

FINAL TRANSCRIPT

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SIGI - Q3 2009 Selective Insurance Group, Inc. Earnings Conference Call

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PRESENTATION

Operator

Welcome to the Selective Insurance Group's third quarter 2009 earnings release conference call.

At this time, for opening remarks and introductions, I would like to turn the call over to Vice President Investor Relations, Miss Jennifer DeBerardino.

Jennifer DeBerardino - *Selective Insurance Group, Inc. - VP, Investor Relations*

Thank you. Good morning and welcome to Selective Insurance Group's third quarter 2009 conference call. This call is being simulcast on our website and the replay will be available through November 30, 2009. 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.

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 10K and subsequent



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Form 10Qs 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, Chief Underwriting and Field Operations Officer, Ron Zaleski, Chief Actuary; and Kerry Guthrie, Chief Investment Officer. Now I'll turn the call over to Dale to review the quarter results.

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

Good morning. We're pleased to report solid insurance results with a statutory combined ratio of 99.8% in the third quarter. Commercial lines renewal pure pricing continues its positive trend with a 1.5% increase in the quarter, up from a positive 0.6% in the second quarter. We're very encouraged by the positive pricing trend and believe it reflects our dedicated field underwriting team leveraging excellent relationships and predictive modeling capabilities in the face of what still can be characterized as a very competitive commercial lines marketplace and a difficult economy.

For the third quarter we recorded strong operating income per diluted share of \$0.44, essentially flat with a year ago. Earnings were driven by better property results, lower catastrophe losses, and improved investment income.

As announced in our press release yesterday, we've entered into an agreement to sell our HR outsourcing business to AlphaStaff of Fort Lauderdale, Florida. The transaction is expected to close by year end. While we strongly believe in HR outsourcing services as a natural complement to our distribution force and business model, it made more sense to find a quality partner who could focus on those efforts as we devote our full-time resources to profitable growth opportunities in our insurance operations. We will continue to support AlphaStaff's business growth through our agency plan as part of the agreement. Note that Selective HR financial results have been moved into discontinued operations, including an after-tax \$7.9 million good will impairment charge in the quarter.

Alternative investments generated a pretax gain in the quarter of \$2.7 million compared to a \$3.2 million gain in the same period in 2008. Five of our seven strategies generated positive results in the quarter. Real estate continues to be a drag on the overall alternative investment performance and we would expect this to continue until the commercial real estate market stabilizes. As our alternatives largely report on a one-quarter lag, the \$11.5 million improvement in the third quarter from the previous quarter reflects second quarter market conditions.

Invested assets were up 6% at September 30, 2009 compared to the December 31, 2008, reflecting an unrealized gain during the period of \$137 million pretax on our available for sale portfolio. The financial markets recovery from its lows earlier this year is the driver of this gain. Market to amortized costs on the whole bond portfolio improved in the quarter to 102.3% from 99.5% at June 30.

For the nine months, our available-for-sale unrealized loss improved from \$57 million to an unrealized gain of \$31 million after tax, driven largely by fixed maturity securities. The net overall improvement increased book value per outstanding share by \$1.67. The valuation improvement, along with higher net income, contributed to the increase in book value from \$16.84 at December 31, 2008 to \$18.58 at September 30, 2009. Other than temporary impairments or OTTI in the quarter, were recorded at \$2.8 million after-tax, primarily reflecting our intent to sell two securities that are currently in an unrealized loss position. This is a substantial improvement from the prior three quarters and reflects the stabilizing financial markets.

Insurance operations performed well in the quarter. Our 99.8% overall statutory combined ratio was up from the 97.6% reported a year ago. Despite lower catastrophe losses and favorable reserve development, the combined ratio was negatively impacted by increased loss costs and the reduction in earned premium, mainly due to audit and endorsement return premium. Pretax catastrophe losses for the quarter were \$1.9 million, or 0.5 points on a combined ratio compared to catastrophe as a year ago that were \$12.8 million, or 3.4 points. Overall casualty prior year statutory loss and LAE favorable reserve development on a

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pretax basis for the quarter was approximately \$8 million, or 2.2 points on a combined ratio compared to \$5 million, or 1.3 points in the third quarter of 2008.

Commercial lines premium growth continues to be a challenge given the tough economic and competitive conditions. Commercial lines premium declined 9% in the quarter, half of which was driven by the impact of audit and endorsement return premium of approximately \$18 million compared to about \$1 million a year ago. This continues to hit the workers' compensation and general liability lines of business the hardest. New business declined 13% in the quarter. Renewal premium declined 2%, while retention ended the quarter at 75%.

Personal lines results improved 1.6 points in the quarter to a statutory combined ratio of 101.8% from 103.4% a year ago. The improvement was driven by a decrease in total property losses and decrease in loss costs in the casualty lines. Personal lines net premium written grew 11% in the quarter to \$62 million. The price increases that we have achieved over the past two years and our expansion efforts outside New Jersey are reflected in the premium growth.

At September 30, the premiums to surplus ratio was 1.6 to 1, down from 1.7 at June 30. Surplus increased \$30 million in the quarter to \$903 million, while stockholders equity increased \$40 million to \$986 million. Now I'll turn the call over to John Marchioni to review the insurance operations.

John Marchioni - *Selective Insurance Group, Inc. - Chief Underwriting & Field Operations Officer*

Thanks, Dale. Good morning. Insurance operations is focused on growing profitably. The decline in commercial line premium this quarter reflects not only a tough economy, but more importantly underwriting and pricing discipline. Pricing and retention are the two levers that underwriters monitor carefully. Our inside renewal underwriting teams are working hard to balance price increases with retention levels. With the success we've had in driving overall price, there was a 2 point drop in commercial lines retention to 75% in the quarter. On a point of renewal base, overall retention in the quarter was 88%, essentially flat with a year ago. When we look further into our retention, it's clear that we are driving improvement in our overall mix. At September 30, retention at the point of renewal for the lower quality 1 and 2 diamond business was 80%, while our best performing 4 and 5 diamond business retained at 90%. We believe this demonstrates that our underwriting expertise and predictive modeling tools are working as intended. Given current economic conditions and the continued presence of some undisciplined competition for new business, we believe that 75% total retention and 88% point of renewal retention are good results in today's markets.

Our field underwriters are writing the majority of new business in the highest quality 4 and 5 diamond range. The shift in quality of new business versus premodelling is noteworthy. 4 and 5 diamond business now represents 67% of new business versus 53% premodelling. While at the other end of the spectrum, 1 and 2 Diamond business represents only 7% of new business versus 17% premodelling. We believe our strong relationships with our 960 agents provides our AMSs with the best new business opportunities.

While the third quarter was the toughest so far this year for new business growth, we are confident that the business we are putting on the books has the best opportunity for profitability, given the underwriting information and granular pricing capabilities our underwriters have at their fingertips. New business pricing was down a modest 0.9% in the quarter, unchanged from the second quarter. In addition, we have seen submission activity from our agents remain very strong, while hit ratios are down from last year. Together, these factors demonstrate the discipline we've instilled in our operations.

Year-to-date commercial lines new business was up 3%. By segment, One and Done automated small business was up 8% to \$56 million. Middle market or AMS generated business was up 1% to \$133 million, Selective Risk Managers or large account business was down 1% to \$16 million, as this segment of the market continues to experience the most competition. We continue to see the shift in our commercial lines book of business away from contractors to our other more profitable classes. At September 30, our contractors mix stands at 40% of commercial lines premium, down from 43% at year end 2008. Our new business success in these classes is demonstrated by the following statistics for the first nine months of 2009. New manufacturer and wholesaler



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business was up \$8.5 million, or 27%. New specialty business, which includes social service, golf courses, and public entities was up \$6.3 million, or 27%. New mercantile and service business was up \$1 million or 2%.

The non-contractor class of businesses performed on average about 6 points better on the combined ratio than the contractors classes. As we grow these classes faster than contractors, our profitability will improve. To that end, we have provided our agents with a variety of programs, such as sales developmental training and active leads for writing good business within our appetite, which support our commercial lines diversification efforts. These leads have been pre-scored through our models and target pricing is provided to best ensure profitability.

For personal lines, market pricing moved much sooner than for commercial lines. We began increasing rates in 2008. Through September of this year, we have implemented 21 rate increases of 3% or more. We are expecting to implement another 6 before the end of the year. Together, 2008 and 2009 increases equate to \$26 million in additional premium opportunity on our in-force book of business.

Our MATRIX homeowner and automobile models with their precision pricing capabilities create organic growth opportunities. In personal lines, total new business increased 43% in the quarter from a year ago, while outside of New Jersey, new business increased 57%. This demonstrates that our diversification efforts are working. We are also seeing significant improvement in the quality of both homeowner and automobile business into higher scored sectors that have better claim experience. We believe that predictive modeling through MATRIX, along with \$26 million of additional rate on this \$216 million book of business will allow us to achieve our goal of being profitable on a run rate basis in the third or fourth quarter of 2010. Now I'll turn the call over to Greg.

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

Thank you, John, and good morning. I'm pleased with our third quarter results. Recovery in the financial markets have moved our alternative investment portfolio back into positive territory for the third quarter. We are seeing fundamental improvement in personal lines as a result of the numerous rate increases we've implemented and the predictive modeling capabilities we have through our MATRIX system. In commercial lines, we have achieved renewal price increases ahead of our competitors. We are benefiting greatly from predictive modeling and our other knowledge management initiatives. We believe that if you cannot deliver granular price changes, you're going to get killed in this market.

Our Knowledge Management tools were key in our ability to deliver positive pure pricing. For commercial lines, renewal pure price increased 1.5% for the quarter, up from 0.6% in the second quarter. For the third quarter, commercial lines renewal pure pricing outside of New Jersey's even stronger at a positive 2.1%. Through October 23, total commercial lines renewal pure pricing was up a positive 2.6%, which was up 0.4 points over the month of September and is now very close to covering our loss trends. Our commercial lines pricing strategy is very targeted. We focus most aggressively on increasing price in the least profitable 1 and 2 diamond sectors. While this does negatively impact retention rates, we are comfortable shrinking in the short-term to preserve long-term profitability.

We believe there will be a change in industry behavior in 2010 and companies will raise prices to improve underwriting results for the following reasons. Loss trends continue to move higher, particularly for medical expenses. Five years of commercial lines pure price reductions, interest rates remain low, and a recognition of more volatile financial markets, and as reserve releases start to diminish and calendar year loss ratios move higher, the past year has been challenging on many fronts, but we've seen significant recovery and progress.

Book value is up 10% since December 2008 with a five-year compounded annual growth rate of 4.4%. We've made significant progress in our personal lines profit improvement plan, with 21 filed rate increases of 3% or more to date and another six anticipated for the fourth quarter. Investment income has stabilized, as alternative investment income turned positive this quarter. Commercial lines pure pricing turned positive and the run rate is getting close to covering loss trends. When we exceed



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loss trends and written policy increases start to make their way into earned premiums, profitability should improve. The economic effect of audit and endorsement return premium comparisons should improve in the fourth quarter, as we move into 2010, we'll begin to show growth in commercial lines unless the competition ignores technical underwriting requirements and remains reckless. We have a number of claims initiatives under way to even more vigorously manage loss and loss adjustment expenses, such as litigation management, ongoing vendor management to get the best quality at the best price, more effective integrated outcomes and the resolution of claims in workers' compensation and other casualty lines, and we've diligently managed our expenses, maintaining about a 31.5% expense ratio in spite of top line premium declines.

We are positively revising our full year 2009 combined ratio guidance to approximately 101% on both a GAAP and statutory basis. This change reflects the improved profitability we've seen year to date and includes a fourth quarter assumption of 1 point of catastrophe losses. It does not assume any reserve development, favorable or unfavorable. Now I'll turn the call to the operator for your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question is from the line of Amit Kumarr with Fox-Pitt Kelton.

Amit Kumar - Fox-Pitt Kelton - Analyst

I was just going back to your comments regarding the change in industry behavior in 2010. Would you sort of hazard a guess or are you in the Bill Berkley camp where you see this in the first half, or are you talking more so about maybe third quarter or fourth quarter of 2010?

Greg Murphy - Selective Insurance Group, Inc. - CEO

I've got to tell you, we've got a pretty clear plan laid out for 2010 and our ability to stand behind that plan is now based on our very granular pricing capabilities. Obviously if the market moves, it needs to move in the first quarter of 2010 for us to exceed that plan, and we believe that because of investment returns, because of loss cost trends, because of five years of ongoing premium reductions, that that price trend needs to move and it needs to start in the first part of 2010.

Amit Kumar - Fox-Pitt Kelton - Analyst

Okay. That's a good point. I think, as I look at your rate changes, and I know you talk about Clips, I think day before yesterday CIAB numbers came out, which I think talked about a 6% rate decrease in third quarter, and if you look at the comments from some of the brokers essentially it's a buyers market. But can you just sort of help me reconcile this Delta where you are able to generate these price increases while some of the peers and the brokers are still talking about it being very easy, simply based on the current economy?

Greg Murphy - Selective Insurance Group, Inc. - CEO

Yes, let's kind of take that as pieces and I'll let John comment on this as well. Let's first understand that the Market Scout and CIAB are not really that scientific or actuarially sound methods, but they are an indication directionally of what you can see in a marketplace. I think these are generally in the larger account sector where you could be seeing more reckless pricing, so that could be one reason. You've got to understand that if you're talking to a large broker about segmentation and pricing changes and then you come and look at our book, for instance, our average account is more in the \$10,000 range. So, and the other

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element of that I think is when you start to look at our book, there's about maybe 30% that we're really focusing on price increases, so there's 70% of the book that really hasn't gotten much, if any, price increases as a result of our very, very granular targeted rate increases. So I think part of it is you've got to look at it more in the account by account basis. You also have to segment the sizes of the accounts, and that's why we believe that we track more closely to Advisen in or Clips and when you look at the Clips Surveys, they have moved positive and it does kind of corroborate our position about what we're doing in the marketplace.

John Marchioni - *Selective Insurance Group, Inc. - Chief Underwriting & Field Operations Officer*

The only other thing I would add is, we certainly saw the market start to get more disciplined in the second quarter and then things turned back to aggressive pricing from a new business perspective in the third quarter. And just to reiterate what Greg had said, when you look at how we're achieving our rate changes, the business that we're pushing out into the market based on applying rate increases tends to be the lower quality business, and I think that's what a lot of the competition is really starting to see out there and starting to pursue with rate levels that quite honestly are inadequate. So, you combine that with the fact that many companies, and we reported to you in our prepared comments a new business pure price number, many companies don't aggressively measure new business pure price. And I think as they start to realize the pricing levels they are putting this business on the books, that's going to force some discipline as well as they start to earn that through that renewal inventory.

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

The other part of the comment, the consumer. I think will be a critical part in maybe maintaining a softer market for a longer duration of time. Business is very difficult today. So in some cases, they can sit there and say, they could tell their agent to move them at any cost to another carrier, just to get a cheaper price. So, those are legitimate head winds out there and I hope you get the message from us with 2.6% price increases through October 23, we're very close to covering our loss trend at that point and we feel good about that but we also understand that we are out there ahead of the market. I read most other commentary. No one else is really getting price increases, particularly in the regional space, so we understand that we are ahead of the market, but until the market gets those kind of price increases, their combined ratio is going to be under pressure for another six or nine or twelve months more than ours will be under pressure. And I just think that's part of the reality of loss trends and price changes as we move forward.

Amit Kumar - *Fox-Pitt Kelton - Analyst*

And those are good points. I guess just talking about your premium to surplus levels being at 1.6, obviously you've talked about the new business opportunities and how much you can expand. How far can you go on the premium to surplus level before you sort of hit some sort of a ceiling?

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

Well, I would say we're very comfortable at our current 1.6 to 1 premium to surplus. Obviously, in this economy and with the pressures we're having, we're actually seeing some decline in premium, which moves that ratio downward, but I would say that we're comfortable with our capital levels. The one thing that we've said publicly is if you did have a very rapid hardening of the pricing out there, there may be some need to do something differently. But quite frankly, we just don't foresee that you're going to see that kind of a rapid hardening, so we're very comfortable where we are.

Amit Kumar - *Fox-Pitt Kelton - Analyst*

Okay, and then final question, and in terms of the reserve releases, I might have missed this, can you give some more color as to what lines did they come from, specific lines?

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Ron Zaleski - *Selective Insurance Group, Inc. - Chief Actuary*

Actually, reserve releases came from workers' comp, general liability and commercial liability. All about the same amount.

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

That was Ron Zaleski, our Chief Actuary, by the way.

Amit Kumar - *Fox-Pitt Kelton - Analyst*

Hi, Ron. Okay. Thanks so much and congrats on the quarter.

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

Thank you.

Operator

And your next question is from the line of Mike Grasher of Piper Jaffray.

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

Hi, Mike.

Mike Grasher - *Piper Jaffray - Analyst*

Good morning, everyone. Just more I guess question around risk to capital, has improved dramatically over the course of the first three quarters in 2009. What level, or what's it going to take from AM best perspective to remove that negative outlook that they have placed? Granted you still have the A-plus rating, but I'm just curious as to what they look at or what they are looking for?

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

Basically what they are looking for is improvement in the operating earnings, which basically the pressure was on the investment side of things, and obviously with the alternatives moving back in the positive territory, that's a very favorable thing. And then to see us begin to generate capital organically, which that's exactly what you're seeing here. So I think beyond that, it becomes that we've got to demonstrate a few quarters of that so that they feel comfortable that it's definitely the new current state.

Mike Grasher - *Piper Jaffray - Analyst*

Okay, and then do they come back to you sort of once a year, or can occur at any time, or how should I think about that?

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

Rating agencies reserve the right to do whatever they want at any time, but we do have a regularly scheduled annual meeting with them, which generally the meeting occurs in late February and they release their results in late April or early May. That's been the tradition, but they are not locked into that.

Mike Grasher - *Piper Jaffray - Analyst*

Okay. So they will get at least one more look before they come in in February?

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

Mike, they have their own model. They have the BCAR model and that's a measurement that we closely follow and we saw quite an improvement in those results in the third quarter as our surplus topped over \$903 million.

Mike Grasher - *Piper Jaffray - Analyst*

Sure. And then I wanted to ask about the workers' comp, just to confirm. It looks like the deterioration in the combined ratio in the loss ratio was entirely related to the amount of premium? For numerator denominator effect more so than deterioration on the--

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

Yes, there's a little bit of movement in the 2009 year, but most of that is, like you say, there's a lot of gyrations happening there in the audit and endorsement from an audit and endorsement standpoint and as Dale mentioned, we had about \$18 million of negative audit endorsement premium in the third quarter. That's substantially lands in two lines. The biggest one is the workers' compensation line and the next one is the GL line, as those are exposure-based lines. Let's make sure we understand that that is less exposure on the books.

Mike Grasher - *Piper Jaffray - Analyst*

Right.

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

That has pushed around both our underwriting expense ratio in that line, our loss adjustment ratio expense in that line, as well as a little bit on the loss ratio as a result of that huge fluctuation, and just to get this point out there, we only had \$1 million of positive audit endorsement in 3Q of 2008. As we move into the fourth quarter of 2009, we'll be comparing it to a fourth quarter of 2008 that's got about \$13.5 million of negative premium. So that's what we're starting to mean, that the comps will start to level out a lot more as we move into the fourth quarter of this year.

Mike Grasher - *Piper Jaffray - Analyst*

Okay, and then the change in the premium from workers' comp, year-over-year, how much was related to the negative audit versus how much on the retention aspect?

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

Dale -- we're looking for that exact split right now. I only have it in total, but I don't have it by line. We'll get that for you in a second. Any other questions that you have while we extract that information?

Mike Grasher - *Piper Jaffray - Analyst*

I'll come back to you a little bit later. That was it for now. Thanks very much.

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

Thanks.

Operator

And your next question is from the line of Sam Hoffman of Lincoln Square.

Sam Hoffman - *Lincoln Square - Analyst*

Yes, I just wanted to follow up on the question because it seems that your loss ratio excluding Cats and excluding development increased to 69.7% for the quarter from 66.9% in the second quarter and it sounds like some of that was due to the workers' compensation kind of one-time item. But I just want to clarify, what do you attribute that increase to and how much was sort of one-time versus a run rate going forward?

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

Well, there's a lot of moving parts in our loss ratio, so it's hard to so succinctly answer that question. I'll just tell you the over-arching issues, you're still earning in negative rate and you still have positive loss trend. So obviously as you move forward, you're going to see the ramifications of the negative rate and the trend impact your loss ratio on a quarter to quarter basis. So, last quarter was the first quarter we wrote at positive rate. This quarter we wrote at even more positive rate level. So you're going to see that kind of affect the liability lines as we move out into the fourth and first and second quarters of 2010. Then the other things that kind of pop the number around a fair amount is your performance in the property lines. But, it's hard to sit there and disaggregate that number into its pieces. There were some reserves that were moved into the current year, but most of that was due to the audit and endorsement situation.

Sam Hoffman - *Lincoln Square - Analyst*

Okay. I mean it just seems a 2.8% increase is quite significant one quarter to the next. And so I mean maybe we could follow up offline in terms of--

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

There's a lot of factors that push those numbers around.

Sam Hoffman - *Lincoln Square - Analyst*

But what do you see the run rate going forward as?

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

We don't prognosticate future run rates in terms of individual loss ratios. What we will tell you obviously is you can expect a combined ratio for the year to be approximately 101. So you can back into that by you know what our expense ratio looks like in the fourth quarter. You know that always tracks higher because our premium on a net premium written basis is always down in the fourth quarter and you can kind of work your model backwards and you can kind of play with that.

Sam Hoffman - *Lincoln Square - Analyst*

Okay, and the 101 excludes reserve releases?

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

There is no contemplation of either favorable or unfavorable development in that number, correct.

Sam Hoffman - *Lincoln Square - Analyst*

Okay.

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

And one point of Cat losses in there as well.

Sam Hoffman - *Lincoln Square - Analyst*

Okay. So I mean implicitly, what you're saying is that the 69.7 was unusually high for the quarter.

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

No, I didn't say that. I said there are a number of factors that push that around and some of them could be the audit premium or other issues and it's very hard to sit there and disaggregate that number any other way than that.

Sam Hoffman - *Lincoln Square - Analyst*

Okay, just quickly, there were two other items. Your yield on fixed income securities dropped to 4.35% from 4.6%. Can you explain that? And is that one-time as well?

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

That's a reflection of the lowering yields that are available in the marketplace and some of the trades that we put on our portfolio that have de-risked it, you can also see at the same time we shorten up duration a little bit as a result of that, but yes, the yields that we brought on versus the yields that came off, you are seeing a separation of that and that's one of the main thesis's for why price increases need to go up in the industry, because absolute yields are lower. And there's a recognition of more volatility in the investment world. So as you deal with both of those issues on the investment side, your underwriting results need to improve to offset that, which means that your pricing increases need to move higher because loss trends are loss trends.

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Sam Hoffman - *Lincoln Square - Analyst*

Okay. Third thing is your other operating income line and other operating expense line decreased dramatically in the quarter and I guess the spread got worse for you guys. Can you just talk about the implications the divestiture, or any other factors for that line? Because that's sort of adversely impacted you guys in the quarter.

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

I mean that is the major impact in the quarter, is the fact that we sold SHRS. So that's now moved to a discontinued operations line. So their income and their expenses are pulled out of those other categories on the face of the income statement and moved to the discontinued operations line. I know that several other analysts have asked the question about that. We're going to try and put together a little bit of a schedule and post it out on the web later today within our investor packet.

Sam Hoffman - *Lincoln Square - Analyst*

Would you expect anything to be less than that line after the divestiture?

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

Yes. Right, basically, yes, both of those will permanently be lower now because they won't contain the SHRS activity.

Sam Hoffman - *Lincoln Square - Analyst*

It's similar to the third quarter?

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

We're not making any prognostications with regards to the individual components that remain there.

Sam Hoffman - *Lincoln Square - Analyst*

Okay, and finally on the tax rate, maybe you could just briefly discuss that.

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

Sure. Basically it's tradition, been there since APB 28 came out, that you have to prognosticate what your expected tax rate will be for the full year and book your taxes on an individual quarter basis to that rate. So the difference between looking at the quarter on a cutoff basis and what your expectation for the full year gets booked as an effective tax rate adjustment within the quarter. So you can particularly tell I guess when you go to the year to date number that the effective tax rate adjustment is pretty small at this point, which is exactly what you would expect by the fourth quarter, you get to your full year run rate.

Sam Hoffman - *Lincoln Square - Analyst*

Okay, thanks again.

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

What all that means is obviously the taxes that will occur in the fourth quarter will be pretty true to the taxable at 35% and tax exempt at the tax exempt rates.

Sam Hoffman - *Lincoln Square - Analyst*

Okay.

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

The other thing, I got some information to Mike Grasher's previous question. Basically the audit side of things is about two-thirds of the audit premium comes from the workers' comp line of business. So out of the \$18 million, it's a little over \$11 million.

Operator

And your next question is from the line of Doug Mewhirter of RBC Capital Markets.

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

Hi, Doug.

Doug Mewhirter - *RBC Capital Markets - Analyst*

Hi, guys. One market-related question, maybe John or Greg could answer, guess it's more of a hypothetical. You've been talking actually for the last couple quarters about how a lot of times a competitor will come in and take away a long-time account at maybe 20% off of expiring. Would you describe that typical competitor as more in the category of a national carrier or more in the category of a regional carrier without getting too specific, of course?

John Marchioni - *Selective Insurance Group, Inc. - Chief Underwriting & Field Operations Officer*

The answer is yes. It's regional, national, and in certain cases, combination of the two.

Doug Mewhirter - *RBC Capital Markets - Analyst*

Okay, and would it be large versus small? I guess it would be more regional in the smaller and national on the larger, or is that not-- ?

John Marchioni - *Selective Insurance Group, Inc. - Chief Underwriting & Field Operations Officer*

Not necessarily. We compete against both national and regional players in our small markets and the middle market business all the way up the line in terms of size of business. So you do see them. It varies more geographically and more by segment. So your contractors competitor set in certain cases slightly different than the competitors set you'll see in manufacturing or specialty.

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Doug Mewhirter - RBC Capital Markets - Analyst

Okay, and--

Greg Murphy - Selective Insurance Group, Inc. - CEO

And I got to tell you, Doug, that has a big impact on our ability to move pricing and I would tell you, that really curtails your ability to move more and get a larger basket of policies in the price increase area. And that's where our struggle is in terms of how we look at 2010 and how hard we want to push and how big we want that inventory to include and how much we want those rate increases to be. And, that's where we, we have spent as a management team, fair amount of time on it. We'll continue to, as we set our pricing strategy for 2010, which theoretically will be done in the next few weeks. I mean you got January pricing that are going to be put out on the street in the next few weeks. So you need to be way ahead of this curve. You miss January, you miss the whole month. Now, that needs to be decided pretty soon.

Doug Mewhirter - RBC Capital Markets - Analyst

Understood. Thanks for your answers. That's all my questions.

Operator

And you do have a follow-up question from the line of Mike Grasher of Piper Jaffray.

Mike Grasher - Piper Jaffray - Analyst

Thanks. Just quick question on the change in good will. I think the discontinued operation impairment charge is \$7.9 million after-tax. Just trying to figure out, I think we ended last quarter at \$29 million in good will, or \$29.6 and now it's dropped to \$7.8. Can you reconcile the change, it's \$7.9 million, I'm assuming 35% tax rate would be \$12 million.

Dale Thatcher - Selective Insurance Group, Inc. - CFO

I'm sorry. I'm trying to figure out where you're trying to go exactly.

Mike Grasher - Piper Jaffray - Analyst

The \$12 million plus what's being reported now at \$7.8 million gets to \$19 million, and \$19 million compared to \$29 million, where did the-- ?

Dale Thatcher - Selective Insurance Group, Inc. - CFO

Take the \$8 million, you use the 35% tax rate, that grosses it up to \$12 million, or the number that you need there I think is what you're looking for, right?

Mike Grasher - Piper Jaffray - Analyst

I'm still \$10 million short.

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

Well, the overall good will that gets eliminated there is about \$21 million. Obviously there's the difference in the loss relates to the fact that we did sell it for \$13 million.

Mike Grasher - *Piper Jaffray - Analyst*

I see now. Okay. Thanks very much.

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

Got it?

Mike Grasher - *Piper Jaffray - Analyst*

Yes.

Operator

And you do have a follow-up question from the line of Amit Kumar of Fox-Pitt Kelton.

Amit Kumar - *Fox-Pitt Kelton - Analyst*

Amit Kumar from Fox-Pitt. Two quick follow-up. In terms of the discussion on competition, can you sort of isolate how much of that impacted your top line decline in commercial line space, maybe an approximate number?

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

It's hard to define that. As John articulated in his comments, we're getting as many at-bats from our agents in terms of being able to put pricing out on the street and our hit ratio is down and--

John Marchioni - *Selective Insurance Group, Inc. - Chief Underwriting & Field Operations Officer*

And in terms of the split-out and the overall 9% decline, it's roughly 2, 2.5 points of the 9% are driven by new business. That's not all competition-related, but you look at that as a subset of the 9% and then as we said, managing new pure price and managing mix the way we have has resulted in a lower hit ratio on the similar number of opportunities versus prior year.

Amit Kumar - *Fox-Pitt Kelton - Analyst*

Okay, that's very helpful. And I guess the only other question is in terms of your rate change of 2.6%, can we just briefly maybe touch upon some of the lines where you're seeing the greatest traction?

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

Yes, I don't have the line breakout on the 2.6%. I can just tell you geographically we now have two of our regions that are over 4% in price increases. I've got the quarterly number by line, but the 2.6%, if you're trying to get your arms behind the 2.6%, I



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will tell you that it's pretty spread throughout many of our geo locations. We have 2 over 4, one at 2.9 and the other region at 2.6. And we still have one region struggling getting any price increases at all. I'll tell you, that clearly falls into the super competitive market that they are in right now in terms of our business, but that kind of gives you the best sense that I have because that's a quick draw off our midterm pricing increases as we roll through the month of October, then we'll have everything by line and then all the other aspects of it.

Amit Kumar - *Fox-Pitt Kelton - Analyst*

And then what region is that, which is super competitive?

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

Right now the most difficult market right now is New Jersey.

Amit Kumar - *Fox-Pitt Kelton - Analyst*

Got it. Okay. That's all for now. Thanks so much, guys.

Operator

And your next question is from the line of Bob Fornam of KBW.

Bob Farnam - *KBW - Analyst*

Good morning. I have just a couple questions. Going back to the reserve, the favorable reserve development, can you give us an idea which accident years, like in workers' comp and general liability, those were coming from?

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

Ron will answer that for you.

Ron Zaleski - *Selective Insurance Group, Inc. - Chief Actuary*

For the most part, it's 2007 and prior for all lines.

Bob Farnam - *KBW - Analyst*

For all lines, okay. And sounded like you were raising your estimates for the current accident year. Can you quantify that?

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

That's two part. One, it's the audit premium impact and the fact that that was extraordinary, the level of audit premium that kind of pushed the levels around. What I mentioned earlier is the natural progression throughout the quarter where we're still earning in minus rate and we still have positive loss trends and that does move your loss ratios higher on a quarter to quarter basis.

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Bob Farnam - *KBW - Analyst*

Okay. I think you indicated before you thought the rates needed to get to like 3% or so to start offsetting loss costs?

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

That's a close number, yes.

Bob Farnam - *KBW - Analyst*

Okay, thanks.

Operator

And you do have a follow-up question from the line of Sam Hoffman of Lincoln Square.

Sam Hoffman - *Lincoln Square - Analyst*

Sorry. Just one other follow-up. You had commented that your real estate alternative investments would be a continued head wind on results, but yet that portfolio I believe was only \$21 million at the beginning of the year and I think you took significant write-downs on it in the first quarter. And so how much of that is actually left? And how significant can that be going forward?

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

Sure, there are three different, three different investments in the real estate sector. It represents approximately 13% of our overall alternative investment portfolio in terms of dollars, that's approximately \$19 million, and as you can see in the package that we disseminated, the loss in the quarter was \$1.2 million in that sector.

Sam Hoffman - *Lincoln Square - Analyst*

Okay, thank you.

Operator

And I show no further questions at this time.

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

I do have, before Greg closes up, just I kind of figured out what Mike Grasher's question was here, actually Tony Harnett figured it out. Where that extra piece of good will is, it's been relocated into the assets of discontinued operations line. So the good will was not written off entirely, it was just written down to reflect the selling price. So that remaining chunk of good will, about \$9.5 million resides in the assets of discontinued operation line on the balance sheet. With that, I'll pop it over to Greg it close it out.



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

Well, thank you, then. Underwriting and reserve discipline, coupled with a conservative well-positioned investment portfolio will be the foundation for our long-term performance. If you've got any other follow-up questions, please contact Jennifer and Dale. Thank you very much.

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