were getting 1.5 years ago. So we feel very good about it.

[Amit Kumar](#) - Macquarie Research

Got it. That's helpful. I'm sorry, go ahead.

[Brian W. MacLean](#) - President, Chief Operating Officer and Member of Operating Committee

I was just going to say, but don't see any major shifts in what's going on in the market.

[Amit Kumar](#) - Macquarie Research

Yes. One quarter does not make a trend, but we'll see. The only other question I had is on...

[Jay S. Fishman](#) - Chairman, Chief Executive Officer, Chairman of Executive Committee and Member of Operating Committee

I will just make an observation. It's not one quarter. It's been a lot of quarters. And just an observation as to the data. That's all.

[Amit Kumar](#) - Macquarie Research

Yes. The other question was on Dominion, Dominion's business mix and a combined ratio. And I know it's a bit too early. Just looking at their business mix and their combined ratios, could you just sort of broadly talk about what your strategy might be and how it might differ versus the current strategy?

[Alan D. Schnitzer](#) - Chief Legal Officer, Vice Chairman of Financial, Professional, International Insurance & Field Management and Member of Operating Committee

Sure. Amit, it's Alan Schnitzer. But when you're talking about the current strategy, I'm not sure exactly which one you're asking.

[Amit Kumar](#) - Macquarie Research

I'm talking about the combined ratios, 106.1% for 2012, and their top line is \$1.2 billion. Just sort of broader thoughts on that going forward. How does that change? Does it change near term? Or does it take somewhat longer to turn that around?

[Alan D. Schnitzer](#) - Chief Legal Officer, Vice Chairman of Financial, Professional, International Insurance & Field

Management and Member of Operating Committee

Sure. Let me take a stab at that. So stepping back, the transaction really is a strategic transaction for us. It gives us important scale and competitive position in a big market that currently we're -- we don't have either in. So from a strategic perspective, we think it's important. In terms of what's driving that combined ratio, a lot of that is their personal lines Auto business. And we think that when we bring our data and analytics and claim expertise to that marketplace, we can -- and it'll take some time, but we think we can substantially improve that result. Also, they've got a small commercial platform that we like a lot. We think we can bring our expertise and analytics from that business into that marketplace. And one of the real benefits for us in this transaction is that they've got a terrific distribution platform in Canada, and we like the opportunity to expand our commercial middle market products through their distribution. So we think that there is good premium growth in the platform from that. So -- and looking overall in international, we've been, certainly over the last couple of years, focused on investing in that business and managing the loss side, which we've done very effectively over the last couple of years. So we're very confident that when we apply that same expertise to the Dominion, we'll be able to have positive effects on that. One of the impacts of what we've been doing for a couple of years is the expense ratio has ticked up, both from investing in people and data and analytics and also from, over the years, having shed some premium that didn't meet the risk and reward calculation for us. So the additional volume that comes on from Dominion really helps us from the expense side as well. So that's really sort of the outlook and the strategic positioning of the transaction.

Operator

Our next question comes from the line of Mike Zaremski with Crédit Suisse.

[Michael Zaremski](#) - Crédit Suisse AG, Research Division

In regards to margins, in the press release, I noticed that low levels of large losses were cited at -- within the international segment. And I also noticed that lower levels of non-catastrophe weather-related losses were cited in personal lines. So I guess, does that mean we should build some margin cushion into our forward estimates given non-cat level large losses have been running below historical averages? Or am I thinking about that wrong -- the wrong way?

[Jay S. Benet](#) - Vice Chairman, Chief Financial Officer and Member of Operating Committee

Yes. This is Jay Benet. As we've said in previous quarters, any individual quarter is going to be impacted by things that go well beyond the general flow of earned rate versus what you'd consider to be the underlying loss trend. Now we spike out at least verbally because that's probably as good as it's going to get. We have things like large loss activity and some view as to, with the non-cat weather, favorable or unfavorable relative to the prior year and we try to give you that perspective. What we always suggest you do is look at the longer-term view as to what the combined ratio looks like x cat and few ID [ph], and with those words around and what others say, try to get a view as to what the weather looks like and build that into your models. I hope that's helpful because that's probably as granular as we can get with it.

[Michael Zaremski](#) - Crédit Suisse AG, Research Division

Okay. Yes, it just stood out because I know in 2Q of last year, you also cited lower levels of large losses.

[Jay S. Benet](#) - Vice Chairman, Chief Financial Officer and Member of Operating Committee

Yes, because the other thing you could do is we wrestle with this as well. So we try to put some words into the outlook within the 10-Q that might also be helpful.

[Michael Zaremski](#) - Crédit Suisse AG, Research Division

Okay, great. Last question, in regards to investment income levels. I noticed the portfolio's average pretax yield actually rose a bit sequentially to 3.9%. And I think you cited duration increasing. Can you comment on how we should perspective think about those dynamics, given the recent increases in new money rates?

[William H. Heyman](#) - Vice Chairman, Chief Investment Officer and Member of Operating Committee

Well, I think what -- it's Bill Heyman. I'd go first to what Jay said earlier and that is the recent increase in market rates obviously permits us to put new money out at better rate than we were before, but still at rates below the book yields on maturing securities. So I think I would simply take the projections which Jay has made in the past of net investment

income going out 2, 3, 4 years and tweak them for this increase in rates, and frankly, I wouldn't tweak them much. If this is -- if what we have seen in June is all we're going to see in 2013 and some will think that may be the case, I wouldn't make major changes in projections.

[Jay S. Benet](#) - Vice Chairman, Chief Financial Officer and Member of Operating Committee

Yes, if I could add a couple of things. The -- we talked about the short position in treasury futures. And by eliminating that at the end of the quarter, that had an impact of slightly expanding the duration of the portfolio. Having said that, too the rise in interest rates also expands the duration of the portfolio, given the expected impact on bonds that would be called or not called under that circumstance. So the change in duration is really not a structural change at all in the portfolio. And as Bill just said, the rise in interest rates would have a fairly moderate impact on the reinvestment yields so -- given how much is rolling over versus what's enforced. And in our 10-Q, in the outlook section, we talk about all of this having an impact that would suggest about \$25 million less in after-tax net investment income off of the fixed income portfolio per quarter going forward, if interest rates stay where they are, and I think before we said the out number was about \$30 million. So it's a relatively modest impact.

[Jay S. Fishman](#) - Chairman, Chief Executive Officer, Chairman of Executive Committee and Member of Operating Committee

And Jay, I would just make some one observation. You just -- you mentioned in passing that the gain was attributable to closing the position. That's actually not completely correct because it's a mark-to-market position, so whether we had closed it or not closed it, the gain would have been there. We closed it because of our expectations of interest rates and the relative cost of carrying the position. But the position is a daily mark-to-market position.

[Jay S. Benet](#) - Vice Chairman, Chief Financial Officer and Member of Operating Committee

That's entirely right. Thanks for correcting that, Jay.

Operator

Our next question comes from the line of Josh Stirling with Sanford Bernstein.

[Josh Stirling](#) - Sanford C. Bernstein & Co., LLC., Research Division

So obviously, we've all been very impressed for the past couple of years with your pricing leadership, pricing approaching, I guess, 20% at this point. You've helpfully done the math for us in 11% or 12% x your ROE. And there's obviously still some pricing yet to earn in and rates are moving higher and so I think we're all sort of sitting out here just scratching our heads, trying to figure out how much longer pricing will continue. You've given us some guidance, which is helpful in your Q. And I'm wondering if you can just expand the math a bit and give us a sense when you've actually worked with your actuaries and meet with your insurance regulators, and share them with your indications, how much more rate in some of your major segments do you actually need to take at these levels?

[Jay S. Benet](#) - Vice Chairman, Chief Financial Officer and Member of Operating Committee

Jay, you want to start or...

[Jay S. Fishman](#) - Chairman, Chief Executive Officer, Chairman of Executive Committee and Member of Operating Committee

Yes, I was just taking about how to do that. First, I -- we've always said that one of the things we can't do is to, in any way, is to project or speculate competitive reactions. So just because we articulate pretty clearly what we intend to do, it certainly doesn't mean that it's going to happen or that we approach it with that certainty. But nonetheless, we continue to have a space to go. We've been saying for the longest time, and I take some pride in the fact that the objective, the financial objective, that we articulated now some 8 years ago is one that we stayed with consistently. It's not been remanufactured to be convenient to the environment. It is what we think long-term returns in our business should be and hopefully can be again. But our goal is to get back to the mid-teens return on equity over time, and at 11.5% now on an accident year basis, round numbers, we still have a ways to go. Not all products are the same, very important. Not all businesses are the same. And as a consequence, not all pricing strategies are the same. We talk all the time about the analytic grid that demonstrates high to low returns and our emphasis on pricing relative to that. But every time you take a step up, it changes, whether you're talking about an individual product line like Workers' Comp or property or whether you're talking about a particular business like construction versus our surety business. So the strategies are all quite different and they are all return-driven. But in the aggregate, we are going to continue to push

as long as we can, until such time as we bring ourselves back to the long-term objective. And I think that's probably about as clear as we can be. I -- we've resisted, even internally setting artificial goals or targets or budgets, and rather always look at what we've always articulated as our long-term goals to be.

[Brian W. MacLean](#) - President, Chief Operating Officer and Member of Operating Committee

Yes. So 2 things that I would add because, Josh, in your question, you put in there rates moving. I would just point out that the rate movement that we just saw in interest rate has really had virtually no impact on our pricing, and to some degree, because it was a relatively small move in rates. But even the 100 basis points, at one point in time, at the 10 year got a lot of play. The duration of our liability is significantly shorter than that. So you have to look at the whole yield curve and see where rates are moving. So that has had minimal impact. And we'd need quite a bit of movement in interest rates before started changing pricing significantly. And the other...

[Jay S. Fishman](#) - Chairman, Chief Executive Officer, Chairman of Executive Committee and Member of Operating Committee

We -- actually, Brian, just in that regard, we asked, and I do think these 2 comments are important, most of our, call it, free cash, I don't mean to define that term, but most of our free cash is used in buying back share. So if you look at our portfolio position over the last several years, it's actually been relatively flat. And most of our investing is reinvesting. And so we're not -- it's not as if we're deploying significant amounts of new cash, we've been deploying it in buying back shares. We did ask our actuaries to make an estimate of what a 100 basis point increase would be in the entire curve if there was a shift because, of course, every product is invested -- the underlying products have a duration philosophy is tied to the -- that's tied to the asset. They're not directly matched but it's very much a philosophical match. And this is just an estimate and I perhaps even would call it a guesstimate. But in terms of returns, the equivalent of 100 basis point move in the yield curve would be about 2 to 3 points in pricing rate. So 2 to 3 points in price would be equivalent in returns to 100 basis point move in the entire yield curve. Brian, am I recalling that correctly?

[Brian W. MacLean](#) - President, Chief Operating Officer and Member of Operating Committee

Yes, that's correct.

[Jay S. Fishman](#) - Chairman, Chief Executive Officer, Chairman of Executive Committee and Member of Operating Committee

Yes.

[Brian W. MacLean](#) - President, Chief Operating Officer and Member of Operating Committee

Yes. The other quick thing I'd point out is that weather volatility is still there. And although our second quarter cat number was dramatically less than what we have seen the last 2 years, it is dramatically higher than what 3 years ago we would have said was historical second quarter norms. So that is still out there and the marketplace needs to deal with it. So that's kind of our view.

[Josh Stirling](#) - Sanford C. Bernstein & Co., LLC., Research Division

That's very helpful, Jay, Brian. Just one other question on strategy and distribution evolution. So your comments about the evolution of comparative raters, agents starting to use them for renewal business as well start to get sort of -- raise a whole bunch of questions and it's not obviously as good for the agents or -- and certainly more challenging for the company. I'm wondering if you can talk about how you think that your sort of broader sort of agency strategy evolves more if there's going to be changes in commissions or if you fundamentally try to change your position or approach to that market? And then just more broadly related to that same point, is this something that sort of starts in Auto and then moves to Home and moves the Select and ultimately as sort of a Pandora's box once it's opened?

[Brian W. MacLean](#) - President, Chief Operating Officer and Member of Operating Committee

So let me -- this is Brian. Let me start with a couple of comments, and then Jay. And I'll go to your last comment first, Josh, which is, clearly, we look at this and say it doesn't have to be just a personal auto dynamic, but complexity of product is really significant in being able to build an efficient rater technology and business process. So even Homeowners is fairly more complicated than Auto and you get into the commercial products and much more complicated than Auto. So we watch it closely but we don't think we're on the verge of comparative raters everywhere. And then I'd say the big backdrop to the question is we're not looking at a fundamental shift across the board of how

we deal with independent agents. One of the great strengths of our franchise is the position that we have with agents, and we have a lot of products and we have a lot of breadth and we're going to continue to leverage that, working with them closely on what their business process is and how we continue to together bring a value proposition to the customers is important. With that said, everything is on the table where we're constantly looking at it all, the dimensions of it, but we feel good about where we are with agents. Jay?

[Jay S. Fishman](#) - Chairman, Chief Executive Officer, Chairman of Executive Committee and Member of Operating Committee

Yes, I know, I'd -- just an observation. I think we have a well-deserved and well-earned reputation for being a low-cost-oriented company. We know from experience, I think, how to do that thoughtfully and in the best interest of the business. I think Brian's comment is right. We're determined to be successful in the business. We have an \$8 billion premium combined personal lines business, and in fact, everything is on the table. But we do know how to do this. And the comparative rating technology, I get asked all the time, is the product becoming a commodity? And I'm always quick to answer, no. A commodity is a product where the only thing that doesn't matter is the price because all the prices are the same. Every -- oil, the price is the same. And that's not the case here. There are value differentiations and value perceptions and strength to agents and strength to customers, and there are differentiations. What the rater is doing, though, clearly, is increasing price competitiveness at the point-of-sale. The technology has introduced the ability of agents to see greater multiples of prices much more easily. And we do think that the onslaught of advertising over the last, and this is just an opinion, I can't prove it as a fact, but the onslaught of advertising in the space over the last 10 years has brought customers to the view that value is a more important component value dollars of the purchase than perhaps it was previously. So it's going to force a greater level of price competition and I think we're up to the task. And that's what we're going to do.

Operator

Our next question comes from the line of Michael Nannizzi with Goldman Sachs.

[Michael Nannizzi](#) - Goldman Sachs Group Inc., Research Division

So one question I had for, I guess, maybe for Brian first is, just looking -- I know we look at this on a year-over-year basis but sequentially, the combined -- the underlying combined in business was up a bit. And then -- and even going back and looking at 1Q to 2Q, it's not clear that the second quarter is always higher than the first. And even if we'd look at year-over-year, I mean, you're 400 basis points better in the first quarter, 300 basis points-ish better here in the second. Just trying to understand that -- was non-cat weather an element of that comparison? Or any color there on kind of the margin in Business Insurance?

[Brian W. MacLean](#) - President, Chief Operating Officer and Member of Operating Committee

Yes, Mike. I think there's always -- as Jay Benet was saying before, there's always volatility in the individual quarters. Nothing fundamental with the trend has changed over where we were with first quarter. And I know deltas have shifted a little bit. If you look at our data on Page 9, 3.1 points of underlying combined ratio better than last year and the first quarter was better than that. That was the movement in those other things. So we're going to have large losses go up or down or non-cat weather go up or down relative to the previous quarter. I think that we're still in the same place we were in the first quarter, where we think the core underlying margins here in BI are improving somewhere between 2.5 and 3 points for the business. And that is unchanged from where we were in first quarter. And everything has been, as I said before, pretty stable, both rate and loss trend there. So we don't see any fundamental shift. I know the numbers do move around a little bit.

[Michael Nannizzi](#) - Goldman Sachs Group Inc., Research Division

Yes. And I'm just trying to understand given -- so that's great. So the 2.5 to 3 points remain so you had some noise maybe in second quarter. But is it possible to just give some parentheses around the rate-driven margin expansion that you saw in the first quarter versus the second quarter? Just because -- again, I mean, this is the first -- I mean, we've had 1, 2, 3, 4, 5, 6, 7 consecutive quarters of sequential improvement in that underlying combined...

[Brian W. MacLean](#) - President, Chief Operating Officer and Member of Operating Committee

Yes, that's -- I think what I was trying to say, Mike, is the rate-driven margin improvement is the 2.5 to 3. When we try to back out the quarterly periodic volatility and what's the impact of the rate we're earning in versus the core loss trend, that continues to run at 2.5, 3 combined ratio points. And again, you have to do the arithmetic to get the -- just bring it

through the combined ratio to get the math to work.

[Michael Nannizzi](#) - Goldman Sachs Group Inc., Research Division

Got it. Okay, great. And then, I guess, one question on the actions in personal lines. Any thought around in this process, the direct business, and kind of cost rationalization or continued investment on that front?

[Jay S. Fishman](#) - Chairman, Chief Executive Officer, Chairman of Executive Committee and Member of Operating Committee

The decision is certainly not being driven by the direct business, but the direct business will most certainly benefit from a lower priced product. So it will certainly help in that regard. I do want to reemphasize, so that everyone understands clearly, that the intention here is to lower cost and increase profitability. So the reduction in cost will, in effect, not be passed on entirely to the price of the product. Some of it will be retained in the form of improved profit. At least that's the plan. So it'll help. It'll certainly help the direct business.

Operator

Our next question comes from the line of Greg Locraft with Morgan Stanley.

[Gregory Locraft](#) - Morgan Stanley, Research Division

Just wanted to follow up on the personal lines segment. The policy counts are -- and I mean, you've admitted the policy count declines are pretty stunning and accelerating, it seems, at least this year. Homeowners back to 2006 levels, personal auto back to '04 levels, the direct initiative seems to have stalled. So you guys are losing a lot of share. You've admitted that. What I'm wondering is, is the cost plan enough? In other words, is there -- there's clearly a pricing problem in the marketplace with this segment. So is the cost plan enough such as you can cut your pricing or get more competitive to begin to stem the share losses? And then second is, what's the timing around when we'll see the tangible actions in the P&L from a PIF perspective? I'm sort of wrestling with how long to take the share losses down in my model?

[Brian W. MacLean](#) - President, Chief Operating Officer and Member of Operating Committee

Yes. Let me start, Jay, and then throw it to you and so I'd -- several comments there. And maybe one of the things I'd say right at the front is that the actions we're taking today are somewhat -- the expense actions are somewhat a reaction to what's going on in our top line but more focused on reacting longer term to some changing dynamics in the marketplace. So it's not just a -- because the PIF is down 12%. I would look at -- so a couple of things, number one is...

[Jay S. Fishman](#) - Chairman, Chief Executive Officer, Chairman of Executive Committee and Member of Operating Committee

Brian, can I also ask you to speak because Greg asked the question with Home, Auto, direct, and I think there is a distinction to be made there as well.

[Brian W. MacLean](#) - President, Chief Operating Officer and Member of Operating Committee

Yes, so let me start with Auto where we -- on the retail auto business through our agent channel. For starters, retentions remain pretty solid and that's been a positive. So although it's down a couple of points, it's still running at a solid level and the shortfall has been in new business. And as we've said and maybe has been obvious, that's clearly been impacted by our pricing action. We feel good that returns have improved, that the -- and 6 months are consistent with our expectations. And our price changes, independent of the expense actions, would -- will be mitigating, as you've seen in the last couple of quarters with the Auto business. So hopefully, that will bring the us back in line. The industry did post the 104.5% combined ratio last year. So it is a product that is needed rate and we feel good about the actions we take. We've taken, we think, the expense actions. And as we said before, anything else that we need to do in this business, everything is on the table, is really -- are really focused on improving that and helping us deal with the changing marketplace. So the Homeowners business, we view as fundamentally different there. We think there are some real capacity issues. That was, I think, much more of a focused weather exposure kind of actions. And so it's not just the pricing we've been driving there, which has fundamentally been driven by the losses, the weather losses, that has been come through. But it's also other actions we've taken from underwriting, deductibles, terms and conditions that have really, really driven us. So we feel very good about where our Homeowners business is right now and feel like we're in a position to move forward. The tricky part of your question is, where do we think the impacts -- well, what's

the time horizon? We don't really forecast that out. We're looking at, clearly, a different PIF situation for 2014. But we'll see what that is, okay?

Jay S. Fishman - Chairman, Chief Executive Officer, Chairman of Executive Committee and Member of Operating Committee

And just a closing comment on the direct because, Brian, I think you got both of those just right. The dynamic in direct is very much what we've been intending to do. We've been doing a test, a test of pricing sensitivity. And so our -- and people have asked you, your advertising is down. Yes, our advertising is down very intentionally because we've been focused on testing price elasticity in a very limited number of markets and gaining some insight into what that means. So I would just observe that there isn't anything in our direct channel other than also seeing and observing, of course, that pricing really matters, great shock, pricing really matters. And so again, what we're going to do in the personal space here will most -- we hope, we believe, will certainly help the direct channel as well.

Gregory Locraft - Morgan Stanley, Research Division

Okay. And I guess, just to follow up on this because the answer is very thorough, but what I'm wrestling with is I love that you're getting good price in the business and the retentions are holding in. So clearly, the core client base is sticking with the Travelers once in the umbrella. Direct is so small. It just seems like -- it's like an experiment, in a way, in the P&L. But really, in the agency side of Homeowners and Auto, it's the lack of the ability to attract new clients in. And I'm wondering if it's more than just the expense side. I'm wondering if it's actually you need to start to ramp advertising a lot more. You need to re-architect the product which you mentioned. I don't know if that costs money. I don't know if that's technology. In other words, I'm just -- I'm trying to wrestle with the cost to fix the new business acquisition engine in the Auto segment and...

Jay S. Fishman - Chairman, Chief Executive Officer, Chairman of Executive Committee and Member of Operating Committee

The analytics that we have indicate, maybe even more than indicate, that pricing sensitivity for new business through comparative raters is just significantly different than it was in the past. And we have all sorts of data that shows when you're lowest in the comparative raters space, when you're second lowest and when you're third lowest. And so we know what it takes to be successful. And so I -- we don't believe that there's anything, with respect to our product, that needs to be reengineered or -- I mean, we're always filing changes. We're always filing changes in pricing. We're always filing changes in underwriting and claimants. So there's always changes going on. But we believe this is the issue in the new business front. And you're right, the renewal business has been quite stable, and that is very encouraging. So we think we're on the right path here.

Operator

Our next question comes from the line of Brian Meredith with UBS.

Brian Meredith - UBS Investment Bank, Research Division

I have 2 questions here for you. First, Jay, I'm just curious, the acquisition of Dominion, nice, opportunistic acquisition. But given where your stock price now is trading on a price-to-book multiple, does it change at all your thought process with respect to capital allocation? Are acquisitions here potentially more attractive than share buyback?

Jay S. Fishman - Chairman, Chief Executive Officer, Chairman of Executive Committee and Member of Operating Committee

No, I don't believe so. This was -- there were a couple of things about the Dominion transaction that were really appealing to us. One, is it gave us some real size and scale in a market where we just were lacking badly; two, there were some scarcity value up there. There are precious few companies to be acquired. They're either mutuals or subsidiaries of larger companies or very large companies themselves. So there is a scarcity value. And it provided a first-rate management team, we think, and a terrific systems and technology and a platform to do business. So it had several compelling reasons that really just had us think about it as a special opportunity but not thinking about it differently in the context of capital management, no.

Brian Meredith - UBS Investment Bank, Research Division

Great. And then the second question, I wonder if you could chat a little bit about the small commercial business. It seems to continue to be a little sluggish there. Is that because of the economic environment? Is it because that there's

maybe more competitive down there? Why is it tending to be a little bit slower from a growth standpoint, actually declining this quarter on a written premium basis than some of the other lines?

[Brian W. MacLean](#) - President, Chief Operating Officer and Member of Operating Committee

Yes, Brian, this is Brian MacLean. I'll start. There's several things that going on there. We've talked a while back about what was going on in the larger end, plus we talked a little bit about Auto trends that we were seeing in commercial and specifically in the Select world. So there were some targeted underwriting actions that we were taking, which we have now pretty much worked through. And it was a business, if you think of -- it's almost a great example of the segmentation concept that I was talking about in commercial accounts. If you looked across our spectrum of businesses in Business Insurance a couple of years ago, Select would've been one that, from a return perspective, we were struggling with more than others. So it would've been on the writer side of the graph of our businesses. And if you look at the pricing that we've gotten there, and in that business, RPC is really driving to the bottom line, we've gone to the point where we feel pretty good. We've worked through some underwriting actions, and that's one that we would be hopeful expecting that as the return picture has improved, we're going to be retaining more of that business going forward. So it is -- it's -- we feel good about how we've executed but we think the trajectory there should be changing in the future.

Operator

Our next question comes from the line of Jay Cohen with Bank of America Merrill Lynch.

[Jay Adam Cohen](#) - BofA Merrill Lynch, Research Division

I guess, a couple of things. First, I guess 2 questions on pricing. The first is, the good news on pricing was, on the international side, it looks like there was an inflection point to the positive side. Can you talk about what's happening there?

[Alan D. Schnitzer](#) - Chief Legal Officer, Vice Chairman of Financial, Professional, International Insurance & Field Management and Member of Operating Committee

Yes, Jay, it's Alan Schnitzer. Certainly, it did pick up a little bit. I wouldn't call it an inflection point. And I'd say that the pricing dynamics outside of the United States continue to be very different than what we see in the United States. I think what you're seeing in our results, in particular, come from our efforts recently to increase our use of data and analytics and manage the portfolio and profitability. I wouldn't say there's an overall shift in the market though.

[Jay Adam Cohen](#) - BofA Merrill Lynch, Research Division

Got it. And I guess getting back to Business Insurance. You described the pricing environment over the past several years as quite stable, and clearly, that shows up in the graph. This deceleration that you've seen, modest as it is in the second quarter, investors are very sensitive to this. And I'm wondering -- I think, Brian, you had mentioned July being reasonably good. If you could give us some indication of where July stood relative to June or relative to the 2Q that would be helpful because, again, people are very sensitive to this issue. Your stock is up 2.3%. Any color would definitely be helpful.

[Brian W. MacLean](#) - President, Chief Operating Officer and Member of Operating Committee

Yes, and I think -- so I completely get it. I'll, on one hand, admit that we obsess over fractional movements in these things, but I think we and the marketplace are obsessing a little too much. And I know, we've got a better window into the detail than you do. So if you look at -- we ticked down a little bit from last quarter, literally rounding off of 7.5%, which had ticked up a little bit from the fourth quarter. So the numbers have really been about, in the aggregate, 7.5%. Within Business Insurance, June was the strongest of the 3 months in the quarters. But again, I'm talking about fractions of a point here, of the difference between 7.2% and 7.4% in total rate. And July looks like -- right now, our look of July looks like it might be a little bit better than June. But again, I'm talking about rounding a couple of cents of a point. So I don't mean to overemphasize it. We get the sensitivity. I think we're all watching the market closely. But it's been about where it's been for a while. And then the last point I'd make is we're really actively managing the business. We're trying to make sure we're getting it in the right places and...

[Jay S. Fishman](#) - Chairman, Chief Executive Officer, Chairman of Executive Committee and Member of Operating Committee

Yes. Brian, I was actually just going to interrupt because I do think that's so important. These conversations, there's

almost a backdrop as if somehow pricing is magically obtained from a third-party source from somewhere. What we're getting is what we're trying to get. I ask the question all the time, are we trying to get 12% and we're getting 7%? And the answer is no. We're managing this process very thoughtfully, always with a focus to not having disruption to agents or customers. We're in the business for the long term. We look at returns over time and will continue to march in improving returns. And as long as we're moving that way, we feel pretty good. And by the way, the retention remains as solid as it has and you can see from the more detailed graph how strong that really is.

[Jay Adam Cohen](#) - BofA Merrill Lynch, Research Division

So I guess, really, the main point based on this conversation is that the monthly data trend does not suggest any sort of slip-off, any notable slip-off? And what you're saying is the market to you does not feel like it is softening at this point despite this modest deceleration in the 2Q?

[Jay S. Fishman](#) - Chairman, Chief Executive Officer, Chairman of Executive Committee and Member of Operating Committee

Well, first, it's only July 23, I think, so it's a little -- always a little reluctant to declare anything. We're only 3 quarters of the way through the month. So what we're getting is, to some extent, anecdotal with some data around it. So it's early. It's early. But if you -- on a more anecdotal basis, if you speak to people in the field, you don't get the comment back that there's any substantive change or receptiveness to our strategy. Brian, would you agree with that?

[Brian W. MacLean](#) - President, Chief Operating Officer and Member of Operating Committee

Yes -- no, I completely agree. And Jay, basically, I think the way you asked the question, yes, we'd agree with that, that what we've seen in our results and what we see and what were out in the marketplace quoting on, the market looks the same to us as it's been for a number of quarters now. We hear the same rhetoric but what we see and what we hear from our people is that it's continuing to move at about the same pace.

Operator

Our final question comes from the line of Clifford Gallant with Nomura.

[Clifford H. Gallant](#) - Nomura Securities Co. Ltd., Research Division

There's been talk in the reinsurance marketplace that some of the new capacity that's come in has perhaps structurally changed the business, maybe made reinsurance permanently cheaper or at least more stable. I'm curious, how do you -- how will that affect your business over time and how you manage things?

[Jay S. Benet](#) - Vice Chairman, Chief Financial Officer and Member of Operating Committee

Yes, this is Jay Benet. Well, first of all, as we've said in the past, we operate the business as a gross under -- gross lines underwriter. We don't rely on reinsurance to be in a particular marketplace. And when we do have reinsurance, it's generally in the larger risk or certainly in the cat area. As it relates to our view of the market, and I'm sure there are others who have a more intense view with their utilizing the market a lot more than we are, but given our view of the market, it would seem like there's a lot of capacity that's come in on the upper level cat kind of coverages. And that's helped drive prices down. And as I mentioned, the cost that we had this July of renewing our coverages were favorable, so it costs us less. How that's going to translate or if it will translate into the working layer-type benefits to companies that rely on that, we don't have any great insight, but it would seem, to us at least, unlikely that that's going to be where this capacity would want to play. So it's not a big impact on our business for sure and we'll see what happens going forward in the marketplace. But it seems like most of this capacity would be for higher-level cat coverage where the expectation of loss -- of actual losses taking place would be very, very low.

Operator

This does conclude our Q&A session for today. I would now like to turn the conference back over to Ms. Nawi.

[Gabriella Nawi](#) - Senior Vice President of Investor Relations and Member of Operating Committee

Very good. Thank you for joining us today, and always, in Investor Relations, we are available for questions and answers. Have a great day.

Operator

Ladies and gentlemen, this does conclude the conference for today. We thank you for your participation and ask that you please disconnect your lines.

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