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PRESENTATION

Operator

Good day, everyone. Welcome to Selective Insurance Group's Third Quarter 2020 Earnings 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, Rohan Pai.

Rohan Pai - *Selective Insurance Group, Inc. - Senior VP of IR & Treasurer*

Thank you, and good morning, everyone. We're simulcasting this call on our website, selective.com, and the replay will be available until November 28, 2020. Our supplemental investor package, which provides GAAP reconciliations of any non-GAAP financial measures referenced today also is available on the Investors page of our website.

Today, we will discuss our results and business operations using GAAP financial measures that also are included in our filings with our annual, quarterly and current reports filed with the U.S. Securities and Exchange Commission. Non-GAAP operating income, which we use to analyze trends in operations and believe makes it easier for investors to evaluate our insurance business. Non-GAAP operating income is net income excluding the after-tax impact of net realized gains or losses on investments and unrealized gains or losses on equity securities and statements and projections about our future performance. These forward-looking statements, under the Private Securities Litigation Reform Act of 1995, are not guarantees of future performance and are subject to risks and uncertainties. For a detailed discussion of these risks and uncertainties, please refer to our annual and quarterly reports filed with the U.S. Securities and Exchange Commission, which includes supplemental disclosures related to the COVID-19 pandemic.

You should be aware that Selective undertakes no obligation to update or revise any forward-looking statements. On today's call are the following members of Selective's executive management team, John Marchioni, President and Chief Executive Officer; and Mark Wilcox, Chief Financial Officer.

Now I'll turn the call over to John.

John Joseph Marchioni - *Selective Insurance Group, Inc. - CEO, President & Employee Director*

Thank you, Rohan, and good morning. I'll make some introductory remarks and then turn it over to Mark to provide the details on our results. I'll then return with some closing remarks before opening up the call to questions.

We experienced another quarter of elevated catastrophe losses. And while the impact on our results is noteworthy, these events devastated a number of individuals and businesses. Our #1 objective in times like these is to help our customers get their lives and businesses back in order, and I can proudly say that our claims team delivered on that mission as they always do. Despite these elevated catastrophe losses, we generated an extremely strong annualized operating ROE of 10.9% in the quarter. Our premium growth, driven by solid price increases, excellent retention rates and strong new business volumes is a testament to our unique market position and deep distribution partner relationships.

The customer-centric focus of our employees has been essential to our success in navigating this challenging environment. We generated a profitable 97% combined ratio for the quarter despite the significant catastrophe losses, which highlights the excellent underlying profitability of our book. While growth in insurance is easy, generating consistent growth and profitability is much harder to achieve. Our track record on delivering both is a reflection of our unique strategy, depth of distribution relationships and sophisticated underwriting and pricing tools and capabilities.

I want to highlight a few key themes for the quarter. First, our results did include $80 million of catastrophe losses, which accounted for 11.4 points on our combined ratio. Our losses in the quarter related to 21 separate catastrophe events, designated by ISO's property claim services, or PCS. The Midwest derecho at $28 million and Hurricane Isaias at $22 million were the largest drivers. Given their moderate size, none of these individual events reached our excess of loss catastrophe reinsurance program, which attaches at $40 million per occurrence. While we have had sizable losses during the last 2 quarters, our catastrophe exposure over the last 15 years has averaged 3 points on our combined ratio. Our historical success managing catastrophe loss volatility stems from our focus on geographic diversification, strict underwriting standards for catastrophe-exposed zones and a strong reinsurance program.

Despite 2 consecutive quarters of elevated catastrophe losses, there has been no notable change to our underwriting portfolio and we expect our longer-term catastrophe loss load to remain largely stable.

Second, while alternative asset returns strongly contributed to the overall 9.4% investment income ROE in the third quarter, the longer-term outlook for overall book yields is challenged. With treasury rates near record lows, reinvestment yields will reduce forward book yields, putting more pressure on underwriting results to generate adequate ROEs. We will maintain our conservative philosophy to managing our investment portfolio and focus on boosting our strong underwriting margins to achieve target returns. The low interest rate environment benefits strong underwriting companies like Selective. A short-term bounce in pricing from a firming market environment will provide near-term relief to most market participants. However, the winners in our business over the long term must be skilled at underwriting and sophisticated and granular in their pricing strategy. The long-term winners will consistently manage pricing relative to loss trends, not based on the whims of the marketplace.

Our Commercial Lines renewal pure price increased 4.6% in the third quarter or 5.6% excluding workers' compensation, which was up from earlier this year. Overall renewal retention in Commercial Lines of 86% is up 200 basis points for the quarter and on a year-to-date basis. It is our granular and sophisticated approach to pricing that has allowed us to generate pure renewal price increases, in line with or above expected claim trend for the past 10 years without sacrificing policy retention or growth.

For smaller accounts with policy premium of less than $10,000, renewal pure price increased 3.9% in the quarter, while larger accounts in excess of $100,000 in premium generated renewal pure price increases of 5.8%. Across all size cohorts on a year-to-date basis, our highest quality accounts based on future profitability expectations, produced 2.8% pure rate and point of renewal retention of 92%, while our lowest quality accounts generated 9.6% pure rate and retention of 84.5%.

Finally, I remain extremely proud of how despite the challenging economic and health environment, our team has remained focused on executing our objectives. These goals are balanced between delivering near-term profitable growth and positioning us for long-term outperformance. We are confident that the investments in agency and customer experience, underwriting and claim sophistication and operational efficiency will secure our position as a market leader for the long term. I'll come back to provide a bit more commentary on this front, but first, I'll turn the call over to Mark to review the results for the quarter.

Mark Alexander Wilcox - *Selective Insurance Group, Inc. - Executive VP & CFO*

Thank you, John, and good morning. I'll review our consolidated results, discuss our segment operating performance and finish with an update on our capital position and guidance for 2020. There are several moving parts this quarter, so I'll make sure I hit the major variances. For the quarter, we reported very strong net income per diluted share of $1.16 and $1.06 of non-GAAP operating earnings per share. We reported an annualized ROE of 11.9% and a non-GAAP operating ROE of 10.9%.

For the first 9 months of the year, we have generated an 8% non-GAAP operating ROE, which is 3 points below our 11% target, driven mainly by elevated catastrophe losses, and to a much lesser extent, COVID-19. However, despite the underlying performance of our -- the underlying performance of our business has been exceptionally strong this year, and we are well positioned to continue to generate superior performance.

On a consolidated basis, it was a solid growth quarter, with net premiums written up 6%, driven by higher retention, overall renewal pure prices increasing to 0.4% and new business growth in each of our segments. For the first 9 months of the year, net premiums written growth was a more modest 2% relative to a year ago. As a reminder, year-to-date net premiums written were significantly impacted by COVID-19 related items, including a first quarter $75 million audit premium accrual and the $19.7 million of second quarter auto premium credits that have collectively reduced our top line by $94.7 million this year and our growth rate by 4.5 percentage points. We reported a consolidated combined ratio of 97% for the quarter, an excellent result in light of $79.5 million of catastrophe losses that added 11.4 points to the combined ratio.

Prior year reserves continued to trend the favorable claims emergence resulted in $25 million of favorable net prior year casualty reserve development that benefited the combined ratio by 3.6 points. COVID-19-related items were relatively modest this quarter, adding just 40 basis points to the combined ratio. On an underlying basis or excluding catastrophes and prior year casualty reserve development, the combined ratio was an excellent 89.2%, a significant improvement compared to 93.6% in the prior year period.

For the first 9 months of the year, the underlying combined ratio of 90% represents 250 basis points of margin improvement compared to a year ago. It is also better relative to our original expectations of 140 basis points of underlying margin improvement we were forecasting at the start of the year. Underlying margins so far this year have benefited from lower-than-expected non-catastrophe property losses and reduced underlying operating expenses.

Turning to the impact of COVID-19, The underlying combined ratio reflects modest COVID-19-related items this quarter that reduced pretax underwriting income by $3.3 million, increased the combined ratio by 0.4 points and reduced diluted EPS by $0.04. The COVID-19 items relate to the earned impact net of reduced underwriting expenses and losses of our first quarter $75 million audit premium accrual. Year-to-date, specific COVID-19-related pretax underwriting charges have totaled $37.4 million and have increased our combined ratio by 1.7 percentage points. These items have reduced our year-to-date EPS by $0.49 and our ROE by 1.7 percentage points.

Recall, earlier this year, we took a proactive approach to booking a number of COVID-19-related items and we've been very transparent in our disclosure of these items. These included a $75 million audit accrual that we booked in the first quarter. During the quarter, we booked $19.7 million of premium adjustments against this accrual related to lower exposures, which brought the accrual down from $61 million last quarter to $41 million at the end of this quarter.

As I mentioned last quarter, we will not know the full extent of the impact of the reduced exposure on our auditable premiums until the latter half of 2021, but thus far, activity has been within our expectations.

Second, we recorded $10 million in ultimate net losses in the first quarter for losses related to the small portion of our property policies and have specific sub-limited coverage for extra expense associated with the government ordered cleaning. Today, the $10 million ultimate net loss estimate remains unchanged and also still remains all IBNR.

And third, through the second quarter, we increased our allowance for uncollectible premiums receivable by $13.5 million due to expectations of elevated past due accounts from the combination of increased business insolvencies and the temporary billing holds where we refrained from canceling policies for nonpayment.

After the billing holds were lifted this quarter, collection activity has been better than we expected, and as a result, we did not increase the allowance further this quarter. In our combined ratio guidance last quarter, we expected some additional pressure from bad debt in the second half of the year. In addition, as we noted last quarter, the current accident year reported claim frequencies have thus far been below normal levels due to the drop-off in economic activity. Despite that, with the exception of the second quarter premium credit-related reductions in the auto lines, our 2020 casualty book loss ratios remain on plan.

Due to the inherent uncertainty presented by COVID-19, including the potential for higher severities, late reported claims and the volatile economic environment, we have not further reflected the temporary frequency reductions at this time. However, we will continue to monitor these trends.

Moving to expenses. Our expense ratio was 32.4% for the quarter or 32.1%, excluding the COVID-19-specific items. For the first 9 months, the expense ratio was 33.9% or 32.4%, excluding COVID-19 related items, which have added 1.5 points to the expense ratio this year.

The underlying expense ratio is coming better than expected and reflects ongoing expense management initiatives. Some of the benefit, however, is, of course, due to lower travel and entertainment expenses as well as some short-term deferrals of projects and new hires and lower employee incentive compensation that over time are likely to return to more normalized levels. However, we continue to seek out ways to improve our operational efficiency, leverage our infrastructure and reduce our expense ratio while continuing to invest in our business. We believe there is room for further expense ratio improvement over the next couple of years.

Corporate expenses, which are principally comprised of holding company costs and long-term stock compensation, totaled $3.9 million in the quarter, reduced from $6.4 million a year ago because of lower stock-based compensation expense.

Turning to our segments. In the third quarter, for our Standard Commercial Lines, we reported a very strong 8% increase in net premiums written. The strong growth was particularly encouraging in light of the challenging macroeconomic backdrop and reflects the strength of our 3 sustainable competitive advantages. New business increased 3% relative to a year ago. Retention increased to a very healthy 86% and renewal pure price increased to 4.6%. Pure renewal pricing has been trending up and is about 1 point higher year-to-date compared to the same period last year.

The combined ratio was a very profitable 92.3% despite the heavy catastrophe losses, which added 7 points. Net favorable prior year casualty reserve development benefited the combined ratio by 4.5 points and included favorable claim emergence of $15 million in workers' compensation and $10 million in general liability. The underlying combined ratio was also very profitable at 89.8% and has improved 2 points year-to-date.

In our Personal Lines segment, we reported a 2% decline in net premiums written, reflecting continued competitive market conditions. Renewal pure price increases averaged 1.8%, retention held steady at 83% compared to the third quarter of '19, although it was down 1 point on a sequential basis. New business volume was up 18%. However, our combined ratio was an unprofitable 119% as we absorbed 37.4 percentage points of catastrophe losses in the quarter, which is well above long-term trends.

On an underlying basis, the combined ratio was 81.6% and benefited from lower non-catastrophe property losses and lower expense ratio. There was no prior accident year casualty reserve development.

In our E&S segment, we reported flat net premiums written volume for the quarter relative to a year ago. Renewal pure price increases averaged 7% and new business was up a strong 29%. The combined ratio, however, reflected a high level of cats which added 19.5 points and resulted in an unprofitable 112% combined ratio for the quarter. The underlying combined ratio was a solid 92.5%. There was no prior accident year casualty reserve development. Over the past few years, targeted price increases, business mix changes and exiting specific underperforming parts of the business have contributed to the improved underlying combined ratio performance in this segment.

Moving to investments. Our investment portfolio remains well positioned. As of September 30, approximately 94% of our portfolio was invested in fixed income securities and short-term investments with an average credit rating of AA-, an effective duration of 3.7 years and offers a high degree of liquidity. Risk assets, which include a high-yield allocation contained within fixed income as well as public equities and limited partnerships and private equity, private credit and real assets represent 9.8% of our investment portfolio. This is up from an 8% allocation at year-end as we have found attractive opportunities this year to increase our allocation given market conditions.

At this point, we may increase our risk asset allocation marginally, but are almost fully invested given our current investment risk appetite. After-tax net investment income of $55.1 million was up 22% from the comparative quarter, with the growth driven primarily by $19 million of pretax alternative gains, which we report on a 1 quarter lag. We more than fully recovered our second quarter alternative losses with the gains in the third quarter, and we've reported $8.9 million of pretax gains from alternative investments thus far in 2020.

The after-tax yield on the fixed income portfolio, including high-yield bonds, was 2.6% for the quarter. The overall after-tax yield on the total investment portfolio is 3.1%. And the total return of the portfolio, which includes after-tax realized and unrealized investment gains and losses as well as impairments was 1.8% for the quarter and a strong 4.1% year-to-date. In addition, the portfolio delivered a very strong 9.4 percentage points of operating ROE contribution this quarter.

Despite the strong performance, the average after-tax new money yield on fixed income purchases during the quarter was down to 2.2% from 2.7% in the second quarter, reflecting a contraction in credit spreads as well as the continuation of low benchmark grades. Over the coming quarters, we are expecting meaningful non-sale disposal activity from higher book yielding AA and AAA-rated securities, mainly agency-backed RMBS. Given the steepness of the credit curve and the lack of spread and yield for the highly rated securities, we will likely reinvest some of these proceeds in other fixed income asset classes where we are obtaining better risk-adjusted returns. This will likely result in our average credit rating notching down modestly to A+ from AA- in the quarters, but will help preserve the book yield without materially changing the overall risk profile of our investment portfolio.

Our capital position remains extremely strong with $2.4 billion of GAAP equity, up 9% from year-end. Our net premiums written to surplus ratio is 1.4x, and we've built significant financial flexibility with $343 million of cash and investments at our holding company. Operating net cash flow has been strong this year at $381 million or 18% of net premiums written compared to 15% last year. During the third quarter, we repaid $85 million of short-term FHLB debt that we borrowed earlier this year, and we expect to repay the remaining $167 million by year-end.

Our debt-to-capital ratio stands at 23.1% and our long-term debt-to-capital ratio stands at 18.7%, well below our longer-term target. Overall, our strong balance sheet and holding company cash and liquidity provides us with the financial resources and flexibility to continue to invest in our business and grow our insurance operations.

Our Board of Directors approved a quarterly dividend of $0.25 per common share, which represents a $0.02 or 9% increase. Before I turn the call back over to John, I'll finish with our updated 2020 guidance. Based on our year-to-date results and our current expectations for the fourth quarter, we have revised our full year guidance to include a GAAP combined ratio, excluding catastrophe losses, of between 88% and 89%. This assumes no prior accident year casualty reserve development in the fourth quarter. Catastrophe losses of 8 points on the combined ratio, after tax net investment income of $175 million, including $10 million to $15 million in after-tax gains from our alternative investments, an overall effective tax rate of approximately 18.5%, and weighted average shares of 60.5 million on a diluted basis.

With that, I'll turn the call back over to John for a review of our strategic initiatives.

John Joseph Marchioni - *Selective Insurance Group, Inc. - CEO, President & Employee Director*

Thanks, Mark. Well, most of our focus this year has been on maintaining operating continuity and delivering best-in-class service to our customers and distribution partners. I also wanted to emphasize progress we have made on a number of key strategic initiatives, which underlie our strong market position now and into the future.

First, our constant focus on delivering a superior omnichannel customer experience has paid significant dividends in this current environment. Our capture of customer communication preference has allowed us to enhance customer interaction through this unsettling time. Enhancements to our digital self-service offerings has resulted in utilization growing to 40% of our customer base. And with ongoing travel and in-person meeting restrictions, we have quickly deployed tools that allow for the virtual delivery of claims and safety management services, enhancing both the customer experience and increasing operational efficiency.

Second, we continue to deliver tools to our underwriters to help them make better decisions faster. Our deployment of a workflow management tool, along with the automated retrieval and presentation of the majority of account-level information required to underwrite accounts will drive significant productivity gains. The underwriting insights tool provides an individualized pricing guidance on prospective new business accounts based on the knowledge of our in-force inventory of accounts by industry, state and line of business. In addition to the value provided on individual underwriting decisions, it provides great management insight into the quality and pricing of new business, a key consideration in projecting forward underwriting margins.

Third, We continue to focus on maximizing our share with existing distribution partners. Late last year, we introduced a tool that help our distribution partners better understand their overall portfolio and opportunities to increase their share with us. This tool has been deployed with approximately 15% of our distribution partners to date and has contributed to our ability to generate solid growth in Commercial Lines throughout these challenging economic times.

We've also begun the initial rollout of a new agency interface for small business, designed to dramatically streamline the quoting and issuance process for this key business segment. The new platform is currently deployed for BOP and auto to a pilot group of distribution partners with a full rollout for these lines expected by year-end. The remaining lines of business are planned for rollout over the course of 2021.

While 2020 has presented many challenges, it has also enabled us to stand out and highlight our capabilities and value proposition to our customers and distribution partners. As we look forward, our competitive position is extremely strong. The tools, talent and relationships that we have built position our platform well for continued operating and financial outperformance.

With that, we will open the call up for questions. Operator?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question is from the line of Mike Zaremski of Crédit Suisse.

Michael David Zaremski - *Crédit Suisse AG, Research Division - Research Analyst*

First question, in the prepared remarks, I think it was, Mark, you kind of stated that you've not fully reflected some of the frequency benefits from lower claims activity this quarter. Maybe you can kind of talk through that more because I think the underlying loss ratio, so accident year ex-cat in Commercial Lines was excellent, better than expected and reserve releases were also much better than expected. So maybe you could kind of elaborate.

John Joseph Marchioni - *Selective Insurance Group, Inc. - CEO, President & Employee Director*

Yes. Thank you. Let me -- this is John. Let me start and then Mark could walk you through the movement in the underlying and the component parts of that. But just to address the first part of your question relative to the 2020 accident year and the lower frequency that has been referenced. As Mark indicated in his prepared comments, while the property results are reflective of that frequency, that does flow right through. For us, the longer tail casualty lines remain on our loss picks. And what we're saying there is, there remains uncertainty, particularly on the severity side, but also to a certain extent on the frequency side. And I think we want to make sure that we're very deliberate in how we evaluate the current accident year.

You do have potential for higher severities. In certain cases, that might be related to COVID and it could also be related to non-COVID general inflationary trends. You also, because of the economic environment, have some risks around slower reporting of claims and then we're still mindful and watchful relative to the potential exposure in the GL and workers' comp lines to potential COVID exposure.

So again, I think we're acknowledging that there has been some frequency benefit. I will say in the third quarter, you have seen reported claim counts bounce back a little bit closer to more of a normal level and certainly higher than we saw in the second quarter. But at this point, as we always do, we book to our best estimate and evaluate each accident year based on the information we have available to us. Now Mark can certainly reconcile the underlying for you.

Mark Alexander Wilcox - *Selective Insurance Group, Inc. - Executive VP & CFO*

Sure. Thank you, John. And good question, Mike. So as John mentioned, we stayed on plan. And as I mentioned in my prepared comments with the 2020 accident year from a loss ratio perspective for the longer tail casualty lines, essentially, the only frequency benefit that's come through has really been through the premium credits that we gave back in Q2 for the commercial and personal auto lines.

When you do look at the underlying combined ratio, it is very strong. Year-to-date, on an accident year, ex-cat basis all-in, we're at 90% underlying combined ratio. You might recall that last year, we were at 92.9%. And as we presented our full year expectations at the end of January, our forecast for this year was a 91.5%. So we're fully better than last year and showing margin improvement from initial expectations at the start of the year. But it is a noisy year, there are a lot of moving parts in the underlying combined ratio.

A couple of things I'd point you to when you look at that 90%. One is, there is a little bit of a drag associated with COVID-19 embedded in that 90%, and that's 1.7 percentage points, as I mentioned in my prepared comments. So if you back that out, you're kind of down to an 88.3%. But relative to our expectations of what we think non-cat property should run on a kind of a normal year-to-date basis, it's about 1.2 points of benefit from non-cat property.

And then from an expense ratio perspective, I would characterize some of the benefit that we've seen on the improved expense ratio ex-COVID-19, it's a little bit of a onetime benefit from the work-from-home environment, the lack of T&E and of course, reduced incentive compensation as the ROE is at an 8% year-to-date versus our target of 11%. So that's about 1 point of benefit. So when you put that all together, year-to-date, we're kind of from our count sitting on about a 90.5% underlying combined ratio.

And then when you go back to the guidance that we issued last night, we give you the ex-cat guidance, if you take the favorable reserve development, that we've booked year-to-date of 2.5 points, kind of normalize that over the full year, it's about 2 points of benefit. That would get you back to about a 90% to 91% underlying for full year 2020, and kind of back to kind of the midpoint of what we're seeing on a year-to-date basis at the 90.5%. So hopefully, that's helpful, a lot of moving parts this year with COVID-19, non-cat property, as well as the expenses, but certainly some strong underlying margin improvement we've seen this year.

John Joseph Marchioni - *Selective Insurance Group, Inc. - CEO, President & Employee Director*

And I think that's the key point to reinforce there is when you adjust for all the moving pieces in there, we expected to have strong underlying performance, and we do have a strong underlying performance.

Michael David Zaremski - *Crédit Suisse AG, Research Division - Research Analyst*

Yes, that clearly came through. Mark, did you elaborate or maybe I missed it in the prepared remarks on the prior year reserve development in terms of color on the commercial side, what were the puts and takes?

Mark Alexander Wilcox - *Selective Insurance Group, Inc. - Executive VP & CFO*

Yes. So let me review that. It was $25 million in total, $15 million of benefit in workers' compensation and $10 million in the general liability line. Unlike last quarter, where we saw a little bit of pressure on the '16 through '19 accident years for commercial auto, we saw no need to adjust the prior year reserves for the commercial auto line of business. So $25 million in total and about 3.5 points on the overall -- 3.6 points on the combined ratio this quarter.

Michael David Zaremski - *Crédit Suisse AG, Research Division - Research Analyst*

Okay. And last question, maybe stepping back. The top line has rebounded nicely. From the prepared remarks, it sounds like you guys -- well, I don't want to put words in your mouth. What are you -- how are you feeling about the competitive positioning, maybe by the business lines versus last quarter? Has anything changed?

John Joseph Marchioni - *Selective Insurance Group, Inc. - CEO, President & Employee Director*

I would say nothing has changed. Our position in Standard Commercial Lines has been and continues to be extremely strong. And I think that's demonstrated not just in the overall top line growth in that segment, but also when you look at new business, in particular, in an environment where average exposures are likely down, we're generating a small, but solid increase in new business in that core Commercial Lines space. And I know we've said this on multiple occasions and most companies will suggest this, but I think the new business growth really supports it, is our relationship model that has an underwriter assigned to an agent in a one-to-one relationship allowed us to move into this environment and continue to support the flow of business and opportunities coming through. And I think that's really important for us to reinforce. And I think that supported our position and continued position to grow Commercial Lines.

Our service experience has not suffered, and in many ways, has been enhanced. I mentioned virtual delivery of both safety management interactions as well as claims interactions. The feedback we're getting from customers and agents on those are extremely strong. And I think those are long-lasting benefits that we maintain beyond the current environment.

And then I also think the pricing tools we have that we deployed for new business also gives us confidence that when we look at the pricing and the underwriting quality of the business we are acquiring, we feel very good about it because we do see in an environment where pricing is up, at least market-wide as meaningfully as it is, not every company is taking the same granular approach. So you do see opportunities coming into the market that are probably being priced well above where they should be. And we think that presents us with some excellent opportunities.

Obviously, Personal Lines for us has been a segment that's been pressured for the last several quarters, and I think that's largely our competitive positioning in the auto side of that market, less so in the home, but because we write most of our business with a companion auto and home policy, it's put pressure on the overall growth. I do think we were out a little bit ahead of the market in personal auto pricing. We are seeing some movements back up again on personal auto, although it's a bit of a mixed bag. But for us, I think we're really repositioning our Personal Lines business to serve a different client base going forward and one that might be a little bit less price sensitive and a little bit more focused on coverage and service. And that's a transformation that will be happening over the course of the coming quarters.

And then E&S, we like our position. The profitability has improved significantly in the last couple of years. Obviously, some noise this year because of cat losses and the growth has been a little bit up and down. But remember, our -- the business we're in for E&S is the smaller policy kind of lower hazard contractor habitational type accounts that are not really driving the market movement like you're seeing in the higher severity, larger property type, larger casualty type accounts that I think are generating some of the headlines. But we like our position there and think we still have a lot of opportunity for additional growth in that segment.

Operator

The next question is from the line of Jamie Inglis from Philo Smith.

James Inglis - *Philo Smith & Co. - MD and Partner*

Could you explain to me why the cat losses in the third quarter were so dramatically different if you look at the Standard Commercial versus the E&S. In the third quarter a year ago, they were both 2 or 3 points. In this quarter, Standard Commercial is 7 points and E&S is almost 20 points. Is it a mix of business? Is it a geographic mix difference? What would cause such a divergence?

John Joseph Marchioni - *Selective Insurance Group, Inc. - CEO, President & Employee Director*

I'll -- this is John. I'll start and then Mark could follow on. The first and most important point of note is that the E&S book is much smaller than the Standard Commercial Lines, and that will create a little bit more volatility. Our E&S book is predominantly casualty, it's about 75% GL. And we're not a property writer in real cat-exposed areas.

Now that said, some of the Gulf Coast events despite our small profile there did generate a little bit of outsized impact. But on a dollar basis, that's a really relatively small number. And for us, a normal year in E&S for cats is about 2.5 points based on that profile. So a little bit of geographic difference, in that we have a little bit of Gulf exposure in our E&S portfolio, not true coastal, more inland. But we don't have that exposure in the Standard Lines.

The Standard Lines was more driven by those 2 events that we mentioned, which was Hurricane Isaias, which clearly was an East Coast event and came up through New Jersey and Pennsylvania and the Northeast. And then the derecho, which was predominately for us an Iowa event and in many ways, more slanted towards Personal Lines, and Iowa is a Personal Lines state for us and hit us particularly hard based on the location of that particular event. So I would say those are the primary drivers of the difference.

But again, I'll highlight for us, yes, it's 2 quarters of elevated catastrophe losses from fairly localized events and a lot of small events. But our long-term portfolio mix has not changed in any meaningful way. And I think you want to focus on the longer-term trends and even if you assume some industry-wide increase in expected cat losses, it's still relatively low compared to the industry for us.

Operator

The next question is from the line of Mark Dwelle from RBC Capital Markets.

Mark Alan Dwelle - *RBC Capital Markets, Research Division - Director of Insurance Equity Research*

A couple of things. First, Mark, you had described, when you were talking about the investment portfolio, some type of a shift or reinvestment shift. Could you go through that again? I was -- I couldn't quite get it all down.

Mark Alexander Wilcox - *Selective Insurance Group, Inc. - Executive VP & CFO*

Sure, Mark. Let me kind of walk you through what I was referring to, which is our investment philosophy hasn't changed. We will continue to have a very conservative investment philosophy. So let me start with that. Embedded within the asset allocation, there are a number of different fixed income classes that we have and we have a relatively sizable allocation to agency...

Operator

Please stand by as we try to recover connection with our speakers.

Mark Alexander Wilcox - *Selective Insurance Group, Inc. - Executive VP & CFO*

Operator, can you confirm we have reconnected?

Operator

Yes, sir, we are now back live. You may proceed.

Mark Alexander Wilcox - *Selective Insurance Group, Inc. - Executive VP & CFO*

Okay. Apologies for that everybody. So let me start back into the question Mark had on the shift in -- slight shift in investment portfolio. So we have an allocation to agency RMBS, it's a highly rated asset class, principally AAA, about just over $1 billion of market value. That has some negative convexity and as interest rates go down, you tend to see an elevated level of prepayment activity. And what we've seen this year is an elevated level of prepayments coming in through the agency RMBS that we need to put back to work. The new money yield on those securities is around 1 point today. So we continue to redeploy the non-sale disposals back into agency RMBS. It will be a pretty significant drag on the overall book yield.

So we're looking to redeploy those cash flows back into other very high-quality fixed income securities, where we can pick up additional book yield. Over time, as we redeploy at slightly lower credit average -- credit ratings, we could see just a slight migration of the overall average credit rating of the investment portfolio ticking down modestly from a AA- to an A+. But overall, we'll continue to maintain a conservative investment portfolio with principally a majority allocation to fixed income and short-term investments. So Mark, I don't -- hopefully, you're still on and connected.

Mark Alan Dwelle - *RBC Capital Markets, Research Division - Director of Insurance Equity Research*

I think I'm still on, can you hear me?

Mark Alexander Wilcox - *Selective Insurance Group, Inc. - Executive VP & CFO*

Yes, we can. Thank you.

Mark Alan Dwelle - *RBC Capital Markets, Research Division - Director of Insurance Equity Research*

Okay. Yes, that was helpful, notwithstanding the glitch. Second question kind of just relates to workers' compensation. We've heard some commentary over the course of earnings season that maybe there's some firming in pricing happening. I was just curious what your experience had been in that area or in that line.

John Joseph Marchioni - *Selective Insurance Group, Inc. - CEO, President & Employee Director*

Yes. I would say from a pricing perspective, what we see in our own portfolio, I would describe as slight movement. So 2% negative in the quarter versus 2.5% on a year-to-date basis. So it's just a small movement. I do think the pricing environment in workers' comp, and there's really 2 aspects to it. One is what's happening in terms of filed loss costs by the NCCI and individual state bureaus, and then the second consideration and aspect to it is, what is the market doing beyond what filed loss cost changes are.

Let me start with the filed loss cost changes, which have continued to be negative, although less negative. And I make that as a general statement, obviously, that's going to vary from one state to the next. And I think that was trending towards closer to 0, if you roll this forward, pre-COVID. I think the manner in which the NCCI and the various state rating bureaus incorporate or ignore the COVID impacts is yet to be seen, and then add to that, what the regulatory response is to those loss cost filings in the current environment. And I think that's an unknown relative to what happens as we move into '21 on the loss cost filings.

With regard to the market conditions, I would say, we've seen -- and I would say it's continued or accelerated, but for the last few years, you're seeing a market competitive move beyond what was filed in terms of loss costs. And I say not just in individual discretionary credits, but you've also seen, specifically on low hazard 4-wall type exposures, you've seen significant increases in commission by a number of market participants as a way to improve their competitive position.

I can't say I've seen that change materially in the last quarter, it might on a go-forward basis because of the concerns over the underlying loss cost. We continue to view workers' comp as a very competitive line in the marketplace, and I think you see it in our own growth of that line relative to the other lines which has been well below the package business we write with our other major lines of business. So I guess, Mark, the short answer would be I have not seen a material change at this point.

Mark Alan Dwelle - *RBC Capital Markets, Research Division - Director of Insurance Equity Research*

That's really very helpful color. One last question, if I can. Your expense ratio improved, and you made a few comments about that. I know it's been an area that you've been focusing on for some time anyway. Is there any way you can kind of just generally split out of a couple of points of expense ratio improvement? How much of that you might view as kind of ongoing or sustainable relative to just some savings that are the byproduct of the current situation?

Mark Alexander Wilcox - *Selective Insurance Group, Inc. - Executive VP & CFO*

Sure, Mark. Let me start and John can jump in as well. So if you look at our expense ratio on a year-to-date basis, we're sitting at 33.9%, and that is elevated versus our expectations for 2020. We put our guidance out back in late January, we were forecasting some expense ratio improvement taking it down from a 33.8% to a 33.4%. But included in the 33.9% are the COVID-19-related charges. So when you think about the lower earned premium from premium credits as well as the auditable premium adjustment we put out as well as the increased bad debt, that's about a 1.5 percentage point drag on the expense ratio year-to-date.

So what I would refer to is the underlying expense ratio is 32.4% year-to-date, which is about 1 point better than we were expecting for the full year. I would characterize most of that point, as I did earlier, that one point benefit, as temporary in nature. When you think about the deferred hiring, short-term deferrals and projects, lower travel and entertainment expenses and also booking incentive compensation to a lower payout ratio, given the reduced profitability from COVID-19 and the cats. About 1 point of that benefit, I think, is temporary in the current year.

Not to say that we wouldn't see expense ratio improvement as we move ahead. We do strongly believe that we can continue to rationalize our expense base, leverage our infrastructure, continue to make the necessary investments, but we would point to a target in the short to medium term of about 32% as an appropriate expense ratio, given our mix of business between Commercial Lines, E&S and Personal Lines. So we're not necessarily saying that's what we're looking for next year, we'll present our updated guidance come January 2021, but we do believe there's some benefits to come in the next couple of years.

John Joseph Marchioni - *Selective Insurance Group, Inc. - CEO, President & Employee Director*

And I would just add to that, I think, Mark hit all the key points. I do think some of what might be perceived as short-term related benefits do have some long-lasting effect. And I'm not in the camp that the work-from-home environment is a permanent shift, but I do think, clearly, there's a positive impact with T&E expenses of some portion going forward, mostly with intracompany travel, where meetings can be done virtually that were previously done with individual employees traveling from one office to another. And I also think, as I mentioned in my prepared comments, the virtual delivery of claims and safety management services has received high marks, and I think the pace at which that got deployed and accepted both by our professionals and by customers and agents, I think has been accelerated because of that. And there's a clear efficiency gain in that when you think about the capacity of your employees in those different disciplines to deliver that service to more customers by doing it virtually.

I think there's some long-term benefit from that perspective as well on top of everything else that Mark has highlighted that we're focused on to drive greater efficiencies going forward.

Operator

The last question is from Bob Farnam from Boenning and Scattergood.

Robert Edward Farnam - *Boenning and Scattergood, Inc., Research Division - MD and Senior Analyst for Property & Casualty Insurance*

You mentioned the rollout of the streamlined small business product, I just wanted a little bit more color there. I didn't know -- is that something that was suggested by agents? Is the businesses that you're targeting are the same type and size that your standard business is? I imagine it's early, but have you gotten any feedback yet from the rollout in the few agents that you have gotten it out to?

John Joseph Marchioni - *Selective Insurance Group, Inc. - CEO, President & Employee Director*

Yes. Great questions. And so small business has always been a core part of who we are and the business we write. And I think if you look back over the last decade or two, we would have always been rated by agents as one of the easiest companies to do business in this space. But obviously, that line of best in class is constantly moving with technology advancements and other market participants advancing. So through our own evaluation and clearly feedback from agents, I think we saw the need to invest in a complete redesign of that interface, taking advantage of a lot of the technology and the intelligence -- artificial intelligence, that's available to us to streamline the amount of information required to generate a quote to allow more business to flow through. And that's really the investment we're making.

I would say if you look at our portfolio of small accounts, we've generally been viewed as the best company in the market for small contractors. And I think we've been trying to improve our competitive position more specifically on BOP type accounts. So more of the retail, professional service type accounts, where we certainly write that, but have been a little bit further off on the competitive positioning side. And I think that's what we would expect to see the greatest lift.

To your other point, the feedback that -- and we've deployed this with about 150 agents to this point relative to the business owner policy, umbrella, EPL, and automobile. And I would say the feedback has been excellent. And the feedback really in terms of speed and also amount of information required to generate a quote. So we'll continue to roll that out. But I don't think other than maybe around the edges for some of that BOP type business, this would be necessarily a significant shift, but we think it provides additional growth opportunity beyond what you've seen from us on a run rate basis for this segment of the market that we haven't been generating as much growth as we have in small contractors and core middle market across all segments.

Robert Edward Farnam - *Boenning and Scattergood, Inc., Research Division - MD and Senior Analyst for Property & Casualty Insurance*

Yes. That was actually one of my follow-up questions was is this -- since you're automating quite a bit of this, is this going to have an expense ratio advantage or perhaps an advantage on the loss ratio, but it sounds like this is more of a growth vehicle than a profitability type vehicle.

John Joseph Marchioni - *Selective Insurance Group, Inc. - CEO, President & Employee Director*

It is a growth vehicle. But I think to your point, the cost of acquisition of this business is lower relative to the business that's more manually underwritten by our underwriting staff. So over time, there is some incremental expense ratio benefit. And also at the same time, as you know, this business does tend to carry higher retention rates with it, which also generates a loss ratio benefit over the long term. So I think there is certainly near-term benefit on the growth side, but I think there's also some longer-term benefit on the combined ratio side as well.

Operator

At this time, there are no further questions on queue.

John Joseph Marchioni - *Selective Insurance Group, Inc. - CEO, President & Employee Director*

Well, thank you all for joining. We apologize for that brief technical glitch that knocked us off-line, and appreciate all the questions and participation. And any follow-ups, please reach out to Mark or Rohan. Thank you, and have a great day.

Operator

That concludes the conference. Thank you all for participating. You may now disconnect.
