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PRESENTATION

Operator

Good day, everyone. Welcome to the Selective Insurance Group second-quarter 2016 earnings call. At this time for opening remarks and introductions I would like to turn the call over to Executive Vice President, Chief Financial Officer, and Treasurer Dale Thatcher.

Dale Thatcher - *Selective Insurance Group, Inc. - EVP, CFO & Treasurer*

Thank you. Good morning and welcome to my final Selective Insurance Group quarterly conference call.

This call is being simulcast on our website and the replay will be available through August 29, 2016. A supplemental investor package, which includes GAAP reconciliations of non-GAAP financial measures referred to on this call, is available on the investors page of our website, www.Selective.com.

Certain GAAP financial measures will be stated during my prepared remarks that will also be included in our quarterly report on Form 10-Q. To analyze trends in our operations, we use operating income, a non-GAAP measure that the investment community also uses to evaluate performance of insurance operations. Operating income is net income, excluding the after-tax impact of both net realized investment gains or losses and discontinued operations.

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

Joining me today on the call are the following members of Selective's executive management team: Greg Murphy, CEO; John Marchioni, President and Chief Operating Officer; and Ron Zaleski, Chief Actuary.

Now I will turn the call over to Greg for introductory remarks.

Greg Murphy - *Selective Insurance Group, Inc. - Chairman & CEO*

Thank you, Dale, and good morning. The second quarter was a continuation of our ongoing effort to consistently generate and operating return on equity of 300 basis points above our weighted average cost of capital.

2015 was a record year for Selective since becoming listed on the NASDAQ, both in terms of underwriting profit and net premiums written. We reported an operating return on equity that was 310 basis points above our weighted average cost of capital. In the first half of 2016, many key metrics across the organization improved and were ahead of last year's record pace as we focus on underwriting and claims improvements, as well as achieving rate increases that match or exceed expected claim inflation.

Year to date our annualized operating return on equity was 11%, 320 basis points above our weighted average cost of capital as net premiums written grew 9% and we delivered a 26% increase in operating earnings per share. At Selective, we remain focused on leveraging competitive advantages to improve our position in the marketplace. Our first competitive advantage, true franchise value with ivy league distribution partners that has been the cornerstone of Selective's success.

One way we measure how distribution partners view their relationship with Selective is through an annual agency survey that measures overall satisfaction on a scale from 1 to 10. In the previous three surveys, Selective consistently received a score of 8.6 and we are pleased that in our most recent survey the score improved to 8.8. In the quarter we continued to engage with our distribution partners about the value of customer experience.

Our second competitive advantage, our unique field model, coupled with sophisticated underwriting and claims capabilities, has enabled us to implement underwriting and claims improvements, effectively balance rate and retention, and improve profitability in most recent years. Standard commercial lines renewal price increases met or exceeded expected claim inflation in the last 27 consecutive quarters. During the 26 quarters that we have access to Willis Towers Watson Commercial Lines Price Monitoring Survey data, we have exceeded industry pricing on a compounded cumulative basis by approximately 1,500 basis points.

Our field model and sophisticated pricing capabilities are also an important part of our ability to grow the organization going forward as we work closely with our distribution partners to underwrite new business and granularly manage the renewal inventory. Over time, the goal is to increase our agents' combined state market share from 17% to 25% and our share of wallet from 7% to 12%.

Within our commercial lines business, which in total represent about a $2.5 billion additional premium opportunity. Both share of wallet and agency market share improved incrementally in 2015 as our market share increased from 1.1% to 1.2% and we are currently ranked 41st in A.M. Best's annual ranking of top 200 carriers in the US, based on 2015 net premiums written.

As we think about growth, we prioritize opportunities in our current footprint where we have established relationships and an operating history. However, we are evaluating opportunities for geographic expansion in our standard lines operation. Over time, we expect to add new footprint states to improve geographic diversification and grow the organization. We will provide more details on these efforts as they develop.

Our third competitive advantage, superior customer experience delivered by best-in-class employees, has been and will continue to be critical to our success. We track a number of metrics related to customer experience including net promoter scores, voice-of-the-customer survey results that are trending in a positive direction. Also we evaluated more than 20 key customer interactions that surfaced through our contact center, survey responses, and omni-channel assessment to pinpoint process disruptions that could negatively impact the customer experience.

Through that evaluation, we identified the most significant friction points among customers. Selective and our distribution partners and efforts are underway to eliminate them. These changes will help us increase efficiency and improve our first-call response resolution of customer inquiries and overall customer satisfaction. In addition, we are investing in technology and employee development that support our strategic focus on customer experience.

With the first half of the year behind us and having achieved better-than-expected results so far, we provide the following expectations for the full-year 2016: a combined statutory ratio, excluding catastrophe losses, of approximately 89.5%, which is a 1.5 point improvement from previous guidance of 91% -- this assumes no additional prior-year casualty reserve development -- catastrophe losses of 3.5 points; after-tax investment income of approximately $95 million; and weighted average shares outstanding of $58.5 million.

Now I will turn the call over to Dale to review the second-quarter results.

Dale Thatcher - *Selective Insurance Group, Inc. - EVP, CFO & Treasurer*

Thanks, Greg. For the quarter we reported net income per diluted share of $0.74 and operating income per diluted share of $0.72, up from $0.58 and $0.62 a year ago. These increases were driven by superior performance within insurance operations.

With two quarters completed, we are ahead of last year's pace when we achieved a record-setting statutory combined ratio. This is a result of ongoing and renewal pure-price increases, strong premium growth, favorable prior-year casualty reserve development, and lower CAT and non-CAT property losses in the first half of the year. Our statutory combined ratio in the quarter was 90.1%, a 3.4 point improvement from the same period last year.

On an underlying basis, excluding catastrophes and prior-year casualty reserve development, the combined ratio was 90.4%, which was 2.3 points better than the second quarter of 2015. Catastrophe losses in the quarter added 1.6 points to the combined ratio, which is better than our full-year expectation of 3.5 points and 3.3 points below the reported amount in the second quarter of 2015. Also, non-catastrophe property losses were 2.3 points lower than the same period last year.

Our reserve position is strong and we recorded favorable prior-year casualty reserve development in the quarter of $10 million or 1.9 statutory combined ratio points, as compared to $20 million or 4.1 points a year ago. In the second quarter of 2016, favorable development was driven by improving claims trends within the general liability and workers compensation lines of business, which, respectively, reported $11 million and $9 million of favorable prior-year casualty development.

Partially offsetting this benefit was $8 million of unfavorable prior-year casualty development in commercial auto, primarily in the 2011, 2013, and 2015 accident years, as well as $2 million of unfavorable prior-year casualty development in excess and surplus lines from the 2014 accident year. As we've discussed in the past, given the size of our excess and surplus lines book, we expect some volatility in reported results.

Top-line growth was robust and overall statutory net premiums written increased 9% in the quarter. This was driven by renewal pure-price increases, stable retention levels, and higher new business.

We continue to achieve pricing levels which exceeded increases reported by the broader market while maintaining retention. We believe this is an indicator of our strong agency relationships and granular pricing capabilities.

In standard commercial lines, renewal pure-price for the quarter was 2.6%, which is in line with the level of expected claim inflation. Personal lines and excess and surplus lines are achieving greater levels of rate increases with homeowners renewal pure-price at 6.7%, personal auto renewal pure-price at 3.6%, and excess and surplus lines overall rate at a 4.8% increase.

On the reinsurance front, excess-of-loss treaties were successfully placed on July 1, 2016, with a structure the remained largely the same. Our casualty excess-of-loss treaty covers $88 million in excess of a $2 million retention and renewed with stable rates and some improvement in terms. Our total property excess-of-loss coverage is currently $58 million in excess of $2 million, which includes a $20 million property excess-of-loss layer that was placed last January. This treaty experienced some loss activity in recent years and, as a result, rate increased at renewal.

Our investment portfolio contributed 6.2 points to operating ROE in the quarter as after-tax net income decreased 5% to $23.5 million from $24.8 million in the prior-year period. Fixed income, which represents 92% of our portfolio, experienced a 4% increase in pretax net investment income as a higher asset base helped to offset the effects of a continued low interest rate environment and the lower returns from our alternative portfolio.

Alternative investments, which report on a one-quarter lag, reported a pretax loss of $600,000 compared to income of $1.4 million in the second quarter of 2015. Over time the market value of our alternative portfolio has declined due to its maturity, with many of our funds in the distribution phase of their life cycle. In the quarter, after-tax new money yields on our fixed income portfolio averaged 2.4% as we invested in high-quality fixed income investments and also added a modest amount of high-yield products during the quarter.

Our fixed income portfolio was highly rated with an average credit quality of AA- and a 3.7-year duration, including short-term investments. Given the sharp decline in treasury yields this year, our pretax unrealized gain position increased to $191 million at June 30 from $69 million at the end of 2015. As a result of the change in unrealized gains, the year-to-date ROE declined by approximately 30 basis points as the ratio of invested assets to stockholders' equity was reduced.

The pretax unrecognized gain position in the fixed income held-to-maturity portfolio was $7 million, or $0.08 per share, on an after-tax basis. Surplus and stockholders' equity were $1.5 billion and $1.6 billion, respectively, at the end of the second quarter. Book value per share increased 10% to $26.86 from year-end 2015, as our balance sheet benefited from strong profitability and the decline in interest rates.

As Greg stated earlier, we achieved year-to-date annualized operating return on equity of 11%, 320 basis points above our quarter-end weighted average cost of capital of 7.8%.

Now I will turn the call over to John to review insurance operations.

John Marchioni - *Selective Insurance Group, Inc. - President & COO*

Thanks, Dale. Our insurance operations are focused on delivering excellent growth and profitability. For the first six months, we achieved an overall statutory combined ratio of 90.4% and net premiums written growth of 9%. While we cannot control the headwinds that we face as an industry, such as moderating price or historically low investment yields, we are executing on our strategies and believe our results highlight the ongoing efforts of our employees and distribution partners.

Year to date, growth in standard commercial lines to June 30 was a strong 9%, driven by stable retention of 83%, new business growth, and renewal pure-price increases to 2.7%. Our commercial line statutory combined ratio was 89.1%, a 0.8 point improvement from a year ago. On an underlying basis year-to-date results improved 0.4 points compared to the prior-year period.

In the renewal portfolio, we successfully balanced rate and retention through the use of our dynamic portfolio manager. For our highest quality standard commercial lines accounts, which represent 50% of our premium, we achieved renewal pure rate of 1.5% and point-of-renewal retention of 91%.

On our lower-quality accounts, which represent 10% of premium, we achieved pure rate of 7.2% and point-of-renewal retention of 77%. Worker's compensation continues to deliver strong results, driven by our focused underwriting and claims efforts and renewal pure-price increases.

Year to date, we achieved an 84.3% statutory combined ratio that included $21 million, or 13.9 points, of favorable prior-year reserve development. This was driven by lower severities in accident years 2013 and prior, due to the significant changes in our claims handling and outcome management, as well as lower prevailing loss cost inflation. This was the 10th consecutive quarter of either no development or favorable development in this line.

Our largest line of business, general liability, reported a year-to-date combined ratio of 83.4, which included $22 million, or 8.5 points, of favorable prior-year reserve development.

Commercial auto has presented challenges for the industry in recent years and we have not been immune to this dynamic. Year to date, commercial auto reported a statutory combined ratio of 106 that included $13 million, or 6.7 points, of unfavorable prior-year casualty reserve development. The increase in our commercial auto liability reserves related mainly to higher severities in accident years 2011 and 2013, as well as higher frequencies in the 2015 accident year.

To address profitability in commercial auto, we continued to achieve rate increases and are taking targeted underwriting actions. Through June 30, year-to-date renewal pure-price in auto liability was 4.6% and auto physical damage was 5.9%.

On the underwriting side, we are restricting new business and not renewing existing policies in certain challenged segments. For the six months of 2016, the excess and surplus line statutory combined ratio was 100.6%. On an underlying basis, excluding catastrophes and prior-year casualty reserve development, the statutory combined ratio was 94.4%, an improvement of 2.5 points compared to the prior-year period.

Margin improvement in E&S is being addressed through a shift in mix of business, claims improvements, and targeted price increases. In 2015 we moved E&S claims management responsibility into our corporate claims group to implement our best practices across all property and liability. The team is in place and we completed the review of the overall claims portfolio following our complex claims review at the end of 2015.

Part of the transition includes the use of more robust monitoring tools to better manage the claims process and outcomes. These changes and aggressive pricing actions are expected to provide benefits and we will continue to focus on refining our E&S claims management practices to improve profitability.

Within personal lines the statutory combined ratio improved 15.1 points to 90.1% through June 30. On an underlying basis, the statutory combined ratio improved 8.1 points and benefited from lower non-CAT property losses. Following a 5% decline in first quarter, net premiums written in personal lines moderated in the second quarter and finished down 0.5% from a year ago. Last month we launched a comprehensive marketing campaign aimed at our distribution partners to emphasize our commitment to personal lines and our target customer, the consultative buyer.

Within homeowners, both the quarter and year-to-date underwriting results benefited from lower catastrophe and non-catastrophe property losses. We set a goal to achieve a 90% combined ratio and normal catastrophe year and are implementing rate increases to move us to that goal.

In personal auto, the year-to-date statutory combined ratio improved by 2 points compared to the prior-year period and benefited from rate increases that we have implemented in that book. We've worked hard to create our position in the market and have no intention of slowing down. As an organization, we remain focused on continuous improvement and outperforming the industry in terms of both growth and profitability.

Now I will turn the call back to Greg.

Greg Murphy - *Selective Insurance Group, Inc. - Chairman & CEO*

Thanks, John. As you know, arithmetic has no mercy and the industry will continue to be pressured to produce underwriting profits as we face the ongoing possibly of low for longer. Interest rates are already at or near historical low levels. We believe that the goal post for acceptable industry returns should not be moved and we are focused on consistently achieving an operating return on equity of 300 basis points above our weighted average cost of capital.

As we look forward, franchise value and superior omni-channel experience for customers will be critical for success in the insurance industry and we are strongly positioned to capitalize on our competitive advantage.

Before moving on to your questions, I would like to take a moment to recognize and thank Dale. In March, Dale announced his retirement and his last day at Selective will be September 1. Since joining Selective in 2000 as Chief Financial Officer, Dale has made significant contributions to our organization as we grew net premiums written 2.5x, increased total assets 2.7x, and quadrupled our market capitalization, as well as expanded into the E&S business with two acquisitions. We wish Dale well and I thank him for his leadership and guidance.

With that, I'd be happy to take your questions, operator.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Arash Soleimani, KBW.

Arash Soleimani - *Keefe, Bruyette & Woods - Analyst*

Thank you. Dale, congrats on your final earnings call.

Just first question, can you provide a bit more color in terms of the new footprint states you are thinking about? What states you might be thinking of going into and perhaps how long you think it will take to sort of get the agent traction there that you have in some of your existing states?

John Marchioni - *Selective Insurance Group, Inc. - President & COO*

Thanks, great question; this is John. I can start and Dale and Greg can certainly fill in.

I would say the focus of our expansion at this point will be the Southwestern part of the country, starting with Arizona and building it out from there. And building a regional operations there over time similar to the five regional operations we have in place in our existing footprint and using the same successful model we have used, which, as Greg indicated in his prepared comments, is around an empowered field model and deep relationships with a smaller group of high-powered agents.

As we build out that footprint over time, we will also continue to add contiguous states to our existing footprint where it makes sense and where we think there is opportunity to build out our existing regional structure as well. And we will do this over a period of years.

The work has begun in earnest on the first couple of states and, generally speaking, we would expect to be operational there in the latter part of next year with the first two states, which means that we will be shortly in the market for agents and employees in those territories to build them out and be able to hit the ground running. Then you would expect to see premium ramp up starting a little bit more slowly in the first year or two as we get our footing with our people and our agency partners, and then building up from there.

Greg Murphy - *Selective Insurance Group, Inc. - Chairman & CEO*

The only thing that I would add to that, obviously, would be leveraging our existing relationships with our distribution partners that have footprints, existing footprints in those states. But also, just to give you a sense, we are always out looking for opportunities in the marketplace but because we are so unique as the way we distribute our product and our high franchise value and we just constantly come to the same point is the only way we can do it is greenfield. And so that's the way we feel that we can successfully replicate our model.

I think you'll see us continue to build out. I don't think we t will be full-service everywhere, but in the rest of the country there are probably about 10 states over a period time that we would be full service. The rest of the states that we will enter, we will enter because our agents have business opportunities in those states and it will give us a 50-state capability.

That will take a longer time, but we don't want to lose business that we have that grows up to a 50-state operation that we can't write because we can't service it. So we know we lose opportunities, particularly on the larger end of that. I think longer term that's the problem that we are also trying to solve in this equation.

Dale Thatcher - *Selective Insurance Group, Inc. - EVP, CFO & Treasurer*

The other color I will add is, keep in mind, we are currently growing an 8% to 9% in our current existing footprint, well in excess of what the industry is able to achieve because of the capabilities that we have built here. So a steady, measured approach in our new states with a greenfield method is, to us, the appropriate way to maintain profitability for our shareholders and provide an opening up of additional growth opportunity, which really is kind of gravy on the overall scheme of things. So to me it's an excellent way to continue to build this company.

Arash Soleimani - *Keefe, Bruyette & Woods - Analyst*

All right, thank you for all of those answers. On the commercial rate increases -- not a big change, but it went from I think 2.8% last quarter to 2.6% this quarter. Is there anything to read into there or would you consider that basically a continuation of the status quo?

John Marchioni - *Selective Insurance Group, Inc. - President & COO*

We view those results as stable quarter on quarter and when you look at our rate level relative to where the industry is, we are very happy with those results. Retentions remain strong. Rate level is pretty much in line with our expected claims inflation targets and when you look at our commercial lines performance relative to our target returns, we want to make sure we continue to maintain those margins. And, therefore, getting rate level in that amount is what we are striving to achieve.

Greg Murphy - *Selective Insurance Group, Inc. - Chairman & CEO*

Just to understand that a fair amount of that rate also came in the commercial auto, which John prefaced in his comments, where our liability, which represents commercial liability -- auto liability is about 76% of the auto premium and that was up 4.3% in the quarter. And to physical damage, which represents about 24% of the commercial auto premium was up 6 spot 4%.

So good, healthy increases in that line and we've pretty much always been ahead. 1,500 basis points ahead of the industry, 27 consecutive quarters of renewal price increases that equaled or exceeded expected claim inflation, in my mind, is quite a track record to stand on.

Arash Soleimani - *Keefe, Bruyette & Woods - Analyst*

I guess the expectation is still to keep pace, at least, with loss inflation this year?

Greg Murphy - *Selective Insurance Group, Inc. - Chairman & CEO*

Our goal, here's how I would state it. We have the underwriting capability and vertically through the entire organization that our inside underwriters can sit across the table agency by agency, 60 to 90 days out in advance with their renewals book, know which accounts they have to play hardball on and are able to do that. And because we have that relationship and knowledge base, we are able to scratch out premium increases where most of our competitors cannot.

Arash Soleimani - *Keefe, Bruyette & Woods - Analyst*

Right, right. I know you mentioned in the prepared remarks that obviously you are not immune in commercial auto from some of the industry trends you are seeing. And, obviously, you are getting good rate there.

I guess my question is -- I know a lot of competitors have mentioned that they are staying away from commercial auto just because of what's going on. I guess what gives you a confidence to grow the way you've been growing in that line?

John Marchioni - *Selective Insurance Group, Inc. - President & COO*

This is John again. I think if you will look at our track record over a long period of time, our performance in commercial auto is very strong relative to the industry. We continue to believe we've got high-caliber underwriters with excellent tools to make good risk selection and pricing decisions.

Those headwinds that we mentioned in our prepared comments that you are referring to certainly do affect everybody, whether it's the economic rebound, and specifically with the contractors the cost of gasoline coming down, unemployment coming down, which are driving up miles driven.

But you've also got the continued impact of distracted driving as well as the cost to repair vehicles because of technology in vehicles that will continue to be on the rise.

So we think there is some staying power to pricing in that segment because it is impacting the industry, but we still believe, as an account underwriter -- again, we don't write a lot of monoline auto. We write account business, property, auto, GL, umbrella, workers comp.

We view it as an entirety. Not that we would have intentional subsidization between lines of business, but we think the stresses that are on that line are something we can manage going forward, bring it into profitability, and in an overall account basis continue to compete effectively.

Greg Murphy - *Selective Insurance Group, Inc. - Chairman & CEO*

You cannot be an account underwriter and not write commercial auto. Again, let's be -- this is the same issue everybody had several years ago with worker's comp.

We are an account underwriter; we write the whole account. GL is our lead line in that's; it's our biggest line, followed by commercial auto. Next is comp.

And we had -- and our comp was running higher than we would've liked. We had a concentrated effort to pull the combined ratio down and the success of that has been phenomenal as our combined ratios have dropped substantially.

And I think that we've got a very good grip on what it is we're doing. We're driving rate well above expected claim inflation. We are working around some of the underwriting and other claim improvements.

So you can't not write that and expect to go in and get the rest of the account. So you've got to manage your way through the profitability on the line and get agents that are willing to work with you to make the improvements in the segmentations that need to be improved.

Arash Soleimani - *Keefe, Bruyette & Woods - Analyst*

Right, that makes sense. My last question just on E&S, I know you mentioned in the prepared remarks that just due to the size of the book there will be some volatility in there. But obviously it seems like a line you are growing pretty strongly in, as we saw this quarter.

Does that imply that as those written premiums earn in there's an expectation for those premiums to be at a combined ratio below 100 consistently? I guess how do you look at that going forward?

John Marchioni - *Selective Insurance Group, Inc. - President & COO*

So we expect all three of our major segments to achieve our target returns over time and certainly consider E&S in that category. I think a couple of points I would make that reinforce.

Number one, our ability to change the makeup of that book of business more quickly than we do in standard commercial lines is there because retention rates in that segment are generally lower than they are in standard commercial lines. Usually in the 50 to 60 kind of range. So you are turning that inventory over a lot more quickly.

Second thing is -- and we have commented on this in the past -- we measure our pricing levels on a very specific segment basis for new business and we are actually acquiring new business at or above our targeted pricing levels. Again, that makes up a more significant portion of the book for the segment than it does in standard commercial, which we also think will contribute to improvement in performance going forward and going forward rather quickly.

Then the final point I would highlight, which was also in the prepared comments, is we are just now starting to realize the expected benefits from migrating the claims management to our overall claims platform. And we think there is significant opportunity for improvement, both in terms of outcomes and loss adjustment expenses, and you haven't really seen that start to come through the numbers.

So on an accident-year basis and an underlying basis, when you strip out the casualty, development, and CAT, we are seeing improvement. As we said, we got about 2.5 points of improvement in the underlying combined ratio so far. And we think we can continue that trend while we are growing it because we are so comfortable with the strength of new business pricing in that segment.

Arash Soleimani - *Keefe, Bruyette & Woods - Analyst*

All right, thank you for all of the answers. Congrats on the quarter and congrats again to Dale.

Operator

(Operator Instructions) Mark Dwelle, RBC Capital Markets.

Mark Dwelle - *RBC Capital Markets - Analyst*

Good morning, a few questions. In the commercial lines segment, the expense ratio had moved up about a point. Is there anything in particular behind that? Obviously the overall combined ratio was good, so I was kind of surprised at that.

John Marchioni - *Selective Insurance Group, Inc. - President & COO*

A little bit of supplemental commission as our profitability continues to improve and it's actually better than we had expected it to be. We are adding more to the supplemental side, so that's the trade-off that -- you've got to remember that we reward performance.

We're a pay-for-performance organization. When our agents generate the results, they get more supplemental commission. And to some extent, even in our own annual cash incentive plan, which as you guys know, is heavily based on combined ratio performance and achieving very, very specific strategic initiatives. Both of those things are doing very well.

That's not all of it, but that's a fair amount of it.

Mark Dwelle - *RBC Capital Markets - Analyst*

Okay, that makes sense. Some questions in the alternative investments continue to kind of struggle. I appreciate there's kind of a portfolio management aspect, but how are you thinking about that in terms of an allocation? It doesn't seem like it's something that's really rewarding you as much as the rest of the business is.

Dale Thatcher - *Selective Insurance Group, Inc. - EVP, CFO & Treasurer*

I think it's important to note -- so alternatives, at our peak, we were up around $160 million, $170 million of allocation to the alternative space. As things kind of blew up in the 2007-2008 timeframe, we really allowed the alternatives to drift downward as we retrenched and really got our arms around exactly what we had in there and where we wanted to go with that class of investments.

We have since rebuilt our capabilities around being able to invest in the space and we feel much better about that now, but you do have that ongoing drag from some of those legacy investments that are, if you think about it, towards the end of their normal lifecycle. So they are the lower-performing of the overall alternatives. So until we get fully back, ramped up and fully allocated to the alternative space, the net income that you are going to see from those for a while is not going to be nearly as robust as we would expect.

But once we achieve the right kind of diversification across vintage years and across classes of alternative investments, then our expectation is to have more consistent performance coming from that class of investment.

Mark Dwelle - *RBC Capital Markets - Analyst*

Okay. I guess staying with the investments. I hope this isn't my last question for you, Dale, but I fear it may be. You noted that the new money yields were above your book yields. Is that because you are shifting into more high yield or --? That surprised me.

Dale Thatcher - *Selective Insurance Group, Inc. - EVP, CFO & Treasurer*

That's really just what drove it this particular quarter is we moved a little bit into high yield, but as you can see, we didn't move so much into high yield that it changed the overall credit quality of the portfolio to AA-. It's been an area of investment allocation that, for us, has been zero for a very long time.

And as we look at comparing our portfolio to our peers, you can see that there's clearly a belief in allocating some level of the portfolio to a high-yield credit strategy and we believe in that also. Again, it was an area that we didn't invest in because we didn't feel like we have all the right horses in place to be able to do that effectively. But we think that we have the right kind of strategy to be able to appropriately manage that.

So it will not be a large allocation in the overall scheme of things, but just starting to ramp that up this quarter and you will see purchases of those kind of yields. That's really what drove the purchase yield just for this quarter.

Mark Dwelle - *RBC Capital Markets - Analyst*

Okay, that makes sense. I guess my last question is for John. The E&S -- the improvement in the E&S underwriting margin, the 2 points that you've mentioned a couple of times, is that driven by a change in the business mix or is that actually better pricing, better underwriting, better class of business, whatever you might want to call it?

I'm just curious because the unit has had a number of fits and starts and an improvement is obviously good, but I'm wondering if it's more driven by risk or your selection or whether it's class.

John Marchioni - *Selective Insurance Group, Inc. - President & COO*

I would say it has actually been driven by both. There are a couple of targeted segments that are geographic and industry vertical in nature that we have, in certain cases, gotten off of; in other cases, stopped writing entirely. Or the third instance would be areas that we've dramatically changed our pricing structure to drive improvement. And if you were to look at our mix of business relative to a couple of those segments, it has, in fact, shifted quite a bit. So that is point number one.

The second point is, while the growth has been there and new business has been strong, that new business pricing strength relative to target levels has been strong for the last couple of quarters at least and the better part of the last two years. So as that new business makes its way into the renewal portfolio, that will also have a positive impact on loss ratios. So I would say it's those two drivers.

The claims improvements, to the extent they are in what we are seeing right now, would be probably slight. We would expect to see those really ramp up on a go-forward basis.

Mark Dwelle - *RBC Capital Markets - Analyst*

Okay, that's helpful.

Greg Murphy - *Selective Insurance Group, Inc. - Chairman & CEO*

Remember there's a good-sized amount of turnover in this business every year, so to improve your performance you've really got to look heavily at the new. And John commented this earlier that of the new business that we are writing is really at or above our target surcharge levels and it is well in excess of what we wrote a year ago and also in excess of our renewal inventory.

We have seen improvement in our renewal inventory quarter to quarter, but it's still -- our renewal inventory is still below our new business level and it's something that we are trying to quickly close the gap on.

John Marchioni - *Selective Insurance Group, Inc. - President & COO*

Mark, the other point I would add is we have seen improvement on the renewal pricing side, but understand the dynamic there is a little different than it is in the admitted business because you do have a wholesaler that's getting that business through a retailer. And they know that that retailer would rather place that business on renewal in the admitted if they can. So it does make it a little bit harder to achieve rate increases there based on that dynamic, on your renewal portfolio. But the strength of our new business pricing we are very comfortable with.

Mark Dwelle - *RBC Capital Markets - Analyst*

Okay, that's very helpful. Good luck to you, Dale. Please continue to stay in touch.

Dale Thatcher - *Selective Insurance Group, Inc. - EVP, CFO & Treasurer*

I will, thank you.

Operator

(Operator Instructions) There are no more questions as of this time. I will turn the call back to Mr. Greg Murphy.

Greg Murphy - *Selective Insurance Group, Inc. - Chairman & CEO*

Well, thank you for participating on the call this morning. If you have any other additional questions, please contact Dale. Thank you very much.

Operator

That concludes today's conference. Thank you for your participation. You may now disconnect.