

FINAL TRANSCRIPT

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SIGI - Q4 2010 Selective Insurance Group, Inc. Earnings Conference Call

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PRESENTATION

Operator

Good day, everyone, and welcome to the Selective Insurance Group's fourth-quarter year-end 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.

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

Good morning. Thank you. Welcome to Selective Insurance Group's fourth-quarter 2010 conference call. This call is being simulcast on our website and a replay will be available through March 4, 2011. A supplemental investor package, which includes GAAP reconciliations of non-GAAP financial measures referred to on this call, is available on the Investors page of our website at www.selective.com.

Selective uses operating income, a non-GAAP measure, to analyze trends and 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.



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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 the 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 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 over the call to Dale to review the quarter results.

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

Thanks, Jen. Good morning. Our results for the fourth quarter and 2010 were on target with our overall expectations. There were a number of moving parts during the year, but overall we were pleased with how well we held our ground.

Soft market conditions persisted in the Commercial Lines space and catastrophe losses were higher than average, but we continued to push positive rate in both Personal and Commercial Lines. We experienced our most significant catastrophe year through a series of micro-cats with over \$56 million in pretax losses, or 4 points on the combined ratio, more than twice what we normally budget. In spite of the difficult industry environment, we successfully achieved our seventh consecutive quarter of Commercial Lines price increases.

For the quarter, we reported operating income per diluted share of \$0.48 as compared to \$0.47 a year ago. Higher net investment income and favorable prior year reserve development due to ongoing net positive claims trends drove results. The fourth-quarter statutory combined ratio was 102.8%, an improvement of almost a point from a year ago. Catastrophe losses in the quarter were a more normal 1.2 points, offset by prior year favorable casualty reserve development of \$7 million pretax or 1.8 points. Total statutory net premiums written were down 1% in the fourth quarter and 2% for the full year.

Due to normal seasonality, our fourth-quarter premium is lower than the other quarters, putting pressure on the statutory expense ratio. Multiple years of declining premium has impacted industry expense ratios across the board. However, we have been diligent in our efforts to remain expense-conscious. Despite the 2% decline in 2010 premium, our expense ratio has remained relatively constant from a year ago. For the year, both the statutory and GAAP combined ratio came in at 101.6%, in line with our guidance of 101.5%.

Commercial Lines growth continues to be a challenge given economic and competitive conditions. Commercial Lines statutory net premium written declined 4% in the quarter, largely driven by audit and endorsement return premium and a decline in new business as we continue to maintain underwriting discipline.

The \$5.5 million in return audit and endorsement premium in the quarter was a significant improvement from the over \$10.8 million we saw in the third quarter. For the full year, we experienced approximately \$48 million in return premium versus \$62 million in 2009. You will note that the historical numbers are revised as a result of a refinement to our definition of audit premium. For the fourth quarter and going forward, workers' comp policies that are canceled mid-term are now included in cancellations, not in audit premium.

Commercial Lines new business declined 29% in the quarter. This decline illustrates the challenge for middle-market and large accounts. We continue to grow small business, which makes up a much larger percentage of our book on a policy count basis versus the middle and large account business.



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Commercial Lines renewal pure price was up 2.8% in the fourth quarter and up 3.1% for 2010. Point-of-renewal policy retention held firm at 87% for the quarter and year as we continue to push for positive pure price. Retention is strongest for small business while middle-market and large accounts are seeing the most pressure.

We reported a Commercial Lines statutory combined ratio of 101.9% in the fourth quarter and 100.8% for the year. Catastrophe losses contributed 3.3 points to the combined ratio in 2010. Commercial property performed very well throughout the year with a 93.7% statutory combined ratio, including 16 points of cat losses.

Commercial auto also had a good year, reporting a statutory combined ratio of 90.2%. Commercial auto results were positively impacted by favorable prior year development of 9.6 points from lower-than-anticipated severity, primarily in the 2004 through 2009 accident years.

Similar to the rest of the industry, workers' compensation results continue to show the negative impact of a soft economy. The fourth-quarter statutory combined ratio for this line of business was 123.8%. This includes about six points of adverse prior year reserve development related to severity in the 2008 and 2009 accident years. And although workers' comp net premium written was up slightly in the quarter, it was entirely due to less audit return premium.

Personal Lines net premium written grew 13% in the quarter to \$64 million and the statutory combined ratio was 108.1%, which included 2.3 points of cat losses. The quarter results also included three large homeowners' property claims totaling approximately \$4 million and adding 7 points to the Personal Lines combined ratio in the fourth quarter. While we continue to grow Personal Lines, given the current relative size of the book, large losses create volatility from quarter to quarter.

Turning to the reinsurance renewals, we successfully renewed the property catastrophe program in January. The program structure changed to \$360 million, in excess of \$40 million, compared to the \$310 million in excess of \$40 million we had in place in 2009. The diversification of the program remains strong and is comprised of a group of financially solid reinsurers with an average A rating from A.M. Best.

Fourth-quarter and after-tax net investment income increased 2% to \$31 million from a year ago. Alternative investment income of \$6 million after-tax drove the increase, partially offset by declining fixed income yields. The after-tax yield on fixed maturities was 2.8%, flat with the third quarter, but down about 50 basis points from 2009.

Invested assets increased 4% from a year ago to \$4 billion. Our overall fixed income portfolio maintains a very high credit quality of AA and duration of 3.5 years, including short-term investments and 3.7 years excluding short term. We continue to increase our investment in corporate bonds while reducing our exposure to municipal securities. Equity exposure was 1.8% of invested assets, up slightly from last year and down from 2.1% in December of 2009.

In the fourth quarter, we had an opportunity to reduce our exposure to alternative investments and sold five funds for a net realized loss of \$3.4 million after-tax. By reducing this exposure, we were able to lower our outstanding commitments by \$22 million to \$64 million and carry back an \$18 million tax loss to take advantage of expiring capital gains offsets.

While we are still committed to maintaining a private equity strategy in our portfolio, the reduction allows us to reallocate risk in the equity and equity-like invested assets to achieve better risk-adjusted returns.

There has been considerable press lately about stress on state and local governments from declining revenues, large, unfunded liabilities and entrenched cost structures. This has spurred speculation about potential fallout on the municipal bond market. With our investment outsourcing arrangement, we have broad access to municipal bond experts who are constantly monitoring the portfolio in light of the changing landscape for municipalities.

Our \$1.4 billion municipal bond portfolio is very high quality with an average AA rating. 33% of the portfolio matures within three years with another 32% maturing between three and five years. The portfolio has a 63% weighting to high-quality revenue



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bonds and an additional 9% weighting to state general obligation bonds. At 13%, our largest state exposure is to Texas. However, the local Texas General Obligation Bonds, that tend to be at a higher risk, represent only \$53 million or 3.7% of the \$1.4 billion portfolio, well diversified and closely monitored by our outside investment managers.

The remainder of our Texas exposure is the highly rated revenue bonds, Texas Permanent School Fund Bonds and pre-refunded bonds that all have dedicated revenue streams. Our exposure to New York, California, New Jersey and Illinois represents only \$34 million, or 2.3% of the portfolio. Overall, we are comfortable with the quality, composition and diversification of our muni exposure and continue to monitor the environment. Compared to a year ago, the unrealized gain position improved to \$83 million pretax at December 31, 2010 from \$45 million at December 31, 2009.

Also noteworthy is the quarter-end unrecognized gain position in the fixed income held-to-maturity portfolio of \$42 million pretax or \$0.51 per share after-tax. Other-than-temporary impairments, or OTTI in the quarter, were minimal at \$278,000 after-tax versus \$7.5 million in the fourth quarter of 2009.

Surplus remains strong at \$1.1 billion at December 31 and stockholders' equity increased 7% to \$1.1 billion from year-end 2009. Our book value per share, which includes minimal intangibles, increased to \$19.95 from \$18.83 at year-end 2009. Our capital position, as measured by the premium-to-surplus ratio, improved to 1.3 to 1, down from 1.5 to 1 a year ago. The dividend yield is currently 2.9%, providing a competitive return while the stock trades at 90% of book value. We continue to monitor our capital levels and review options to maximize shareholder returns.

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. Our agents and employees held their ground through another challenging year in the Commercial Lines market. I am proud of the discipline our underwriters continue to exercise. We achieved our seventh consecutive quarter of positive Commercial Lines renewal price, a substantial achievement considering the market we continue to face.

Our 980 agents play an integral part in achieving this success and we continue to value our strong relationships with them. We closely monitor retention as we execute our pricing strategy. On a point-of-renewal basis, Commercial Lines policy retention for the quarter was 87%, relatively flat with 2009. Full-year policy retention was also 87%.

Pressure on retention levels remains greatest on the large accounts as competitors are still most aggressive for this business. We remain focused on the long-term profitability of our Commercial Lines book of business.

By using our underwriting tools and leveraging the relationships between our agents and underwriters both inside and in the field, we have improved our overall mix of business. The policy retention at the point of renewal is strongest on our highest quality accounts. In 2010, this business, comprising about 58% of our modeled book, retained at 2 points better than average as we achieved renewal price increases of 1.7%.

Our worst performing business, comprising about 15% of our book, showed retention levels 7 points below the average as we achieved a 9% renewal price increase. These statistics demonstrate the success of our strategy to get rate on a granular basis when market conditions do not permit more broad-based renewal price increases.

If companies don't have the capability to target rate through this level of detailed segmentation, we believe they will find it difficult to achieve renewal price increases when the market starts to firm.

We are writing the majority of our new model business in the highest quality four and five diamond range while we work to achieve profitability in our worst performing business through disciplined underwriting and more aggressive pricing.

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Our agency partners are supporting these efforts as submission activity from our agents remain strong, although pressure remains on hit ratios. As a result of the pressure on hit ratios, Commercial Lines new business was down 21% for the year compared to 2009.

By segment, one-and-done automated small business was flat at \$74 million. Middle-market or AMS-generated business was down 26% to \$125 million. Selective Risk Managers, our large account business, was down 50% to \$12 million.

We have made progress in diversifying our Commercial Lines book of business. In 2010, non-contractor new business comprised 68% of Commercial Lines new business, 4 points better than a year ago. The line of business showing the greatest strain is workers' compensation. While frequencies have declined 26.9% over the three years since we deployed predictive modeling, medical and indemnity severity is up substantially, driven by medical cost inflation and the soft economy.

This is an industrywide issue. We are addressing the situation by increasing rates where we can and by diversifying our Commercial Lines book away from contractors, the segment most impacted by economic conditions.

On the claims side, we have a number of initiatives underway to improve case management, better assigned claims and a more specialized model and increased penetration with our preferred provider networks.

The Personal Lines book is growing. Much of the growth reflects rate increases we have been able to achieve and new business as we diversify the book outside of New Jersey. New business increased 12% in 2010 as policy counts outside New Jersey were up 15%.

Unlike Commercial Lines, the Personal Lines market has been more receptive to price increases as we achieved pure renewal rate increases of 6.4% in the fourth quarter and 5.4% for the year. For the full year, our pure rate on automobile was 6.1% while homeowners was 4.9%. We implemented rate increases in 2010 that will generate \$14.8 million in additional premium on our in force book and we expect to implement another 39 rate increases in 2011 that will generate \$15 million on our in force book.

Not only have we had success increasing price, but retention remains strong. The quality of our Personal Lines book continues to improve. The mix of business is changing as we write a greater distribution of low frequency, high retention business. The overall insurance score is also improving.

We did not achieve our Personal Lines goal of a sub-100 combined ratio run rate in the latter half of 2010. Results were negatively impacted by elevated catastrophe losses, large fire losses in the fourth quarter and the cost of new business.

Personal auto profitability is directly related to the age of a book of business. The immaturity of our book will produce results that are below industry performance, but we expect that as our book ages, this penalty will drift downward. We fully expect to be profitable in Personal Lines for the full year 2011 despite this new business penalty.

Personal Lines is an important component of Selective's business model as it has historically helped smooth industry cycles and reduced earnings volatility. It is also important to our agents that we offer Personal Lines products as the majority of independent agents write both commercial and Personal Lines. Earning and rate increases and maturing the book will allow for more consistent profitability over the long haul. Now I will turn the call over to Greg.

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

Thank you, John, and good morning. Reflecting on 2010, I am pleased with the progress Selective has made on a number of fronts that have set the stage for us to outperform our Commercial Lines competitors. We are at the trough of a multiyear, highly competitive Commercial Lines cycle coupled with a still struggling economy.

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We met our expectations in 2010 despite a significant and unusual number of micro-cats and higher-than-expected Commercial Lines, audit and endorsement return premiums. Back in 2009, we took a leadership position to drive Commercial Lines renewal price rate increases and ended 2010 with our seventh consecutive quarter of positive rate. Our inside underwriters and agents fought an uphill battle to achieve the pricing success while artfully balancing retention. It is not an easy accomplishment in a continued undisciplined marketplace.

We made significant investments in our insurance operations for long-term efficiency and profitability. We completed and implemented the second generation of predictive models after bringing them in-house. The use of models is one of many underwriting tools that allow us to improve our underwriting quality.

Over the past two years, we continue to increase our underwriting appetite, as well as added 11 new Commercial Lines products provide greater opportunity for our agency force to place more business with Selective.

In addition, we expanded our one-and-done pipeline to drive more small business through this seamless underwriting system, an area where we've experienced ongoing new business growth. In our Personal Lines operation, we achieved significant rate success in 2010 and will continue to drive rate into 2011, particularly in the homeowners line. As John stated, we are on track to achieve overall profitability in Personal Lines in 2011.

In 2010, we embarked on initiatives in our claim organization, which are expected to reduce claim costs by 3 points over the next three-years period that include litigation management through more effective use of staff and panel counsel, ongoing vendor management to ensure we have the highest quality vendors at the best price that add expertise to our underwriting adjustment -- our claim adjustment process and more effective integrated outcomes in the resolution of claims in workers' compensation and other casualty lines of business.

In April, we announced the outsourcing of our investment portfolio to outside managers to take advantage of the broad sector and security expertise offered by dedicated investment managers. We completed several reviews of our portfolio that focus on the municipal sector. We are able to take advantage of an opportunity in the alternative investment space to reduce our exposure and reallocate risk to achieve better long-term risk-adjusted returns.

The hard work of our employees and agents over the past several years will not go unrewarded. We expect to participate more fully in a market turn than those carriers without similar granular pricing and underwriting capabilities.

As we move through 2011, we will control the things within our power and continue to drive long-term profitability and growth. It's difficult to fathom that we are looking at another year where pricing discipline may still be elusive for the broad Commercial Lines industry.

Despite being subject to the same industry fundamentals, principally lower investment returns and rising loss costs, the talk at the top of most companies about the need for rate still isn't being deployed at the street level.

In addition, the well of reserve releases will soon run dry making the need for increased pricing and underwriting discipline even more critical.

Our 2011 plan anticipates an ongoing difficult Commercial Lines marketplace without broad-based price increases. We're able to incorporate into our plan 3 points of positive Commercial Lines price increases and 5 points of Personal Lines price increases that we achieved in 2010, as well as our expectations to drive positive rate in both segments in 2011.

Most of the premium increases will offset higher loss trends we have anticipated due to increasing medical and other claim costs. As a result, we provide the following 2011 guidance -- a statutory and GAAP combined ratio of between 101 and 102, which includes an elevated catastrophe loss assumption of 2 points and no assumptions for reserve development, favorable or unfavorable, and weighted average shares outstanding of approximately 55 million.



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We are not providing investment income projections, but our investor packet includes an exhibit that shows investment income by component for the fourth quarter and full-year 2010 with related yields and tax rates. We believe this information will allow you to create your own 2011 models using your own assumptions on interest rates and financial market movements.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Doug Mewhirter, RBC Capital Markets.

Doug Mewhirter - RBC Capital Markets - Analyst

Good morning. I just had a few questions. First, I noticed that considering the winter storm activity up in the Northeast in the fourth quarter, your cat losses seemed unusually low, to be quite frank. Were there -- could you even come close to quantifying what maybe the non-cat wintr-related losses were from that -- those snow storms, like either in the auto or the homeowners, if there were even any at all?

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

I am just going to kind of frame it in terms of -- when you look at snowfalls like that, you always have to look at the weight of the snow and you have to look at when it came. And I think this storm was a little bit different than some of the storms that maybe we had in the early part of 2009 and if you kind of reflect on the storms that we had in early 2009, there were like 25, 30 inches in places that normally don't get high snowfalls, i.e. Maryland, Virginia and even further down south and that is where a lot of that claim activity came from, fairly heavy weight of snow claims.

But when you look at this storm that happened recently, more of it was here in the north. The snow was lighter. It was coupled with higher winds, didn't create big snow loads on roofs and therefore, it did not create an unusual number of losses. Although the snow was rather large, it didn't create a lot of losses for us. Do you have anything else to add in terms of --?

Doug Holbrook - Selective Insurance Group, Inc. - SVP Chief Claims Officer

No, I would say, as far as fourth quarter of last year, most of the storms came in late December, so we didn't see really any impact on a frequency standpoint on losses. And as far as the storms in the first quarter of this year, we haven't seen a significant increase.

Doug Mewhirter - RBC Capital Markets - Analyst

Okay, thanks. That's very helpful. My second and final question, I guess toward Dale, so it sounds like you're pretty cautious on municipal bonds even though the spreads have widened considerably. I assume that you wouldn't see this as a buying opportunity seeing that you are still reducing your exposure to this asset class?

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

Well, that is obviously the challenge is that there is a steeper muni yield curve that makes it somewhat tempting in that regard, particularly in this low-yield environment. But the other thing we have to balance our muni purchases with is not only a concern about the financial health of the various municipalities, which obviously is definitely a concern, but also with our AMT position and given the fact that our guidance indicates between a 101 and a 102 combined ratio without those underwriting profits, then you start breaking into the AMT area, which removes some of the benefit of the municipals and the interest-free loans of the federal government that you have to contemplate in the overall returns that you are ultimately achieving. So the combination of that is what makes us less inclined to delve into the muni area in any big way.

Doug Mewhirter - *RBC Capital Markets - Analyst*

Okay, great. That's helpful. That's all my questions.

Operator

Bob Farnam, KBW.

Bob Farnam - *KBW - Analyst*

An overall question on the pricing model. I know you have talked several times about the diamond pricing -- the pricing for the different diamonds. And I am wondering how you avoid adverse selection with those one diamond accounts that you are jacking up the rates for. Some are walking and some are taking the rates, but I am just wondering how you avoid adverse selection there.

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

This is John Marchioni, Bob. I will answer that. A couple of things. We do obviously look at retention very closely, as well as the pure rate that we're earning on that business. But I think the most important thing to keep in mind there is the numbers we give you relative to rate and retention by those segments are at a line-of-business level and we continue to write -- and an account level. So in many cases, those lines will be associated on the same policy with other lines that score differently and in certain cases score better.

So when you look at our retentions there, we manage it from that perspective. We certainly look at things on an account level. We have been getting a fair amount of price on our retention -- in that segment rather. The retention has been fairly low. And then the other thing we do is manage very closely our new business with the same measures. So we understand where that business is coming in. The percentage of business we write in those categories relative to our existing inventory is significantly lower. Again, generally the business we will see there is associated with higher quality lines. And because we have built and deployed models at the line-of-business level, you need to manage it that way, but also look at it in the context of the overall account.

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

Bob, I would add to that. We have underwriting tools that allow us to flag a whole number of things. Diamond score is only one element and so we can look at the profitability of the agent. We can look at holistic areas where we have concerns from a segmentation, from a corporate underwriting standpoint that might maybe drive down through a sector of a book.



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So when we are looking at renewal inventory on a month-by-month basis, our inside underwriters aren't just looking at diamond score, they are looking at a multitude of issues that through some of the tools that our folks have on their desktop, they are allowed to quickly sift through all of that and focus on the accounts that they need to really drive. So we provide a lot of knowledge for them to know the accounts that they need to be driving the highest rate on. They are not just doing it across the board for that particular segment. So even within that segment, they have certain things that they are trying to accomplish, which I think helps even more so avoid being left with the worst of the worst.

Bob Farnam - KBW - Analyst

Very good. Thanks for that.

Operator

Alison Jacobowitz, Bank of America-Merrill Lynch.

Alison Jacobowitz - BofA Merrill Lynch - Analyst

Good morning. Good, good, good. Just a number clarification. Can you -- I just want to make sure I am getting it -- give the net prior year reserve change in the quarter?

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

It's \$6.5 million, \$7 million rounded.

Alison Jacobowitz - BofA Merrill Lynch - Analyst

And that was favorable?

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

Favorable, yes.

Alison Jacobowitz - BofA Merrill Lynch - Analyst

And were there any current year true-ups in the quarter?

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

Not that were of any substance, not like what we had at the end of the third quarter where we -- in the third quarter, we added to our comp line to bring the year-to-date up to a run rate. Nothing unusual in the fourth quarter happened.

Alison Jacobowitz - BofA Merrill Lynch - Analyst

Okay, great. Thank you.



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Operator

John Grimstad, Piper Jaffray.

John Grimstad - Piper Jaffray - Analyst

Hi, good morning. Just a question -- a little follow-up on the \$7 million of favorable development. Could you break down the origination of that in terms of year-end line?

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

Sure. You guys want to (inaudible)?

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

Sure, you've got \$3.7 million of unfavorable development or adverse development in the workers' comp. You've got \$5.7 million of favorable development in general liability. You've got \$1.1 million of favorable in commercial auto, \$2.5 million in personal auto liability and a mixed bag beyond that.

John Grimstad - Piper Jaffray - Analyst

Great. In terms of the years, the years that that would come from?

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

Basically you are seeing the '08 and '09 year develop a little bit on the unfavorable side and prior years are the ones that are developing favorably. So the '07, '06.

John Grimstad - Piper Jaffray - Analyst

Great. Thank you. And then you talked a little bit about the immaturity of the personal auto book and just was wondering if you could maybe give us a little bit more color in terms of simply when do you think it will become more mature.

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

Let me just kind of -- I think it is helpful if you kind of look at the Personal Lines book under the following. On a year-to-date basis, if I kind of frame it at a high level, I think this will give you a little bit more clarity. If you looked at the Personal Lines book overall for the year, it came in at 106.4%. In the 106.4%, there is about 7.5 points of catastrophe losses and just a small amount of development in there that was favorable, about a point.

So when you look at that line ex cats, it is running at about 100% and for us, I would say a more normalized cat year, because, by all records, this year past 2010, was clearly an extreme, extreme event. And when -- we would probably normalize about 3 points of cats in the line. So we are kind of looking at a core book somewhat normal because we can't sit here and play take-out with cats. So we normalize for cats 3 points. We are running 103.



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And then when we look at our book of business, we are paying a new business penalty in our book that we feel adds approximately 8 points to the overall book. And so when you look at -- and that is on the auto side. On the home side, it is a lot less than that. It is probably in the -- maybe say half of that on the home side.

So when you look at what John talked about in terms of rolling that forward into 2011, there is a lot of rate. I mean we wrote almost 5 points of positive rate in 2010. That is going to earn into 2011. Our loss trend home is -- I mean in Personal Lines is actually a little bit lower than it is in Commercial Lines and then we expect to drive a lot more rate in there.

So you are going to have just a lot of rate that will improve that book. And then on a more gradual basis, let's call it penalty for new business growth will subside over time. So the 8 points will slowly diminish and that will take a number of years and a lot of that is really predicated on how much new business you continue to write relative to your total inventory. But the new business penalty as the book matures will continue to lessen and then our pricing, which is really the major factor when we look at the migration of the book in '11 over '10, is the fact that we are expecting a more normalized cat year, earning in a lot more rate and then a small amount of normalization on the new business load.

John Grimstad - Piper Jaffray - Analyst

That's very helpful.

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

Can I put a little bit more clarity around how we -- how do you take 106 book and say you are going to be profitable in 2011? That is how -- in our process, that is what we are looking at relative to the personal line segmentation.

John Grimstad - Piper Jaffray - Analyst

Great. Thank you. And one more quick one if I could. The three large homeowners' claims that I think you had said added 7 points to Personal Lines ratio this year, are those claims related at all or those are just distinct, separate --?

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

No, they are completely unrelated and I think the key point there is with the size of our home book as we continue to build scale, you're going to have that quarter-to-quarter volatility from large losses, but those are unrelated losses.

John Grimstad - Piper Jaffray - Analyst

Thank you. Understood. Thanks a lot.

Operator

(Operator Instructions) Caroline Steers, Macquarie.

Caroline Steers - Macquarie - Analyst

Hi, morning. Just when you talk about the pricing declines of your competitors in Commercial Lines, I was just wondering how much farther below are their rates than yours and are their rates starting to get closer to yours over the past few quarters?



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

Yes, I would just tell you, in some cases, we are losing accounts that we can't even get there in our pricing structure on certain cases. That is not all the time, but we find that, when a competitor wants to get very aggressive to write one of our accounts, we find them going extremely well. In some cases, below what we will call our technical premium, our pure premium, which is loss cost. So in some cases, we're losing an account to what we perceive to be -- at what we are paying out in losses, forget about expenses.

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

Yes, this is John. The only other thing I would add to that is just keep in mind, unlike Personal Lines, Commercial Lines pricing at a policy level is very much driven by discretionary credits that are applied to your base rate. So if you were to look at base rate structures for competitors, they are going to be all over the place and you may see some outliers. But generally speaking, that is not where the difference is. It is the decisions an underwriter makes when determining price per unit of exposure and how much schedule credit they apply to an individual account, which is where you see what Greg talks about technical pricing levels manifest itself.

Many states, you can deviate on an individual account as much as 40 or 50 points off of your filed base rates. When we talk about discipline in our operations, it's our underwriters looking at an account, doing an exposure analysis, using the various tools we have and then determining their comfort level deviating from the filed base rate.

So I think that is where you see from the discipline Greg's talking about is the level of individual schedule modifications that are put out on an individual policy account level as opposed to just pure base rate structures that are far lower.

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

Caroline, some of the things that we look at to make sure -- because obviously you only know your pricing year-on-year in terms of your same-store sales relative to your existing inventory, but some of the things that we look at relative to new business, we have our diamond score, so we look at the credit, we look at the quality of the business. We are not only looking at the diamond score, but we're also looking at the safety management reports. There is a whole host of things that we look at relative to that.

But then we also look at how we are writing that business relative to manual premium and that is just a barometer that we use. It is not a perfect barometer, but it is a barometer and when we look at our business in terms of what we write year to year relative to manual, those are holding stable and are actually slightly improving year-on-year. And if you are a company constantly cutting, cutting rate, it would evidence itself in a deterioration in your premium as a percentage of manual.

Again, it is not a perfect measure. It doesn't tell you what the competitor wrote it at, but it is an indication in terms of -- if you want to look at a benchmark, it is probably one of the only benchmarks out there that is probably most universal.

Caroline Steers - *Macquarie - Analyst*

Okay, thanks. And then just going back on exposure units, some of your larger competitors have sort of indicated some modest improvement there. And I don't if that is just a function of the size of the business that they are writing or if you guys are seeing that too in some of your small, middle-market sized?

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

Well, the best thing I can point there to is our audit premium, and our audit premium as you saw Dale mention that, our total audit premium for the fourth quarter was only \$6.2 million. That compares to a third quarter that was \$9.2 million, a second quarter that was \$13 million return. These are all return premiums, these are all RPs. A first quarter that was \$11 million and a full-year 2009 that ran \$39 million.

So you are seeing a slowdown in audit premium, which is telling you you haven't seen the total stabilization, but you are clearly seeing a reversal of some of the heavy, heavy RPs that you were experiencing before and a better leveling of that.

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

The other point -- just to point back to something that was in the prepared comments and the reason we have been focused on diversification, when you look at the contractors book and the exposure impact to contractors as the economy really went down a couple years ago, that was the segment hit the hardest and has been the slowest to come back from an exposure perspective. So when you look at our book, there is an impact of that as well.

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

Then the other side of it is endorsement premium. Our endorsement premium where you are starting to see endorsement, people are adding power units, they are adding other things to their schedules. We had positive endorsement premium in the fourth quarter. Fine, it was only 700 -- it was a little less than \$1 million, but that compares to some numbers that were running a lot more negative than that.

Our endorsement premium for all of 2009 was a return \$23 million in the first quarter -- let me put my glasses on here -- in the first quarter it was at \$5 million, second quarter was \$3 million, third quarter was \$2 million. Now the fourth quarter is positive \$1 million. So again, that is an exposure indication.

And you've got to remember, when you look at our topline premium, about 3.5 points of the premium reduction is generated by return -- if you just said the return audit and endorsement premium for 2010 was zero, that is where we are losing 3.5 points of the top line relative to that exposure diminishment. And it is starting to kind of trough out and pick up.

Caroline Steers - *Macquarie - Analyst*

Okay. That is all really helpful. Thank you.

Operator

(Operator Instructions) Robert Paun, Sidoti & Company.

Robert Paun - *Sidoti & Company - Analyst*

Good morning. Can you talk a little bit more on the comp business and what actions you are taking to reduce the losses in that book? I know you talked about raising rates. Do you have the number on increased rates on renewals in the quarter?

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

Yes, we do. I will give you the -- so for the quarter it was -- on comp 2% was the quarter, and the year on comp still running 2.2%. And that line has a tendency to be under a little bit more pressure because you do have some administered states that do their rate increases. And we are starting to see some pickup on that side.

So it's an area that we are driving more rate, but I think it's an area for us as an organization that we are going to be much more focused on managing our cost of goods sold down.

We have a number of initiatives focused around our PPO network in terms of the size of the network, and then much better focus on triaging, getting claimants into network as fast as possible into the right triage; more aggressive utilization on that front, doctor-to-doctor involvement.

It runs a multitude of items that we just need to get much more aggressive at the management of that claim inventory.

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

Greg's points are right on. As we said again in the prepared comments, if you look at frequency in the comp line over the last few years, it has been down, and down quite a bit. What is driving the performance there for us, and we anticipate the industry, is severity.

So there are certainly things you could do on the underwriting side, on the pricing side. As Greg indicated, you've got bureau established rates in many cases. You are starting to see some hardwire rate increases filed state-by-state within our footprint.

But it's about managing the severity, some of which is class driven, class of business driven. That is where the underwriting comes into play, but the rest of it is what you do in terms of medical management and identity management early in those claims. And that is why a lot of it is on the cost of goods sold side and claims initiatives.

Robert Paun - *Sidoti & Company - Analyst*

Okay, thanks. That's helpful. Just a last question on the investment portfolio. Greg, in the press release you said there has been some renewed interest in the alternative investments. So why reduce the exposure at this time? Can you just walk us through your thoughts on some of the sales that you made in the quarter?

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

This is Dale. We look at the alternatives as a whole. One of the issues, obviously, that we ran into in the '08-'09 timeframe was that we were predominately investing in private equity space, so they have very limited liquidity capability. So although the alternatives are performing a bit better, that also gave us a liquidity opportunity.

So in the interest of balancing the overall risk, it made sense to us to lighten that up to eliminate some of that liquidity risk, and put us in a better position on an overall basis. So that was kind of the thinking there. We had that opportunity.

We also had a tax position where we had capital gains in the 2007 tax year. Those were -- in effect, that tax year was closing at the end of 2010. So by generating capital losses in 2010 that we could carry back to '07, that provided us with really a yield opportunity in effect. Because those alternatives would have had to perform at substantially higher rates of return in the future to make up for that tax play that we were able to take advantage of.

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So I think if I had to -- as Dale said, it's about flexibility. We are not backing off that risk asset class. We are, but we just want to have more fungibility with our money to be able to move in and out. So we thought that, again, signing down the illiquid part of it and increasing the liquid part, but yet still staying in that risk classe, is something that we are trying to do. So it is a just a movement within a fungible group.

Robert Paun - *Sidoti & Company - Analyst*

Okay, got it. Thank you. That's all I have.

Operator

Bob Farnam, KBW.

Bob Farnam - *KBW - Analyst*

Hi, thanks. Just one quick follow-up on the workers' comp claim frequency. Obviously, you said it's been down a pretty good amount over the last two years. What is it looking like more recently, though? I'm curious whether that is bottoming or not?

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

Give us a second; we'll look it up.

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

Right now, the frequency is still for the accident year -- it's still down 4.5%. So it was still in 2010, on an earned payroll basis, down 4%. So frequency has still been declining. And let me -- I think you bring up a great point about frequency and frequency severity because I've heard a lot of these comments mentioned around the edges.

When we do our -- just so we are clear, when we do our 2011 budget and expectations, we have zero change in frequency. We are not budgeting an ongoing declination in our frequency count. You can do that; we have budgeted zero.

Now on the severity aspect, how we build our severity in, we do a four-year lookback. We bring everything on level, and then we build into our severity a higher cost of goods sold increase, and that is reflective of the fact that the medical aspect which is the largest part -- about 52% of the comp losses are medical. About 47% of that is in physician services, 47% in hospitals.

And when you look at those elements, they are up substantially in terms of inflationary aspects. And the remainder of it is drugs that are still up in the 3.5% range. So when you go through and look at that element and the fact that liability claims for the most part trade off of medical. So your medical is going higher and liability claims trade off medical; and the other aspects on the property side are more around repair, and repairs still go higher; that's how we do our planning process for 2011.

So we have a higher loss cost trend in. And I am kind of not hearing that same kind of methodology employed, and I am not sure exactly how that doesn't hold together for everybody.

Bob Farnam - *KBW - Analyst*

Okay, thanks for that. Thanks again.



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Operator

I currently show no further questions. I would like to turn the call back over to the presenters for closing comments.

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

All right, thank you very much, operator. Then, obviously, if anybody has any follow-up, please reach out to Dale and Jennifer. So thank you very much, operator.

Operator

Thank you. This does conclude today's conference. Thank you for participating. You may disconnect at this time.

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