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Selective Insurance Group, Inc. *(SIGI)*

Q2 2012 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day everyone. Welcome to the Selective Insurance Group's Second Quarter 2012 Earnings Release Conference Call. At this time, for opening remarks and introductions, I would like to turn the call over to Senior Vice President, Investor Relations and Treasurer, Ms. Jennifer DiBerardino. Ma'am, you may begin.

Jennifer W. DiBerardino

Treasurer & Senior VP-Investor Relations, Selective Insurance Group, Inc.

Thank you very much. Good morning, and welcome to the Selective Insurance Group's Second Quarter 2012 conference call. This call is being simulcast on our website and the replay will be available through August 24, 2012. A supplemental investor package, which includes GAAP reconciliations of non-GAAP financial measures referred to on this call is available on the Investors page of our website at www.selective.com.

Selective uses operating income, a non-GAAP measure, to analyze trends and operations. Operating income is net income excluding the after-tax impact of net realized investment gains or losses as well as the after-tax results of discontinued operations.

We believe that providing this non-GAAP measure makes it easier for investors to evaluate our insurance business. As a reminder, some of the statements and projections that will be made during this call are forward-looking statements as defined by the Private Securities Litigation Reform Act of 1995. Forward-looking statements are not guarantees of future performance and are subject to risks and uncertainties. We refer you to Selective's

Annual Report on Form 10-K and any subsequent Form 10-Qs filed with the U.S. Securities and Exchange Commission for a detailed discussion of these risks and uncertainties. Please note that Selective undertakes no obligation to update or revise any forward-looking statements.

Joining me today on the call are the following members of Selective's executive management team; Greg Murphy, CEO; Dale Thatcher, CFO; John Marchioni, EVP of Insurance Operations; and Ron Zaleski, Chief Actuary.

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

Dale A. Thatcher

Chief Financial Officer & Executive Vice President, Selective Insurance Group, Inc.

Thanks, Jen. Good morning. Catastrophe events in the second quarter, once again, masked the continued improvement in our underlying results. Despite $30 million of the catastrophe losses resulting from the latest storms, we continued to improve commercial lines pricing, while maintaining very strong retention levels.

For the quarter, we reported operating income per diluted share of $0.01 versus zero a year ago. As we stated in our pre-release, the biggest impact on earnings was catastrophe losses, but lower than anticipated net investment income also contributed.

The second quarter statutory combined ratio of 106.2% was a 3.3 point improvement from the year ago quarter. Catastrophe losses in the quarter were $30 million pre-tax or 7.7 points versus 10.7 points a year ago. Favorable prior year casualty development of $5 million or 1.3 points partially offset these results.

As indicated last quarter, the expense ratio was slightly elevated due to additional underwriting expenses related to the E&S operations. On acquisition, MUSIC's unearned premium was fully ceded back to Montpelier, which results in the GAAP underwriting expense ratio being under some additional pressure until the premium that we write is earned and is able to support the ongoing expenses of these operations.

Total statutory net premium written was up 14% in the quarter with commercial lines up 15%. The increase was driven by our 6.5% standard commercial lines renewal price, strong retention and our E&S business, which contributed $28 million.

Audit and endorsement additional premium continued to benefit the top line, adding $6 million in the quarter. This is a positive indication as this marks the fifth consecutive quarter of additional audit and endorsement premium.

Standard commercial lines pure price was up 6.5% and retention improved to 82% from 80% a year ago. For the quarter, the commercial lines statutory combined ratio was 105.6% including 5.8 points of catastrophe losses. Commercial property ex-cat continued to perform well with a statutory combined ratio of 87.7%.

Commercial auto also turned in another good quarter with a 96% combined ratio. The BOP line ex-cat reported a second-quarter statutory combined ratio of 85.7% including favorable prior-year development of 14.5 points. Personal lines net premium written grew 8% in the quarter to $77 million and we achieved 5.6% rate on the book. The statutory combined ratio, however, was 109.2% and included 16.5 points of catastrophe losses. The homeowners ex-cat combined ratio improved 4.5 points from a year ago to 82.3% as we have driven significant rate in this book of business.

We successfully completed placement of our July 1, 2012 excess of loss treaties. The casualty excess of loss treaty was renewed with substantially the same terms as expiring and continues to provide $88 million in coverage in excess of our $2 million retention.

We expanded our property excess of loss treaty adding an additional $10 million in limit to the top layer. The treaty now covers $38 million in excess of a $2 million retention. Pricing on the program was flat as reinsurers benefit from underlying primary price increases while maintaining their own expiring rates.

Turning to investments, second quarter after-tax net investment income declined 13% from a year ago to $26 million. The decline was largely driven by alternative investments, which produced after-tax income of $2 million in the quarter versus $5 million last year. The older vintage character of the alternative investment portfolio leads to lumpiness in reported income from quarter to quarter. Market volatility and a slower merger and acquisition pace due to the economy negatively impacted the private equity portfolio, as results are not highly correlated with the S&P 500.

In the second quarter, we added to the alternative portfolio with two new investments in the mezzanine financing strategy. We invested capital on one fund over the course of the quarter and have committed capital to the second fund as seen in the exhibit on page 18 of the investor packet.

Invested assets increased 4% from a year ago to $4.2 billion. The after-tax yield on fixed maturity securities was 2.6% for the quarter, flat with last quarter and down about 20 basis points from the year ago period. We maintained an overall credit quality of AA minus in the fixed income portfolio and increased duration slightly to 3.3 years including short-term investments. We continue to invest in high-quality corporates and selectively in the municipal sector.

Our unrealized gain position improved to $172 million pre-tax at June 30, from $102 million a year ago. Also of note is the quarter-end unrecognized gain in the fixed income held-to-maturity portfolio of $44 million pre-tax or $0.53 per share after-tax.

Surplus and stockholders' equity remained strong $1.1 billion at June 30. Book value per share increased 2% to $19.75 from $19.31 at June 30, 2011, which has been restated to reflect the adoption of a deferred policy acquisition cost accounting change on January 1, 2012. Our premium to surplus ratio was 1.5 to 1. We continually review capital management options to maximize shareholder returns.

Now, I'll turn the call over to John Marchioni to review the insurance operations.

John J. Marchioni

Executive Vice President-Insurance Operations, Selective Insurance Group, Inc.

Thanks, Dale. Good morning. Through our commercial lines underwriting and pricing sophistication, we achieved our 13th consecutive quarter of price increases with 6.5% in the second quarter ahead of the 5.1% we achieved in the first quarter. This is a good result given the still competitive commercial lines market and continued weak economic environment. Our ability to push price while maintaining strong retention levels is a testament to both our granular pricing strategy and superior agency relationships. We provide our underwriters with the business intelligence they require to price by line and by class of business to actuarial sound rates.

We've been successful with commercial lines pricing by targeting rate when we needed them most. By line, we're getting high single-digit price increases in workers compensation, general liability and BOP, while averaging 6.5% on the overall commercial book in the second quarter. In fact, as we track pricing and retention by quality of account, we achieved 14% pure rate on our lowest quality accounts with retention of 68% while our highest quality accounts retained at 89% with a pure rate increase of 5%. This differentiation will lead to mix improvement as we continue to achieve overall rate increases in excess of loss trends. Having this data allows us to take a granular approach to pricing and refine our strategy.

The dynamics in the commercial lines marketplace are such that some carriers were pushing rate across the board at levels not supported by the current market. Many of these carriers are now backing off pricing somewhat to avoid large drops in retention levels. This has caused some changes in the market where we believe we have an advantage over other carriers as the sophisticated tools and agency relationships we have in place make it easier to react to a changing marketplace.

Market pricing for new business remains inconsistent, creating less adequately priced new business opportunities this quarter. As a result, new business in the second quarter totaled $59 million, which was down sequentially from $70 million in the first quarter. By market size, new business versus a year ago was as follows. Small business was flat at $19 million and middle market and large account business was up 9% to $40 million. Personal lines net premium grew 8% in the quarter, while new business was flat with the year ago period.

The second quarter catastrophes that occurred in our footprints had a significant impact on personal lines profitability adding 16.5 points to the combined ratio including 37.4 points in the homeowners line. However, our homeowners ex-cat combined ratio improved 4.5 points from a year ago period to 82.3% as we have not only driven rate across the book, but have made underwriting changes including significant changes to deductibles in order to achieve profitability in this line.

Weather related losses are always a factor in homeowners and drive the need for not only price increases but a meaningful shift in cost sharing and other underwriting changes to get this line to an acceptable profitability level. We're pleased with the improvement in our underlying results and we'll continue to push rate and refine our underwriting initiatives to generate further profitability improvement in this line to a target range of high 80s combined ratio in a normalized catastrophe year. Overall filed personal lines rate increases that were effective for the quarter averaged 5.6%, while retention held steady at 87%.

Earlier this month, the President signed a law extending the National Flood Insurance Program until September 30, 2017. As the sixth largest writer of flood premium, we view this as a positive development, since this is the first time since 2004 that an NFIP long-term reauthorization has taken place. In addition to the five-year extension, the bill increases the annual limitation on premium increases from 10% to 20%, as well as other changes to move with the program towards charging adequate rates. As a Write Your Own carrier, our flood premium is 100% seeded to the federal government and we receive revenue through servicing fees without any loss exposure.

Our E&S operations are fully integrated and contributed $28 million in net premiums written in the quarter. This business is now written on MUSIC paper. Pricing is beginning to build as the market improvement we're seeing in the standard lines business is making its way into the E&S space. In the short-term, results will be negatively impacted by the fact earned premium will take some time to catch up with the expenses. But we're pleased with the progress we're seeing to date in the E&S.

Lastly, I'd like to mention that the change in our A.M. Best rating to A stable appears to have had no impact on our operations. Our agents tell us that it has not encumbered their ability to write the best quality business with Selective as the majority of our competitors operate at or below an A rating. Agents are selling Selective superior products and service. Our 80 plus year history of being rated A or better from A.M. Best is a testament to our longstanding financial strength.

Now, I'll turn the call over to Greg.

Gregory E. Murphy

Chairman, President & Chief Executive Officer, Selective Insurance Group, Inc.

Thanks, John, and good morning. We do not view the current commercial lines market conditions as hard by any measure. In fact, the conditions are constantly changing. As commercial lines marketplace began to firm last year, some of our competitors attempted to quickly raise prices on an across the board basis. As these companies strive to decipher what level of price the market will support, their rate increases appear to be moderating.

Our strategy has been to work in partnership with our excellent agency force to achieve the rate necessary to improve profitability while still focused on retention. We're still very comfortable with the commercial lines marketplace – given the still very competitive commercial lines marketplace and a weak economic environment, we're comfortable with our three-year target of 5% to 8% rate increases.

What's not changing in the industry is the low interest rate environment and the elevated level of catastrophe losses. Both of these factors continue to weigh on the industry results and should be the impetus for driving significant commercial lines pricing power.

However, the market continues to limp along with very inconsistent industry-wide new business pricing. Due to our sophisticated underwriting tools, we're better positioned to deal with the fluctuations in the marketplace. Our AMSs have the ability to evaluate new business opportunities and price them appropriately with the aid of our new models, which are going through their third generation roll-out. With the dynamic portfolio manager, our inside underwriters have the tool they need to evaluate their entire book of business and the impact that their underwriting decisions have on profitability. Carriers without this level of sophistication will not be able to adapt to the market that's ever-changing.

We've demonstrated our ability to manage the market cycle by reducing premium growth when the markets are highly competitive and achieving commercial lines renewal price increases well ahead of the competition. At 6.5% and at 82% retention for the quarter, our commercial lines price increases are comfortably in the 5% to 8% band that we projected.

For the full year 2012, filed home rate is expected to top 10%, while auto should be around 6%. Ongoing personal and commercial lines pricing efforts coupled with other underwriting and claims initiatives should enable us to achieve a 95% combined ratio by 2014. Our claims initiatives have already delivered 1 point of loss cost savings and are progressing nicely towards our 3 point goal. Underwriting improvements, although masked by catastrophe losses, are having the positive impact we expected while we continue to actively manage expenses.

While I'm pleased with the underlying improvements in our business through the first half of the year as a result of catastrophe losses and continued pressure on investment income from alternatives and the low interest rate environment, full year 2012 guidance is being revised to, one, a statutory GAAP combined ratio between 102% and 103%, which does not include any reserve development assumptions either favorably or unfavorably, catastrophe loss estimates of 3.5 points for the full year, investment income between $100 million and $105 million after-tax, weighted average shares outstanding of 55.6 million.

Now, I'll turn the call over to the operator for your questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Your first question comes from Ray Iardella, Macquarie. Your line is open.

Ray Iardella
Analyst, Macquarie Capital (USA), Inc.

Q

Thanks, everyone, and good morning.

Gregory E. Murphy
Chairman, President & Chief Executive Officer, Selective Insurance Group, Inc.

A

Good Morning, Ray.

Ray Iardella
Analyst, Macquarie Capital (USA), Inc.

Q

Good morning. So a quick question I guess on pricing in July. I know I think I asked the question last time about April. Any early indications in terms of commercial lines pricing for July?

John J. Marchioni
Executive Vice President-Insurance Operations, Selective Insurance Group, Inc.

A

Ray, this is John. We're not going to give out pricing for July at this point. But I think as you've heard during the prepared comments from both myself and Greg, you're seeing a change in the environment. We feel like clearly the reported numbers are well within that 5% to 8% range that we felt the market needed to be bear over the next couple of years. And I would say, as we sit here today, we feel good about maintaining those sorts of levels as we look forward into the coming quarters.

Ray Iardella
Analyst, Macquarie Capital (USA), Inc.

Q

Okay. And, maybe, touching on commentary on the audit premium, I know Dale mentioned some tailwind in terms of premiums from audits. But, John, I think you'd mentioned the weak economy is still sort of inhabiting some of the growth in the business. I'm just curious, kind of, what are your expectations going forward in terms of the economy, and particularly, I guess, how it relates to the contractors book?

John J. Marchioni
Executive Vice President-Insurance Operations, Selective Insurance Group, Inc.

A

I would say the reference was to a continued weak economy. And clearly with that continued economic environment, we saw stability relative to audit premium changes, both up and down. And I would say, as long as you continue to see the key economic indicators hover around the levels that they are at, you wouldn't expect to see a big move in any of the directions on audit premium. And certainly contractors will be a bit of a leading indicator going forward depending on what starts to happen in the housing market, which has been a little bit up and down in terms of prognostications last month or two.

Dale A. Thatcher
Chief Financial Officer & Executive Vice President, Selective Insurance Group, Inc.

A

And one thing I'd like to clarify, Ray, is that the audit premium for the last five quarters has turned over to an additional premium. So, it's actually a favorable for the last five quarters. Prior to that in the 2008, 2009, and 2010 timeframe is when we had the written premium that was causing a headwind. So, now we definitely are having a small positive, anyway, from the audit premiums as we see stability. Still a weak economy, but as John indicates, it's at least stabilized.

Ray Iardella
Analyst, Macquarie Capital (USA), Inc.

Q

Okay. That's helpful. And then a last question, a quick numbers question for you Dale and then I'll re-queue. Any development on the personal line side of the business, of reserve development?

Dale A. Thatcher
Chief Financial Officer & Executive Vice President, Selective Insurance Group, Inc.

A

Yes, we did have small development there, where we had basically adverse development in personal auto of $1 million and favorable development in homeowners of $2 million.

Ray Iardella
Analyst, Macquarie Capital (USA), Inc.

Q

Okay. And then the personal auto side, is that the high severity, I'm assuming?

Dale A. Thatcher
Chief Financial Officer & Executive Vice President, Selective Insurance Group, Inc.

A

Yeah, basically it's...

Gregory E. Murphy
Chairman, President & Chief Executive Officer, Selective Insurance Group, Inc.

A

It's a constant drag between PIP and BI.

Ray Iardella
Analyst, Macquarie Capital (USA), Inc.

Q

Okay. Fair enough. I'll re-queue. Thanks again.

Operator: Your next question comes from Alison Jacobowitz with Bank of America Merrill Lynch. Your line is open.

Alison Marnie Jacobowitz
Analyst, Bank of America Merrill Lynch

Q

Hi, thanks. If I could just confirm, one question, just the number up front. The $5 million of reserve development, that's net of everything. Correct?

Gregory E. Murphy
Chairman, President & Chief Executive Officer, Selective Insurance Group, Inc.

A

That's correct.

Dale A. Thatcher
Chief Financial Officer & Executive Vice President, Selective Insurance Group, Inc.

A

That's correct.

Alison Marnie Jacobowitz
Analyst, Bank of America Merrill Lynch

Q

Okay, and so then the real questions. I was wondering if you could talk about the expense ratio and how that – the timing of the earned premium, I think if I calculated correctly, it was 35.5 in the quarter, how that plays out over the next several quarters, if you could just help out with timing may be for the model?

And then as far as the guidance, your own outlook, is concerned, last quarter I think it was 102.5% combined ratio with 2.5 points of cats. And then the change this quarter is basically, you gave a range, but you gave a cat number that could go a couple of points higher. It feels like you improved your underlying – underwriting outlook for the accident year ex-reserves through the second half of the year this quarter versus last, and then you expect some improvement there. I'm just wondering if I'm getting that right.

Dale A. Thatcher
Chief Financial Officer & Executive Vice President, Selective Insurance Group, Inc.

A

Well, lots of questions embedded in that long question. But I'll try and handle all of them...

Alison Marnie Jacobowitz
Analyst, Bank of America Merrill Lynch

Q

Sorry.

Dale A. Thatcher
Chief Financial Officer & Executive Vice President, Selective Insurance Group, Inc.

A

...we'll figure out what I missed. But, basically, we revised our guidance to be between 102% and 103%. Previously, the statutory combined ratio was expected to be at 101.5%. So, the 3.5 points of catastrophe losses basically says we're taking the actual cat losses for the first six months and we're keeping our original estimate of 2.5 points of cat losses in the remaining six months. So, if you take the actual 6 points plus 2.5 points from the remaining 6 points, you end up with about a 3.5 point cat load for the full year. So, hopefully that makes sense.

As far as expense ratio, when I look at the statutory underwriting expense ratio is at a 32.5%. The GAAP expense ratio is going to be the one that's higher because of the fact that the E&S premium is not yet earned in fully, but you've got full running operations there. So, basically, that's going to come back down a little bit over the course of time.

I guess the best way to look at that is, I kind of use the stat expense ratio as a way to project the future GAAP expense ratio, because that – you're using the stat. You're using it on a written basis, so you'll end up seeing that benefit ultimately come through in the GAAP once you have the written premium coming through at a fully earned.

Gregory E. Murphy
Chairman, President & Chief Executive Officer, Selective Insurance Group, Inc.

A

And, Alison, this is Greg. The only thing I would add, when you look at relative to the performance, and John touched on this before, what we're pleased about is the 6.50% rate in the commercial lines which is ahead of our plan, and not only that, but strong retention at 82% which is probably slightly better than what we expected to get that kind of rate level.

So that kind of improvement really doesn't affect the current year that much. It will have some very mild impact. I mean more of that gets pushed out into the 2013 year and now that – so that kind of – that's the thing that we look at relative to performance. I don't think that our loss trends have changed really much from what we prognosticated during the year. So I don't think you're really seeing anything specific in the guidance directing you one way or another, other than what we've already achieved.

Alison Marnie Jacobowitz
Analyst, Bank of America Merrill Lynch

Q

Thank you, very much.

Operator: The next question comes from Drew Woodbury, Morningstar. Your line is open.

Drew Woodbury
Analyst, Morningstar Research

Q

Hi, good morning. Thanks for taking my question. I was wondering if you could give me some more specific commentary on the pricing market. The difference between national and regional players, where you're seeing competition there, specialty versus primary and where the most aggressive nature is? Basically, it seems that your rate increases are accelerating, but yet you're not very bullish on the pricing market in general and a hardening. So I'm just trying to reconcile those things. Thanks.

Gregory E. Murphy
Chairman, President & Chief Executive Officer, Selective Insurance Group, Inc.

A

Yeah. This is Greg and I'll let John comment too. Some of the things that we're looking on, obviously, when you look at the amount of new business we wrote sequentially, that was down. That tells us that customers are now trying to hunker down on their renewal inventory and protect that better. And you've got to really think about it from the standpoint that we operate in. Most companies' new business opportunities are other companies' renewal inventory. So, as that protection starts, that starts to slow down the capability to drive rates.

And I think when you – you got to really look at it as, as we look at driving rate across our book, for us to get elevated rates in totality, we need to go deeper into the inventory, to go deeper into the inventory that could cause more accounts to be pushed out into the marketplace. As competition on the other side is very aggressively trying to market your business, this is what creates that cyclical side of trying to push rate. And we feel that if any company out there, we've demonstrated the ability when no one was getting price increases, we were able to get loss trend. We feel very positive about that. We think it's reflective of our capability.

But now that we've gotten rate level at this 6.5% and 82% retention, we feel that we're at a point that we're comfortable in. And as we told you in our Investor Day, we thought rate level of 5% to 8% over the next three year period is what we needed to have. And if you take the midpoint of that, that's 6.5% and that's exactly where we are. We're not saying we're stopping there. But, certainly, we're running into a resistance point out there, because some companies now have gotten pretty aggressive in writing new business. And John, what's...

John J. Marchioni
Executive Vice President-Insurance Operations, Selective Insurance Group, Inc.

A

Yeah. And just to add a little bit to that, I think we've clearly hit our stride in terms of managing rate retention. We've been at this for 13 quarters. We built it in a very measured way over that time period. We look at our retentions in a very granular fashion to understand what's happening.

But the reason I think we're not bullish over the market continuing to move directionally is what you saw is, as companies who were later to the game in starting to drive price, jumped in with an aggressive first step and really went across the board with some pretty high single-digit numbers. And then they sat back at the end of the quarter, look at their retentions, saw a pretty significant dip and made a correction in the second quarter.

So, I think what we're seeing now is other companies who were just jumped into this, trying to find their way a little bit and that will cause that quarter-to-quarter volatility relative to new business and our expectations relative to price on our own book of business. So, we think it's sustainable, but we think you're going to have some choppiness because other companies are starting to feel their way through this rate and retention balance.

Drew Woodbury
Analyst, Morningstar Research

Q

Okay. Thank you very much.

Operator: Your next question comes from Scott Heleniak, RBC Capital Marketss.

Scott G. Heleniak
Analyst, RBC Capital Markets Equity Research

Q

Yeah, Good morning. The first question I had was on the investment side. You mentioned you're increasing investments in the alternative investment portfolio. That's the first time you done that in a long while. I'm just wondering how do you came to that decision and whether we can expect to see more of that in the future.

Dale A. Thatcher
Chief Financial Officer & Executive Vice President, Selective Insurance Group, Inc.

A

Well, we're moving into that in a very measured way and the investments that we have added are mezzanine financing style. So they're not quite the same kind of J curve profile that you see in the other private equity space. So it's a little bit more consistent reserve, not nearly as much volatility, performs a lot more debt-like. But it's certainly an opportunity to achieve better yield. It was – since 2007 was the last time that we made new alternative investments, although obviously we provided additional commitments to some of the previously committed alternatives before that.

Again, we feel it's an appropriate investment class, always have felt that way. But we've also felt that it was one that we needed to commit just the right amount of dollars to and not something that we wanted to have as too strong a portion of the overall portfolios. We feel very good, basically, right about where we are. There may be some additional small things as older investments provide some additional – as they have events that sell out some of their underlying [ph] investment (0:28:43) and return capital to us, we'll have an opportunity to invest additional in that space. But don't anticipate it to be substantially larger as a percentage of our portfolio than it is currently.

Drew Woodbury
Analyst, Morningstar Research

Q

And any change really in the credit quality of some of the -your corporate investments you're making?

Dale A. Thatcher
Chief Financial Officer & Executive Vice President, Selective Insurance Group, Inc.

A

Now, the average quality of the overall portfolio is still at a AA minus and we're not stretching for yield. I think that's how you get in trouble in this kind of an investment environment. Clearly, everyone is troubled by the low rates that are available out there. But it would be a mistake we feel to try and move away from what has served us well over the years.

Drew Woodbury
Analyst, Morningstar Research

Q

Okay. And then on the personal line side, the growth of the past couple of quarters is mostly come from homeowners. And I understand probably most of that is price, but could you kind of break out how much of that is price versus actually new PIP growth? You don't have to give exact numbers.

Gregory E. Murphy
Chairman, President & Chief Executive Officer, Selective Insurance Group, Inc.

A

Yeah, a lot of it's rate.

John J. Marchioni
Executive Vice President-Insurance Operations, Selective Insurance Group, Inc.

A

Yeah. And just as Dale's pulling the price number versus the PIP count, that's a number that we constantly look at, the ratio of new home to new auto. I think we're a little bit ahead of where we would have expected to be in terms of mix of business. But part of that too is where is the pricing environment relative to auto and how comfortable are we getting more aggressive on auto pricing, which to this point we have not been. So it's certainly an important balance.

But at the same time, while we're building in a bigger cat load from a profitability perspective, we feel like we've gotten the home book close to where it needs to be on a run-rate basis ex-cat coming in at that 82% kind of number. Probably need a little bit more cushion built in for cat losses, but your question about mix is one that we look at very closely.

Drew Woodbury
Analyst, Morningstar Research

Q

And then I'm just wondering on the agency side, how many new agency appointments you've had this year as part of your growth. Does that really change much versus what you typically do in a given year?

John J. Marchioni
Executive Vice President-Insurance Operations, Selective Insurance Group, Inc.

A

We're still around 1,000 agency relationship number, slightly above that, probably pushing about 1,050. We're focusing on adding some store fronts in some locations that we don't have complete geographic coverage of, but there is no dramatic change in the number of agencies that we have.

But, you'll see the number of storefronts tick up and especially in areas where we think we're missing opportunity relative to personal lines and small commercial. But I would still define our strategy as one of franchise value. We don't have segments of agents. We have agency contracts from top to bottom that we think are going to be top performers, and we're going to occupy one of those top spots. So a little upward movement, but no real change in strategy relative to agency count.

Dale A. Thatcher
Chief Financial Officer & Executive Vice President, Selective Insurance Group, Inc.

A

And with regard to the home, basically six points of the growth is related to pure price.

Drew Woodbury
Analyst, Morningstar Research

Q

Okay. Thanks a lot.

Operator: [Operator Instructions] Your next question comes from Ron Bobman, Capital Returns.

Ron D. Bobman
Analyst, Capital Returns Management LLC

Q

Hi, good morning. Thanks a lot.

Gregory E. Murphy
Chairman, President & Chief Executive Officer, Selective Insurance Group, Inc.

A

Good morning, Ron.

Ron D. Bobman
Analyst, Capital Returns Management LLC

Q

I have a few questions. I think John mentioned the E&S IP program extension till 2017. Could you remind about your – again, I know, it's a fee-for-service business, not risk bearing for Selective. You'll see that you collect for servicing those policies, and I guess writing those policies. Is it unit-based or as the premium dollars charged increase, there is some degree of increase in your fee that you receive? Are you, in any way, benefiting from the higher rates?

Gregory E. Murphy
Chairman, President & Chief Executive Officer, Selective Insurance Group, Inc.

A

Yeah, we get paid a commission rate on the premium base, obviously, to the extent that the price per unit of exposure increases in the current construct of the program that would increase our revenue.

Ron D. Bobman
Analyst, Capital Returns Management LLC

Q

Thanks and what – go ahead, sorry.

John J. Marchioni
Executive Vice President-Insurance Operations, Selective Insurance Group, Inc.

A

Your two revenue streams are that the premium-based fee that you're paid for servicing the accounts from an underwriting perspective, and you may also get paid for servicing the claim activity. So those are the two primary revenue streams on the claim side.

Ron D. Bobman
Analyst, Capital Returns Management LLC

Q

And, whether it's like year-to-date 2012 or 2011, how much revenue did you receive and what was the split claim base and production base roughly?

John J. Marchioni
Executive Vice President-Insurance Operations, Selective Insurance Group, Inc.
A

In a normal year, the majority is going to be underwriting servicing-based. But, obviously, last year would have been a little bit more elevated because of the high degree of the flood activity.

Ron D. Bobman
Analyst, Capital Returns Management LLC
Q

Right.

John J. Marchioni
Executive Vice President-Insurance Operations, Selective Insurance Group, Inc.
A

It's a ballpark – give us a second, I just...

Gregory E. Murphy
Chairman, President & Chief Executive Officer, Selective Insurance Group, Inc.
A

I got it right here. So the commission revenue side – on the side that comes from handling the production of the business from an underwriting standpoint was – for the six-month period, it was like $34 million. And it looks like from what I could see here that the claim revenue fees were around $1 million, just to give you an idea what that looks like.

Ron D. Bobman
Analyst, Capital Returns Management LLC
Q

Great, okay. Another question I had was personal lines retention. I'm sorry if I missed it. It sounds like from the...

Gregory E. Murphy
Chairman, President & Chief Executive Officer, Selective Insurance Group, Inc.
A

It sounds like 82%.

Ron D. Bobman
Analyst, Capital Returns Management LLC
Q

...rate numbers you mentioned, the combined personal lines rate increases were somewhere like 5%. But it sounds like the planned rate increases are going to take – well, hopefully take that up a little further. But I was curious in a way retention is and where it was.

Gregory E. Murphy
Chairman, President & Chief Executive Officer, Selective Insurance Group, Inc.
A

We're talking about personal line now.

Ron D. Bobman
Analyst, Capital Returns Management LLC
Q

Correct.

Gregory E. Murphy
Chairman, President & Chief Executive Officer, Selective Insurance Group, Inc.
A

Still stays stable...

John J. Marchioni
Executive Vice President-Insurance Operations, Selective Insurance Group, Inc.

A

At 87%. So retention on personal lines was at 87%. And that's been very stable over the last several quarters, actually probably slightly ahead of our plan, but not materially.

Ron D. Bobman
Analyst, Capital Returns Management LLC

Q

Okay, and then my last question relates to sort of – related to the cats. And in a scenario, I guess, Greg or John, if this run of derecho and hailstorm and tornado and locust, famine continues, and if you were of the firm belief that we're going to have this level of cat activity for the next, let's say, three years, what would you need to do?

Are you changing the terms and conditions of the homeowners policies with respect to deductable requirements or roof grade to even writer risk, would it be activities along those lines that you're doing or would be doing, is it steeper rate increases? Would it be exiting personal lines altogether? Would it be a different reinsurance program?

John J. Marchioni
Executive Vice President-Insurance Operations, Selective Insurance Group, Inc.

A

Yes.

Ron D. Bobman
Analyst, Capital Returns Management LLC

Q

What are your thoughts?

John J. Marchioni
Executive Vice President-Insurance Operations, Selective Insurance Group, Inc.

A

It's a great question. So, in terms of terms and conditions, you're definitely seeing movement there market-wide and we have certainly moved all payroll deductibles up through a $1,000 and $1,500 based on roof age in particular and also gotten a lot more aggressive in terms of underwriting to roof age. So you're seeing that movement market-wide. Greg has talked over the last several quarters about the need for a different risk-sharing structure there relative to both hail claims and wind claims. So that is certainly happening.

Ron D. Bobman
Analyst, Capital Returns Management LLC

Q

But where were you three years ago? Like what was your average deductible three years ago and where would you hope it is 12 months from now? Is it material?

John J. Marchioni
Executive Vice President-Insurance Operations, Selective Insurance Group, Inc.

A

Well, yeah, it is. So you used to see your deductibles in the range of $250 to $500 three to five years ago. And now with the changes we're putting in place, once you go through a full renewal cycle, you're going to have your book at $1,000 to $1,500 depending on the mix of business relative to roof age. So, in my mind, when you look at average severity of cat claims in the personal lines area, that additional $500 deductible is in fact material.

On the risk-sharing part, that's what I would say you're seeing. In terms of rate that market has run pretty aggressively and retentions have stayed pretty high, market-wide.

Ron D. Bobman
Analyst, Capital Returns Management LLC

Q

Yeah.

John J. Marchioni
Executive Vice President-Insurance Operations, Selective Insurance Group, Inc.

A

So, I would say that as companies now recognize that we probably are in a different weather pattern for an extended period of time, we bumped up our expected cat loads that needs to come through in pricing. So what may be used to be in 80% to 85% sort of combined ratio ex-cat for the homeowner as a target needs to drop lower than that. And I think, as a result of those things, you're seeing companies get lot more aggressive on pricing.

And I would say the same thing applies on the commercial property side. There is no question that, for us and a lot of competitors, the underlying commercial property book has been very, very strong over the years. But now you have to build in a higher expected cat load and perform extremely well, 70s to low 80 kind of combined ratios, when you don't have excess cats. This way when it does happen from time-to-time, you've got that built into your overall profitability model.

Gregory E. Murphy
Chairman, President & Chief Executive Officer, Selective Insurance Group, Inc.

A

Hi, Ron, and this is Greg. And I'd also just to talk a little bit to about some of the things John mentioned. I think the difference fundamentally between personal lines and commercial lines, in commercial lines we saw in the entire account. So, we're driving rates in commercial lines. Our folks are working hard. You guys haven't asked a lot of questions, but comps running close to 9%, rate yields at about the 7%, 7.2% level, and not only includes the primary, but it's also the excess GL. And then we're also pushing to a lesser degree rate in the auto side on the commercial line side.

But yet, we look at that, we look at the account. We write the package. That's how we view that line of business. So I'd say there's maybe a little bit more fungibility on that side between prop and liability. But we're pushing rate on the most significant areas on the liability side. So slightly different story in home and auto where we want to make sure we're writing the account. We want to make sure our home policies are priced up properly and where the proper account discount starts to work in. So somebody wants to bifurcate their home from their auto, we're just trying to look at the account credits relative to that style of business.

And we're hitting – as I mentioned, we expect the home rates to top 10% that we're filing this year. And the other thing is when you look at the core book and even given the amount of whether through the first kind of six months of the year, our ex-cats have really improved. Now, Dale mentioned there's a little bit of favorable development in there, but I believe there was – possibly a little bit last year. But we're running at about an 82% ex-cat and a 106% for the year with cat.

Now, we don't take cats out of our compensation. They're in there, so we just report to you those numbers, so you can see the underlying improvement. But we're going to keep doing the things that we need to do in home to improve that performance; its rate, its cost sharing and its other changes relative to underwriting criteria.

Ron D. Bobman
Analyst, Capital Returns Management LLC

Q

Thanks. If you oblige to me, the 10% rate filing increased for home, if we fast forward 12 months, thereafter, the effective date of that filing, do you expect, in fact, to have gotten an average 10% on your book of business or is this just a case where the rate filing is 10%, but credit, etcetera, mix of business is going to be a good bit below that?

John J. Marchioni
Executive Vice President-Insurance Operations, Selective Insurance Group, Inc.

A

So, there's no impact of discretionary credit applied in homes, so that won't have any impact. The one thing you may see is a little bit of downward pressure based on a mix change. So if the account with the characteristics that have the biggest rate increase attached to them, whatever you're looking at, building age or insurance, or whatever it maybe, they may retain at a slightly lower level than the accounts getting a little bit of a less increase. That would, but I would say that based on where the market is, and how prices hitting the home line, it is clearly more of an across-the-board style rate increase that's coming through the entire market, not just us. So, that will actually mitigate any mix impact on the overall rate number.

Ron D. Bobman
Analyst, Capital Returns Management LLC

Q

Thanks for your patience and your help.

Operator: Your next question comes from Robert Paun, Sidoti & Company.

Robert Paun
Analyst, Sidoti & Co. LLC

Q

Good morning. Most of my questions have been asked, but I had question generally on rates in the economy. You guys are pushing rate increases through with pretty good retention. Can you just talk about the impact of a weakening economy would have on your ability to push further rate increases? And if the economy does continue to weaken, is this something that could also impact your expectations for the 5% to 8% increases?

Gregory E. Murphy
Chairman, President & Chief Executive Officer, Selective Insurance Group, Inc.

A

Let me take a shot at this. I honestly feel the bigger drag is the competitive factor over the economy. So I would say that the bigger element in limiting our ability to drive rate higher is more competitive forces [indiscernible] (0:41:58) necessarily than economic forces. As we tell our distributors, our great agents, we're the one industry that's delivered price reductions to customer year after year after year. And pricing now ultimately has got into the point where it's too thin. Our folks have been delivering price increases to the customers, but they've been pretty moderated on an overall basis.

And when you compare this to other, I wouldn't even call this a hard market, as I said before, by any measure. You know whether you look at growth in the industry relative to the GDP, you look at renewal pricing increases, you look at new business, you look at migration of business out of the primary into the E&S, you look at E&S pricing, all of those things, there isn't any sign there that demonstrates a really firm market overall.

But I would say that it's more of the competitive factors than that and what happens in a soft economy and customers are trying to do – they will stop their business if they feel that, "Hey, I have to reduce my cost structure somehow and what I'll do is I'll take my renewal account and turn it into a new business account, put it out to market, and see who's willing to bid on that account to bid it down cheaper." That's where, I think, more of the drag comes in the marketplace overall.

John J. Marchioni
Executive Vice President-Insurance Operations, Selective Insurance Group, Inc.

A

And just to add to that, I think Greg is right. The competitive forces are keeping that in check. But I'd also say, inherent in our 5% to 8% band that we talk about going forward, there is – the impact of the economy on the customer and their ability to absorb rate increases is inherent in that assessment as well.

So, when you look at rate need for the market overall based on expected elevated cat activity as well as expected continuation of depressed investment returns, that number is higher. It should be higher in terms of a traditional firming market, but inherent in the 5% to 8% assessment that we have out there is the customer under pressure from the economy, as well as Greg said, driven also by the economic – the competitive conditions in the market.

Robert Paun
Analyst, Sidoti & Co. LLC

Q

Okay. Thank you, that's helpful. That's all I have.

Operator: Your next question comes from Alison Jacobowitz, Bank of America Merrill Lynch.

Alison Marnie Jacobowitz
Analyst, Bank of America Merrill Lynch

Q

Thanks. I don't think I heard it and I'm sorry if you said it, but can you tell us the difference between the new money yield and the fixed income portfolio yields?

Dale A. Thatcher
Chief Financial Officer & Executive Vice President, Selective Insurance Group, Inc.

A

Yeah, the new money yield pre-tax is running around 2.4% right now. The stuff is rolling off, pre-tax is running at about 3.4%.

Alison Marnie Jacobowitz
Analyst, Bank of America Merrill Lynch

Q

Thank you.

Gregory E. Murphy
Chairman, President & Chief Executive Officer, Selective Insurance Group, Inc.

A

Yeah, just let me add something to that. We closely monitor where our investment portfolio is, what our after-tax ROE is on – what our ROE on investment portfolio generates, how that's declining through time and what it means from an underwriting improvement standpoint. So, we closely monitor all of those elements as well as the potential threat of cost shifting as a result of what may happen out of Obamacare.

Operator: [Operator Instructions] Your next question comes from Bob Farnam, KBW.

Robert Farnam
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Hi, thanks. Good morning.

Gregory E. Murphy
Chairman, President & Chief Executive Officer, Selective Insurance Group, Inc.

A

Good morning, Bob.

Robert Farnam
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Quick question from me, if I missed it. How much are the commercial lines rate increases in excess of loss trends?

Gregory E. Murphy
Chairman, President & Chief Executive Officer, Selective Insurance Group, Inc.

A

I would say, right now, our trend continues to be around 3% and, right now, our overall written price is at about 6.5%.

Robert Farnam
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Great.

Gregory E. Murphy
Chairman, President & Chief Executive Officer, Selective Insurance Group, Inc.

A

Just so we're good on the math on this, because I'd read a lot of calls over the last 24 hour period, the difference between those two numbers does not reduce your combined ratio on a hundred cents on a dollar. So I think you guys need to understand that if you're writing at 6.5% rate and your trend is 3%, that doesn't mean your combined ratio is going to come down by 3.5 points because you guys have got to remember there is the expense ratio element that gets taken out. There is an element that gets paid to agencies for commission. There is an element that gets paid for premium taxes and other expense levels. So it's only – the impact on the combined ratio is only its effect on the loss ratio element you need to understand that because I've seen a lot of misinterpretations over that. And I think you guys just need to understand how that works through.

Robert Farnam
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Got it. And the fact that it's earned over 12 months, so...

Gregory E. Murphy
Chairman, President & Chief Executive Officer, Selective Insurance Group, Inc.

A

And that's – the other element of this which my actuary reminds me of every day is that in our is that it earns in over time.

<<Q – [06P88M-E]Bob Farnam – Keefe, Bruyette & Woods, Inc.>: Right. Okay, thanks.

Operator: [Operator Instructions] At this time, there are no further questions. I will now turn it back to you for closing comments.

Gregory E. Murphy
Chairman, President & Chief Executive Officer, Selective Insurance Group, Inc.

Well, thank you operator. And if you have any follow-up matters, please contact Jennifer or Dale. Thank you very much for participating in the call.

Operator: This does conclude today's conference. Thank you for attending. You may disconnect at this time.