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SIGI - Q3 2018 Selective Insurance Group Inc Earnings Call

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PRESENTATION

Operator

Good day, everyone. Welcome to Selective Insurance Group's Third Quarter 2018 Earnings Conference Call. At this time, for opening remarks and introduction, I would like to hand the call over to Senior Vice President, Investor Relations and Treasurer, Rohan Pai.

Rohan Pai

Thank you, and good morning. This call is being simulcast on our website, and the replay will the available through November 26, 2018. A supplemental investor package, which includes GAAP reconciliation of non-GAAP financial measures referenced on this call, is available on the Investors page of our website, www.selective.com.

Certain GAAP financial measures stated in today's call are also included in our previously filed annual report on Form 10-K and quarterly Form 10-Q reports. To analyze trends in our operations, we use non-GAAP operating income, which is net income excluding the after-tax impact of net realized gains or losses on investments and unrealized gains or losses on equity securities. 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 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 risk 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.

On today's call are the following members of Selective's executive management team: Greg Murphy, Chief Executive Officer; John Marchioni, President and Chief Operating Officer; and Mark Wilcox, Chief Financial Officer.

And with that, I'll turn the call over to Greg.

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

Thank you, Rohan, and good morning. I'll make some first introductory remarks that focus on some high-level themes for the quarter as well as those that continue to drive our strategy for profitable growth. Mark then will discuss our financial results, and John will review our insurance operations in more detail, providing additional color on key underwriting initiatives. We generated excellent results in the third quarter as each of our underwriting segments contributed to strong profitability. Our overall GAAP combined ratio of 94.6, generated 6.1 points of return on equity or ROE. Our investment department had a spectacular quarter with net investment income after tax up 45% to $43 million, which added 10 points of ROE. Our third quarter results were particularly impressive in the context of elevated catastrophe losses, highlighting the strength of our underlying business.

For the quarter our annualized non-GAAP operating ROE was 13.8, about 200 basis points above our target of 12%. We established a high bar by targeting our return on equity at 300 over our weighted average cost of capital. For the quarter, consolidated net premium written growth was a robust 8%, driven by renewal pure pricing momentum and strong retention rates. For the third quarter, the underlying combined ratio, or after adjusting for catastrophe losses and prior year casualty reserve development, was 92. For the 9 months of the year, we reported a consolidated combined ratio of 95.8. Our investment results reflect: one, an effective tax rate of 18%, down 8.6 points from 2017; two, alternative investments added $6 million after tax; and 3, tactical moves we've been making to optimize after-tax investment income on a risk-adjusted basis. Our investment portfolio is conservatively managed from a credit and duration standpoint at $3.37 of investments per dollar of stockholders' equity, generating a 10% return on equity. This year we've been executing on 4 major initiatives. One, achieving overall standard in Commercial Lines pure price increases in excess of expected claim inflation as well as improving the business mix. Two, continuing to deploy our customer experience strategy and value-added services that should increase both retention and new business hit ratios. Three, improving profitability in our Excess and Surplus Line segment. And four, building supplemental sources of growth: a, additional agents in our existing 22 states; and b, pursuing growth and diversification through geographic expansion. We are an execution-focused company, and we've made major strides in each of these areas. First, we achieved overall renewal pure price increases to 3.7 points in our Standard Commercial Lines segment for the third quarter, close to expected claim inflation levels. We are pleased to see the Towers Watson CLIPS second quarter commercial lines renewal pure pricing survey up 130 basis points sequentially to 2.8 points, which should provide an additional amount of tailwind. For the remainder of the year, we expect to continue to edge pricing higher, particularly in light of the ongoing industry pressures in commercial automobile and property lines, which should help sustain our underwriting margins in 2019 as prices are earned. We provide our frontline and inside underwriters with sophisticated tools that help improve the business mix while maintaining or even increasing retention levels.

Second, as we discussed last quarter, we've made considerable progress in improving the overall customer experience strategy, with the goals towards increasing customer switching costs. We are pleased with the adoption rates on our digital self-service platform and continue to enhance customer engagement through initiatives such as proactive messaging.

We have begun to roll out our Selective Drive sensor and mobile application technologies to customers, which will enhance their fleet management capability and monitoring of driver behavior. The ability to access and service the business by utilizing technology solutions will be critical as we position ourselves for the future.

Third, we've been taking active steps to address profitability in our E&S segment, where results in recent quarters have lagged our expectations. We continue to, one, implement targeted rate increases. Two, eliminate challenged segments. And three, drive ongoing claim improvements. Finally, our geographic expansion efforts remain well on track. We opened Arizona and New Hampshire in 2017 and entered Colorado earlier this year. As of the fourth quarter, we are now also operational in Utah and New Mexico, which increases our Commercial Lines states to 27. We're looking forward to a long-term strategic partnerships, and we're very happy with agent and customer receptivity in the new states.

I'd also like to share some thoughts on weather-related losses, which for the past 2 years have been elevated for the industry. While the damage from Hurricane Florence was certainly devastating to the affected communities, losses would have been far worse had it struck the coastline as a Category 3 hurricane as initially projected. Hurricane Michael was the strongest hurricane making landfall in the Florida Panhandle in over 150 years as it approached as a strong Category 4 storm. The series of Atlantic storms over the past 2-year period serve a significant reminder of the potential for severe losses and the inherent volatility assumed in the property lines. Add to this the non-CAT weather-related losses, which have also been running high for the industry for the past number of quarters.

When you look at the context of the competitive pricing environment for property business, in recent years, the industry certainly appears to be adopting a hope strategy rather than one that's based on fundamental trends.

While still relatively early, given the complexity of losses involved, our initial estimate for losses from Hurricane Michael is approximately $10 million. We take an extremely conservative approach to managing our catastrophe aggregations and risk, with a property-CAT program that limits losses from a single 0.4% probability event loss to approximately 5% of stockholders' equity. Moreover, our reinsurance program limits any losses in the non-footprint states such as Florida to $5 million.

Turning to guidance. After 3 quarters of results, we are increasing our full year 2018 after-tax investment income guidance by $6 million to $156 million as well as increasing catastrophe losses by 0.5 points to 4 points. All other assumptions remain the same, and our full year expectations are as follows. A GAAP combined ratio, excluding catastrophe losses of 92%. This assumes no fourth quarter 2018 prior year casualty development. Catastrophe losses of 4 points, reflecting 2 hurricanes. After-tax investment income of $156 million. An overall effective tax rate of approximately 18%, which includes an effective tax rate of 17% for net investment income, reflecting a tax rate of 5.25 for tax-advantaged municipal bonds and a tax rate of 21% for all other investments and weighted average shares of 59.6 million.

Now 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, Greg, and good morning. For the quarter, we reported fully diluted earnings per share of $0.93 and non-GAAP operating earnings per share of $0.99. The annualized dollar ROE was 12.9% and the annualized non-GAAP operating ROE was a very strong 13.8%. As a result of our solid financial results over the past 2 quarters, our year-to-date annualized non-GAAP operating ROE has improved to 11.3%. Although a strong result on a year-to-date basis, particularly in light of the property losses we incurred in the first quarter and a major hurricane in our footprint in the third quarter, it is below our target of 12% for 2018.

Consolidated net premiums written increased 8% in the third quarter, driven by 6% growth in our Standard Commercial Line segment, 4% growth in Personal Lines and 27% growth for the E&S segment. The growth in standard lines was driven by continued strong pure renewal price increases and high retention rates. New business was down on a comparative quarter basis.

Growth in the E&S segment was the result of a new producer relationship that incepted during the quarter. The consolidated combined ratio was a solid 94.6% in the third quarter. On an underlying basis or adjusting for catastrophe losses at prior year casualty reserve development, our combined ratio was 92%, largely in line with the year ago level. For the first 9 months of the year, our consolidated combined ratio was 95.8% and the underlying combined ratio was 93.1%. Our ex CAT combined ratio was 90% for the quarter and 91.8% year to date.

For the quarter, catastrophe losses added 4.6 percentage points to the combined ratio. Losses from Hurricane Florence accounted for $15 million on a pretax basis or 2.4 combined ratio points. As a result of our participation in FEMA's National Flood Insurance Program, we've recorded approximately $1 million of claims handling revenue from Hurricane Florence in the quarter. Noncatastrophe property losses in the quarter equated to 14.6 points on the combined ratio, which was about 1.4 points above our expectations. Year-to-date, non-CAT property losses impacted the combined ratio by 15.4 percentage points, which is 2.7 percentage points higher than the comparative period of 2017 and is also above our expectations.

During the third quarter we experienced $12 million of net favorable prior year casualty reserve development, which reduced the quarter's combined ratio by 2 percentage points. Better-than-expected claims emergence in our Workers' Compensation line totaling $20 million and General Liability line totaling $8 million were partially offset by $10 million of adverse development in our commercial auto line of business and $6 million of adverse prior year casualty reserve development for our E&S segment, principally related to 2015 accident year for E&S.

We also experienced some pressure on the 2018 accident year, principally driven by commercial auto, which negatively impacted our consolidated combined ratio by 1.5 percentage points in the quarter. Our expense ratio was 32.5% for the third quarter, which is down 1.4 percentage points compared to the year ago, mainly due to ongoing expense discipline we've been highlighting in recent quarters, coupled with a modest decline in profit-base incentive to our agents and employees due to a high-than-expected combined ratio thus far in 2018.

For the first 9 months of the year, the expense ratio of 33% is down 120 basis points from the comparative period of '17. We remain focused on seeking out areas of efficiency and cost savings while continuing to invest in our employees and in key initiatives around geographic expansion, enhancing our underwriting tools, technology and the customer experience. The profit-based portion of our expense ratio is about 3.3 points thus far in 2018 compared to 3.8 points in '17.

Corporate expenses, which are principally comprised of holding company costs and long-term stock compensation totaled $7.5 million in the third quarter, and we're up $1.2 million on a pretax basis relative to the comparative quarter. The primary reason for the increase was high long-term stock compensation expense, resulting from the significant increase in our share price during the quarter. While we expect there to be quarterly volatility in this line item based on fluctuations in our share price, we have made some structural changes to our long term share-based compensation program back in early 2017 and that should lead to lower costs as well as lower volatility over time. Year-to-date, corporate expenses are down $4.6 million.

Turning to investments. For the quarter, net investment income after tax was a very strong $43 million, which is up 45% from a year ago and is driven by high yields on our fixed income investments, strong income from our alternative investments and the lower corporate tax rate. Overall, the after-tax yield on the fixed-income portfolio was 2.84% during the third quarter compared to 2.2% a year ago. The new money yield on the fixed-income portfolio during the third quarter was 2.9% after tax. We continue to actively manage the investment portfolio, tactically seeking opportunities to increase the after tax book yield on a risk-adjusted basis. Year-to-date, the pretax book yield on our core fixed-income portfolio is up 37 basis points as we picked up another 8 basis points of pretax book yield in the third quarter.

The increase in book yield is driven by 2 main factors. First, approximately 17% of our fixed-income portfolio is in floating-rate securities, which reset based principally on 90-day LIBOR, with the increase in interest rates this year, specifically the front end of the curve, the book yield for our fixed-income portfolio has benefited from a 70 basis point increase in 90-day LIBOR and the portfolio is currently very well positioned to benefit further if the front end of the curve continues to move up.

Secondly, we've been actively managing our core fixed-income portfolio with $2 billion of purchases this year, increasing the book yield while keeping our risk profile consistent. Our average credit rating remains strong at AA minus and the effective duration of our fixed income and short-term investments portfolio is relatively unchanged at 3.7 years. Risk assets, which principally include high-yield fixed-income securities, public equities and alternative portfolio accounted for 7.3% of total invested assets at the end of the third quarter. We've been gradually diversifying our portfolio risk assets and we've worked towards modestly increasing our allocation over time to about 10%, depending on the conditions and opportunities. However, thus far in 2018, high-yield credit spreads have remained high and equity valuations have remained elevated, and we have modestly reduced our risk assets from 7.9% at year end to 7.3% at the end of the quarter. We continue to diversify our alternative portfolio by making targeted commitments. But these commitments will take some time to fund and impact our overall level of risk assets. Our other investment portfolio, which primarily consists of limited partnerships and private equity, private credit, real asset investments and reports on a one quarter lag, generated pretax income of $7.2 million for the quarter compared to $2.7 million in the year-ago period.

Turning to capital. Our balance sheet remains strong with $1.7 billion of GAAP equity, and we are adequately capitalized to support our expected growth. We continue to adopt a conservative stance with respect to managing our underwriting risk appetite, investment portfolio, reserving processes, reinsurance buying and catastrophe risk management.

Our debt-to-capital ratio of 20.2% at the end of the third quarter is trending below our longer-term target of approximately 25%. With our 1.4x premiums to surplus ratio, it means that each point of underwriting margin equates to 110 basis points of ROE.

In addition, a 3.37x investment leverage implies that every 100 basis points of pretax book yield from our investment portfolio results in 276 basis points of ROE. Based on our strong financial position and future earnings potential, we have increased our quarterly dividend by 11% to $0.20 per share.

With that, I'll turn the call over to John to discuss our insurance operations.

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

Thanks, Mark, and good morning. I'll begin with an overview of some of our strategic initiatives and then discuss the results of our insurance operations by segment. In particular, we're focused on our geographic expansion plans and initiatives leveraging technology to enhance the overall customer experience. These are key areas that will drive our ability to generate sustained out performance in the years to come. Our long term Commercial Lines targets are to build distribution partner relationships, representing 25% of their markets and seek a 12% share of wallet in each agency. This translates to a goal of 3% market share in Commercial Lines or an additional premium opportunity in excess of $2 billion in our existing footprint. So far this year, we've appointed 90 new distribution partners, including our newly opened states of New Mexico and Utah, bringing the total to over 1,300 and approximately 2,200 store fronts. We've been successfully executing on our geographic expansion plans, which have been outlined in recent quarters. We've established a strong presence in the Southwest with the opening of Utah and New Mexico for Commercial Lines earlier this month, complementing the recent expansion in Arizona and Colorado. We maintained our franchise distribution strategy in these states, opening Arizona with 18 partners, Colorado with 10, Utah with 8 and New Mexico with 6. We are also moving forward with our plans to open Arizona and Utah for Personal Lines in the fourth quarter of this year. Our early results are strong, and we're pleased with the quality of new business opportunities being presented.

We continue to invest in technologies that help us enhance the overall customer experience with a goal towards increasing retention rates over time. We strive to deliver a superior omni-channel experience, enabling our customers to interact with us in a 24/7 environment in a manner of their choosing. Policyholders who prefer a fully digital experience now have that option available to them. Take up rates for our digital platform offerings are strong in both personal and Commercial Lines. Our master data management capability provide us with a 360-degree view of our customers, enhancing our ability to service our policyholders and distribution partners effectively. This information allows us to engage with our customers through proactive messaging in relation to product recalls, potential loss activity or policy changes in the manner of their choosing.

We are executing on this path in concert with our agency partners, so that our customers will have a seamless experience regardless of how they choose to interact with us. As we mentioned in our last call, we are looking for ways to employ technology solutions to add value for our clients, with a goal towards further increasing customer satisfaction. We expect these initiatives to over time help increase new business hit ratios and retention rates. For example, we rolled out our Selective Drive program in a pilot phase for 20 Commercial Lines policyholders with auto fleets. This platform uses connected telematics sensors to improve fleet management and driving behavior. Selective Drive provides information such as driver speed, location and route and harsh driving events such as sudden breaking and turning. It can also detect distracted driving by measuring when the driver's phone is accessed while the vehicle is in motion. We expect that over time this service, which is currently offered free of charge to customers will add business value for our customers while also leading to improved driving behavior.

Turning to our underwriting operations. Our Standard Commercial Lines segment, which represented 79% of premiums for the first 9 months, generated 6% net premiums written growth for the quarter, driven by stable retention of 84% and overall renewal pure price increases of 3.7%. Our ability to maintain stable retention rates while achieving strong renewal pricing is a testament to our relationship with our distribution partners. The Commercial Lines segment generated a combined ratio of 94.5% on a reported basis and 93.6% on an underlying basis. For the first 9 months of the year, the segment generated a 94.8% combined ratio on a reported basis and 93.6% on an underwriting basis. For the highest-quality Standard Commercial Lines accounts, based on future profitability expectations, we achieved renewal pure rate of 2.2% for the first 9 months of the year and point of renewal retention of 91%. This cohort represented 49% of our Commercial Lines premium for the year-to-date. On the lower-quality accounts, which represented 11% of premium for the first 9 months, we achieved renewal pure rate of 7.8% while retaining 77% at point of renewal. This granular approach to administering our renewal pricing strategy allows us to achieve additional loss ratio improvement for mix of business changes while continuing to deliver pure rate increases that equal or exceed expected claim inflation. Direct new business premiums declined 7% for the third quarter but we're up 2% for the first 9 months of the year. The decline in new business in the quarter reflects the generally competitive market conditions as companies continue to seek out new growth opportunities. We remain focused on generating new business growth, but will do so within the context of our disciplined underwriting and pricing philosophy.

Going down to the results by line for Commercial Lines, our largest line of business, General Liability, generated a combined ratio of 84.3% in the quarter and 88.2% for the first 9 months in the year. We achieved year-to-date renewal pure price increases of 2.7% for this line. Reserve releases totaled $8 million in the third quarter, primarily due to favorable development on loss adjustment expenses for accident years 2014 through 2017. Decrease in frequency trends had led to meaningful favorable reserve development over the past several years, but reserve releases have moderated substantially so far this year. The Workers' Compensation combined ratio was 70.3% in the third quarter and 74.1% for the first 9 months of the year. This line experienced $20 million of favorable prior year reserve development for the quarter as a result of lower-than-expected severities for accident years 2016 and prior. On a year-to-date basis, we achieved 0.1% of renewal pure price as we have worked to hold the line in the context of significant industry-wide pressure. While reported profitability remained strong due to favorable emergence on prior year reserves, current accident year margins do not support significant reductions in overall rate levels. In particular, while medical inflation has been modest in recent years, the reversal of those trends can lead to significant increase in lost costs, affecting both current and prior accident years.

Commercial auto results remain challenge for the industry and for us. In the case of our book, elevated loss experience has mainly been the result of higher liability of frequencies. The commercial auto combined ratio was 118.2 in the third quarter and 112.8 for the first 9 months in the year. Results from the quarter included $10 million of unfavorable prior year casualty reserve development due to higher claim frequencies as well as increases in claim severities in accident years 2016 and 2017. In addition, we increased the current year loss estimate during the quarter by $13 million, taking into account the elevated loss experience. We've been taking active steps to address profitability in this line by implementing price increases that have averaged 7.4% so far this year. This is on top of price increases of 6.7% in 2017 and 4.9% in 2016.

Unfortunately, we have seen a continued increase in loss frequencies and severities that have offset the benefit of earned price increases. As such, we believe that the elevated loss trends should support additional rate moving forward. In addition to price increases, we've also been actively managing our new and renewal books in targeted industry segments and reducing exposures to higher hazard classes. Our initiatives around the Selective Drive sensor technology program should also help with loss experience by improving driving habits.

Our commercial property book generated 108.1% combined ratio for the third quarter and 103.8% combined ratio for the first 9 months of the year. Results this year have been impacted by substantial catastrophe and noncatastrophe weather losses. This line remains generally competitive, but despite elevated levels of CAT and non-CAT losses for the industry over the past few years. While industry pricing appears to be heading in the right direction, recent loss activity suggests more rate is needed to reflect the inherent volatility of this line. Renewal pure price increases for commercial property business averaged 4% so far this year and have climbed since the start of the year.

Our Personal Line segment, which represented 12% of premiums for the first 9 months generated 4% growth in the quarter driven by growth in personal auto. The Personal Lines segment produced profitable combined ratio of 95.9% in the third quarter and 97.2% for the first 9 months. Weather-related losses were elevated but manageable. We've made significant progress in lowering the expense ratio for this segment, which was 27.9% for the first 9 months, a significant 310 basis point improvement from a year ago. Lower data costs, reduced expenses for technology development and benefits from increased scale have all helped drive the expense ratio down. The homeowners' line generated a combined ratio of 102% during third quarter, including 16.1 points of catastrophe losses. Net premiums written were approximately flat compared with prior year due to a competitive pricing environment and efforts we've been taking to limit catastrophe exposure. Our plans for 2018 incorporate rate filings averaging 3.4% for this line. In personal auto, net premiums written increased 7% compared to the same prior year period, driven by higher pricing and new business growth. Renewal pure price increases on our book averaged approximately 6.1% during the quarter. The combined ratio for personal auto was 101% in the third quarter and 103% for the first 9 months of the year.

Profitability for this line should improve with the benefits of greater scale and efficiencies along with generating earned rate in excess of expected claim inflation.

Our plans for 2018 incorporate rate filings averaging approximately 8%. Our E&S segment, which represented 9% of total net premiums written for the first 9 months generated 27% growth in the third quarter compared with the year ago period. For the first 9 months, net premiums written increased 7%.

Over the past year we have taken steps to exit some underperforming classes while entering into new distribution relationships. The premium growth in the third quarter reflects the impact of 1 particularly large relationship that we reestablished in the second quarter of 2018. The combined ratio was 93.7% for the quarter and 103% for the first 9 months. Results in the third quarter included $6 million of net unfavorable reserve development relating primarily to the 2015 accident year.

Overall price increases in E&S casualty lines averaged 2.9% in the third quarter. We've been aggressively addressing profitability in this segment through targeted price increases, business mix shifts and improved underwriting standards. We feel good about the pricing on the in-force book, which is essentially at target levels. While the emergence of adverse development on prior year reserves has been a disappointment, we believe the steps we have been taking set us on the right path for profitability.

Overall, we remain extremely pleased with our market position and execution of our plans for generating profitable growth. By maintaining a steadfast focus on underwriting discipline, we've been achieving pure price that is exceeding our current estimates for loss inflation. The investments we are making today in our franchise distribution model, sophisticated underwriting tools and technology and enhancing the overall customer experience in an omni-channel environment remain differentiating factors and position us well for sustained out performance.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Christopher Campbell with KBW.

Christopher Campbell - *Keefe, Bruyette, & Woods, Inc., Research Division - Analyst*

I guess first question is just kind of on pricing and Commercial Lines. SIGI got, like, 370 bps, which was up 20 bps. Whereas, if I'm looking across kind of larger competitors you guys would compete with in that small commercial space, one was kind of flat quarter-over-quarter and then another one was down 130 bps. So I guess just qualitative, why are (inaudible) rates better than competitors when we're looking across there? And what are you guys doing differently? And are you seeing a trend for kind of these larger national carriers? So like, are they resisting rate increases for retention, I guess? What's the competitive dynamic you guys are seeing?

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

Chris, thank you. This is John. And personally, I appreciate the question. And I'll explain our perspective on why we think we're able to continue to perform extremely well relative to that balance between rate and retention. And then we can get into our conversation about the competitive environment, but I can't really speak with confidence in terms of how other companies view that balance between rate or retention. From our perspective, we've now established a very long track record, dating back to 2009, in terms of managing to our overall rate targets and our rate targets relative to how we think about expected claim inflation or claims' trends. We really attribute it to 2 factors that have been very consistent for us. Number one is we think that we have a high degree of sophistication in terms of the underwriting and pricing models that we utilize and the manner in which we deliver to our underwriters on both new and renewal business at a point of an individual transaction very specific pricing guidance relative to the expected profitability on the bucket of business that, that account is placed into. So very granular approach, and we've been doing that now with modeling since the 2005 kind of time frame. So very mature on that perspective and continue to enhance those capabilities. But I would say the second part of this, and I think this is what really makes our approach unique, is that we're delivering this in a model that's supported by a high relationship, high-franchise value set of distribution partners. And I know a lot of companies will talk about having that. I think if you're looking for evidence of whether or not it's real, you have to look at retention rates relative to pricing. So our ability to have a conversation with an agency -- individual people in agencies' offices who control those books of business to explain what our pricing stance is on an account by account basis, manage the overall portfolio is a big point of differentiation. By having a franchise model or a limited distribution model, we own a significant position in every one of our agency partners, so our relationship is extremely important to them and it runs to both of our benefits to manage this effectively and therefore we get the opportunity to have last look on accounts and really execute our strategy effectively.

So we continue to view it that way. I think there are certainly differences by line in the competitive environment, and I think what you're seeing in Workers' Comp based on loss cost filings continue to be flat to negative across the country, which would suggest that frequency and severity trends will continue on that downward trend that they've been on. From a market perspective it's putting a lot of pressure on that line from a pricing perspective. Where we continue to run that line at about 0, which is probably better than what most companies will be reporting.

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As we've said in the prepared comments, commercial auto continues to support higher rate level. We continue to earn rate and have written rate in excess of 7%. And we think that the trends continue to support that for us and for the industry. And we have seen some improvement sequentially on the property line for us. And based on market surveys, I think that corresponds to the volatility we've seen. And as Greg has indicated, the entire market has seen on both the CAT and non-CAT basis for property. So that's kind of how I would see both the external environment, how we've managed the internal pricing strategy over the last several years.

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

And Chris, this is Greg. Let me just add a little bit to that in terms of -- and please don't be fooled by companies' changing the definition of renewal pure price. Exposure is exposure, payroll is an exposure. And you can't analyze your overall loss trends against the pricing number now that has all kinds of takeouts in it. We're in an industry that's been classic on playing takeout, but when it comes to performance, the biggest measurement of how you're going to perform next year is renewal pure price up against the expected loss inflation or claim inflation, which I say we're going through our budget process now. We'll probably going to see that number elevate just based on what we select for frequency in commercial auto. But you've always heard me say, hope is not a strategy and arithmetic has no mercy. And in the case of 2019 -- it's already done. 2019 is already finished because what you're going to earn rate-wise is already on -- is already in your inventory. So as John mentioned and you heard this through Mark's comments, we're very close to that renewal price at 4. That's kind of where my belief is you're going to see claim inflation. So when you're thinking about performance year-on-year, '19 to '18, it's going to be what are you doing in underwriting and claim improvement? And then how is your rate -- earned rate going to match up against your expected trend. So don't be fooled. I know you guys are focused on that. And that's how we manage our organization. Let's also remember that when you look at '19 to '18, we're in a good position on all our lines. Are we unsatisfied with our commercial auto result? Yes. But I will tell you, the things that we're seeing on comp in terms of what's being thrown out on the street in terms of credits, in terms of higher commissions, in terms of -- this is the longest tail with the longest medical inflation on it that the price levels that this is being thrown out at is getting to the point of disturbance.

Christopher Campbell - *Keefe, Bruyette, & Woods, Inc., Research Division - Analyst*

Got it, it's very helpful. So I just think -- I guess, digging in a little bit on Worker's Comp. So I think, John, you had mentioned like maybe like 10 bps of positive rate. You guys are trying to manage that to, like, flat, I guess, just as pricing is coming in. I guess just -- what are you guys seeing in terms of, like, your loss cost trends now? I mean, you've got some competitors that have talked about higher frequency. You guys are getting lower severity and releasing about $20 million of reserve. I guess, just how should we think about, like -- how are you feeling about the Worker's Comp book overall and then...

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

Yes. Chris, this is John. I'll start. I guess, we clearly have seen continued improvement in reserve development, which suggest that for both frequency and severity basis, our actual reserve development has continued to run better than expected. And that has been the trend for a number of years. But we also recognize that trend can't go down forever. And this is, in many cases, similar to where commercial auto was 5 to 10 years ago. And ultimately, the trend did soft and ultimately reversed itself. Without getting into too much specifics around actual frequencies from an overall perspective, less so in terms of versus expected, I think you are starting to see a little bit of a slowing of the downward trend in frequency. And I would describe an environment of more of a leveling off for us at this point from a Workers' Comp perspective.

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

And Chris, Greg here. I would focus more on the underlying combined ratio than I would reported. And when you look at our underlying at 90, call it the mid-96 range in our accident year. And in our internal targets that we sit there, which are risk adjusted, those are all fairly tight in the mid-90 range. And so what you're seeing pushing this around a little bit is very long term expected inflation rates versus actually what we're settling out some of the inventory and how some of the inventory is being pushed around. As John stated, frequency can't go to 0, right? I mean, it's not going to go to 0. And the question is no different than, what your actuaries are trying to figure out, when does the claim trend in commercial auto apex and start to level out or actually diminish. They're also looking at the comp line in terms of when does that flatten out to that side. So both of those trends can't go monotonically higher forever. So I just think I would keep that in line. Keep focused about where we are more on our underlying, and I would not -- and again -- I also want to emphasize, we are an account underwriter. We're not writing principally monoline, we're not writing monoline auto. We're not writing monoline comp. That doesn't mean we don't have a few policies in the inventory. But as an account underwriter, we're focused on the overall experience on the accounts.

Christopher Campbell - *Keefe, Bruyette, & Woods, Inc., Research Division - Analyst*

Yes, it makes sense. And then just one final one on the E&S segment. So you had about $6 million of adverse developments of kind of some (inaudible) business in there, but the core loss ratio is down, like, I guess, 13% sequentially. So looks like you're writing some good new business or you're shifting the mix maybe towards more property versus casualty? So I guess just given your history here, like, why are you confident in putting off like kind of a (inaudible)

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

Let me start on that, Chris. I would not be -- I would not put up an enormous amount of focus on that quarter number. That quarter number was significantly benefited by way lower non-CAT property than expected and catastrophe than expected. So that number really adjusted is more in the upper 90s, which is where the books run. So that is what I would keep the focus on.

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

And this is John. I'll just add to Greg's point, which is from a mix perspective, there has been no significant shift from a casualty to property. That continues to be in 75% casualty range. And no real change in mix. But again, as we've said for a number of quarters now, we continue to like where new business pricing is coming in and where the renewal inventory is migrating to. So overall pricing levels on the existing in force inventory, we like where they are. And unfortunately we continue to see some adverse development in some of the older accident years.

Operator

Our next question comes from Mike Zaremski with Crédit Suisse.

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

If we could move -- I know it's not a huge line for you, but personal auto, you said you're going to keep pushing for -- looked like high single-digit rate increases. It feels like competitors have been -- have seen kind of much improved results. And are kind of saying that they don't need to push for what they -- they were -- the high singles that -- they were earlier in the year or last year. So just kind of curious maybe your starting point was worse or what are you guys seeing in personal auto?

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

Mike, thank you. This is John. I'll start on the question. So our reported combined ratios, as you saw for the first quarter, were 101% and 103% per 9 months. We have seen significant improvement over the last several years. And our rate level continues to be strong. And as we said in our prepared comments, our current rate filings for '18 are averaging about 8%. And when you think about where trends are from our perspective, we need to continue to get rate in excess of trends. Greg's comments earlier about the overall industry certainly apply to personal auto. So I think even if there are industry participants recording flattening or normalizing frequency trends, you still have an inflationary factor that's going to drive up loss cost on a go forward basis if -- even if there's no movements year-over-year in frequency. And when you add to that the fact that a lot of the increase on the physical damage side of the line is driven -- and also what is PB liability is driven by the increased cost of repairing vehicles because of all of this advanced technology that's not going to slow down, because if fleets continue to turn over, model years continue to turnover and the percentage of vehicles on the road that have advanced technology and sensors and therefore are higher cost to repair, we don't assume that's going to stop. So our expectation is that we were able to hard book, but our expectation is when you look at industry performance and assume just normal loss cost inflation going forward, more rate is needed for the overall industry. And that's the stance we're taking on this line.

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

Okay, great. And maybe sticking with auto, but to commercial auto. You guys mentioned your telematics offering. Just curious if you think your agent partners like -- it's kind of -- it's different than what they're used to offering. Are they acceptive of -- even can be acceptive of telematics for commercial auto, because it seems like commercial auto is ripe for it given the industry's issues. But I don't know if the drivers or the agents want to push for telematics?

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

Yes. Thanks, Mike. This is John, again. So I would say, our agents are excited about this. And as one point of clarification, this product that we offer, Selective Drive, is not used for purposes of rating individual accounts. What we have here from an agent's perspective is a value-added product now that they can go out and offer to their customer that helps them better manage their organization, better manage their fleet, not just from a safety perspective, the benefits are clear on the safety side, but it also helps them in terms of logistics management. Understanding where their vehicles are at any point in time and to the extent they need to redirect vehicles to a job opportunity or delivery opportunity, whatever it might be, they now are getting real-time information about where their vehicles are in addition to how they're being operated. In terms of a loss benefit side, there's no question. If anybody is unhappy about this program or be the individual drivers whose behavior is now being more closely monitored, but the business owner and the agent will get enormous value out of this. And I think that's how they're viewing it and it's a really value-added service offering.

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

And I -- just to touch on that. I mean, let's also remember the type of book that we write, Mike, which is contracting, it's manufacturing and understand that we're not writing long haul. That's where there are driver shortages. That's where a lot of a pushback can be where driver turnover is high. You're talking about the 2 larger fleets that we've done this in has been landscapers. These were large fleets of -- now that business owner knows where all their vehicles are, knows fuel utilization, can monitor and measure that, but also get an understanding and a beat on it. This is a win-win as a matter of fact from a customer's standpoint, we always are trying to find ways to measure what I'll call housekeeping. Their level of risk management, whether it's keeping their vehicles well-serviced, keeping their employees well-paid, doing all the right things. I view this as another item that they can add in to better manage their business, but then also get a handle on all this distracted driving and all the other things that are happening in the marketplace. So this is something that I clearly put in the square of increasing switching cost as -- one of our end customer has this product, it makes a little bit more difficult for them to move to another carrier that does not offer the same product. And also understand many of our customers are paying for the service now through other services that are provided.

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

Okay, interesting. Moving to the expense ratio, the improvement has been, I think, you guys talked to the initiatives and it's been coming through clearly. If we're thinking about into 2019, is it fair to assume that the improvement will level off?

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

Mike, it's Mark Wilcox. I'd say that's probably a good assumption going into 2019. As you've seen on the expense ratio side, we were down about 140 basis points on a comparative quarter basis. That look points you more towards the year-to-date result where we're down about 120 basis points to 33%. You might remember the guidance we set forth earlier in the year, which was for about 80 basis points of expense ratio improvement.

So that was our expectation going into 2018. One element of the expense ratio improvement this year that I would expect to be sort of, call it, nonrecurring, is the profit-based element of the expense ratio. So with the full year guidance at 96% that was above our target when we went into the year of 94.5%. So we've seen about -- and I've mentioned this in my prepared comments, about 50 basis points of reduction in the profit-based element of the expense ratio. So that leaves about 70 basis points of expense ratio improvement year-to-date. So some of that will probably unwind going into 2019. But suffice to say, we're very focused on expense ratios, very focused on continuing to drive operational efficiency throughout the organization and managing expense ratio in the context of all the other initiatives that we spoke about, including the geo expansion and the significant investments we're making in underwriting technology and the customer experience.

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

Okay, great. And one last one, just to clarify. And I can read over the transcript too, but the non-CAT weather, I thought you said it was above expectations. If you can clarify if that's correct in which segment and is it kind of a point or 2 above?

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

Yes, I mentioned that in my comments, Mike. For the quarter we were 140 basis points above expectations for the third quarter of 2018.

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

And that was Commercial Lines mostly?

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

Commercial Lines and personal, both.

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

Yes. That's commercial and personal both. We looked at kind of on the overall book business that hits the commercial property book, it -- to some extent it hits commercial auto as well. So some of the physical damage property losses. But for the most part it hits the property book with it -- Commercial Lines and Standard Personal Lines as well.

Operator

Our next question comes from Scott Heleniak from RBC Capital Markets.

Scott Gregory Heleniak - *RBC Capital Markets, LLC, Research Division - Associate VP*

You guys mentioned a really tightened competition in Commercial Lines. I was just wondering, is there -- are you seeing that more evident in particular either account size or industry class? And are you seeing that pretty much across the board? Are there -- a [few sought] players? Wonder if you could flesh it out a little bit. And then along those lines, are you also referring to kind of more aggressive behavior or the examples you gave about credits or higher commissions and that being heightened competition that you're talking about?

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

Scott, this is John. Thanks for the question. And I would say, it's always more acute at the large end of the market, but I would say competition on new business is -- has gotten fairly acute up and down the spectrum. And the comments that Greg were -- was making were specific to Workers' Comp, and I think completely accurate, which is that's a line that despite the reported results we think are running fairly close to target for us and the industry, but yet you have seen significant increases in commissions across the board that had historically been the lowest commission line for the industry. And you're seeing companies raising base commissions and putting short-term incentives in place that are 5 or more points above standard commissions to drive new business. And you're seeing aggressive pricing, especially on smaller, lower hazard Workers Comp business from a number of competitors out in the marketplace. And again, we think there's opportunity for us to grow new business overall. And -- but we're going to do so with the same underwriting and pricing discipline that we've always exhibited and that we continue to exhibit on our renewal portfolio. Unfortunately, it's harder to measure underwriting quality and pricing quality on new business accounts. We think we do a pretty good job of it. And we think in many cases we're competing against players who don't really attempt to measure the quality and the pricing aggressiveness on their new business. And that have to deal with as part of the renewal portfolio and that's a dynamic that we're seeing out there right now.

Scott Gregory Heleniak - *RBC Capital Markets, LLC, Research Division - Associate VP*

Okay. And then on E&S, just -- is it fair to say that a lot of new business that you generated this quarter was from the new distribution relationship? Would you expect that kind of revenue trend to continue? And would you also look for other opportunities to announce different kind of partnerships just like the one you did as you sort of remix this business?

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

So Scott, this is John, again. A couple of answers there. Clearly, the reestablished relationship that we had for a number of years and then left because of a change in ownership and has now come back, I would view it -- view that from your perspective as more of a book transfer, where they're now moving the business to a few other partners from the paper that it used to be written on. That's within our appetite. It's similar to the business we write. Wouldn't really characterize it as a program. And because it's a book transfer that is going to be -- that will have an impact in the near term, but it'll settle into more of a normal run rate just like every other agency would once they established the core book of business they're going to move over upon appointment. But beside that, we continue to add locations to our wholesale distribution plan within E&S where it makes sense for us on a geographic basis, and we will continue to do that going forward. But it's a small book of business. This was a bigger relationship that impacted the quarter. We don't necessarily think about growth rates at that kind of level continuing.

Scott Gregory Heleniak - *RBC Capital Markets, LLC, Research Division - Associate VP*

All right, okay. And then one -- just one last one. Wonder if you could talk about just your -- in general your construction and contractors' book. I know you dialed that back a few years ago and I'm sure it's obviously benefiting from a better economy. So just wondering if you can touch on that book. How it's performing? And if you've seen any impact yet from higher interest rates on that book or anything else you can share?

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

So this is John, again. We've always been a great contractors' market. And just to clarify one of your points, I wouldn't describe us dialing it back a few years ago. We've been growing that segment. We've just been growing other segments, historically, a little bit of a faster clip. That's a segment that they did get hit particularly hard back in the '08 to '10 time frame when the recession hit, but it's also been benefiting of late by higher growth as the housing market and construction opportunities have continued to run from an economic perspective at a pretty good clip. Our book of business in that segment continues to be predominantly artisan contractors, small and midsize artisan contractors that bring a heavier casualty focus, so it's really GL and commercial auto driven, which, in a lot of our footprint, we view it as a big advantage for us in terms of how we manage our aggregations to property exposure. So we're -- we continue to see good economic growth there. And we continue to really like that business and will continue to be focused on growing it, but we want to maintain a balanced portfolio and continue to write some of those other segments that we've had a lot of success writing as well.

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

And I would just add to that. What surprises me on that book is the fact that our audit premium has not started to elevate over prior years relative to -- just trying to find a contractor in any market right now relative to getting things done. So the construction seems like it's fairly -- that's something we have a very close eye on, audit premium. Make sure that we don't get into a situation where we get behind in audit premium. So that scenario that we have a very close focus on as well.

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

Overall, we're comfortable with the profitability of that book. We don't put out combined ratios by SBU, but that's a book that really is a significant part of our overall commercial portfolio and is reflective of that level of profitability.

Scott Gregory Heleniak - *RBC Capital Markets, LLC, Research Division - Associate VP*

Is there any state you feel like you're a little bit overweight compared to other states. Obviously, mid-Atlantic is your bigger states, but is there other states that you...

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

Our largest state, obviously, is New Jersey, represents approximately 20% of our premiums. And I think -- you've heard us over the years, Scott, methodically talk about trying to get better diversification across the country. That's why when we first entered the E&S segmentation that was principally a casualty book, about 75-25 casualty property. It gave us diversification across the country. And then as we started to migrate now in Arizona, Colorado, Utah, New Mexico, eventually looking at the northwest as well, that changes the catastrophic kind of exposure that we have and gives us a little bit more diversification as well. So we've always been focused on diversification. We always try to manage our Northeast wind, or even southeast wind exposure and that's something that I feel we do an excellent job as an organization.

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

And Scott, just to clarify, were you talking overall geographic mix or contractor specifically?

Scott Gregory Heleniak - *RBC Capital Markets, LLC, Research Division - Associate VP*

I was talking about contractors specifically. But if there's anything else -- sounds like you're doing that across the board and that's -- contractors is just one part of it.

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

Yes, we are.

Operator

Our next question comes from Bob Farnam from Boenning and Scattergood.

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

Just a couple of questions. One is the other or alternative investment income. Just any details in there what types of investment generated that solid $7.2 million performance?

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

Yes, Bob. This is Mark Wilcox here. We have -- we look at our alternative investment portfolio in a couple different categories. One of which is the legacy portfolios versus the new -- kind of, the newer commitments that we've made post 2015. We did have 1 investment, an energy-related investment in the legacy portfolio that had a very strong income quarter -- in the third quarter that drove about, it's about $1.7 million. So that was part of the reason for the increase. But overall, when you look at the legacy portfolio versus the new commitments about $4 million of the $7.2 million came from the new commitments. About $3.2 million came from the legacy commitment, so then when -- the legacy half came from 1 relatively large investment that we made a number of years ago.

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

Okay. And I think question for John. In your commentary, you're talking about the take up on the digital platform by small businesses. And I just wanted to know, are you talking -- are they going direct? Are the business owners making coverage decisions on their own? Like -- I'm trying to get a feel for what the types of businesses are doing that? And how it -- how the process actually works?

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

Yes, great question. And just to clarify, we're generally talking about noncoverage decisions here. What we -- the digital take-up rates we're referring to are mostly around active utilization of our self-service platform. In our self-service platform, in addition to getting policies and bills on a digital delivery basis, the self-service platform allows customers to access information about their accounts real-time, but also to initiate basic transactions with regard to adding or deleting vehicles or getting auto ID cards or getting certificates of insurance on the Commercial Lines side. But to the extent those need to be underwritten or produced by an agency, a personal license agent, that's handled traditionally. This is just a portal for them. It's not a new business acquisition. And they're not making coverage changes on their own. We still have either one of our licensed professionals in the service center or the agency personnel whose licensing (inaudible) complete those transactions like they always would.

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

Okay. Yes, I just wanted to clarify that because -- that's what I figured was going -- the case. I didn't think that they're making the coverage decisions on their own, but I just wanted to verify that, so...

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

And at the same time we're also trying to continue to find ways to eliminate the need for that human interaction. And this is where it's not adding value. And only have that interaction where it's adding value, so more self-service all the way through. But when coverage issues come up, that's something that definitely will involve a professional.

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

Operator, are there any other questions on the line?

Operator

(Operator Instructions)

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

Operator, if there are no further questions, then we'll conclude the call right now.

Operator

Yes, there's no questions in queue.

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

All right. Thank you very much for participating in the call. If you have any follow-up items, please contact Mark or Rohan. Thank you very much.

Operator

And that concludes today's conference. Thank you all for participating. You may now disconnect.
