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Presentation

Operator

Good morning, ladies and gentlemen, and welcome to the Liberty Mutual Insurance Conference Call on its Fourth and Full Year 2018 Financial Results. [Operator Instructions]

To begin Liberty Mutual's presentation is Ed Peña, Vice President and Director of Investor Relations. Mr. Peña?

Edward Peña
VP & Director Investor Relations

Good morning, and welcome to Liberty Mutual's Fourth Quarter and Full Year 2018 Earnings Call. Hopefully, you have seen the earnings release and financial statements posted yesterday evening on our website, libertymutualgroup.com. David Long, Chairman and Chief Executive Officer of Liberty Mutual Insurance, will provide updates on some of our recent announcements, followed by his opening remarks on the quarter. Following David, Chris Peirce, Liberty's Chief Financial Officer, will review our financial results. Also participating on today's call are Neeti Bhalla Johnson, Chief Investment Officer and President of Liberty Mutual Investments; Jim Kelleher, Chief Legal Officer; Tim Sweeney, President, Global Retail Markets; and Dennis Langwell, President, Global Risk Solutions.

Also, as a reminder, today's discussions may contain forward-looking statements that represent the company's beliefs concerning future operations, strategies, financial results or other developments. Actual results may differ materially from those expressed or implied. Please refer to the Liberty Mutual website for a complete discussion of the risk factors related to this presentation and the company. The company does not intend and does not undertake any obligation to update these forward-looking statements, which speak only as of today's date.

I will now turn the call over to David for his opening remarks.

David Henry Long
Chairman, President & CEO

Thanks, Ed, and good morning, everybody. Consolidated net income from continuing operations was $251 million in the fourth quarter, an increase of $98 million from $153 million in Q4 2017. The improvement reflects higher net investment income, including Partnerships, LLC and other equity method income and more favorable prior year developments. These items were partially offset by realized losses in Q4 2018 versus realized gains in Q4 2017, and higher net catastrophe losses, including around $260 million from Hurricane Michael and $300 million from the California Wildfires. Due to the more material gross catastrophe losses in 2017 and how our aggregate cover responded, we saw greater reinsurance recoveries in the fourth quarter of 2017 leading to higher net catastrophe losses quarter-over-quarter in 2018.

Net written premium was $9.4 billion in the quarter, up $545 million or 6.2%. Both businesses, Global Retail Markets, GRM; and Global Risk Solutions, GRS, contributed to this growth with the most notable gains coming from GRS.

Looking at underwriting results. Our core combined ratio ticked up 0.5 point versus the prior year quarter. Core loss ratio was up 1 point, driven by higher current accident year non-cat loss activity in GRS, which added 1.2 points, partially offset by lower current accident year non-cat loss activity in GRM. The underwriting expense ratio was down 0.6 points, driven mostly by growth and our total combined ratio was 100.4%, down 0.1 points from Q4 2017.

Within GRM, net written premium for the quarter was $6.6 billion, up 2.9% versus the prior year quarter. Excluding the impact of FX, growth was 4.1%. While all market segments contributed to this growth, the U.S. was the largest component, primarily driven by rate. In U.S. personal lines, private passenger auto

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rate was up 6.5% in the quarter and homeowners rate was up 3.8%. Within U.S. business lines, rate was up 6.3%.

International growth at 2% was mainly driven by commercial ratings in Chile, partially offset by foreign exchange, which was primarily due to the weakening of the Brazilian reais versus the U.S. dollar. GRM pretax operating income in Q4 2018 was $626 million, a considerable improvement from a pretax operating loss of $71 million in Q4 2017. The improvement was a result of lower catastrophe losses, improved core underwriting margins in U.S. personal lines as well as favorable prior year developments and some unfavorable current accident year reestimation we did in 2017 that did not recur.

Switching to loss trends. We are seeing frequency of minus 2% to minus 4% within U.S. personal lines auto for both bodily injury and collision, but with elevated severity trends in the mid-single digits. The personal lines property severity trends are slightly elevated compared to long-term averages at 5% to 6% with frequency flat. In U.S. business lines, we're still seeing elevated auto severity trends in the mid-single digits with slightly increasing frequency. The workers' compensation, we're seeing low single-digit declines in frequency and 3% to 4% severity trends.

For GL, severity trends of 5% to 6%, while frequency is flat.

And finally, for business lines property, we continue to see higher-than-historical severity trends in the 5% to 7% range with low-single-digit frequency.

The GRM combined ratio was 93.3% in the quarter, a 10.3 points improvement from the prior year quarter. Catastrophe losses were 3.8 points, down 8 points from 11.9 points in Q4 2017. The combined ratio also benefited from the current accident year reestimation in 2017 that did not recur, driving 0.8 points of improvement and more favorable prior year development at a 0.6 points of improvement.

Continued expense discipline resulted in a decline in the underwriting expense ratio of 0.6 points and the loss ratio also improved 0.2 points due to improved auto liability results.

Moving on to GRS. Q4 top line growth was strong at a 11.7%, or 12.6% excluding the impact of FX, bringing net written premium in the quarter up to $2.8 billion. The majority of this growth has come up from favorable rate and new business within specialty insurance and reinsurance, which grew at 15.4% and 17.6%, respectively. Renewal rate for GRS in total was 3.5% in the quarter with positive rate across just about all lines with the exception of Workers' Compensation. GRS had a pretax operating loss of $103 million in the fourth quarter versus pretax operating income of $30 million in Q4 2017. Higher catastrophe losses, largely from Hurricane Michael, are the largest driver of the swing with unfavorable prior year development and higher current year noncatastrophe losses also contributing.

The GRS combined ratio was 111.7% in the quarter, up from 105.8 in the prior year quarter, largely driven by an elevated catastrophe ratio of 9.5%, up 5.9 points. The core combined ratio showed slight deterioration rising from 101.2% in Q4 2017 to 101.4%.

Turning to investment results. Net investment income, including LT, LLC and other equity method investment income was up $208 million from the prior year quarter to a total of $752 million. The increase reflects more favorable private equity valuations and a higher invested asset base.

Net realized losses for the quarter were $139 million versus realized gains of $122 million for the same period in 2017. The 2018 realized losses reflect impairments related to natural resource investments and company-owned real estate in addition to fixed maturity net losses, and Chris will provide more color on the realized losses in a minute.

All in all, we had an okay fourth quarter, which rounded out a strong year. Following the sizable catastrophe losses of 2017, we produced solid earnings and further strengthened our capital position, growing equity ex OCI to $24.1 billion, up over $2.4 billion from 2017. Looking to 2019, we plan to continue this positive momentum focusing on improvement in operating results, particularly within GRS North American commercial and specialty and improving growth in GRM.

And with that, I'll turn the call over to Chris.

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Christopher Locke Peirce
Executive VP & CFO

Thanks, David, and good morning, everyone. Our full year 2018 pretax operating income before partnership, LLC and other equity method investment income was nearly $1.5 billion, up almost $2.5 billion from 2017. Drivers of this improvement include significantly lower catastrophe losses following the historic losses in 2017, net favorable prior year development versus unfavorable development last year, which was largely within commercial auto and higher net investment income.

The combined ratio we improved to 99.2% for the year, down from 105.6% in 2017. This decline was driven largely by the lower catastrophe losses previously mentioned in addition to 2018's favorable development. The core combined ratio increased slightly from 2017, primarily driven by business mix. Also, while the expense ratio was flat, higher incentive compensation based on profitability drove a roughly 50 basis point increase year-over-year.

As we mentioned during our Investor Day, we will continue to focus on improving our expense ratio to maintain our competitive position. Pretax partnership, LLC and other equity method investment income was $978 million, up $408 million from 2017, largely reflecting more favorable valuations and distributions across the portfolio in addition to more favorable net operating income from our direct investments in oil and gas.

Realized losses for the year were $147 million versus realized gains of $468 million in 2017. The 2018 realized losses reflect impairments on natural resource investments and company-owned real estate and fixed maturity net losses, partially offset by gains from privately held equity securities. Ironshore acquisition and integration costs were flat year-over-year at $86 million. Restructuring costs were also roughly flat at $94 million in 2018 versus $91 million in 2017. Consolidated net income from continuing operations was $1.6 billion versus a loss of $194 million last year. The results of our life company are reported in discontinued operations and were $528 million in 2018, including the gain on the sale versus $213 million in the prior year. This brings us to net income attributable to LMHC of about $2.2 billion for 2018.

Cash flow provided by continuing operations was just over $3.5 billion, nearly double the amount in 2017, reflecting higher premium collections and lower catastrophe payments in GRM. 2017 also included onetime payments for the Ironshore ADC and pension funding, which did not recur in 2018.

We ended the year with financial leverage of 22.3%. This level is well within the requirement for our ratings. GAAP equity at the end of the year was nearly $20.8 billion, which is a slight improvement over 2017 ending equity of $20.7 billion. Despite strong net income, equity growth was dampened by unrealized investment losses due to rising interest rates.
This concludes our prepared remarks, and we'll now open it up for questions.

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Question and Answer

Operator

[Operator Instructions] And we'll go and take our first question from Brett Gibson with JPMorgan.

Brett G. Gibson
JP Morgan Chase & Co, Research Division

Couple from me. So I wanted to first talk about the capital needs at the subsidiary level. Given capacity is obviously much higher at the LMIC level. How do you think about needs at that entity on a go-forward basis? That's number one.

David Henry Long
Chairman, President & CEO

Yes. We had a significant increase in capacity in 2018, largely resulting from the sale of the life company. So I think we look at the capacity we have at the end of 2018 is being very solid, and we would expect that to sort of grow with normal operating results. But we think as a baseline level where we are at the end of 2018 is sort of where we need to be.

Brett G. Gibson
JP Morgan Chase & Co, Research Division

Okay. And then, can you maybe walk us through a little bit of the thought process related to the recent exchange? And how you think about your debt maturity profile. Is that where you wanted to be?

David Henry Long
Chairman, President & CEO

Yes. So we were pretty happy with our profile, but certainly saw the concentrations of maturities in that stretch and felt like it was a good opportunity to extend a little bit. It gave us the opportunity to sort of create a nice 10-year benchmark bond and take away a little bit -- or almost half of the reinvestment risk from those 3 years. So it was bit of an opportunistic play for us. I think it positions us even better than we were before. And I think we continue to look at the profile and -- but we're, I would say very satisfied with where it stands now.

Brett G. Gibson
JP Morgan Chase & Co, Research Division

Great. And the last one kind of a higher level theoretical question. But as we kind of look back, it's been about 4.5 years since the ADC. Can you talk about how that has performed relative to your initial expectations? Are you happy with it? And then separately, can you break out the amount of the current cushion you have to the sublimits, including if you can breaking it out between asbestos and comp?

David Henry Long
Chairman, President & CEO

So I think the easy answer is we're very satisfied with the transaction that we did. I think the asbestos issue was a big driver for us and comp has a lot of uncertainty around it. I mean, certainly comp has been more favorable in the last few years than it was 4 years ago. But that's a line that still drives a lot of capital charge and has a lot of long-term volatility associated with it. So we're very satisfied with the transaction we did. I think it has performed as we expected. We would -- I wouldn't get into any details on the sublimits, but we still have substantial room on the asbestos and environmental piece. So I think that in conjunction with the carried reserves, we feel good about and the comp has a lot of room on it. So we're very happy with the transaction, I think if we were doing it all over again, we would do it.

Operator

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And our next question comes from Jeff Bernstein with Insight Investment.

Jeffrey Bernstein

Just 2 quick questions. On Slide 10, looking at your retention on the lower end of this particular history, is this kind of what you're targeting with your rate increases?

Christopher Locke Peirce
Executive VP & CFO

Jeff, what line of business are you concerned with in particular or -- because it comes around a little bit depend upon the line.

Jeffrey Bernstein

Looking at Slide 10, I was looking primarily at auto, but also homeowners.

Timothy Michael Sweeney
Executive VP & President of Global Retail Markets

Yes. Okay. Yes. This is Tim Sweeney. I would say we want to be above 80, low 80s over time, a couple of extraordinary things last year. We had a nonrenewal program. We identified the bottom 1% of our business that was at something well north of 100% loss ratio, and we went through an orderly nonrenewal programs. That was a little over 1 point. We also wanted to get our new business loss ratio back in balance with our renewal loss ratio, so we've been above market rate for the past 2, 2.5 years. We are now pulling back on rate as we go into this year relative to -- we're back to pricing right at trend. So we quite consciously over the past 24 months were taking rate in the advance of the industry average, which was driving down our retention, but it was a trade off that we knew we were making to get back to solid footing on profitability, and as we go into 2019, we'll resume growth. But our expectation would be across all lines because your direct channels have lower retention than your more traditional distribution channels. We would expect to run retention in the 80% to 81% range over time, and let's say what you're looking out in 2018 is a little bit of a residual of some of the nonrenewal and rate actions that we were intentionally taking.

Jeffrey Bernstein

And the other question I had, just I sort of forgot. Do you report your private equity results on a quarter lagged basis?

Neeti Bhalla Johnson
Executive VP, President & Chief Investment Officer of Investments

Yes. So as of now, the results are through September 30.

Jeffrey Bernstein

Okay. And any -- Q4 was a tough quarter. Anything you'd like to say or what we should expect for Q4?

Neeti Bhalla Johnson
Executive VP, President & Chief Investment Officer of Investments

No. You're right. Q4 was a tough quarter, and I would say even in a challenging sort of market, that portfolio, as we look at it now with that 1 quarter lag, generated a small positive return of about 1% in that quarter. And if the volatility that we saw in the public markets had persisted, I think you would have seen some more volatility emerge on the private market side, but given the quick reversal in the public market, we don't anticipate any sort of dramatic noise in Q4 with private equity valuations at this point.

Operator

[Operator Instructions] Our next question will come from Rob Hauff with Wells Fargo Securities.

Robert Glenn Hauff

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Wells Fargo Securities, LLC, Research Division

Liberty. Just to follow-up on Jeff's last question there. If I'm understanding that correctly on the investment income, Neeti, you said that was a positive 1% return from the fourth quarter on the alternatives portfolio?

Neeti Bhalla Johnson
Executive VP, President & Chief Investment Officer of Investments

Rob, no, what I said was the total portfolio generated a return -- a small positive return of about 1% in Q4. That's the total portfolio.

Robert Glenn Hauff
Wells Fargo Securities, LLC, Research Division

Okay. So including the limited partnership and traditional fixed income investments?

Neeti Bhalla Johnson
Executive VP, President & Chief Investment Officer of Investments

That's right, in public equity and the natural resource portfolio. So if you look at the mix as a whole, right, rates came in, spreads widened a little, private equity with the lag and public equity did decline, all in thrown together for Q4, the total portfolio was a small positive return.

Robert Glenn Hauff
Wells Fargo Securities, LLC, Research Division

Got it. Okay. Very helpful. And then, I wanted to ask about, it looks like the rate increases you guys are getting in specialty continued to gain some momentum with the GRS. What has been the biggest driver there? And do you think that you're going to continue to get these rate increases as we look through 2019? And do you foresee this segment getting to an underwriting profit in 2019 with the rate increases you're getting?

Dennis James Langwell
Executive VP & President of Global Risk Solutions

Rob, we're pushing rate pretty hard across all the specialty lines. I'd say casualty has been a significant source of rate increase and property, of course, and we're pretty aggressively pushing property rates in '19 as well and reunderwriting the cat-exposed book. So I'd say across all lines, we continue to push rate. And as David mentioned in his opening comments, we've been getting rate in excess of loss trends across virtually all lines, Workers' Comp being the notable exception where we're giving back a couple of points of rate against the negative, say, 1 point loss trend, so a small loss in the loss ratio there.

Robert Glenn Hauff
Wells Fargo Securities, LLC, Research Division

Okay. That's helpful. And then, on the commercial auto side, correct me if I'm wrong. It looks like the revised loss picks from 2017 have been holding up. If that comment is not accurate, please correct me. As a progress check too, could you tell us what the combined ratio was for commercial auto in 2018 versus 2017?

Christopher Locke Peirce
Executive VP & CFO

Rob, this is Chris. I'll just start at a high level. I think you're right. So we significantly increased the loss picks in the second half of '17 sort of throwing up all '17. And I think the '18 accident year has been largely consistent with that. So we think they're holding -- I'd have to say and I think you'd probably heard this on just about everyone's calls. I think there remains significant uncertainty in the market around the ultimate loss trends in commercial auto and a little bit in GL. But there's still a lot of uncertainty around it, but I'll probably let Tim and Dennis comment on their segments a little more detail.

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Timothy Michael Sweeney
Executive VP & President of Global Retail Markets

Yes. Actually on the smaller end of commercial auto, we still see kind of high single-digit trend. What we're seeing from a severities perspective on the smaller end of commercial auto is similar to personal auto, which is labor rates and some materials. Repair costs continue in the same mid-single-digit, nothing troubled -- nothing terribly problematic on the severity side. On the personal auto side, we've got offsetting frequency declines that are keeping the overall trend within reason. On the small commercial auto side, we're seeing small frequency increases, which are driving -- which are compounding the severity to high single-digit trend -- loss trend on the small commercial auto book. Having said that, we're still taking double-digit rate on commercial auto last year and again in this coming year. So we're keeping rate well ahead of trend and expect that combined ratio to continue to come down pretty steadily.

Dennis James Langwell
Executive VP & President of Global Risk Solutions

Rob, on the...

Robert Glenn Hauff
Wells Fargo Securities, LLC, Research Division

Was there -- go ahead. I'm sorry.

Dennis James Langwell
Executive VP & President of Global Risk Solutions

Just going to add very similar comments on the larger side with rate activity in the high single-digits, close to 10% and loss trend in the 6% to 7% range. So making progress, but there is ways to go. There's lot of factors there on the loss trend, including just litigation trends and some of the larger verdicts that are coming out of juries and encouraging more litigation.

Robert Glenn Hauff
Wells Fargo Securities, LLC, Research Division

Okay. So it sounds to me, piecing all this together, 2018 is probably more of a stabilization story and 2019 still a lot of moving pieces, but maybe some margin improvement in 2019 on the commercial auto side?

David Henry Long
Chairman, President & CEO

So Rob, this is Dave. I'd say a little better than that in 2018. So I would describe it as 2017 was stabilization. And as Chris said, the reestimation of current accident year that we did in 2017 looks like it's holding pretty well. As Dennis and Tim said, we're getting pretty good rate, but the trends are higher than they have been historically. So we've taken a bite out of it, but we need to continue to take a couple more bites.

Robert Glenn Hauff
Wells Fargo Securities, LLC, Research Division

Understood. And last one from me. Chris, you made a passing comment at the Investor Day meeting about the S&P change in hybrid methodology. As you've had some more time to digest some of this, I mean, do you see any impact to your existing hybrids under the S&P proposal?

Christopher Locke Peirce
Executive VP & CFO

So Rob, they -- if the proposal goes forward as is, they would be impacted, but we think it would have a pretty modest overall impact on our equity, more of a sort of leverage capacity issue for us. So we're -- we'll just continue to look at, wait and see what the ultimate outcome is and then look at various options. But I wouldn't say we feel any pressing need to react or to do anything. I mean, the biggest issue is, if it

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goes through, it just becomes very expensive senior debt for us. So if there are opportunities that make sense, we'll look at them, but we'd be sort of in no rush to run out and do something.

Operator

[Operator Instructions] Our next question will come from Reed Eckhout with Legal & General.

Reed Eckhout

Just one for me. What has the attritional loss environment been across lines so far this year? And how are you guys approaching your management of severe losses in 2019 versus 2018?

Dennis James Langwell
Executive VP & President of Global Risk Solutions

I'd say in terms of large loss activity, we had a higher level in the fourth quarter, largely in our specialty lines being energy-related losses, in particular. But nothing on the large commercial side in the property sector that would give us concern. I know a lot of companies have been reporting large attritional losses in property, but we haven't in the larger end of the business seen anything unusual in 2018.

Reed Eckhout

Okay. And can you comment year-to-date?

Dennis James Langwell
Executive VP & President of Global Risk Solutions

Yes, year-to-date, at least on the GRS side, it's about $100 million higher than what it was last year. But again, it's -- that includes a large surety loss and then the largest items are generally energy-related losses.

David Henry Long
Chairman, President & CEO

It's '18.

Dennis James Langwell
Executive VP & President of Global Risk Solutions

Yes, 2018. Yes.

Operator

And our next question will come from Chad Stogel with Spectrum Asset Management.

Chad Stogel

As you commented on GL severity 3% to 5%. I think you said frequency flat. Just curious if I can get any additional color on that. Where you are seeing pockets of concern, pockets of severity trend?

David Henry Long
Chairman, President & CEO

So Chad, I think it was me. I commented GL severity trends that while the frequency is flat, the severity trends are about 5% to 6%. And I think they've been in that neighborhood for a couple of years. I think the combination of flat frequency and 5%-or-so on severity, I think we're having prices that are a little bit in excess of that. So making a little bit of progress there. Some normal medical inflation, legal litigation inflation, but we're not seeing anything troublesome on the severity trend -- on the severity side and frequency is pretty benign.

Dennis James Langwell
Executive VP & President of Global Risk Solutions

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On the GRS side, I'd say the same thing I'd mentioned on commercial auto. Litigation trends are a concern, others have mentioned on their calls. A lot of reasons behind that, but we're seeing larger verdicts coming out and more litigation as a result.

Operator

And that does conclude the question-and-answer session. I'll now turn the conference back over to you for any additional remarks.

Edward Peña
VP & Director Investor Relations

Thank you, everyone, for your questions. If you have any further follow-ups, please contact us via our website. Thank you, and have a nice day.

Operator
Thank you. That does conclude today's conference call. Thank you for your participation, and have a wonderful day.

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