Company Name: WR Berkley
Company Ticker: WRB US
Date: 2018-04-24
Event Description: Q1 2018 Earnings Call

Market Cap: 9,393.40
Current PX: 74.32
YTD Change($): +2.67
YTD Change(%): +3.726

Bloomberg Estimates - EPS
Current Quarter: 0.839
Current Year: 3.619
Bloomberg Estimates - Sales
Current Quarter: 1874.500
Current Year: 7551.500

Q1 2018 Earnings Call

Company Participants

- W. Robert Berkley, Jr.
- Richard Mark Baio
- William Robert Berkley

Other Participants

- Amit Kumar
- Arash Soleimani
- Kai Pan
- Jay A. Cohen
- Ian J. Gutterman

MANAGEMENT DISCUSSION SECTION

Operator

Good day and welcome to the W.R. Berkley Corporation First Quarter 2018 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 using – of the use of forward-looking words including, without limitation, believes, expects or estimates. We caution you that such forward-looking statements should not be regarded as representation by us that the future plans, estimates or expectations contemplated by us will be, in fact, achieved.

Please refer to our Annual Report on Form 10-K for the year ended December 31, 2017, and our other filings made with the SEC for a description of the business's environment in which we operate, and by 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 of new information, future events or otherwise.

I would now like to turn the call over to Mr. Rob Berkley. Please go ahead, sir.

W. Robert Berkley, Jr.

Brian, thank you very much. And good afternoon, all, and welcome to our first quarter call. Joining me on this end of the phone as in the past is our Executive Chairman, Bill Berkley; and Rich Baio, our Chief Financial Officer. And then the agenda for today, again, following through this, I'm going to kick it off with a few general comments about the industry, give you a few high-level observations about our quarter and then pass it over to Rich who will be getting into the details of the quarter. And then following his comments, we will be opening it up for questions for as long as you like more than we do.

So inflation, from our perspective, clearly the topic of the day. I think it is the topic of the day across many industries, in the insurance industry. It's certainly included in that. I think for some it is the moment that people have been speculating or waiting for, for some extended period of time, and it is upon us.

Some of the obvious questions are how much, how quickly is it going to get here, and how long will it stay? Obviously from our perspective, the impact that will come along is with a rising interest rate environment. Other questions for the industry, what is the impact on loss costs going to be, and ultimately reserved. And of course, as well, what is the impact going to be on investment portfolio and investment income.

Having said this, we think there are a couple of other questions that one needs to be grappling with when they think about inflation and a higher interest rate environment. One of them clearly is will targeted returns in moving up with a higher benchmark. Will people be looking to think about the risk-free rate, and as a result of that, the hurdle or the delta above the risk-free rate that they should be achieving in this industry, is that going to be moving up as well?

And then finally, there is a question around alternative capital which also has been discussed and considered and speculated about for an extended period of time. Is alternative capital a permanent part of this industry, or is it something that is here during a low interest rate environment, and when you see interest rates return to a more historic level, will alternative capital withdraw as they are more easily able to achieve their targeted returns?

All important questions from our part, and ultimately we will not have the answer other than through the passage of time. But we think they're important because the answers are exceptionally leveraged for this industry in particular.

Second thought or observation is cycles. And at the risk of stating the obvious, it is clear from our perspective that there no longer is one cycle. And on one hand, I think that this is widely understood. At the same time it seems as though many people, both in and outside of the industry, speak of the cycle as if it is one across all industry product lines. From our perspective probably a couple of decades ago, different product lines within the marketplace started to march to the beat more and more of their own drum.

You can see that in the difference in what's going on in the insurance industry and the reinsurance industry, and you certainly can see that even within the insurance or reinsurance marketplace, the differences between various lines of business. For example, the challenges of property, while on the other hand, workers' compensation for the past few years has been very attractive.

So you might have asked why do we focus on this, why do we think this is relevant? And the answer is we think it is relevant because it brings one to the idea of specialization. It is our view the reason why you're seeing product lines marching less and less in lockstep is because there is greater specialization among skill sets and how capital is deployed.

I think this is relevant. I think it is important to bring it to people's attention because more and more people view the insurance industry as a commodity industry. And without a doubt, there are parts of the industry that certainly lends itself to that type of observation or statement. Having said that from our perspective, there are aspects of this industry where specialization is very much alive and well. And quite frankly, specialization is the opportunity for an organization such as ours to truly differentiate itself and ultimately bring value to customers and bring value to our owners by generating excellent returns as a result of our skill set.

Let me turn to some things that are perhaps a little bit more directly related to the day-to-day of the industry. Reinsurance marketplace, it hasn't gone any less painful to talk about or to operate in over the past 90 days. Quite frankly, for the life of me, after what happened in the third and a bit in the fourth quarter of 2017, I can't figure out why the property reinsurance market hasn't responded more.

Some would say – I might be one of those people – that a lot of it does have to with alternative capital that is willing to accept a lower return, that gets somewhat trapped in the marketplace through the managers that manage that capital in the marketplace and it is just looking to be deployed. And again, I'm not sure if it has the same focus around risk adjusted return that some of the traditional players have.

As far as the casualty market, much to my surprise, as I think I mentioned in the fourth quarter call, it seems to have incrementally more legs than the property market. What that really means is for accounts that have had lousy experience the reinsurers are seeming to get enough leverage that they can push rates up. I'm hoping that this is the beginning of a gradual building of a groundswell, if you like. Again, we will see with time.

Switching over to the insurance market, clearly, a brighter situation from our perspective. Casualty overall still remains quite attractive. Workers' comp, which as we've discussed in the past, has peaked, but there is still plenty of margin in certainly many territories within that marketplace. Having said that, there are parts of the comp market that I think also, as we've commented in the past, that scare the daylights out of me. Florida would be an excellent example of that.

Property, on the primary or insurance front, also a mixed bag, or in my notes here I wrote down the word bizarre. I do think it's absolutely bizarre. For accounts that were impacted by storms in the third quarter and there were losses, they certainly are seeing rate increases. For accounts that were not impacted in the third quarter but our cat exposed, the rate increase that they are getting is surprisingly modest if even that much. And ironically, sometimes non-cat exposed property is getting more of a rate increase than cat-exposed property that wasn't impacted in the third quarter. So that's why I guess I wrote in my note bizarre.

Professional, still from our perspective, ripe for change, and we're pleased to see in the quarter there were some early signs that there are pieces of the professional market that are getting some traction. And again, quick comment about auto, we are pleased to see that the momentum continues to build there.

Pivoting over to our quarter, from my perspective, I think from our perspective, it would be defined or viewed as a solid quarter. I think the fact is that there was a bit of cat activity. The funny thing about cats is everyone defines cats in their own way. If you look at the property losses that we had in the aggregate stemming from what I would define as weather related, it was not insignificant. Yet, in spite of that, we still were able to achieve what I would define as a good result to say the least.

In addition to that, as far as the top line goes, you saw the 1% growth which was an improvement from what we've seen over the past couple of quarters. But I think you need to peel a couple of layers back, and it really goes back to this idea that we grow where the margin is and we shrink where it isn't. Unfortunately, per my comments earlier, reinsurance still remains exceptionally competitive. And as a result of that, you can see that we're off considerably. On the other hand, the insurance market, we still find opportunity there and it's meaningful. And as a result of that, the insurance business grew more than 3%.

Another quick comment this time on the top line overall, we did achieve a rate increase that we were particularly pleased with which is in the neighborhood of 3.5%. This was more of a step than I had anticipated. I was expecting it was going to be between 2% and 3%. But we are – I think this is just evidence that we are pushing for rate and we are finding opportunities to achieve that rate.

Again, as far as the results go, combined ratio 94.6%, the loss ratio was 61.4%. My boss commented to me, I guess he took note that it was the same in the fourth quarter and asked if we, for some reason, liked that number 61.4%. But Rich assured me that we got there a different way this time than last time. And the expense ratio, the 33.2% was I thought a good improvement from where we've been and that's in spite of the fact that we moved some start-ups over from holding company expense or parent expense over into the expense ratio.

Balance sheet, starting with the reserves and, again, Rich is going to get into the details. But $12 million of positive developments, which again I think is an indicator take we continue to think what we would view is a very prudent approach to how we make our initial picks.

And over time, we tighten them up and we like to err a little bit on the side of caution early on and as this come more into focus, we're going to tighten that. And at this stage, I'd like to begin. Rich keeps track of the number of quarters. I don't know how many quarters, but it's a lot of quarters of positive development in a row.

A couple of other things on the investment portfolio and, again, Rich will give you the details on this. But I did want to just tip my hat to our colleagues at Berkley Dean that manage the portfolio. They, in spite of the challenges, have managed to keep the duration short for the year, they've maintained the quality and they've maintained the yield. I'm not sure how they've done it, but they've done it very well.

And as a result of their skill and the skill of some others as well, we've benefited by positioning the business, so not only in the quarter was book value up, but we think that we're very well-positioned as we see interest rates continue to move up to optimize.

So, I will come back to you once Rich is done with his comments. Let me hand it over to him and he'll take you through the numbers. Thank you.

Richard Mark Baio

Great. Thanks, Rob. We reported net income of $166 million for the first quarter of 2018 or $1.30 per share which is approximately $43 million higher than the prior year and represent an increase of 35%. The improvement over the year ago quarter is primarily attributable to higher underwriting profits and net investment income.

In addition, our overall income tax expense decreased significantly due to the reduced U.S. tax rate of 21% versus 35% in the prior year.

As you saw from the earnings release, it is more challenging to compare our current results with prior periods. This challenge results from tax reform passed in December 2017 and accounting rules adopted in 2018 relating to equity securities.

If we have followed the accounting rules for equity securities before this change, our pre-tax gains would have been higher by $94 million which would have resulted in a 7-point increase in our annualized pre-tax return on equity. I'll explain further some of the details in just a few minutes.

Pre-tax underwriting income increased $70 million to $84 million this quarter. Net premiums written increased, as Rob mentioned, 1.1% to approximately $1.67 billion. The growth was led by the insurance segment, which increased 3.3% to $1.54 billion.

We continue to see a competitive market in many areas where our Reinsurance segment putting pressure on the rate environment. In particular, the North American assumed property and casualty business continues to shrink. This decision was driven by a marketplace that did not allow for us to achieve our risk adjusted returns. Accordingly, overall, the Reinsurance premium declined 20% to approximately $122 million.

The accident year loss ratio before cat of 61.7% was largely unchanged from the year-ago quarter. Cat losses declined from $14 million or 0.9 loss ratio points for the prior year to $7 million this quarter or 0.5 loss ratio points. And as many companies have defined cat losses differently, I thought it'd be wise to remind you how we define cat losses. We follow PCS-identified cat losses which are based on events that cost $25 million or more in directing shared losses to property and affect a significant number of policy holders and insurers. Accordingly, we did experience, similar to others, an increase in non-cat weather-related property losses, largely attributable to winter freeze which did not meet the PCS definition as a catastrophe event.

We also experienced several large fire losses during the quarter, although do not see this claims activity as a trend. Loss reserves developed favorably by $12 million or 0.8 loss points compared with $2 million or 0.2 loss points for the same period last year. You may recall that first quarter 2017 was adversely affected by the change in the Ogden discount rate in the UK for lump-sum bodily injury claims.

Accordingly, our reported loss ratio declined 1 loss ratio point to 61.4% quarter-over-quarter. The expense ratio was relatively flat from the year-ago quarter and lower by 0.3% from the consecutive quarter. The current quarter expense ratio was favorably impacted by the reduction in commission expense relative to the change in net premiums earned. This reduction was partially offset, as Rob mentioned, by increased compensation expense in the full quarter of expenses for Berkley One which was moved out of corporate expenses in the fourth quarter 2017.

This brings our combined ratio for the first quarter 2018 to 94.6% compared with 95.7% in the prior year. Investment income increased 17% or $26 million to $175 million. The investment income of the core portfolio increased approximately $13 million led by fixed income and real estate income. Investment funds increased $14 million due to mark-to-market adjustment in real estate funds and new investments that we did not hold in the first quarter of 2017.

As anticipated, energy fund performance was in line with the prior quarter. We have maintained an average rating of AA- and as Rob alluded to, an average duration of three years for fixed maturity securities including cash and cash equivalents.

We reported pre-tax net realized gains and pre-tax net unrealized gains on equity securities of $48 million. This amount reflects a change in the treatment of fair value movement on equity securities. In prior periods, these fair value changes for equity securities were reported in AOCI, component of stockholder's equity. Commencing with the first quarter 2018, the fair value changes were reflected in the income statement.

Accordingly, there are two components in the first quarter 2018 pre-tax gain amount. The first is pre-tax realized gains from the sale of investments; and secondly, the change in unrealized gains on equity securities resulting from the adoption of this new accounting pronouncement. The change in unrealized gains on equity securities is not reflected in any prior quarterly results and therefore, creates an inconsistency to comparable periods in our income statement.

To put some numbers behind the quarterly comparison, we realized pre-tax gains on the sale of investments of $142 million in the first quarter of 2018 and $52 million in the year-ago quarter. However, due to the new rules, we reflected a reduction in the current quarter's pre-tax gains of $94 million for changes in unrealized gains on equity securities.

Our after-tax unrealized gains reported in stockholder's equity declined from $375 million to $35 million. The decline resulted primarily from the addition of the new accounting rules on equity securities, which required the transfer of after-tax unrealized gains from AOCI to retained earnings.

The effective tax rate was 20.6% for the quarter. The total income tax expense reflects the reduction in the U.S. statutory tax rate from 35% to 21%. The effective tax rate differs from the U.S. federal income tax rate of 21% primarily because of tax exempt investment income offset by foreign operations with a higher tax. Our return on equity for the quarter on an annualized basis was 12.3% on net income. Book value per share increased $0.32 from $44.85, representing an increase of just under 1%.

Due to the short duration of our investment portfolio, we've not been affected by the rise in interest rates at perhaps others and continue to see growth in book value per share. We repurchased 101,000 shares in the quarter at an average price per share of $67.31. Thank you. Rob?

W. Robert Berkley, Jr.

Rich, thank you very much. And obviously, in addition to your usual comments, a little bit of complexity brought to us compliments of the FASB in the quarter. So, Brian, at this time, if we could please open it up for questions.

Q&A

Operator

My pleasure, sir. [Operator Instructions] And our first question will come from the line of Amit Kumar with Buckingham Research. Your line is now open.

<Q - Amit Kumar>: Thanks, and good evening.

<A - W. Robert Berkley, Jr.>: Hello, Amit. Thanks for calling in.

<Q - Amit Kumar>: Two questions. The first question is for you, Rob. You broadly covered the trends in the marketplace. I think what would be helpful is would it be possible to maybe just go a bit deeper into some of the pricing trends you might have seen in the insurance sub segments?

<A - W. Robert Berkley, Jr.>: Yeah. Honestly, I think that we try and steer clear of getting into granular detail as to where we see rates going up. I tried to give you a broad sense. So for example, workers compensation I think it's generally speaking widely understood that state rating bureaus in the NCCI are moving rates down and that's impacting the product line pretty much across the board. On the other hand, I think commercial auto would be example of where rates are going up in general. But I don't think it makes a lot of sense to start trying to get into the weeds much beyond that. But...

<Q - Amit Kumar>: I guess what I was trying to understand was obviously there's a lot of debate on the trajectory of rates and I guess the slope of the rate change, and that's what I was trying to understand. If you look at the trajectory in Q1 versus Q4, if I was to take that trajectory and overlay that with the comments you guys made in the letter to shareholders, is there a greater urgency based on the change and the tenure or is this a much a longer term process? I guess that's what I'm trying – I was trying to better ascertain.

<A - W. Robert Berkley, Jr.>: I think the answer is that we are comfortable with our loss picks and we are looking to make sure that we achieve the required rate to support those loss picks and to the extent that there are certain parts of the book that will bear additional rates. And then, we will be pursuing that. So there is not a policy that we write, a treaty that we write where we think it is not going to achieve our loss pick. But to the extent that there are parts of the market that will bear more, we're going to try and take it advantage of that.

Do I think that, all of a sudden, the 10-year pops up and is flirting with 3% and all of a sudden, we go down to the boiler room and try crank up the rate? No, it doesn't work like that. At least, it doesn't work like that here.

Do I and more importantly my colleagues have a view as to where inflation is going and where loss cost is going and what our experience has been? And when we put that all into the sausage maker, what kind of rate do we need? Yes. We have a view on that. In addition to that, to the extent that the market will bear more than what even we think we technically need or our technical rates, then we will be looking to take advantage of that.

<Q - Amit Kumar>: Got it. That's helpful. The only other question I have is you referenced NCCI.

<A - W. Robert Berkley, Jr.>: Yes.

<Q - Amit Kumar>: NCCI is now recommending pricing decreases coupled with the Tax Reform. In fact, they're making – they're recommending different rate filings in different states which factors in the benefit from the tax rates. So I was trying to better understand, you have a combination of NCCI pushing for rate decreases, coupled with an industry already probably under competitive and pricing pressure versus the past. I mean how should we think this thing will play out for the industry over the next few quarters?

<A - W. Robert Berkley, Jr.>: So, my answer, Amit, to that question would be, it is still a cyclical industry. And from our perspective, the pendulum tends to swing back and forth in workers' compensation as much as any part of this marketplace. There are many parts of the comp market where we think that there is healthy margin. We think we understand the margins that are available. And depending on where the market is, we will be opening this figure or closing this figure.

So NCCI, they have a job to do. They are charged with making weights for several of the states, and we understand that and we respect that. And we take the data that they provide the industry and other data that we have access to as well as our own, and then we make judgment. So, as I tried to touch on, maybe I wasn't clear, clearly, comp rates have peaked, but there are many markets within the broader comp market that we believe still offer attractive opportunities. How long those will last? It's hard to say.

<Q - Amit Kumar>: Fair enough. Okay.

<A - W. Robert Berkley, Jr.>: But we do not see falling off a cliff. I think that you'll – there is an opportunity that will certainly be measured in quarters.

<Q - Amit Kumar>: Okay. That's actually a good point. I will stop here. Thanks for the answers and good luck for the future.

<A - W. Robert Berkley, Jr.>: Thank you for the questions.

Operator

Thank you. And our next question will come from the line of Arash Soleimani with KBW. Your line is now open.

<**A - W. Robert Berkley, Jr.**>: Hello. Good afternoon. Hello?

<**Q - Arash Soleimani**>: Hi. Good afternoon. Sorry about that.

<**A - W. Robert Berkley, Jr.**>: No problem.

<**Q - Arash Soleimani**>: Just first question, is $25 million a quarter still the right run rate for 2018 on the realized gain?

<**A - W. Robert Berkley, Jr.**>: I think that's a reasonable way to think about it. Obviously, as I've...

<**Q - Arash Soleimani**>: Okay.

<**A - W. Robert Berkley, Jr.**>: ...discussed in the past, it can be lumpy. And we have lots of things in the hopper or the pipeline, but from our perspective, we think that that is a still a reasonable placeholder.

<**Q - Arash Soleimani**>: Okay. And then maybe just a follow-up on that for Rich, the performance fees associated with the gains, which line items do those show up in and do they impact the segment or just corporate?

<**A - Richard Mark Baio**>: It just impacts corporate. So, when we were, at one point, reporting operating earnings, you may recall that we had adjusted for those net performance compensation-related items. And now that we don't report operating earnings because we're managing on a total return basis, we wanted to make certain that the Street was still calculating things, factoring that in. So, you'll see there's $4 million associated with that.

<**Q - Arash Soleimani**>: Okay. So, just corporate, no segment impact, okay. And the other question I had – so if you – I mean if you factor in the 70 basis points of non-cat weather, I guess just starting there, what was non-cat weather last year? Was 70 basis points consistent year-over-year or was that – was it higher this quarter than it was in 1Q 2017?

<**A - W. Robert Berkley, Jr.**>: It's about the same.

<**Q - Arash Soleimani**>: That's about the same. Okay. Okay. And the 3.5% rate increase you mentioned, where was that in the book?

<**A - W. Robert Berkley, Jr.**>: It was in different pockets of the book. And again, we don't generally get into the details of where we're getting rate by product line or by operating unit. But I would tell you that if you think back to some of the comments I made about where there are opportunities in the marketplace, that's a pretty good indicator to where we're seeing rate.

<**Q - Arash Soleimani**>: Okay. Well, I guess, all I was asking was the 3.5% on average across a certain...

[indiscernible] (30:01)

<**A - W. Robert Berkley, Jr.**>: That was for the group overall.

<**Q - Arash Soleimani**>: Okay. Across both segments consolidated, you're saying...

<**A - W. Robert Berkley, Jr.**>: Correct.

<**Q - Arash Soleimani**>: ...3.5%? Okay.

<**A - W. Robert Berkley, Jr.**>: That's correct.

<**Q - Arash Soleimani**>: Okay. And I think maybe this is a follow-up to Amit's question a bit. But, on the rate increases, I mean, do you view those as sustainable? Do you think they'll lose some steam throughout the year?

<A - W. Robert Berkley, Jr.>: I think that sometimes people get a little bit hung up on a 90-day period just because that's how the calendar falls. I think, at this stage, we're looking for rate in many pockets of the business. And our expectation is that it's going to sort of float between 2% and 4% if I were to speculate.

<Q - Arash Soleimani>: Okay. Perfect. Thanks very much for the answers.

<A - W. Robert Berkley, Jr.>: Thank you.

Operator

Thank you. And our next question will come from the line of Kai Pan with Morgan Stanley. Your line is now open.

<Q - Kai Pan>: Thank you and good afternoon.

<A - W. Robert Berkley, Jr.>: Hi, Kai Pan.

<Q - Kai Pan>: Hello. My first question is on the core margin, underlying margin. And if you take it out the [indiscernible] (31:12), it looks like its flattish year-over-year in terms of underlying core combined ratio. Given the pricing environment, do you think you get enough pricing to offset the loss cost trend that will be able to maintain or improve the margin going forward?

<A - W. Robert Berkley, Jr.>: The answer is we expect the margin should improve a bit from here. I know that it's easier to calculate when you start trying to use rate increases. But I would tell you that the bigger opportunity for us is some of the adjustments that we're actually making to the portfolio overall, certain classes of business that we are de-emphasizing, other parts of the business that we are expanding in, that on its own I think will have a meaningful impact on the financial results. And what we're able to do on rate, I think, will be helpful, but that is secondary to the pivoting of the portfolio.

<Q - Kai Pan>: Okay.

<A - W. Robert Berkley, Jr.>: One of the pluses at our organization and you've heard – I've talked about it in the past, probably forever. My father certainly talked about it in the past as well and that is because of our decentralized structure, we're able to be particularly nimble and take advantage of opportunities and actually get visibility into business at a very granular level, and that's helpful on multiple levels.

<Q - Kai Pan>: That's great. And since you mentioned about sort of one competitive advantage here for W. R. Berkley has been the decentralized structure, I'm wondering like because when the company is sort of like many years ago when you had several startup companies and now you have more than 50. I just wonder are you coming to the point you have to centralize somehow like in terms of infrastructure or are you becoming unmanageable?

<A - W. Robert Berkley, Jr.>: Well, I think we – certainly, our view that it's not unmanageable. Hopefully, it's your view as well. As far as opportunity for efficiencies, that is something that we, as an organization, pay close attention to. We're very sensitive to, on one hand, ensuring that what looks good on a whiteboard and the opportunity to combine or centralize like other carriers do that may have value. At the same time, we do not want that to overshadow quite frankly our ability to be local and to be responsive to the marketplace and for the people that are close to the distribution and the customers to have authority.

So, it is certainly something that we have been looking at. We continue to actively look at, but I don't think that you're going to see us overnight turn into a model that you may see a typical national carrier operate with. At the same time, we are conscious of the cost and we are willing to consider opportunities for efficiency.

<Q - Kai Pan>: That's great. My last question on the investment side and looks like you've been guiding $100 million each year, realized gains, but you did more than that in the quarter, as well as for the last couple of years as well. It's a – maybe a question for Bill, you've said – is the market condition like you guys feel like more opportunity to harvest sort of gains so that we would see more to come?

<A - William Robert Berkley>: I think that we told people $25 million a quarter because they wanted a number to put in their model and we felt comfortable giving that number out with a fairly high degree of conviction. And, yes, you're correct. This is an opportunity for us to harvest some gains to good environment and we would expect that will continue for a while. $25 million was placeholder to let people use models to forecast our results. Yes, we had more than that in the first quarter. And I would expect that while we might have more or less in the second quarter or the third quarter, we'll have more than $100 million by a significant amount we would expect by the end of the year. But again, it's meant as a placeholder so people can come up with a forecast. But it will be disappointing if this year we didn't do substantially more.

<Q - Kai Pan>: Thank you so much. And I'll re-queue.

Operator

Thank you. And our next question will come from the line of [ph] Mike Saremski with Credit Suisse (36:02). Your line is now open.

<Q>: Hey. Good afternoon, gentlemen.

<A - W. Robert Berkley, Jr.>: Good afternoon.

<Q>: You mentioned how you started out your remark saying inflation is here. Maybe you can talk about trends or anything you're seeing in the corporate liability arena. I'm a novice, but there's been a – because of the securities litigation decision by the U.S. Supreme Court that keeps flashing across my screen is just one example.

<A - W. Robert Berkley, Jr.>: Look, from our perspective, when we – I don't know if it was a year ago, 18 months ago, or 9 months ago. But we for some period of time have been beating the drum that we are seeing early evidence that there is inflation coming out of the legal system in the rulings or the awards. And we are just seeing inflation, quite frankly, and perhaps a little bit of spike of severity and maybe a frequency, if you will, of severity as well. So we are paying close attention to that and obviously on the other fronts we all understand what's going on with this general economic inflation and there is impact on the industry and the cost of settlement claims in the future.

<Q>: Okay. That's helpful. And next is a follow-up to the other question about the NCCI prescribing rates. I think there's other states where there's maybe it's not the NCCI but they're still kind of...

<A - W. Robert Berkley, Jr.>: Yeah.

<Q>: ...something else that's not free market based. Are you able to approximate what percentage of your book is, I guess, free market based competition versus these prescribing authorities? And I guess also what do you prefer?

<A - W. Robert Berkley, Jr.>: Well, basically, every state has a rating bureau. So as far as writing primary comp is you will, there's a, if you will, a framework that is prescribed by a rating bureau that works in collaboration, if you like, with the insurance department and other stakeholders.

<Q>: Okay. So, there's...

<A - W. Robert Berkley, Jr.>: So I don't know if you were referring to occupational accident or something else that...

<Q>: No. You see a lot of headlines come out all the time and some of them talk about there not being inflation in that line that's why they're even lowering the rates so I've always been a little confused. I think, other people are confused, too, about...

<A - W. Robert Berkley, Jr.>: No. I think it's pretty widely understood that medical inflation has been here and real for an extended period of time. I think as far as comp goes, really since the financial crisis, people have been particularly surprised with the trend around frequency, and that has persisted or continued until recently. Whether it continues going forward, I think there are a lot of questions around that particularly in a tight labor market when you get people working overtime, you get people taking jobs that they're not as well trained for. Oftentimes, that's when people get injured on the job. So we'll have to see if that frequency trend continues.

<Q>: Okay. And if I could sneak one last one in on the duration of the investment portfolio on the fixed income side, I looked back a number of years and it doesn't seem like it's ever been much over in the 3s. I guess, what would get you to increased duration of it, would it just be simply spreads coming out a lot barring changes in place?

<A - W. Robert Berkley, Jr.>: I think ultimately if you see the 10-year as a benchmark moving up to a 4%-plus, you're probably going to see our colleagues actively thinking about, is this the moment to start looking a little bit longer term. But look, the duration of our liabilities is roughly four years. We've created a collar for ourselves that we're generally speaking, others are an occasional an exception. Not going to be more than a year less than that or a year longer than that, but look, the interest rates have been pretty low for a long time. As you see them move up as we expect, they are going to move up. You're going to see us take the position that we're willing to extend duration.

<Q>: Appreciate the insights.

Operator

Thank you. And our next question will come from the line of Jay Cohen with Bank of America Merrill Lynch. Your line is now open.

<Q - Jay A. Cohen>: Thanks. Mike actually asked my question. So, thank you.

<A - W. Robert Berkley, Jr.>: Thanks Jay. Have a good day.

Operator

Thank you. Our next question will come from the line of Ian Gutterman with Balyasny. Your line is now open.

<Q - Ian J. Gutterman>: Hi. Thank you. I just had a few things to clarify, I guess. Rob, first when you talked about rates up 3%-plus, is that including exposure or is there exposure of growth on top of that?

<A - W. Robert Berkley, Jr.>: No. That's rate, rate, rate. That's not price, that's rate. So that is...

<Q - Ian J. Gutterman>: Okay

<A - W. Robert Berkley, Jr.>: ...dollar collective for unit of exposure if you like.

<Q - Ian J. Gutterman>: That's right, guys. I just want to make sure. So with exposure, which I assume is growing, you're kind of getting apples-to-apples, call it, mid-single digits growth and yet the net premium growth all in is 1%. So are you – is retention coming down? Is the new business coming down? I'm just sort of wondering what the offset is.

<A - W. Robert Berkley, Jr.>: It really depends on the factor of the business. Both Rich and I have commented on the challenges in the Reinsurance segment, for example...

<Q - Ian J. Gutterman>: Right.

<A - W. Robert Berkley, Jr.>: ...where I think the overall segment was down 22% – around 20%. I think the domestic treaty reinsurance operation was down more than 40% in the quarter. So we have 53 operating units, some are growing, some are shrinking at any moment in time. Some are gaining rates, some are, quite frankly, willing to give up rates so there are a lot of moving pieces.

Overall, I would tell you that between what we're doing with the portfolio as far as repositioning it, shutting some business, building up of other areas and achieving overall rate, from our perspective, our math both at a micro level as well as a macro level, our margin is improving.

<**Q - Ian J. Gutterman**>: For sure. For sure. Okay. So moving on, just to get back to Reinsurance, just – I mean, I understand the challenges there and shrinking makes a lot of sense. I just want to – as a far as the numbers in the quarter. You put the 107% combined with a very minimal amount of cat. I know you don't like to talk about reserve development by segment until the Q, but if I can ask you this way, is it reasonable to think there is maybe 5 or 10 points of adverse development or something maybe a little bit larger than normal and that's why we're seeing the combined ratio there?

<**A - W. Robert Berkley, Jr.**>: I think probably the best thing to do, again, because we just don't really talk about reserve development by segment is why don't you – if you want to give Karen a call offline and she can try and give you a little bit more color. But for the most part, we try not to start getting into that level of leads or detail on the call.

<**Q - Ian J. Gutterman**>: Understood. Okay. Fair enough. I thought I'd try. The expense ratio, so I just want to make – as you said, I expected the Berkley One expenses to move into the insurance line this quarter. I guess what threw me and maybe my math's wrong because I was doing it quickly, but it seemed like your unallocated expenses actually went up about $10 million. I guess I thought they would've been flagged down with the Berkley One coming out. Is there something else in there this quarter or did I do my math bad?

<**A - Richard Mark Baio**>: When you say the unallocated expenses, are you talking about the corporate expense?

<**A - W. Robert Berkley, Jr.**>: Do you mean the corporate expenses?

<**Q - Ian J. Gutterman**>: Yeah. The corporate. Right. The corporate expense not in the combined ratio.

<**A - W. Robert Berkley, Jr.**>: It was down compared to the fourth quarter by about $4 million.

<**A - Richard Mark Baio**>: Yeah. $4.5 million it was down from the fourth quarter.

<**Q - Ian J. Gutterman**>: Okay. It must have done it...

<**A - W. Robert Berkley, Jr.**>: So I think one of the trickier things with some of these numbers is the way we present it in the release, we're showing first quarter versus first quarter, which is – it's not that that's not relevant. It is relevant, but with some of the things, we probably should give you a reminder as to what the fourth quarter looked like as well.

<**Q - Ian J. Gutterman**>: Okay. Fair enough. Fair enough. And then I think just last number [indiscernible] (44:47)?

<**A - Richard Mark Baio**>: Pay loss ratio?

<**Q - Ian J. Gutterman**>: Yeah, the pay loss ratio. Yes.

<**A - Richard Mark Baio**>: It's 58.8%.

<**A - W. Robert Berkley, Jr.**>: And that's up a little bit, about 3 points or so, and a lot of that, quite frankly, had to do with claims stemming from the third quarter in particular. As well as other property claims. For us, just to – since you gave me the window, I'm going to take it. For us, the claims are – nobody likes claims. At the same time, from our perspective, it creates a great opportunity. And we go out of our way – our colleagues in the claims areas or departments go out of their way to try and get people their money in a timely way. So what really pushed that up was certainly some claims from the third quarter, but also some of the claims that occurred during the first quarter associated with some of the cats and some of the – what I would – as Rich defined it, the non-cat weather-related property losses.

<**Q - Ian J. Gutterman**>: Got it. And then if I can ask just one broader question that I don't think came up yet was, since the last call, we've seen sort of another wave of M&A in this sector and I just wonder if you had any thoughts you'd like to share or just observations about what it means and are we in for another wave, and how does that affect Berkley either positively, negatively or neutral?

<**A - W. Robert Berkley, Jr.**>: Well, I'll give you my two cents and then I'll hand it over to my boss. My two cents is that there's been a fair amount of consolidation. I think there are parts of the insurance marketplace that are viewed as particularly attractive. In some of those more attractive areas, there's less and less real estate available, if you like. And

we'll have to see what unfolds, but from our perspective, consolidation creates opportunity for us as an organization, not just to attract talent, but also to attract relationships and insureds because our ability to provide predictability, continuity and consistency to the marketplace is perhaps very meaningful or even more meaningful when other organizations are disrupted or distracted by internal activity.

<A - William Robert Berkley>: I think that I would add that the quality and culture really determine an insurance company's success, all things being equal, that you have the financial capacity to meet your obligations. Just as we were more than happy to pay our claims as rapidly as we were reasonably able to because we felt that's why people buy insurance, we wouldn't want to do anything that would have an adverse impact on the culture or the quality of our enterprise.

And while we look at many opportunities, it's hard to find things that we think would be a good and useful way to spend our capital that would approach the value of returning it to our shareholders. There's lots of things in the marketplace. There are many companies that are out there looking for ways to find new homes. And we look at most of them, and it's just hard to find things that we think are additive and create value for our shareholders.

<Q - Ian J. Gutterman>: Got it. Do you have any – do you view that as coincidence or not that we've seen a pick-up in offshore sales since the tax law passed?

<A - W. Robert Berkley, Jr.>: I think that pre-tax reform, post-tax reform, there are some businesses that are trying to look long and hard in the mirror and evaluate what is their business model. What is their offering? What is their value added? What is the differentiator? I think there are some businesses that were formed and set out to be in one part of the market. That got tough and they thought it would just be easy to get involved in another part of the market. I think it's proven to be disappointing and frustrating for them that maybe it's not quite so easy. And as a result of not being able to find a greener pasture, I think they're being forced to grapple with what should their future be.

<Q - Ian J. Gutterman>: Understood. Thank you for the time.

<A - W. Robert Berkley, Jr.>: Thank you.

Operator

Thank you. [Operator Instructions] And we have a follow-up question coming from the line of Kai Pan with Morgan Stanley. Your line is now open.

<Q - Kai Pan>: Thank you for the follow-up. There are two of them. Number one is the invested fund return, $40 million over the quarter. My understanding is that you have [ph] let (50:09) the sort of performance of that by quarter. So do you have preliminary indication for the second quarter investment fund returns?

<A - W. Robert Berkley, Jr.>: We have some visibility into that, but generally speaking, we don't get into a lot of details. A part – the piece of the funds that historically has given us a fair amount of volatility would be some of the energy related funds. And again, I think that's sort of flattish from where it's been or neutral. But again, if you'd like some more detail, I suggest that you reach out to Karen and she'll give you as much color as the law allows.

<Q - Kai Pan>: Thanks. I will. And lastly, just to follow up on Ian's question in a different sort of direction, on your Reinsurance business it's less than 10% overall premiums, and the combined ratio have been above that 100% for the last couple of years. So if you step back, what do you think is the strategic value of the business to overall W. R. Berkley? And have you thought about sort of your divesting or scale up that business?

<A - W. Robert Berkley, Jr.>: We view the Reinsurance business no differently than any other part of our business. Let me be very clear, from our perspective it is a core activity for us as a group. And we applaud our colleagues that are managing the capital in that part of the business for not sliding down the slippery slope that, in our opinion, others in the market are. The fact of the matter is our expense ratio is probably, I don't know, 6 to 8 points above some of the mid-sized competitors, and probably 10 points above or more than some of the large competitors.

When the market condition shift change and improve from where they are today, you will see this business scale up as our colleagues see that there is an opportunity to deploy capital. Fundamentally, we believe long-term in the Reinsurance business. We do not view it the same way some of our competitors do. We have no interest in disputing stupid capital that gets arbitraged at the convenience of [ph] seasons (52:28). We had a great deal of interest in being partners with those that value us beyond this capacity. So to put, hopefully, a fine point on it for you, we are committed to the business. We are frustrated, all of us as a team, collectively. At the same time, we believe that at some point the market will come about. There certainly are parts of the business that is questionable what its future will be such as property cat, but that is a part of the market that we participate in in a very selective manner in particular. Did I answer your question?

<Q - Kai Pan>: Oh, thank you so much for your thoughts.

<A - W. Robert Berkley, Jr.>: Thank you.

Operator

Thank you. And we have a follow question coming from the line of Arash Soleimani with KBW. Your line is now open.

<Q - Arash Soleimani>: Well, thanks. I just wanted to follow up on Berkeley One and see – is there any more detail you can provide there in terms of the continued rollout? I know there were two states I think you mentioned last time you were planning.

<A - W. Robert Berkley, Jr.>: Yeah. At this stage we're in three states and we expect that we're going to be in a – our expectation, our plan is that we will be in another eight states by the end of the year. The reality is we can run it fast as we like, but we can only make insurance departments move as fast as they want to move. So we will be prepared. It is a matter of whether the insurance department move at what type of pace. But our colleagues that are running that part of the business are successfully managing the heavy lift of building this platform out, and I think are building healthy and constructive relationships with the insurance departments. And again, I don't know if it will be eight or not, but it will be considerably more than the three that we are currently in.

<Q - Arash Soleimani>: Thanks. And Rich, did you say the expense ratio uptick from Berkley One was fully offset by the commission expense reduction?

<A - Richard Mark Baio>: Yes.

<Q - Arash Soleimani>: Thanks. And can you remind me what drove the commissions' reduction again?

<A - Richard Mark Baio>: Part of it is with regards to the business mix that Rob was alluding to earlier.

<Q - Arash Soleimani>: Okay. All right. Perfect. Thanks very much for taking the follow-ups.

<A - W. Robert Berkley, Jr.>: Sure.

Operator

Thank you. And I'm showing no further questions via the phone lines. So now, I'd like to hand the call back over to Mr. Rob Berkley for some closing comments or remarks.

W. Robert Berkley, Jr.

Yeah. Thank you, Brian. And thank you, all, for your time today. Again, from our perspective, very solid quarter. I think some of the news that you're hearing from others would suggest that our approach to managing volatility, particularly around the property lines, we're able to demonstrate that again. Looking forward, we see quite a bit of opportunity. Obviously, we can't control the market but we can control what we do, and many of the parts of the market that we have a meaningful presence in we think are providing significant opportunity.

I think the growth that you saw in the Insurance segment, quite frankly, is what we have alluded to in the fourth quarter. And I think there is a better-than-average chance as we make our way through 2018 there will be more growth coming out of the insurance segment. And on the other hand, the reinsurance market which is, at least parts of it's showing signs of bottoming out and maybe some greens shoots. We remain with the dry powder ready to work with seasons when the opportunities present themselves.

So again, thank you for your time and we will talk to you in 90 days.

Operator

Ladies and gentlemen, thank you for your participation on today's conference. This does conclude our program and we may all disconnect. Everybody, have a wonderful day.