

# FINAL TRANSCRIPT

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## **SIGI - Q2 2010 Selective Insurance Group, Inc. Earnings Conference Call**

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

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*Selective Insurance Group, Inc. - EVP, Chief Actuary*

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*Piper Jaffray - Analyst*

**Scott Heleniak**

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*BofA Merrill Lynch - Analyst*

## PRESENTATION

**Operator**

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

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

Thank you. Good morning, and welcome to Selective Insurance Group's second-quarter 2010 conference call. This call is being simulcast on our website, and the replay will be available through August 27, 2010.

A supplemental investor package, which includes GAAP reconciliations of non-GAAP financial measures referred to on this call, is available on the investor's page of our website at [www.selective.com](http://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 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 uncertainty. We refer you to Selective's annual report on Form 10-K and any subsequent

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Form 10-Qs filed with the United States Securities and Exchange Commission for a detailed discussion of these risks and uncertainties. Please note that Selective undertakes no obligation to update or revise any forward-looking statements.

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

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

Thanks, Jen. Good morning. Second-quarter results were strong despite another high catastrophe quarter due to severe storm activity throughout our footprint. Catastrophe losses totaled \$16 million in the quarter, including \$3 million in additional development from first-quarter catastrophes related to the last storm on March 31.

For the second quarter, we reported operating income per diluted share of \$0.41 as compared to \$0.42 a year ago. While earnings were reduced by the high catastrophe losses, offsets included positive alternative investment income due to general financial market improvements and favorable prior-year reserve development due to ongoing positive claim trends.

The second-quarter statutory combined ratio was 101%, 2.2 points higher than a year ago. Catastrophe losses accounted for 4.5 points on the quarter's combined ratio, partially offset by favorable casualty lines reserve development of \$11 million pretax, or 3.1 points on the combined.

Commercial lines growth continues to be a challenge, given economic and competitive conditions. Commercial lines net premium written declined 6% in the quarter, driven mainly by \$18 million in return audit and endorsement premium that was essentially flat with a year ago, as the economy and unemployment continue to impact audits.

New commercial lines business declined 21% in the quarter, while renewal pure price was up 3.3%. Policy retention declined a point to 75% as we continue to push for positive commercial lines pure price. We are mindful of a delicate balance between price and retention, and we monitor it very closely.

We reported a commercial lines statutory combined ratio of 99.9% in the second quarter. Cat losses contributed 3.7 points to this combined ratio. Commercial property ex-catastrophes performed very well, with a 70.8% statutory combined ratio. General liability also had a good quarter, reporting a statutory combined of 93.5%, as did commercial auto, with 87.9%. Commercial auto results were positively impacted by favorable development of 13.7 points as a result of lower than anticipated severity, primarily in the 2007 to 2009 accident years.

General liability results included 11.9 points of favorable development in the quarter related to 2008 and prior accident years. The second-quarter Workers Compensation statutory combined ratio was a 127.4%. This line continues to be negatively impacted by return audit and endorsement premium and also includes about 12.9 points of adverse prior-year reserve development related to severity in the 2008 and 2009 accident years. There is also some pressure on the current 2010 accident year; however, frequency continues to trend lower.

We rolled out the first predictive model for the Workers Compensation line in 2006 and the second-generation model for this line in 2009. Given that the models are primarily predictive of the probability of frequency, they did not predict the level of severity development that we experienced. The economy and unemployment levels continue to weigh on this line of business the most.

Workers' compensation is also the most regulated line of business, and while we increased pricing 2% in the second quarter, it is more difficult than other lines to raise price. Additionally, we are seeing some very aggressive competition for Workers Comp, as some carriers use flat 10% commissions, making it even more competitive.



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Personal lines net premium written grew 14% in the quarter to \$67 million. The personal line statutory combined ratio for the quarter was 107.6%, including 8.5 points of catastrophe losses. Retention improved 4 points from the second quarter of 2009, while we continue to drive rates higher.

We successfully completed negotiations on our July 1, 2010 excess of loss treaties. The property excess of loss treaty was renewed with the same terms as expiring, and the treaty rate decreased 2%. The casualty excess of loss treaty was also renewed with the same terms as expiring, and the treaty rate increased 9%.

Turning to investments, second-quarter net investment income after tax increased 28% to \$28 million, and was primarily driven by after-tax alternative investment income, which increased \$8.9 million from the second quarter 2009 to a \$3.2 million after-tax gain. The first-quarter rebound in the equity and credit markets drove the improvement for alternatives.

Commercial real estate continues to produce a loss, albeit only \$321,000 after tax this quarter versus \$1.2 million in the first quarter. Partially offsetting the positive impact alternative investments had on investment income was a decrease in fixed income due to lower yields and a higher than usual short-term and cash position. We expect this cash to be opportunistically deployed in the third quarter.

Our fixed income portfolio after-tax yield was 2.9% for the quarter. Expenses were higher than usual in the quarter due to an additional \$300,000 after-tax charge from the outsourcing of the Investment department, which was completed in the second quarter. We hired two managers to invest our fixed income portfolio, Conning Asset Management and Deutsche Insurance Asset Management, with Conning being the lead, with a larger allocation of the portfolio.

As we have stated, we don't anticipate a change in investment strategy, just the execution model. We believe we will benefit from broader sector-specific knowledge, advanced risk management tools and greater flexibility and trade execution. Over the longer term, we anticipate better risk-adjusted investment yields.

Compared to a year ago, the unrealized gain position improved from \$4.7 million pretax at June 30, 2009 to \$89.6 million at June 30, 2010. Other than temporary impairments, or OTTI, in the quarter, were recorded at \$4 million after tax versus \$8.1 million in the second quarter of 2009, primarily reflecting the continuing credit crisis and the associated securitized problem loans.

Private label structured security exposure has been substantially reduced to \$108 million, with \$12 million in unrealized losses. Commercial mortgage-backed securities, which continue to be the most challenged, represent \$63 million of the total and \$8 million of the unrealized loss.

Invested assets were up 8% from a year ago to \$3.9 billion. Market to amortized costs on the whole fixed income portfolio remains strong, ending the quarter at 104.2%, up from 99.5% a year ago. We've lowered our exposure to equities to only 1.6% of invested assets versus 2.3% a year ago as a result of the sale of our master limited partnership portfolio in the quarter. This sale resulted in a \$10 million pretax gain.

Our \$1.6 billion municipal bond portfolio is very high-quality, with an average AA+ rating. 70% of the portfolio is in the held-to-maturity category, with the balance in available for sale. Revenue bonds represent 61% of the total municipal bond exposure, with the bulk of those in essential services.

The portfolio is geographically diverse, with exposure in 48 states. Municipalities and public entities in Texas represent our largest state exposure at 12%. No other state represents more than 6% of the portfolio.

Our fixed income managers have large municipal credit groups that provide deep resources to monitor the state economic and regulatory environment and, where possible, make adjustments to the portfolio.



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Our overall fixed income portfolio maintains a very high credit quality of AA+ and duration of 3.3 years, including short-term, and 3.7 years, excluding short-term. We continue to watch for inflationary trends and feel we are well-positioned to weather potential increases.

Surplus crossed back over the \$1 billion mark in the quarter and stockholders' equity increased 4.7% from year-end 2009 to \$1 billion. Our book value remains very strong with very little impact from intangibles. Book value per share increased from \$18.83 at year-end 2009 to \$19.65 at the end of the quarter. The dividend yield currently stands at 3.4%, providing a good return while the stock trades at 79% of book value.

The improvement in our capital position continues, as the premium-to-surplus ratio was 1.4-to-1 at quarter-end, down from 1.7-to-1 a year ago. While we view our stock valuation as very attractive, we are maintaining our current levels of operating leverage and capital. The environment of late has created a new normal for capital levels, and we will maintain any excess capital to be prepared for an anticipated market hardening and to fully realize our growth capabilities.

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

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

Thanks, Dale. Good morning. Given how competitive it remains in the commercial lines space, I am proud of our employees' efforts. Our inside underwriters continue to maintain pricing discipline, and, as a result, we are seeing increasing pressure on retention, which is down about a point from a year ago and about a point and a half from last quarter. We are monitoring this closely as we continue to retain the best-performing business at the highest rate while seeing more of the worst-performing business walking away from fairly substantial price increases.

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 the point of renewal for the lower-quality, one- and two-diamond business coming in 6 points less than average, as we added almost 9 points of additional rate on this business. Our best-performing four- and five-diamond business retained at 2 points better than average, with rate increases of 2%.

During the second quarter, we refined our strategy to focus our pricing efforts most aggressively to achieve profitability on the one- and two-diamond business, while focusing strongly on retention for the four- and five-diamond business. In the end, pricing will fall out where it will.

Working with our 980 agency partners, our field underwriters are writing the majority of new business in the highest-quality four- and five-diamond range. Submission activity from agents remains strong, but there continues to be pressure on hit ratios.

Commercial lines new business was down 17% for the first half of the year compared to 2009. By segment, One & Done automated small business was up 6.5% to \$41 million. Middle-market or AMS-generated business was down 22.3% to \$71 million, and selective risk managers, our large account business, was down 49% to \$6 million. New business pricing was up a very strong 5.9% in the quarter, further demonstrating the discipline we've instilled in our operations.

From a profitability perspective, the line showing the greatest strain is Workers' Compensation. While frequencies have declined 27% over the past three years since our deployment of predictive modeling, severity continues to rise. We are seeing increases in pain management treatment beyond the point of maximum medical improvement. This development is exacerbated by the economy, where jobs for the injured worker to return to are harder to come by.



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Our business owners' results are also not in line with our expectations. While part of this underperformance is the result of heavier-than-normal catastrophe activity, 12 points on a year-to-date basis, we are taking specific underwriting and pricing actions to improve this line's performance.

In addition, it is important to note that the performance of the associated lines of business, Workers' Compensation, automobile and umbrella, result in much stronger profitability on an account basis.

We continue to make progress in diversifying our commercial lines book of business. In the quarter, noncontract or new business comprised 63% of commercial lines new business, up from 58% a year ago.

Personal lines results are improving, but that improvement is masked once again this quarter by catastrophe activity. If we exclude cat losses, the combined ratio year to date was 97.5%. The pricing product and technology changes we've made to grow the book with granular pricing capabilities through our matrix modeling is showing traction.

We continue to grow the book, with new business up 27% year-to-date. We anticipate filing rate increases in 2010 that will potentially generate \$14.8 million in additional premium. 25 increases have already been filed year-to-date.

We continue to be optimistic about achieving our goal of being profitable in the third or fourth quarter of 2010. We are confident about achieving profitability for three reasons. Number one, our immature book will continue to age. Two, we will begin to earn the implemented rate increases. And three, we will continue to get additional rate where possible and continuously refine our model.

We have a series of initiatives underway to enhance our claims handling process. These initiatives focus on improved workflows, better management of litigation and cycle times, as well as medical expense management. Now I will turn the call over to Greg.

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

Thank you, John, and good morning. The underlying commercial lines and personal lines results were solid once again this quarter, and our investment performance improved, driven by positive alternative investment returns. Premium volume has declined as the economy continues to take its toll. Audit and endorsement return premiums reduced our net premiums written by 5% for the quarter and year-to-date.

Again this quarter, high industrywide catastrophe losses point to the need to raise rates in property lines. The industry cannot continue to play takeout with the impact of catastrophe losses. These losses need to be priced in. Additionally, declining interest rates call for rising commercial lines prices in order to produce appropriate returns on equity.

As the competitive commercial lines environment shows little signs of improvement, we continue to scratch our heads over the pricing we are seeing from our competitors around our footprint. We are all experiencing the same industry forces, but Selective is one of the only carriers willing to raise commercial lines prices. In fact, we have successfully had positive commercial lines prices for the past five quarters.

We were able to achieve positive rate for two main reasons -- one, our excellent agency relationships, and two, the tools in place to granularly price commercial lines business. According to analysts and investors, management teams say it is the competition who continues to cut price and not them, and their agents will not allow them to increase price. When the market firms, we believe our success rate for both renewals and new business will greatly increase as a result of sophisticated pricing tools and strong agency relationships. Relationships really matter in times like this and we have some of the strongest in the industry.

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For personal lines year-to-date, there is much less resistance to rate increases, as shown by our strong new business growth of 27% and a 4 point improvement in retention, which now stands at a solid 83%. As price and retention continue to strengthen, we're on track to meet our personal lines profitability goals.

Overall, it is a very difficult commercial lines marketplace due to a soft economy and undisciplined competition. It is unfortunate, however, that it seems to be the general consensus that a hard market is another year away. If that's true, industrywide commercial lines accident year results and returns will likely deteriorate for the next two-year period and valuations will continue to be under pressure, most likely leading to industrywide consolidation.

We believe that companies competing on price as their only competitive advantage will fall behind in the next market cycle. Our competitive advantages continue to center around franchise value, sophisticated underwriting and granular pricing tools due to our second-generation models, technology that provides our agents with ease of doing business, strong agency relationships as a result of our unique field model, and two, a strong A.M. Best rating of A+.

We have the capacity for profitable growth. We have the people, tools and strategies in place to persevere through the soft cycle and thrive in a firming cycle. Year-to-date, our statutory combined ratio was 101.9%. Catastrophe losses were partially offset by favorable loss development as our underwriting results remained within our expectations. Therefore, we are maintaining our statutory combined ratio guidance of 101.5% for 2010. The weighted average share assumption of 54 million at year-end remains the same.

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

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## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) Mike Grasher.

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### Mike Grasher - Piper Jaffray - Analyst

Piper Jaffray. Congratulations on putting together a nice quarter in a very difficult environment.

I want to go back to the -- you had broken out sort of the small, middle-market, large account businesses in terms of the 4 or 5 diamond. What has been the sort of change that -- the net premium written down in comp in general liability and commercial auto, how much of that mix is sort of the exposure units versus price versus culling of accounts, if that's a way we could look at it?

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

Why don't I start with part of it, and then John and Dale can jump in? Let's focus on the price aspect first. That's the easiest part to drill down on, Mike.

Year-to-date, our price in comp, as you know that is the most regulated line out there in terms of pricing, and that line was up only 2.2%. As you know, our year-to-date pricing is 3.3 overall. That comp is a line that we've been concerned about, and from a regulatory standpoint, many of the price filings coming out of NCCI are trailing by as much as two years in terms of loss trend. So that is an area where we've gotten 2.2% of price.



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And then I will just touch on the audit and endorsement, and then the other guys can jump in on the other factors. Audit and endorsement overall on comp for the quarter was \$8.5 million of return premium on audit aspect against the \$6.5 million a number year ago. So you've seen -- and our expectation, Mike, that actually would start to flatten out as we got in through the first quarter and clearly at the second quarter of 2010. And that hasn't. And I think that is reflective, clearly, of a very, very soft economy.

And then from an endorsement standpoint, our comp premium was down \$1.5 million in the second quarter of 2010 versus \$5.5 million in the second quarter of 2009.

So that is a little bit about what is happening in terms of pricing and the economic factors on audit and endorsement. And John or Dale, why don't you comment on some of the larger account pressure you are into on top line there?

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

Clearly, as we said, our pricing on renewal continues to be positive, as does our pricing on new business, and that is largely across the board. We continue to be an account underwriter. So when you think about those lines, they tend to hang together in terms of hit ratios, in terms of retention. As Greg indicated, because of the difference in how base rates are established for comp versus the other lines, they may look a little bit different in terms of overall price achievement, but that is a big impact on it.

The other part of this is from a retention perspective, as we mentioned in the prepared comments, our retention is weakest, as my sense is the entire industry's would be, at the larger end of the market. That is where there continues to be the greatest deal of competition. That is where you continue to see companies getting overly aggressive on new business, and therefore, our retention is under a great deal of pressure there. So that is also driving a fair amount of the decline in the top line that you are seeing.

So on a policy count basis, retention remains fairly strong. On a premium basis, because of that distribution from small to large, it is under pressure.

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

I guess the only other thing I would add, Mike, is obviously, with positive pure price, the decline in premium volume is not a matter of giving up price so much as decline in exposure, which is coming through, as you saw, in the audit premium. So those policies still exist, but they are smaller. So you've got the contractor at the start of the year with 15 employees is ending the year with 10 employees, and our average policy size is declining as a result of that.

Also, as John indicated, a lot more pressure on the top end as far as policy size, so you see a lot more policies that we walk away from there. Yet at the same time, at the very small side of the equation, the one-and-done style business, we continue to increase our production there. So again, that will drive a smaller average policy size, but also one that is much less susceptible to price fluctuation and much less price-sensitive. So overall, I think it improves the overall book ultimately.

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

And Mike, the one thing I will say, too, is that comp is the one line we are most concerned about from an inflationary standpoint. You've got a lot of things that are going to be happening in healthcare that are going to change the paradigm for pricing by providers and physicians. And we feel -- or we are concerned about the cost shifting capability back onto the private payors, and particularly how that would land squarely on the backs of Workers' Compensation providers, and also the medical aspect in the personal and commercial lines aspects of our policies.



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So we are something very closely monitoring that, and are just concerned about the inflationary aspects there.

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**Mike Grasher** - Piper Jaffray - Analyst

Okay, and just to clarify, I think you said new pricing up 5.9%, John. Could you clarify or explain exactly how that is measured, if it's a new account coming in? How do we know it is 5.9%? Is it relative to last year's new accounts or --?

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

It is done on a book of business level, and unlike renewal pure price, where you could actually look at the same policy set from one year to the next, with new pure price, what we do is look at base rates on a class of business level and average schedule mod or individual account credits, and put those two factors together and then compare them year-over-year to see what your price looks like class-by-class.

Now what it doesn't account for is that improving mix we are showing. So when you think about the improving mix of new business from a quality of account standpoint, as measured by diamond score, that would actually put downward pressure on your pure price for new business, because if you are writing more high-quality accounts, you expect to write them at lower pricing levels relative to manual. Still achieve profitability, but write them at lower pricing levels, more schedule mod in particular.

So that is a downward pressure. So despite an improving mix of new business, we are still at positive price. But it is a combination of base rate changes year-over-year plus average schedule mod.

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

And Mike, I would say that this is an internal benchmark that we use, and it is a gauge for us to see how aggressive our people are in the field, and it's up against, like John said, a manual premium. And it takes into consideration where base rates are, what kind of credits we are putting on it.

It doesn't say what the competition wrote the account for, and I understand that that's information that you generally do not have. But what we do have is a baseline, and it is a gauge to sense how we are doing overall as an organization. It is not a perfect measurement, but it is a good measurement to kind of sense that.

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**Mike Grasher** - Piper Jaffray - Analyst

Okay. Fair enough. And then Greg, just a final question and I'll get back in the queue. Your comments around the market and whether or not it continues to be soft for the next year or so. What is your own opinion, or what is your outlook as we move forward? Obviously, you are seeing your own rate, but from a bigger picture perspective, how much longer can sort of this soft environment continue?

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

In my mind, it can't continue, and that is why, Mike, we've been raising rate for -- when I say raising rate, we've been raising rate for a long time, probably two years now, but have had positive rates for five quarters now. We just don't understand and don't match the rhetoric that we hear from many other companies.

You've seen a lot of the other press releases and conference calls that have come out recently, and, you know, the rhetoric doesn't match with positive rate. And that causes more pressure on and more difficulty in achieving what we are trying to get done in a more complex marketplace.

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So like we said, we've refined our strategy, and we are focusing on retention at the best end of the market. We are focusing on getting and continuing to get rate on the worst end of the market. And that is our strategy as we move forward.

We would like to have much more aggressive strategy than that, but based on what we see, I just don't think that -- that is a year away. It's unfortunate. It's a year away, though. But we all suffer from the same declining interest rates, we are all suffering from the same wind activity and hail and other catastrophic events. And at the end, some of that needs to be priced into the market place.

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

What I might add to that, Mike, is that it seems strange to us that A.M. Best is indicating an accident year commercial lines combined ratio for this year of about a 106. You tack on negative pricing for the year, and you're talking a 108 at least next year. There is no ROE in a 108 that anybody can write home about. So it just doesn't make sense why prices aren't going higher right now, although obviously, I understand with the economy and the shape that it is in, it is difficult to sell those price increases. But anyway --.

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**Mike Grasher** - *Piper Jaffray - Analyst*

Okay, that's helpful. Thanks very much.

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**Operator**

(Operator Instructions) Scott Heleniak.

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**Scott Heleniak** - *RBC - Analyst*

RBC. A couple questions, first on the investment portfolio. You guys mentioned deploying cash in Q3. Just wondering where you expect to deploy that cash specifically and what kind of yields you expect versus kind of where they are now?

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

Well, basically, the difficulty with deploying cash right now is that we want to deploy it in the corporate space. The problem with that is corporate new issuance, at least in the quality level, is not where we would like to see it. But obviously, we will continue to work on that, and one of the advantages of having the outside managers is you get much better execution, much higher allocations when you do have IPOs of bonds. So it is a little bit better kind of situation that you are going to have there.

I mean, we are looking at in terms of yields, they are definitely down from where they have been. But certainly they are better than cash yields that we are seeing right now. I mean, cash is barely paying anything. So to get a couple of points out of a bond yield makes sense. We don't anticipate any substantial movement in terms of duration. So it would be invested in the corporate space at that same kind of a 3.5-year duration. It really kind of depends what is going to be available out there in the marketplace.

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**Scott Heleniak** - *RBC - Analyst*

Okay, and then next, you guys got a nice contribution from the alternative portfolio this quarter. Any sense on what that might look like for Q3? That is all still reported on a one-quarter lag, right? So do you have any general sense on what that contribution might look like for Q3?

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

That is a one-quarter lag, but we are not prognosticating the alternative performance, because they have been, obviously, very volatile. We continue to be optimistic, let's put it, with regards to the fact that we do have some stability in the broad marketplaces. You are seeing about -- a lot more chatter around positives in terms of distribution starting to occur from some of the Alts as they see opportunities to start new funds. So we are generally optimistic, but we are not prognosticating any specific numbers.

**Scott Heleniak** - *RBC - Analyst*

Okay. And then moving on to cat losses, they were again a little bit higher than normal this quarter. Just wondering if you could break out how many different weather events that you had cat losses from, and then specifically what the loss was from the Tennessee flooding.

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

I don't have that right in front of me here, but I can tell you that there were a significant number of small cats that added up to that dollar amount. So it was broadly throughout our footprint.

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

Tennessee wasn't that large. I mean, we don't -- this was a quarter of pretty non-headline cat activity that ended up being a series of smaller, \$1.5 million to \$3 million style events, wind, hail, in some cases, flooding. And you do pick up flooding in commercial lines policies.

But nothing that was major, like last year, some of those significant -- not last year, the last quarter, where some of those were significant -- weighted snows, big, 30-plus-inch snowstorms in Maryland, Virginia, DC and some of these other areas that really created a lot of loss activity. This was more of a series of smaller style events.

**Scott Heleniak** - *RBC - Analyst*

Okay. And then just one last question. You mentioned the decline in retention. I'm wondering how much of that is -- I know you talked about large account businesses where you're kind of losing them. Just wondering how the retentions are holding up in the small account business, which is really kind of your core anyway. So is most of that 1.5 decline in retention, is most of that or virtually of that large account business?

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

Our retention overall for the second quarter was -- and this is just overall retention in commercial lines was 75.2, and on a year-to-date basis, it was 75.8. So we only lost a little bit of ground on a quarter.

And what we have seen is that we are having more difficult at the upper end of the market, because that is the area where other companies are trying to meet their premium targets from and are extremely competitive. We talk to our field guys regularly, and in some cases, our guys are telling us that we cannot even get to the price that some of the competition is putting on the table to that, when they are trying to take some of these large accounts. We can't even get there. So I don't know, John, if you have specificity around any of that, but --.



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

The retention for small account continues to be strong. We look at it in essentially \$20,000 buckets up the chain in terms of size. So it continues to be very, very strong on the small end. And as you move up, it clearly gets weaker.

The other important item of note, in the prepared comments, you see that we report on total retention as well as retention at point of renewal. The fact that retention of point of renewal is holding relatively firm, that is where you would expect to see the real big impact of our pricing stance. And you're not seeing it as much there, whereas total retention includes those accounts that don't reach their expiration dates. So the impact of the economy is driving, to a certain extent, your total retention number.

So we look at that very closely, and when you look at that as well from small to large, you will see that the price sensitivity on the smaller end is keeping those retentions at point of renewal relatively high. And that is really where you are seeing the pressure, on the bigger end, at point of renewal.

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**Scott Heleniak** - *RBC - Analyst*

And how do you define large account? Is that over \$50,000 in premium, or --?

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

Well, for us, we look at -- in different buckets. But our pressure starts above \$100,000. That is really where you are really starting to see the pressure. We traditionally define large accounts as \$250,000 on an account basis, \$100,000, \$150,000 by line. But when you look at where the pressure is at retention, it really starts to hit when you get above \$100,000 on an account basis.

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**Scott Heleniak** - *RBC - Analyst*

Okay. Thanks a lot.

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**Operator**

Caroline Steers.

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**Caroline Steers** - *Macquarie - Analyst*

Macquarie. My first question is just on the commercial lines side. In terms of competition there, who is it that is being most competitive? Is it still both regionals and large companies, or is it other large competitors, or is it more one than the other?

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

It is a combination of both.

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**Caroline Steers** - *Macquarie - Analyst*

Okay.

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

Let me be no more specific than that.

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

The one thing that I think that drives that is I do think that -- we talked earlier about our new business pricing and how we monitor our new business pricing. It is our sense that a lot of other companies don't have that same capability.

So although they may have some level of price discipline on their renewal book, they just don't have a way to monitor the new business. And obviously, our renewal is their new business that they are striving to get. So I think that is a piece of what drives some of that competition, and why you hear rhetoric at the top about pricing being firm for that particular company. But it is not when it gets down to the street level.

**Caroline Steers** - *Macquarie - Analyst*

Okay, thanks. That's helpful. Then just shifting onto the personal lines, are you all nervous at all about the recent uptick in cat activity that you've seen? And do you have any -- sort of as you grow in that line, then, do you have any initiatives underway to ensure profitability there, as this segment of the business starts -- continues to grow?

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

We monitor our cat wind loads very closely as part of the new business process. When we underwrite a piece of business, we know where it fits on the cat map, and we know our aggregations. So yes, and actually we've grown most of our personal lines business in-state rather than more on the coastal areas. So yes, that is something that we closely monitor.

You know, it's funny, a lot of the activity just generally cat load has been more holistic wind, straight wind, hail, or other aspects of it. And those are perils that now through our by-peril product that we have, we can more closely match to pricing for those.

And we are driving much higher -- we're driving rate. What we are most pleased about, Caroline, in this segment is that our rate has been several years of price increases. We are very pleased with where we stand in the marketplace with respect to New Jersey personal auto, and then the fact that we've been growing our non-New Jersey business. And we are comfortable with where we stand and what we are doing in terms of from our rate mix of business and from an overall the fact that there is a new business penalty as you grow that segment.

And in the home market, I think prices just have the capability to elevate a little bit because the long-term home experience in the industry hasn't been particularly good, and I think that's a product that is just too thinly priced.

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

Just a couple of other additions to that. Greg is absolutely right. We track very closely expected loss to wind versus property premium and have managed that number pretty aggressively over time. So if you look at our growth in the property side for personal lines, even in those coastal states, the mix is very strong away from the coast.

The other thing I would add is when we talk about by-peril rating, we are one of the few companies in the market doing that right now. So you rate on seven different perils, including wind and weather are separate perils, separate from crime and theft and fire. So that is just not about managing your coastal wind exposure. You are also managing your weather exposure in those Midwestern states.

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And then finally, the rate activity we've talked about in personal lines, if you were to look at our property rate changes in the Midwestern territory, you are in the double digits there, and the market is bearing that out. So you are seeing a lot more rate flowing through that Midwest book as well.

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**Caroline Steers** - *Macquarie - Analyst*

Okay, thanks. Have you guys quantified how much your auto and homeowners rates were up in the quarter?

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

4.3% is the rate increase on renewal in the quarter.

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

Overall.

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**Caroline Steers** - *Macquarie - Analyst*

Okay. And then just final question, I know you talked a little bit about consolidation perhaps in the future, if the market continues to remain soft. And I was just wondering what your perspective is basically from Selective's perspective on consolidation, you know, one or two years out.

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

And we've talked about this before, and we look for something that obviously from -- our business model is tougher for us to look for something in this footprint. And so if it was something that had the capability to bring new product into our existing franchise, that would be an opportunity, because anything really outside of that would probably trample over the very strong franchise.

I mean, there's not a lot of companies out there that will do 22 states with 980 agents writing an average premium volume of \$1.5 million in their agencies. You've got to understand -- we rank number one, number two and number three in a significant portion of our agencies. And that is where the franchise aspect starts. So that is a difficult [in-stay].

And then from a footprint expansion [staying] capability, that may bring another set of opportunities. And my belief is as we move through, there may be a renewal write deals out there and there may be a whole host of other activities that may become available that you haven't seen in years past.

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**Caroline Steers** - *Macquarie - Analyst*

Okay. Thank you all very much.

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**Operator**

(Operator Instructions) Mike Grasher.

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**Mike Grasher** - Piper Jaffray - Analyst

I wanted to go back and ask about the alternatives. The \$94 million that is committed, for what timeframe does that get deployed?

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

Well, although it is a \$94 million legal commitment, we expect that there will be some significant portion of that that will never be called. So there is no requirement that any of it actually be called by the general partners. Obviously, some of it will be. So it really kind of depends on the investment opportunities that the general partners end up seeing.

I would say that as you look at our schedule that we put in our investor packet, you will see that there is about \$30 million of secondary equity funds. Those probably have a higher likelihood of being called, just because that is probably the most active space in the alternative space right now.

The other thing to look at as you look at the schedule that we provide is the older the fund, the less likely the remaining commitment will be called, at least in full. Again, doesn't mean that they can't legally do that and we can't really provide you any precise number on that, but it really will have to play out with the investment opportunities the general partners see on a go-forward basis.

**Mike Grasher** - Piper Jaffray - Analyst

Okay, so it is not like you are committed to X amount in 2010 or 2011 or anything like that?

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

They tend to have specific investment periods, and then generally they will have an option on that even to extend the investment. So it is generally going to be, I guess, five to seven years beyond the vintage when they can call the commitment. But we've had funds in the past that have closed without ever fulfilling their commitment.

**Mike Grasher** - Piper Jaffray - Analyst

Okay, and is there a duration on the legality of it or on the agreement? Is there sort of, okay, at the end, if it expires after five years or three years or seven years or whatever it may be?

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

It does vary. Each one is different, and as I said, they each generally have an investment period of five to seven years. So if they haven't made a call in that time frame, then it is not -- you're not going to end up having that. But it does vary by commitment.

**Mike Grasher** - Piper Jaffray - Analyst

Okay. And I guess the final question around this, how do the rating agencies look at this? Do they view it as committed capital, or is there a haircut on this?

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

Not on the remaining commitment. They only look at the NAV and it is treated as an other asset, and does have a little bit higher charge than an equity investment. But that is basically -- they treat it equity-like.

**Mike Grasher** - *Piper Jaffray - Analyst*

Okay.

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

That's the way we've always kind of described this. It is sub-equity allocation strategy, and it has way outperformed the S&P 500. But, Mike, you and I have talked about this many times. The problem with this is the (inaudible) geography in the sense that when it comes through the P&L and the volatility that it creates.

And this is why we are always opportunistically looking at this portfolio and price discovery in this segment has improved tremendously.

**Mike Grasher** - *Piper Jaffray - Analyst*

Thanks very much.

**Operator**

Alison Jacobowitz.

**Alison Jacobowitz** - *BofA Merrill Lynch - Analyst*

Bank of America Merrill Lynch. Thank you. I didn't hear it. I just wanted to see if there was anything unusual or if you could talk a little bit about the expense ratio in the quarter and also the other earnings. And maybe just from a modeling perspective, how that might trend going forward, both those items.

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

I wouldn't say there is anything dramatically unusual in the expense ratio in the quarter. Obviously, the other expenses, as we've talked before, the biggest fluctuation that you end up seeing there really comes from how our equity acts, because that is -- our long-term awards run through there. So it's a compensation expense at the holding company level, and that is where those numbers run.

So that is the biggest item that you see there. I don't know that I would model anything differently, other than whatever you expect our stock price to do.

**Alison Jacobowitz** - *BofA Merrill Lynch - Analyst*

Okay. Thank you.

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

The other thing I would add to that, Allison, our variable expenses have been remaining pretty consistent, in the 19, 19.1, 19.2. And there was a very, very modest uptick in variable costs in the quarter of about 40 basis points; it went from 19.1 to 19.5. But that flops around a little bit, but that is pretty consistent.

**Alison Jacobowitz** - *BofA Merrill Lynch - Analyst*

Okay, thanks.

**Operator**

(Operator Instructions) At this time, I am showing no further questions.

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

If you have any other follow-up items, please contact Jennifer and Dale. Thank you very much.

**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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