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SIGI - Q1 2010 Selective Insurance Group, Inc. Earnings Conference Call

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Dale Thatcher

Selective Insurance Group, Inc. - EVP, CFO

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CONFERENCE CALL PARTICIPANTS

Joe DeMarino

Piper Jaffray - Analyst

Doug Mewhirter

RBC Capital Markets - Analyst

PRESENTATION

Operator

Good day, everyone. Welcome to the Selective Insurance Group's first quarter 2010 earnings conference call. At this time, for opening remarks and introductions, I would like to turn the call over to Senior Vice President, Investor Relations, Ms. Jennifer DiBerardino. You may begin.

Jennifer DiBerardino - *Selective Insurance Group, Inc. - SVP of IR*

Thank you. Good morning, and welcome to Selective Insurance Group's first-quarter 2010 conference call. This call is being simulcast on our website, and the replay will be available through May 28, 2010. A supplemental investor package, which includes GAAP reconciliations of non-GAAP measures referred to on this call, is available on the Investors page of our website at www.selective.com.

Selective uses operating income, a non-GAAP measure, to analyze trends in operations. Operating income is net income excluding the after-tax impact of net realized investment gains or losses, as well as the after-tax results of discontinued operations. We believe that providing this non-GAAP measure makes it easier for investors to evaluate our insurance business.

As a reminder, some of the statements and projections that will be made during this call are forward-looking statements, as defined by the Private Securities Litigation Reform Act of 1995. Forward-looking statements are not guarantees of future performance, and are subject to risks and uncertainties. We refer you to Selective's annual report on Form 10-K and any subsequent Form 10-Qs filed with the US Securities and Exchange Commission for a detailed discussion of these risks and uncertainties. Please note that Selective undertakes no obligation to update or revise any forward-looking statement.

Joining me today on the call are the following members of Selective's executive management team -- Greg Murphy, CEO; Dale Thatcher, CFO; John Marchioni, EVP, Insurance Operations; and Ron Zaleski, Chief Actuary. Now I'll turn the call over to Dale to review the quarter results.

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

Thanks, Jen. Good morning. As we previously announced, catastrophe losses totaled \$24 million in the first quarter, and results from five February and March winter storms in the Northeast and mid-Atlantic states. Although it was the worst catastrophe quarter for Selective in over 20 years, underlying quarterly results were well within expectations.

For the first quarter, we reported operating income per diluted share of \$0.12 as compared to \$0.05 a year ago. Earnings were reduced by catastrophe losses, but offsetting these were a significant improvement in alternative investment income, favorable prior-year reserve development due to ongoing favorable claim trends and improved non-catastrophe property results as compared to the first quarter of 2009.

The first-quarter statutory combined ratio was 102.8%, 2.6 points higher than a year ago. Catastrophe losses accounted for 6.8 points on the combined ratio in the quarter, partially offset by favorable reserve development of \$9 million pretax, or 2.5 points.

Commercial Lines growth continues to be a challenge, given economic and competitive conditions. Commercial Lines premium declined 4% in the quarter, driven by \$18 million in return audit and endorsement premium compared to \$17.5 million a year ago. We still anticipate that the return premium trend will reverse later in 2010 if unemployment rates don't increase from current levels.

New business declined 12% in the quarter, while renewal pure price was up 3.4% and policy retention improved to 76.6%. We are one of the few carriers who have been successful in getting positive Commercial Lines pure price since the second quarter of 2009, when pricing increased 0.6%. Our price increases are now exceeding projected loss cost trends.

We reported a Commercial Lines statutory combined ratio of 101.9% in the first quarter. Commercial Property, ex catastrophes, performed very well in the quarter, with an 80.5% statutory combined ratio. Non-cat property losses in the Commercial Property line improved 19.3 points from the first quarter of 2009. General Liability also had a good quarter, reporting a statutory combined ratio of 92.8%. Premium growth in this line was negatively impacted by return premium in the quarter, as approximately 50% of this premium is subject to audit.

The first-quarter Workers' Compensation statutory combined ratio of 116.7% continues to be impacted by return audit and endorsement premium, and also includes about nine points of adverse reserve development related to severity in the 2008 and 2009 accident years. Frequency has not been an issue.

Commercial Auto came in at 90.9% combined ratio, which included 9.4 points of favorable reserve development, primarily from the 2008 and prior accident years. Net premium written was down 5%, due mainly to competitive conditions in the marketplace.

Personal Lines net premium written grew 12% in the quarter to \$56 million. The Personal Lines statutory combined ratio for the quarter was essentially flat with a year ago at 107.1%, including 11.1 points of catastrophe losses.

Turning to investments, first-quarter net investment income increased 77%, and it was primarily driven by after-tax alternative investment income, which increased \$15.9 million from the first quarter of 2009 to a \$2.5 million gain. The improvement in the equity and credit markets in the latter half of the year drove the improvement for alternatives. As was the case last quarter, six of the seven alternative strategies had positive investment income in the quarter, with commercial real estate still producing a loss.

Partially offsetting the positive impact alternative investments had on investment income was a decrease in fixed income due to lower yields. Our fixed-income portfolio after-tax yield was 2.9% for the quarter. Additionally, expenses were higher in the quarter due to a one-time \$1.6 million charge from the outsourcing of the investment department.



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In the quarter versus a year ago, our unrealized loss improved from \$17 million to an unrealized gain of \$35 million after-tax, driven largely by our available-for-sale fixed maturity securities. Other than temporary impairments, or OTTI, in the quarter were recorded at \$5.4 million after-tax versus \$17.6 million in the first quarter of 2009, primarily reflecting the continuing credit crisis and the associated securitized problem loans.

Invested assets were up 5% from a year ago to \$3.8 billion. Market to amortized cost on the whole fixed income portfolio remained strong, ending the quarter at 102.3%, up from 98.8% a year ago. Our fixed income portfolio overall maintains a very high credit quality of AA+ and a duration of 3.4 years, including short-term, and 3.6 years, excluding short-term. We believe we are conservatively postured for any additional market volatility as the economic and political environments remain in flux.

We continue to watch for inflationary trends and feel we are well-positioned to weather potential increases in inflation. Our cash position is higher than we have kept historically, but believe it is still appropriate. However, given the steep yield curve, we do carefully monitor market opportunities to increase yield.

Surplus grew to \$994 million, and stockholders' equity increased 1% to \$1 billion from year-end. Book value per share increased from \$18.83 at year-end 2009 to \$18.97 at the end of the quarter. The improvement in our capital position continues, as the premium to surplus ratio was 1.4-to-1 at quarter-end, down from 1.8-to-1 a year ago.

We remain comfortable at our current levels of operating leverage and capital. We expect to maintain excess capital to be prepared for an anticipated market hardening and to be positioned to fully realize our growth capabilities.

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

John Marchioni - *Selective Insurance Group, Inc. - EVP, Insurance Operations*

Thanks, Dale. Good morning. We are in the business of covering losses, and occasionally, large catastrophic events will impact our industry. This quarter included historically large catastrophe losses for us. The five storms we experienced provided an opportunity to demonstrate the power of our field service model.

Claims management specialists, or CMSs, were on the scene quickly because they live and work in the territories they service. Our CMSs adjusted about 2600 storm claims through April, demonstrating our credo, "Response is Everything." Flood operations worked alongside our CMSs to bring relief to families in need throughout the Northeastern and Mid-Atlantic states. This service model continues to generate significant customer loyalty for us.

The Commercial Lines marketplace is still very competitive, but we continue to achieve pure price increases due to the combined efforts of our superior agency force, field and inside underwriters. Together, they work with our sophisticated underwriting tools in a very disciplined and targeted way to minimize the impact of the soft market and write and retain business with us.

Our inside renewal underwriting teams work hard to balance price increases with retention levels. With the success we have had in driving price on a targeted portion of our book of business, Commercial Lines policy retention increased from year-end to 76.6%. On a point of renewal basis, overall policy retention for the quarter was 88%, up slightly from 2009.

Pressure on retention levels remains greatest on the larger accounts. The overall mix of our business continues to improve, with policy retention at point of renewal for the lower-quality, 1 and 2 diamond business at 9 points less than average, as we achieved rate increases on this business of 10.3%.

Our best-performing 4 and 5 diamond business retained at 2 points better than average with rate increases of 1.7%. We believe this demonstrates that our underwriting discipline and predictive modeling tools are working as intended. These tools, combined

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with strong relationships with an outstanding group of 970 agency partners, allow us to outpace the market in terms of price management.

Our field underwriters are writing the majority of new business in the highest quality 4 and 5 diamond range. Submission activity from our agents remains strong, but there continues to be pressure on hit ratios. Also noteworthy is that new business pricing was up a strong 4.9% in the quarter. Together, these factors demonstrate the discipline we've instilled in our operations.

Commercial Lines new business was down 12% compared to the first quarter of 2009. By segment, One-and-Done automated small business was up 11% to \$20 million. Middle-market, or AMS-generated, business was down 19% to \$39 million. Selective Risk Managers, our large account business, was down 32% to \$4 million. We continue to make progress growing our Commercial Lines non-contractor book. In the quarter, non-contractor new business comprised 68% of Commercial Lines new business, up from 61% a year ago.

Personal Lines results are improving, but that improvement is masked this quarter by extreme catastrophe activity. Excluding cat losses, the combined ratio in the quarter was 96%. The pricing, product and technology changes we've made to grow the book with granular pricing capabilities through our matrix modeling is beginning to show traction. We continue to grow the book, with new business up 33% in the quarter.

We anticipate filing rate increases in 2010 that could potentially generate \$14 million in additional premium. Eight increases were already filed in the first quarter. We continue to be optimistic about achieving our goal of being profitable in the third or fourth quarter of 2010.

Now I will turn the call over to Greg.

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

Thank you, John, and good morning. For the quarter, the underlying Commercial and Personal Lines results were solid, and our investment performance improved, with alternative investments generating positive returns. As we previously announced, we made the strategic decision to outsource our investment operations. While we don't anticipate any broad changes in investment strategy, we expect our performance to improve, with less overall risk.

We have access to broad sector-specific knowledge and expect to utilize advanced risk management tools. An additional benefit will be greater flexibility in trade execution through the outside managers' more significant buying power. We've hired Susan Sweeney as a Chief Investment Officer to oversee the outsourcing arrangement. Susan has over 20 years of experience managing an outsourced portfolio, most recently as Chief Investment Officer with the State of Connecticut pension fund.

The economy continues to take its toll on Commercial Lines results. Return audit and endorsement premiums reduced the top line again this quarter, outpacing our expectations. Had there not been \$18 million of return audit and endorsement premium in the quarter, Commercial Lines premiums would have grown instead of declining 4%. The contracting book, representing 37% of the Commercial Lines, continues to be disproportionately impacted by those return premiums.

Our Commercial Lines claim trends continue to be positive, which led to favorable reserve development this quarter. We also continue to drive rate increases through disciplined underwriters and dedicated agents, supported by sophisticated underwriting tools. As John mentioned, we've achieved pure price increases on difficult accounts, while retaining our best business.

This doesn't mean it's easy being the first in the marketplace to raise pricing. By maintaining our underwriting discipline, we are sacrificing some top-line growth, but we are willing to accept a lighter top line in exchange for the ability to write profitable business.

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In January, I laid out four Commercial Lines industry fundamentals that should foster a hard market. Now you can add a significant first-quarter catastrophe activity to the list. You've seen some big cat numbers being posted for the quarter. We strongly believe that Commercial Lines rate levels need to move higher, and recent catastrophe losses only magnified that situation.

While catastrophe losses are part of our business and can never truly be excluded, I want to highlight our solid results this quarter, excluding catastrophe, a 96% combined ratio for both Commercial Lines and Personal Lines. Therefore, with only one quarter behind us, we are maintaining our 2010 statutory and GAAP combined ratio guidance of 101.5%. The weighted-average shares assumption of 54 million at year-end remains the same.

Now I will turn the call back to the operator for your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Joe DeMarino.

Joe DeMarino - Piper Jaffray - Analyst

I'm with Piper Jaffray. Good morning. I just have a couple questions. Did you talk about pricing on new business within Commercial?

Greg Murphy - Selective Insurance Group, Inc. - Chairman, President, CEO

We'll take them one at a time. Go ahead, John, why don't you address the (multiple speakers) there?

John Marchioni - Selective Insurance Group, Inc. - EVP, Insurance Operations

Yes, the pricing number that we cited in the prepared comments of plus 4.9% was a Commercial Lines new business pure price number.

Joe DeMarino - Piper Jaffray - Analyst

Okay. How are you able --

Greg Murphy - Selective Insurance Group, Inc. - Chairman, President, CEO

And Joe, I would add to that on the Personal Lines side, as you know, we've gotten a series of rate increases, and I think what we told basically the Street was that we were expecting about an additional \$14 million in rate level on the Personal Lines book, generated by rate increases over the course of the year as well.

Joe DeMarino - Piper Jaffray - Analyst

Okay, but it seems like -- so pricing on new business is off just as it is on renewal business within Commercial. Is that correct?



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John Marchioni - *Selective Insurance Group, Inc. - EVP, Insurance Operations*

It is. It is up that 4.9%. And as we said, the downside to that, obviously, is the pressure that puts on hit ratios. And that is from our perspective a big measure of discipline. So you combine the improving distribution from a quality perspective with the improving price, and while we think our folks are making the right decision, it is clearly putting pressure on new business premium.

Joe DeMarino - *Piper Jaffray - Analyst*

Okay. So on business that you are walking away from or not retaining, how bad is pricing on some of that still?

John Marchioni - *Selective Insurance Group, Inc. - EVP, Insurance Operations*

It's all over the board. If you are talking about lost renewals, you will still see renewals, on occasion, lost for 10% to 20%. And on new business opportunities, again, in many cases you are going to lose it for double digits.

But based on our relationships with our agents and where we stand in terms of the business they quote with us, we are generally not going to lose for a couple of points, because of the service -- the claims service and the coverages that we offer. So generally speaking, you are in that double-digit range.

You know, it varies on who it is we are talking about. You see different companies in different marketplaces being that outlier. But it is still happening.

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

And Joe, I would kind of add to that. I am disappointed. I expected Commercial Lines pricing to build through the quarter, and that hasn't happened.

Joe DeMarino - *Piper Jaffray - Analyst*

Okay, all right. Moving on, it looks like Workers' Comp -- correct me if I'm wrong -- I think premiums were pretty much flat there year-over-year. But you also mentioned you had some return premium there. So I'm wondering what -- do you know what it would have been if you didn't have the return premium? What the growth --

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

Sure. We could tell you that. The audit premium and comp was 7 million return for the first quarter on the audit side; on the endorsement side, it was another 1.6 million return. So you can just kind of layer those numbers in to get in a sense of it.

And just to get a clarification, Joe, on my earlier comment, when I was talking about pricing building, I was referring to industrywide pricing and not our efforts.

Joe DeMarino - *Piper Jaffray - Analyst*

Sure.

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

Our efforts are clearly an outlier.

Joe DeMarino - *Piper Jaffray - Analyst*

All right. And then on your contractors' exposure, are you seeing any type of improvement at all in terms of hiring recently -- going into the second quarter? Is there any positive signs within any of your contractors' business in terms of the impact the economy has there?

John Marchioni - *Selective Insurance Group, Inc. - EVP, Insurance Operations*

Unfortunately, we are not seeing that. And we continue -- a lot of the worse-than-expected return premiums are still coming through our contractors' book, so we are just not seeing that turn.

Joe DeMarino - *Piper Jaffray - Analyst*

Okay, and then one last question. On the alternative portfolio, is the commercial real estate -- can you remind me, is it on a lag at all, a one-quarter lag?

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

Yes, the commercial real estate is on a one-quarter lag.

Joe DeMarino - *Piper Jaffray - Analyst*

Okay, and do you expect that to -- what is your outlook for when that one last portion of your portfolio might start to normalize or contribute to noninvestment income, and what kind of leverage can that bring to the portfolio?

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

To be honest with you, I don't have any prognostication on the real estate marketplace. That is a difficult one to predict. Obviously, that particular piece of the alternative portfolio has a current market value of \$15 million, so it represents approximately 10% of our alternative portfolio. It just remains to be seen how that generates over time.

Joe DeMarino - *Piper Jaffray - Analyst*

Okay, thank you. That's very helpful.

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

Joe, the one thing I would add, all the other strategies in there were all profitable, with the exception of the one you pointed out.



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Joe DeMarino - Piper Jaffray - Analyst

Yes. Thank you.

Operator

(Operator Instructions) Doug Mewhirter.

Doug Mewhirter - RBC Capital Markets - Analyst

RBC Capital Markets. Just two quick questions. First, just a quick cleanup. Dale, in your remarks, I missed one little fact. You were describing one of the Commercial business lines. You mentioned it had 9 points of adverse development. Which line was that? I just missed it.

Dale Thatcher - Selective Insurance Group, Inc. - EVP, CFO

Let me just --

Doug Mewhirter - RBC Capital Markets - Analyst

It was right before you talked about Commercial Auto.

Dale Thatcher - Selective Insurance Group, Inc. - EVP, CFO

Let me go back to my prepared comments here and take a quick look. So the Workers' Comp was the only one that had the adverse development, and that was 9 points.

Doug Mewhirter - RBC Capital Markets - Analyst

Okay, that's probably the one that I missed then. And actually on -- further to that, the Workers' Comp and general liability, we've heard some commentary from some insurance brokers that -- ironically may be an encouraging sign in that buried in some bad news, in that they seem to be getting feedback from the customers, the end buyers, that they are buying -- still buying sort of the minimum amount of insurance or buying a low amount of insurance, even though they may be expressing some private optimism in their business. But they are saying, we are just going to buy 100 units of insurance, even though we may need 120, but we are going to let the -- we're going to let the audit pick that up later in the year.

Have you been getting any kind of feedback or any kind of -- is that consistent with what you are seeing as well?

Greg Murphy - Selective Insurance Group, Inc. - Chairman, President, CEO

Not from what we are explicitly seeing. Obviously, we saw a pretty heavy return premium going out the door on the endorsement side, so that is based on some pretty good information. So that is a tough one to call.

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John Marchioni - *Selective Insurance Group, Inc. - EVP, Insurance Operations*

The only thing I will add -- when you're getting commentary from the broker market, this probably tends to be your larger accounts. And there's no question over the last couple of years, they've become a lot more sophisticated in understanding their exposure base and how that drives premiums.

So I'm not surprised to hear that they may be pushing for that, to start with a lower point and figure they will get caught up on audit. But we don't see as much of that in our book because of the size that we generally play in.

Doug Mewhirter - *RBC Capital Markets - Analyst*

Okay.

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

But the one thing I will add to that, though, is traditionally over the course of time, there is just a natural lag, both on the return premium side of the audit equation and also on the additional premium side of the equation. So when things do turn around, that is what you will end up seeing ultimately.

Doug Mewhirter - *RBC Capital Markets - Analyst*

Okay. Thanks for your interest. That's all my questions.

Operator

Thank you. At this time, I am showing no further questions. I will turn the call back over to the speakers.

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

Great. Thank you. So we have the capacity for profitable growth. We have the people, tools and strategies in place to persevere through the soft market and emerge in a very competitive position on the other side.

So with that, thank you. If you have any follow-up questions, please contact Jennifer and Dale. Thank you. Bye.

Operator

Thank you, and this does conclude today's conference. We thank you for your participation. At this time, you may disconnect your lines.

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