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WRB - Q4 2017 W. R. Berkley Corp Earnings Call

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PRESENTATION

Operator

Good day, and welcome to W.R. Berkley Corporation's Fourth Quarter 2017 Earnings Conference Call. Today's conference call is being recorded. The speakers' remarks may contain forward-looking statements. Some of the forward-looking statements can be identified by the use of forward-looking words including, without limitation, beliefs, expects or estimates. We caution you that forward-looking statements should not be regarded as a representation by us that the future plans, estimates or expectations contemplated by us will, in fact, be achieved. Please refer to our annual report on Form 10-K for the year ended December 31, 2016, and our other filings made with the SEC for a description of the business environment in which we operate and the important factors that may materially affect our results. W. R. Berkley Corporation is not under any obligation and expressly disclaims any such obligation to update or alter its forward-looking statements, whether as a result of new information, future events or otherwise. I would now like to turn the call over to Mr. Rob Berkley. Please go ahead, sir.

William Robert Berkley - *W. R. Berkley Corporation - CEO, President & Director*

Thank you, and good afternoon, everyone, and thank you for calling in for our fourth quarter call.

As in the past, joining me on this end of the phone is Bill Berkley, our Executive Chairman; and Rich Baio, our Chief Financial Officer. And also consistent with our past calls, the agenda is going to be, I'm going to offer some general comments or some macro comments on the marketplace; couple of sound bites on the fourth quarter from my perspective; and then Rich is going to be walking you through the quarter in some greater detail.

So from our perspective, it is an interesting moment for the industry. And I'm not necessarily talking about some of the things that we've discussed in the past, though they are meaningful. I'm not talking about data or analytics or technology or shifting distribution or change in customer behavior or any of those things that get a lot of headlines and are meaningful again. But I'm really talking about something that's a little bit more vanilla in nature.

And that is some of the fundamental changes or meaningful variables that we are seeing a shift in. And the first one I'll mention is tax. Obviously, that is a topic that we have talked about extensively on these calls. Others have talked about quite a bit, and many of you have written about. From our perspective this is a double plus, if you will. Obviously, domestic-based insurers will benefit as all of corporate America will benefit from a lower tax rate. But in addition to that, the reality or what has finally become a reality, this concept of leveling the playing field is very meaningful.

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I think some appreciate how significant this is. I think others are still beginning to get their head around it, but from our perspective it is consequential for many stakeholders.

There has been some speculation that this new reality is going to get dissipated through competition, while I'm happy to get into that during the Q&A. From our perspective, that is not going to happen and to the extent it does, it will not happen for many years. And again, during the Q&A, if you like, we can speak to that.

Second, what's worth mentioning is the strength of both the U.S. economy and for that matter, global economy. The health of the economy impacts obviously the health of our customers or our insureds. Our insureds, we are seeing their numbers growing. In addition to that we're seeing growth in auto premiums as well. In addition to that, a healthy economy oftentimes leads to an increased or rising interest rate environment. And obviously, for organizations like ours, that's very important for our economic model, while it may impact booked value in the short run, ultimately the trade-off of the benefit in the higher interest rate environment for our investment portfolio, and ultimately our economic model is consequential, to say the least, and that applies to others as well.

And finally, there is good old-fashioned idea of risk-adjusted return. Both in the third quarter and the fourth quarter, mother nature framed that for the industry once again. It continues to be a reality that this industry seems to struggle with. From our perspective, we are hoping that when the day's all done, the industry is going to be able to be more successful in getting their head around this idea of risk in return and appropriately factoring volatility to when they think about this concept.

Few specific or more specific comments on the industry. The reinsurance market place, well I guess, the good news is it's a little bit less lousy today than it was in the past, and hopefully it will be even better tomorrow. Much to our surprise when we look at the won ones, we were really taken aback that the property reinsurance market did not get more traction. Yes, there were rate increases, particularly parts of the market that were severely impacted, but it was really modest relative to historical data points when you've see events of this magnitude you would have expected a more severe reaction from a pricing perspective.

On the other hand, the casualty market seems to be showing signs, again, on the reinsurance front of gaining some momentum. Quite frankly, we are more encouraged with the traction that is being had in the casualty market. And quite frankly, it's very surprising to us. The only theory or idea that I can offer is the casualty market does not face the same surplus of capital or pressure from alternative capital that the property market faces, and perhaps the alternative capital, it is what dampening down more severe reaction in the property market, whereas in the casualty market where there isn't a significant presence of alternative capital, traditional markets have more pricing leverage.

Switching over to insurance. Remains a more positive picture. Generally speaking, we are actually quite positive as to where things stand. Maybe a quick sound bite on casualty. Much to our surprise, quite frankly, we think there is more momentum, there is more pricing leverage today than it was a year ago. Workers comp, slightly different story, though we'd still like margin in a lot of that marketplace. Clearly, the actions of state rating bureaus is starting to take hold. The property market, again, is an area where we are not a very large player, but we do participate. Clearly, pricing is moving up and cat-exposed pricing is moving up even more. And auto, which is something that we've discussed quite a bit with many of you in the past continues to be pointed in the right direction and is clearly getting greater and greater traction every day.

Probably the one piece of the insurance market that's making us pause and scratch our head a little bit is professional liability. We've touched on this in the past. Very broad marketplace, a variety of different classes, if you will, or exposures under that umbrella. But when we look at that part of the market overall, we believe it is becoming evermore right for a hardening. It's difficult to say when that is going to occur, but quite frankly, based on how we see planets and the stars lining up we would think that it would take 12, maybe 18 months at the most, but probably sooner rather than later given the amount of pain.

Turning to our quarter. Obviously, the 94.9% is not what we are looking to achieve. Having said that, if you look at the environments, if you look at the results of many market participants and you look at the volatility the industry has faced yet again in the fourth quarter, 94.9% not all that bad given, again, the circumstances.



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Rich is going to get into the details behind that, the 61.4%, the 33.5%. And he's also going to give you a little bit of visibility on the expense ratio and how much of that is coming from what we would define as startup businesses, de novos, what have you, that are 3 years old or less and the impact of that's having on the expense ratio.

Top line. Obviously, it was modestly negatively impacted by the reinsurance market -- right, the reinsurance business, excuse me, and particularly the challenges in the domestic or U.S. treaty reinsurance market. We applaud our colleagues and their efforts and their discipline and ultimately, we expect at some point the marketplace will provide an opportunity for us to expand that platform again in the future.

On the other hand, the insurance business was flattish, if you like. There are some components of that, that I think Rich is going to reference, where quite frankly we've gotten rid of or have jettisoned a few books. And that has had a negative impact. That impact will probably be behind us by the end -- certainly the first quarter, maybe sometime in the second quarter. And my best guesstimate and given all the disclosures that I've already mentioned earlier, I can probably say this, is that you're likely to see us start to grow in the second quarter, maybe the first quarter, we'll have to see how that plays out.

Turning to the balance sheet briefly. And again, Rich will get into the weeds here. But on the reserve front, yet another quarter of net development that was to the positive. I don't know how many it is in a row, but it's a lot at this stage. It's worth mentioning that we are very conscious of some of the macro shifts that are going on in the environment. We've talked a little bit about inflation. We've talked a little bit in the past about loss trends. And we are, again, sensitive to, aware of the fact that the industry has benefited from an extended period of really very benign loss trends by and large with the exception of perhaps medical inflation. And we are not betting so to speak that, that will continue in the future. So when we look at the picks that we are carrying and the picks that we are using going forward, we again are very in touch with that.

On the investment front, yet another quarter of gains. I think we have talked to you also we're blue in the face about how we have pivoted the approach that we're taking on the investment front. Very much focused on total return investing for wherever we think we can get the best risk-adjusted returns and sometimes those returns don't come through operating. They thus come through net thanks to the accounting profession. Having said that, from our perspective, as it relates to the fixed income portfolio, we do see rates no different than most other folks see rates moving up, and we think that it is going to our -- to benefit the actions that we have taken as we have held our breaths and shortened up our duration, and quite frankly given up some fixed income yield. Our colleagues on the investment side operated with a great level of discipline, and now we're going to see yields probably going back up and it will give them the opportunity to reconsider that.

So this is a point of comparison. The duration of the investment portfolio is about 3 years. The average ratio of our reserves is a little bit north of 4. I don't think you're going to see that spread much more, but again we are pretty well positioned for a rising interest rate environment.

So that is enough from me. I will leave it there and turn it over to Rich. Thank you.

Richard M. Baio - *W. R. Berkley Corporation - CFO, SVP and Treasurer*

Thanks, Rob. We've reported net income of \$155 million or \$1.21 per share for the fourth quarter, representing a slight improvement from a year ago. We're pleased with our quarterly results and continue to demonstrate a sound approach to managing exposure to catastrophic events.

Pretax underwriting income was \$81 million, largely unchanged from the year ago quarter. Gross premiums written were unchanged due to our disciplined focus on risk selection and pricing and adequacy. Our cautious approach to exposure management and use those outward reinsurance led to a small decline in net premiums written of about 2% to approximately \$1.48 billion.

The insurance segment was relatively flat with \$1.35 billion of net premiums written. New operating units and product offerings as well as expansion in several International geographies contributed to premium growth. While our withdrawal from a few lines of businesses at certain operating units offset this growth. The reinsurance segment decreased \$27 million to \$127 million in the quarter due to the North American property and casualty treaty reinsurance business. The accident year loss ratio before cat was 60.7% compared with 60.1% the year ago.

Cat losses declined from \$37 million a year ago to \$18 million this quarter, of which \$8 million related to wildfires in California.



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This translates into 1.1 loss points for 2017 compared with 2.3 loss points for 2016.

Loss reserves developed favorably by \$7 million or 0.4 loss points compared with \$17 million or 1.1 loss points for the same period last year. We carry out an internal ground up reserve review each quarter, and the quarterly prior year development is based upon this analysis. At the end of the year, our external auditor carries out the reserve review with part of the audit, which validates the adequacy of our reserve position. Accordingly, our reported loss ratio is relatively flat at 61.4% quarter-over-quarter. The expense ratio decreased slightly from the year ago quarter, which was favorably impacted by the reduction in commission expense relative to the change in net premiums earned.

In part, this reduction was offset by increased underwriting expenses from the addition of new operating units. In addition, Berkley One, our high net worth business began underwriting risk in Illinois during December, and it's quarterly expenses will be reflected in the first quarter of 2018.

Historically, the average for new operating units, as Robert referenced, defined at less than 3 years of operation, contributed approximately 0.5 expense ratio points. This brings our combined ratio for the fourth quarter of 2017 to 94.9%, unchanged from the prior year. The core portfolio investment income increased approximately \$14 million compared to a year ago led by fixed income securities with an annualized yield of 3.5% and real estate income. Investment funds contributed \$17 million to net investment income, which declined \$21 million from the prior year as energy prices were below the prior year's level. We've highlighted the potential variability that may arise in the fund performance on a quarterly basis. We anticipate the energy funds performance in the first quarter of 2018 may approximate this quarter's energy funds result.

Pretax net realized investment gains were \$57 million, net of performance-based compensatory costs. We continue to have significant unrealized investment gains in our equity portfolio, including HealthEquity as well as Fannie Mae and Freddie Mac. Beginning in 2018, new accounting rules become effective causing the change in fair value of certain equity investments to be reflected in the income statements rather than accumulated other comprehensive income.

And accordingly, we'll see the effects of this change in our first quarter 2018 results. The effective tax rate was 22.4% for the quarter. There are 2 elements impacting the rate this quarter. First, the realized investment gains, which increased the rate above normalized levels due to its disproportionate contribution at a 35% rate. Second, the tax reform legislated late in December under the Tax Cuts and Jobs Act of 2017. As it relates to the tax reform, there are 2 key drivers resulting in the estimated tax benefit of \$21 million or \$0.16 per share. The reduction in the tax rate from 35% to 21% is applied to the net deferred tax liability we've established in the U.S.

Offsetting this benefit is the onetime deemed repatriation of foreign earnings and related impact on the utilization of foreign losses. It's important to note that limited guidance has been issued by treasury and the IRS regarding the application of many complex provisions. We have reasonably estimated the impact of the tax reform and expect any adjustments to be reflected following on the completion of our 2017 tax returns.

We continued to annualize the impact of tax reform on our 2018 effective tax rate, which will depend on the mix of domestic and foreign income as well as tax-exempt income. At this time, we estimate the effective tax rate should approximate the marginal rate of 21%. At December 31, 2017, after-tax unrealized investment gains were \$375 million. The average rating was unchanged at AA-, and the average duration for fixed income maturity securities including cash and cash equivalents was 3 years. Our return on equities to the quarter on an annualized basis was 12.3% on net income and 10.9% for the full year. Book value per share increased \$2.88 to \$44.53 from the beginning of the year, representing an increase of 6.9%. We repurchased approximately 290,000 shares in the quarter at an average price per share of \$67.02. Total capital return to shareholders for 2017 was \$236 million, resulting in book value per share growth of 10.9% for the full year.

Thanks, Rob.

William Robert Berkley - *W. R. Berkley Corporation - CEO, President & Director*

Great. Thank you, Rich. Okay, if we could please open it up for questions now.



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QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Amit Kumar with Buckingham Research.

Amit Kumar - *The Buckingham Research Group Incorporated - Analyst*

I guess, 2 quick questions. The first question goes back to your opening comments. And I was wondering if you could sort of sketch that out a bit more and this goes back to the comment you made on the tax benefit not getting competed away on, I guess, the commercial and specialty lines versus personal lines. Can you just elaborate on that?

William Robert Berkley - *W. R. Berkley Corporation - CEO, President & Director*

Yes. So when you think about at least the space that we operate in and a significant number of our specialty commercial lines competitors, they are parent, if you will, are domiciled outside of the United States. They effectively have had a tax rate that is materially below the tax rate that we as an organization and other peers that are domiciled in the U.S. have had to deal with. So what has effectively happened is our tax rate is going down, and their tax rate may very well be incrementally going up. And that gap has narrowed. So for them to be able to achieve the same results and compete in the market, something is going to have to give. They are either going to change their pricing and raise it. They are going to change their risk selection. They are going to accept lower returns, something is going to have to give. And when I made that comment, I'm assuming that they are not inclined to want to accept dramatically lower returns. So those that have enjoyed a lower tax rate, that is a meaningful part of the marketplaces that all of a sudden are not going to have that advantage in their economic model, I think will be the biggest backstop to this marketplace eroding. They need to with -- they are going to have to figure out how they compete.

Amit Kumar - *The Buckingham Research Group Incorporated - Analyst*

Got it. And, I guess, you slipped the discussion on personal lines. And obviously there is a lot of discussion out there. And I'm sure you've seen the California insurance commissioner and all the news out there. Does this change in tax rate, does this provide, I guess, support for the Berkley One high net worth product down the road or how should we think about the impact of your expansion in this space down the road?

William Robert Berkley - *W. R. Berkley Corporation - CEO, President & Director*

Yes. We -- honestly, we certainly catch the headline as you do. And from our perspective, it does not impact or change the opportunity that we see for Berkley One both in the short, intermediate and long term.

Amit Kumar - *The Buckingham Research Group Incorporated - Analyst*

Got it. And then just one final question on, I guess, on the reinsurance and it was interesting to listen to your comments. I think you said it did not get more traction. If you look at the book where it stands on the reinsurance side in terms of, I guess, the top line, and I think you made a comment that Berkley Re America had shrunk. How should we think about this for 2018? Do you think based on the pluses and minuses, you are where it should be or there could be incremental opportunities in it?

William Robert Berkley - *W. R. Berkley Corporation - CEO, President & Director*

I think it's hard to know exactly what tomorrow will bring. At this stage, at least in the short run, I think there is probably more opportunity outside of the U.S. than in the U.S. just due to competition. That could change, however, very quickly. Having said that, obviously, when we write a treaty, it takes time for that quota share structure to come through in the net written premium. So my view is that we'll have to see how it unfolds. But



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we think we have a great team of people both domestically as well as outside of the U.S. And they know the expectation is to make money, not to issue treaties or reserves. I think the other piece is, that's worth mentioning, we do have a meaningful fact presence. And ultimately, if you see a market that starts to really harden the fact that this could provide a meaningful upside. So again, the division of the business has shrunk and, again, we think that in the aggregate it might shrink a bit more during '18. But we'll have to see what holds for the second half of the year.

Operator

Our next question comes from Arash Soleimani with KBW.

Arash Soleimani - Keefe, Bruyette, & Woods, Inc., Research Division - Assistant VP

So one question I had. I know you don't give guidance. But in terms of the tax rate on operating income. I mean, is that reasonable for us to expect that to be below 21% given the favorable tax treatment on investment income?

Richard M. Baio - W. R. Berkley Corporation - CFO, SVP and Treasurer

It's certainly a possibility. I think, as I was mentioning in my remarks, a lot of it will be dependent upon where the profitability of the business lies. We have International businesses that are taxed at much higher rates. So if you look, for instance, in our Latin American operation, Argentina tax is at 35%; Brazil tax is, I believe, at 45%. So once again, it will really depend on where the profits come and then that in relation to the tax exempt interest, which is a preference item to bringing that 21% marginal rate down. So we will need to, obviously, do our best to maximize the profits in the right place.

Arash Soleimani - Keefe, Bruyette, & Woods, Inc., Research Division - Assistant VP

Okay. And I think you may have mentioned this in the remarks also, but in terms of the higher other costs and expenses this quarter, is that just a function you said of new units that you're investing in and ...

William Robert Berkley - W. R. Berkley Corporation - CEO, President & Director

Yes. That as I've commented, Rich has commented as well, when we start a new operation, when it's in its formation stages before they actually start running business, we keep that expenses at the holding company or parent, if you will. Once they are operational, then they will appear or come up in the expense ratio, not in the holding company, if you will, expense. And what ended up happening with one of the units during the fourth quarter was they went live during the quarter. So part of it is in the holding company expense and part of it is in the expense ratio. But it will be all in the expense ratio for the first quarter and there will be some impact.

Arash Soleimani - Keefe, Bruyette, & Woods, Inc., Research Division - Assistant VP

And that was Berkley One, right?

William Robert Berkley - W. R. Berkley Corporation - CEO, President & Director

Yes.



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Arash Soleimani - Keefe, Bruyette, & Woods, Inc., Research Division - Assistant VP

Okay. Okay. And does anything change with higher interest rates? If we do have higher interest rates, does anything change in terms of your investment strategy? Like, is the \$100 million per year still something that you would target in realized capital gains if we could have a meaningful?

William Robert Berkley - W. R. Berkley Corporation - CEO, President & Director

Yes, I think the answer is yes. Obviously, if you look back over the past couple of years, we have comfortably exceeded that. It can be lumpy at times, but the placeholder that we've provided over the \$100 million that certainly from our perspective comfortably make sense for the foreseeable future.

Operator

Our next question comes from Kai Pan with Morgan Stanley.

Kai Pan - Morgan Stanley, Research Division - Executive Director

Just want to confirm on the tax rate. Did Rich mention like 21% would be sort of all-in effective tax rate or that's like given the plus, like, and minuses on the tax law changes?

William Robert Berkley - W. R. Berkley Corporation - CEO, President & Director

Rich, what did you mention?

Richard M. Baio - W. R. Berkley Corporation - CFO, SVP and Treasurer

I mentioned 21% and that would be our expectation right now on a global basis. Although, as I mentioned, that could change depending upon the mix of where the profits are coming.

Kai Pan - Morgan Stanley, Research Division - Executive Director

Okay. I just wanted to confirm that because you have a sizable muni portfolio. I would think that tax rate will be lower than the new corporate tax rate. But you mentioned you have some international operations that's higher than the U.S. tax rates.

William Robert Berkley - W. R. Berkley Corporation - CEO, President & Director

Yes, right.

Kai Pan - Morgan Stanley, Research Division - Executive Director

But overall probably like 21%.

William Robert Berkley - W. R. Berkley Corporation - CEO, President & Director

I think Rich is suggesting that's a good placeholder, but there can be pluses and minuses. And unfortunately, treasury has not provided perfect clarity yet. So we're still working through that just like everybody else.



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Kai Pan - Morgan Stanley, Research Division - Executive Director

Okay, great. And then on the pricing outlook seems like you are more positive on that. I just wonder if you compare the pricing trends you're seeing now versus the loss cost trend you're seeing. Do you think we're -- the pricing still need to catch up the loss cost trend or we could potentially see the underlying margin expansion?

William Robert Berkley - W. R. Berkley Corporation - CEO, President & Director

Yes, from our perspective the pricing is, give or take, in lockstep with loss cost trend. So we're probably not getting a lot of altitude there. But I would suggest to you that we are getting altitude in mix of business, and I would expect that overall margins will benefit from that due to mix of business. And then in addition to that, quite frankly, I think it's certainly possible that the pricing will get momentum from here in some parts of the portfolio. So as I sit back and look at the business overall, I do think that there is margin expansion going on, but I don't think it's necessarily driven by -- solely by the rate lever.

Kai Pan - Morgan Stanley, Research Division - Executive Director

Okay, great. And then my last question on the sort of a merger acquisition front. If you think about now the tax reform also leveraging the plain field potentially in the merger acquisition front opportunities as well and you recently see a large commercial player buying up a muni reinsurer. I just wonder, from your perspective, right now, do you see that, like, acquisition opportunities for Berkley?

William Robert Berkley - W. R. Berkley Corporation - CEO, President & Director

Well, I think that, obviously, we are an organization that tries to pay attention to what's going on. We try and make sure that we are aware of what opportunities are out there. At the same time, we are cautious and cheap with the shareholders money, some people have suggested. And as a result of that, we take a view that when it comes to building the business, we are very comfortable being patient and building it organically brick by brick. That way it's much more controlled. Having said that, we would certainly never rule out an acquisition if we thought that it made sense for the shareholders.

Operator

Our next question comes from Brian Meredith with UBS.

Brian Robert Meredith - UBS Investment Bank, Research Division - MD, Financials Research Sector Head & Global Insurance Strategist

Robert, just curious. Back to tax and computation. Specifically on workers compensation insurance. I mean, you're obviously very involved with the NCCI. And why wouldn't it have an impact on kind of what the kind of rate levels that they are indicating that should be on workers comp?

William Robert Berkley - W. R. Berkley Corporation - CEO, President & Director

The truth is that, I think that for the most part, the rate levels for workers comp are mainly driven by people looking in the rearview mirror and historical data and experience. We'll have to see what the impact is over time. But from my perspective, we certainly don't see that having a visible impact at this stage.



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Brian Robert Meredith - UBS Investment Bank, Research Division - MD, Financials Research Sector Head & Global Insurance Strategist

Okay, great. And then secondly, Rob, just curious on loss cost inflation. But talking about an improving economy, I think sometimes you actually see a pickup in lost cost inflation with an improving economy. I'm not sure you guys generally agree with that, and if so, is it something you guys are looking for?

William Robert Berkley - W. R. Berkley Corporation - CEO, President & Director

Yes. It's clearly something that we're paying close attention to in certain lines of business when you see the economy humming along. Oftentimes, you can see lost cost trend moving in the direction that can have a negative impact on claims activity. So we are focused on it. Hence, the comments earlier, we don't want to overreact, at the same time we do not want to get caught behind. I think there are some folks out there that are perhaps mistakenly assuming that they can bank on what's been a very benign environment for the past many years. We will not be in that camp.

Operator

Our next question comes from Ian Gutterman with Balyasny.

Ian Gutterman - Balyasny Asset Management L.P. - Portfolio Manager

I guess, my first question is on investment income. First, the fixed coupon income has been ramping up \$3 million, \$4 million, \$5 million a quarter each quarter throughout the year. But the investment assets aren't growing that significantly. So I assume that's pickup in short-term yields or you're rearranging on the longer side too. I'm just sort of curious what's driven that and whether that might continue?

William Robert Berkley - W. R. Berkley Corporation - CEO, President & Director

Pickup in short-term yields is correct.

Ian Gutterman - Balyasny Asset Management L.P. - Portfolio Manager

Okay. Have you allocated more towards short-term investments or it's just the existing bucket is getting better yields?

William Robert Berkley - W. R. Berkley Corporation - CEO, President & Director

The answer is both.

Ian Gutterman - Balyasny Asset Management L.P. - Portfolio Manager

Both. Okay. Are you finished allocating more to short term or is this kind of where you're at a good proxy for '18?

William Robert Berkley - W. R. Berkley Corporation - CEO, President & Director

I think that we've probably gone as far as we could. I'll find out from our general counsel if you can come to our investment meeting.



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Ian Gutterman - Balyasny Asset Management L.P. - Portfolio Manager

Okay. The other part on investment as I was a little surprised that the energy mark would be tough again in Q1 because I thought in general the commodity complex did pretty well in Q4.

William Robert Berkley - W. R. Berkley Corporation - CEO, President & Director

I think just as a reminder, and I think Richie has commented on this in the past. We booked that on a quarterly lag. So we're not going to give you the indicator necessarily as what to expect in the first quarter. But if you look at what's happened with energy prices a quarter before, that's not a bad leading indicator as to what you might expect.

Ian Gutterman - Balyasny Asset Management L.P. - Portfolio Manager

Okay. I thought I heard comment that Q1 would be similar to Q4, so maybe I misunderstood that.

William Robert Berkley - W. R. Berkley Corporation - CEO, President & Director

No, I don't think so.

Ian Gutterman - Balyasny Asset Management L.P. - Portfolio Manager

Okay. Okay, got you.

William Robert Berkley - W. R. Berkley Corporation - CEO, President & Director

Anyway, sorry, if there was a misunderstanding.

Ian Gutterman - Balyasny Asset Management L.P. - Portfolio Manager

That was probably just me, mishearing it. So I had a broader question on your commentary on professional lines and beyond sort of the tough pricing just what you're seeing in the loss environment there. I mean, it seems like obviously, just the D&O filings, maybe a lot of it is nuisance-type stuff, but it is still -- the filings are way up. And then obviously, we see headlines about all the harassment-type stuff that I assume would lead to EPL claims. But I don't know how significant that is for -- does every newspaper article mean for your settlement or how we should think about that? But maybe just in general, sort of where you're seeing pressure on the loss side?

William Robert Berkley - W. R. Berkley Corporation - CEO, President & Director

So I think, by and large, while it's not everywhere, more often than not, there is an increase in the claims activity that has been hitting the professional liability market and this is on top of a marketplace where they -- for the most part directionally rates have been headed in the wrong direction for some period of time now. I think, the point that you made earlier is not a bad leading indicator. You pick up the newspaper you hear about what's going on in the world and you try and think about what does this mean for the insurance industry. Well, you know what? There is more claims activity that's hitting the professional liability space. Because of some of the things that you referenced, but also some of the things that we've discussed in the past where from our perspective, you were seeing a, generally speaking, more litigious environment. You're seeing a more aggressive plaintiff bar that is getting traction. You're seeing an increasing frequency of severity. And it's one of those things where it doesn't really appear typically in a very abrupt way, it kind of creeps up when you're not paying attention.



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Ian Gutterman - Balyasny Asset Management L.P. - Portfolio Manager

Agreed, agreed. Okay. And then just my last one is on the Berkeley One. Could you give us a sense of sort of where the next states are beyond Illinois, are you sort of starting in the Midwest or was that -- just trying to figure out or can you give anything for that or?

William Robert Berkley - W. R. Berkley Corporation - CEO, President & Director

I'll give you what clarity I can. So our expectation is by the end of the first quarter where we will be in 2 more states. Some of that is a little bit out of our control, quite frankly, because we are at the mercy of insurance departments and their approvals. So we haven't come out and said exactly what those states are. But the gang that's running that business they have a few in the hopper, and I think there are 2 at the top of the list. But I don't know how much we've communicated it. What I would tell you is, we are going to markets that you expect we would go to markets, markets that are not as rich, if you will, and our target market are probably not markets that we are making as much of a priority.

Ian Gutterman - Balyasny Asset Management L.P. - Portfolio Manager

Got it. So it still sounds like a -- I was trying to dance round a little bit, I guess. It sounds like less coastal and more maybe sort of windtail type states for now, is that a reasonable proxy?

William Robert Berkley - W. R. Berkley Corporation - CEO, President & Director

I'm going to stick to my answer before. And we will make sure that when we announce it, you're on the distribution.

Operator

Our next question comes from Jay Cohen with Bank of America Merrill Lynch.

Jay Adam Cohen - BofA Merrill Lynch, Research Division - Research Analyst

Two questions. I guess, the first one for Rich. Rich, can you talk about the new -- on the fixed income side, kind of the new money yields you're looking at in the market relative to what your portfolio is yielding now?

Richard M. Baio - W. R. Berkley Corporation - CFO, SVP and Treasurer

The new money rate on that we are seeing now is at about 3%.

Jay Adam Cohen - BofA Merrill Lynch, Research Division - Research Analyst

Okay. And so that's still slightly below your fixed income portfolio yield?

Richard M. Baio - W. R. Berkley Corporation - CFO, SVP and Treasurer

Yes, that's correct.



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Jay Adam Cohen - BofA Merrill Lynch, Research Division - Research Analyst

Okay.

Richard M. Baio - W. R. Berkley Corporation - CFO, SVP and Treasurer

And it's shorter duration, also don't forget.

Jay Adam Cohen - BofA Merrill Lynch, Research Division - Research Analyst

Right. So extending the duration, obviously, would change that. So I can see that. I guess for Rob, your comments on your offshore competitors probably having to change the way they price business to achieve similar returns does make some sense. Having said that, they seem to be commenting, the ones that have commented publicly, have kind of said the tax change shouldn't have a material impact on their results. How do you square those 2 things?

William Robert Berkley - W. R. Berkley Corporation - CEO, President & Director

So Jay, I would suggest that that's a conversation for you to have with them. I can't square it, so if they connect the dots for you, maybe you could pass it on to me particularly to my father, he would be very interested. But again, I just look at the macro and I look at their economic model. I look at economic model that others have similar to ours. I look at what's changing. And if people want to be able to remain where they are, it just doesn't work. So maybe there's something that I'm missing. And again, I certainly don't want to be rude or disrespectful to any of our competitors outside of the United States. We have a lot of time for them. But when I look at the situation as a case study, I don't understand how they would reach that conclusion. So maybe you can figure it out and let us know.

Operator

Our next question comes from Josh Shanker with Deutsche Bank.

Joshua David Shanker - Deutsche Bank AG, Research Division - Research Analyst

So just wondering if you can give me a little bit of background on what you're seeing in the medical stop loss market. I know it's not a huge market for you, but you guys are there. I'm hearing a lot of companies are thinking about getting in, and I'd like to know a little bit about barriers to entry, and whether you think this market in particular has any tax-related implications going forward?

William Robert Berkley - W. R. Berkley Corporation - CEO, President & Director

So as far as that marketplace goes, I think that the #1 barrier to entry is expertise. Unfortunately, that barrier is not always recognized by pools of capital and they just step in and oftentimes, it takes a little while but that ends in tears and then they respond accordingly. So -- and we've seen that happen. The good news about this line of business is it's relatively short tail, so people who zig when they should zag it, it comes into focus pretty quickly. As it relates to the marketplace overall, I think one obviously needs to be very cognizant of what's going on with loss trend. But generally speaking, from our perspective, we've been in the business for many years now. We're very pleased with our participation. And while it's competitive market like every market we operate in, we are not particularly put off at the moment by the level of competition.

Joshua David Shanker - Deutsche Bank AG, Research Division - Research Analyst

Are there some switching costs involved?



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William Robert Berkley - *W. R. Berkley Corporation - CEO, President & Director*

The answer is that any time an account moves from one place to another, there is a bit of friction, if you will. But I wouldn't want to lead you to the belief that, that is a significant barrier.

Joshua David Shanker - *Deutsche Bank AG, Research Division - Research Analyst*

Okay. And then on workers comp. Can you just discuss the will of regulators to win public support for their actions and how that can affect your desire to seek rate in that line of business?

William Robert Berkley - *W. R. Berkley Corporation - CEO, President & Director*

Ultimately, it really varies very much by state and by regulator. Clearly, there are some insurance departments and state rating bureaus that are very focused on the idea of a healthy and sound workers comp marketplace for their state, and understand the implications on their economy in their state. I think there are others that may take a shorter-term view. When the day is all done, we look at a marketplace, we look at exposure, we think about what an appropriate rate is. If we can get that rate, we'll write the business. If not, we're not going to write it.

Joshua David Shanker - *Deutsche Bank AG, Research Division - Research Analyst*

And you can move in and out as you please in a highly regulated line like that?

William Robert Berkley - *W. R. Berkley Corporation - CEO, President & Director*

The answer is that we are in a position to provide continuity to a marketplace that we think make sense. Ultimately, if the marketplace moves away from what we think is an appropriate rate, customers are certainly able to find an alternative perhaps at a different rate. But our goal, as we have explained and demonstrated to stakeholders, is to provide a continuity for customers and ultimately we think that's part of our value proposition.

Operator

(Operator Instructions) Our next question comes from the line of Arash Soleimani with KBW.

Arash Soleimani - *Keefe, Bruyette, & Woods, Inc., Research Division - Assistant VP*

I just had a quick follow-up. I wanted to make sure I understood the comment on the energy portfolio. Could you just repeat it one more times?

William Robert Berkley - *W. R. Berkley Corporation - CEO, President & Director*

Sure. Let me make sure this is what you think you heard. We may have made a couple of comments on the energy portfolio. Long story short, we bumped the energy portfolio on a quarterly lag. As a result of that, what you saw come through in the fourth quarter was actually the results from the energy portfolio in the third quarter. So when you look to the first quarter results, those will actually be a reflection of what happened in the fourth quarter. So to the extent that you want to try and anticipate what will happen in the quarter, if you look at the prior quarter, that will give you a sense.



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Arash Soleimani - Keefe, Bruyette, & Woods, Inc., Research Division - Assistant VP

Okay. And maybe just one for Rich real quick on the accounting change you had mentioned. I think that's just the mark-to-market changes that you're talking about. And if so, will that just cause a bit more volatility in the numbers?

Richard M. Baio - W. R. Berkley Corporation - CFO, SVP and Treasurer

Yes, they will. So as you know right now we mark-to-market the equities as well as our fixed income portfolio for the most parts through equity. And so this accounting change is going to apply to the -- obviously, to everyone. So equities will now go through P&L and we'll weigh up that variability. But it is only as it relates to certain equities, just to be clear. So -- and that's been fund and so our equity accounted for, so those would not be mark-to-market other than if the underlying fund to market is positioned to market.

Arash Soleimani - Keefe, Bruyette, & Woods, Inc., Research Division - Assistant VP

Right, right. And will you just lump these mark-to-market changes into your capital gains line or will it have a separate line item?

Richard M. Baio - W. R. Berkley Corporation - CFO, SVP and Treasurer

There are special disclosures that we'll need to follow under the accounting rules, so there will be change with regards to that. But you'll see the delineation.

Operator

Next, we have a follow-up question from the line of Jay Cohen with Bank of America Merrill Lynch.

Jay Adam Cohen - BofA Merrill Lynch, Research Division - Research Analyst

My question was answered. I just couldn't figure out. I withdraw the question. So I'll do it verbally.

Operator

Thank you, And I'm not showing any further questions at this time. I would like to turn the conference back over to Mr. Berkley for closing remarks.

William Robert Berkley - W. R. Berkley Corporation - CEO, President & Director

Okay. Well, thank you all for calling in. Couple of quick sound bites before you run off and start checking out other releases. From our perspective, our strategy around risk-adjusted return and focusing on volatility, we were able to execute that, again, second quarter in a row. I think that was demonstrated in the results. In addition to that, we are optimistic quite frankly about market conditions for parts of the market that we are meaningfully players in. I think we touched on that as far as rate as well as some of the underwriting actions that we have taken. In addition to that, we continue to be very enthusiastic about what has happened on the tax front and ultimately, what that means for our economic model. And finally, of course, the comments earlier about a rising interest rate environment and the leverage for us and our economic model, in particular, given the significance of investment income as a result of our large reserve base.

So by and large, we are very enthusiastic about '18. We think '18 is going to be good year for us. And quite frankly, it is going to be an opportunity for us to set the table for what will be a good '19 as well. Thank you all for calling in and we will speak with you next quarter. Good night.



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Operator

Ladies and gentlemen, thank you for your participation in today's conference. This concludes today's program. You may now disconnect. Everyone, have a great day.

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