

Commercial P&C Underwriters

Assuming and Initiating Coverage of Four Commercial Insurers

Cash flow is a leading indicator. As a leading indicator of commercial insurance results (i.e., earnings and returns), cash flow provides a significant advantage in understanding when to buy and sell the stocks. Cash flow reflects current day economics of property-and-casualty (P&C) results and provides the best indications of near- and long-term prospects. The leading nature of cash flow inherently bridges the natural lag between revenue and cost recognition in the insurance business. This report includes a new and unique valuation measure for P&C stocks that is based on future cash flows. The price-to-cash-flow ratio, or P/CF (stock price to average four-year operating cash flow), has a high correlation with future returns, which suggests it is a relatively good predictor of movements in P&C stocks.

Eight years of soft P&C pricing have resulted in deteriorating cash flow. The industry is in the early stages of an inflection period. Cash flow, however, has deteriorated materially in the last four years (2007 to 2010) and is half the level observed in 2006. In the next two to three years, we expect it to drop by another 25% at a minimum.

Stocks appear expensive on price-to-cash-flow metric. Currently, the selected group of commercial P&C stocks appear to be overvalued, based on our cash flow analysis. Declining cash flow, combined with stable to moderately rising stock prices, means that the stocks are expensive on a historical basis. On average, the stocks are trading at a cash multiple nearly 30% higher than their five-year median and 1.5 standard deviations above their 10-year median. The stocks look appropriately valued on a price-to-book basis (average of 1.2 times). However, the potential for returns on equity (ROEs) to move to 8%-9% suggests valuations could slide further.

Recommend caution in near term. We would stay away from most of the commercial insurance stocks, based on declining fundamentals. We are initiating coverage of Chubb and assuming coverage of HCC with Underperform ratings. Exposure to long-tail liability lines could cause a greater negative swing in cash flow and ultimately lower ROEs. We are initiating coverage of RLI and Travelers with Market Perform ratings, based on less proportional long-tail casualty exposure at these companies. However, ROEs for RLI and Travelers will also likely decline over the next two years.

Positive and negative catalysts that could alter investment outlook. Potential negative catalysts for the stocks we rate Underperform include evidence of increasing claim activity and further declines in cash flow. A potential positive catalyst for our Market Perform ratings would be an early turn in the commercial P&C cycle. However, if this occurred, the majority of the upside for the underwriters would likely occur three to five years after the pricing turn.

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Financial | Property & Casualty Insurance

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Basic Report (11-079)

The Chubb Corporation

Stock Rating: **Underperform**
Company Profile: **Core Growth**
Symbol: CB (NYSE)
Price: \$62.61 (52-Wk.: \$49-\$66)

HCC Insurance Holdings, Inc.

Stock Rating: **Underperform**
Company Profile: **Core Growth**
Symbol: HCC (NYSE)
Price: \$31.50 (52-Wk.: \$24-\$33)

RLI Corp.

Stock Rating: **Market Perform**
Company Profile: **Core Growth**
Symbol: RLI (NYSE)
Price: \$61.92 (52-Wk.: \$51-\$62)

The Travelers Companies, Inc.

Stock Rating: **Market Perform**
Company Profile: **Core Growth**
Symbol: TRV (NYSE)
Price: \$58.38 (52-Wk.: \$48-\$64)

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Investment Thesis

Summary

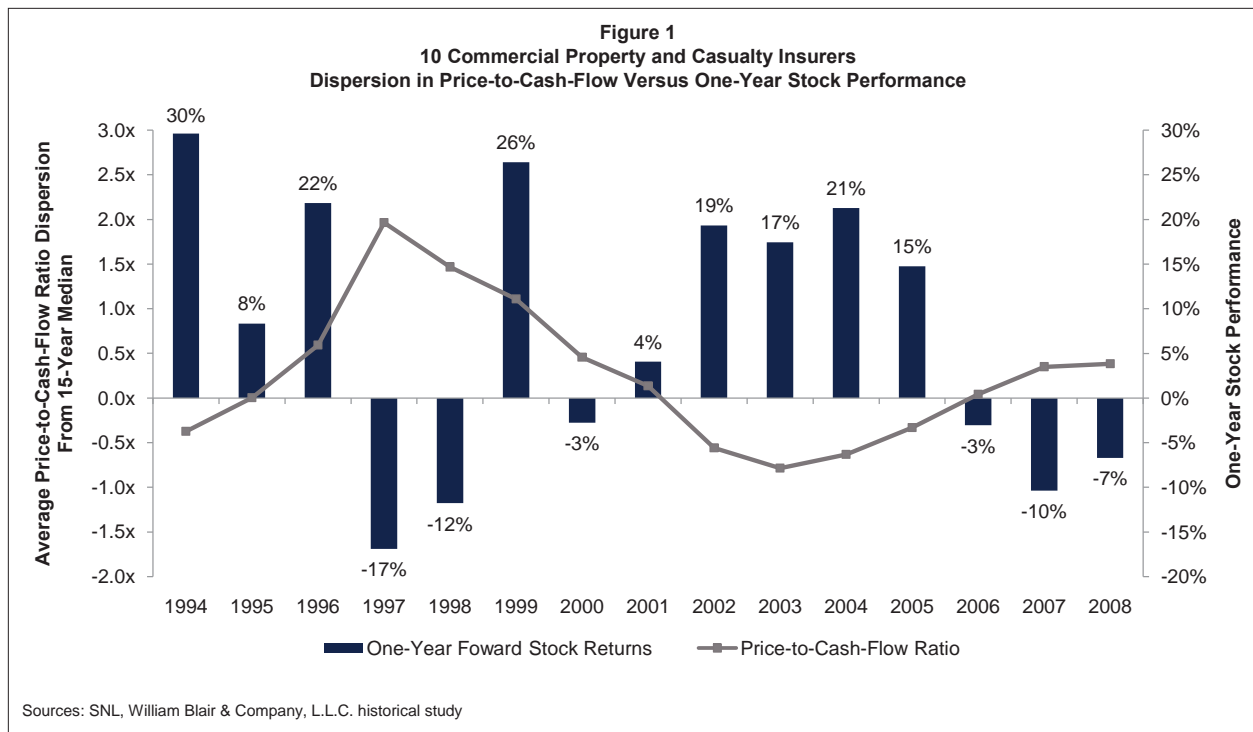
The commercial P&C cycle is nearing a trough after seven years of declining prices, providing a dilemma for investors. The stocks look inexpensive, but fundamentals (i.e., earnings and ROE) will likely deteriorate further. The questions are: 1) For how long will fundamental metrics continue to deteriorate? 2) How far will they deteriorate? 3) How will we know when they have hit bottom? The lagging nature of the industry's fundamentals, with cost of goods sold dragging for 5 to 10 years after the year of occurrence, adds significant complexity to zeroing in on when the true bottom will occur for commercial insurers.

The answer to this riddle is simple—follow the cash. Cash trends provide a relatively clear picture of where industry and company fundamentals are going, particularly during periods of inflections in the insurance marketplace. This basic concept has been encapsulated in our cash flow index, which we have used for almost a decade to understand changes in industry pricing behavior; cash flow has proved to be an accurate benchmark of changes in industry pricing. (We track the cash flow trends on a quarterly basis.) Our index comprises 22 of the larger publicly traded commercial insurers, and we believe it is a good indicator for predicting the beginning and end of the commercial P&C premium rate cycle. Historical data shows that cash flow drops before pricing improvement and increases before pricing declines.

This report takes the cash flow concept one step farther. We use underlying premium and loss trend data estimates to derive future cash flow projections to examine companies' current valuation levels. This allows us to differentiate how each commercial insurer will perform as it moves into the trough of the cycle. The concept is relatively simple: We believe that insurers with declining cash flow should experience declining returns; the trend in cash flow tends to lead returns, particularly during inflections. Therefore, we developed and tested a price-to-cash-flow valuation methodology (insurance investors have long relied on a price-to-book-value multiple). The price-to-cash-flow metric is based on average operating cash flow over a four-year period—the previous year, current year, and the two years following. The calculation includes past and future cash flow to acknowledge that valuations are based on past performance and investor expectations of future trends. We compiled and examined price-to-cash-flow data for 10 key commercial insurance stocks over a 15-year period. The data conclusively showed that stock performance reacts to changes in cash flow on a consistent basis. Thus, we believe this valuation methodology provides a clear picture as to when investors should buy and sell commercial insurance stocks. Based on this metric, stocks currently look overvalued on a historical basis. We would stay away from most of the commercial insurance stocks, based on deteriorating fundamentals.

Valuation Methodology

Similar to the price-to-earnings metric, the price-to-cash-flow measure allows investors to gauge relative stock valuation, based on the expected financial performance. The measure has a high correlation with future returns, suggesting it is a relatively good predictor of movements in P&C stocks. This measure works because cash flow accurately reflects acceleration or deceleration in financial momentum. Cash reacts ahead of earnings and ROE and thus signals early on when to buy and sell stocks. If investors wait for material changes in reported measures, it is often too late to realize the majority of the price movement in the stocks.



Cash flow and related valuations are particularly helpful at industry inflections. The P&C industry is cyclical, with material swings in economics and earnings. From peak to trough, it is not unusual for P&C insurers' ROE to decline by 15 to 20 points. Unfortunately, material changes in ROE lag changes in economics—i.e., the business becomes unprofitable, but it takes several years to actually show the extent of the deterioration, as incurred losses catch up to the paid trend. Earnings and ROE both have a relatively low level of transparency, due to statutory accounting and how changes in reserves affect financial statements, mainly because losses that affect the income statement are based on lagging estimates. This does not mean that GAAP income statements are wrong, but it suggests the material changes in loss patterns are revealed at a relatively slow rate. We therefore believe that cash flow is a better detector of true underlying performance. Operating cash flow is based on paid losses (versus incurred losses), which are far tougher to mask or adjust.

Current Industry Conditions

The industry is in the early stages of an inflection period. Declining cash flows suggest that the P&C industry is in the fifth or sixth inning of a cyclical slide—and that slide is gaining momentum. The peak of the last underwriting cycle was 2004. From 2004 to 2006, cash flow was relatively stable, declining by an average of only 5% annually. Cash flow, however, deteriorated materially in the last four years (2007 to 2010) and is down to half the level observed in 2006. In the next two to three years, we expect it to drop by another 25% due to continued pressure on pricing and rising accident-year loss ratios.

The deterioration reflects roughly 50% lower prices for most commercial P&C products since their peak in 2004, combined with a degree of increasing claims activity. In contrast, the traditional barometer, ROE, would suggest that returns have moderated, but are relatively healthy and stable. Consensus ROE estimates range from 10% to 13% for 2012 and 2013, which are stable with 2010 levels.

Table 1
Commercial P&C Insurers
Cash Flow Valuation Comparison

Company	Ticker	Rating	Current Price	Cash Flow Valuation						Earnings Valuation				Book Valuation		
				Cash Flow Per Share 2011	Cash Flow Per Share 2012	Price to Cash Flow ¹	2006-2010 Median	Current Valuation vs. 5-Year Median	Number of Std. Deviations From 10-Year Median	EPS 2011E	EPS 2012E	PE 2011	PE 2012	Current Book Value	Current Price to Book	2012 ROE
The Chubb Corporation	CB	U	\$62.61	\$6.26	\$6.09	9.4x	7.3x	30%	1.5	\$5.40	\$5.30	11.6x	11.8x	\$53.26	1.2x	9.2%
HCC Insurance	HCC	U	\$31.50	\$3.25	\$3.23	9.2x	5.7x	60%	2.6	\$2.66	\$2.78	11.8x	11.3x	\$28.99	1.1x	8.7%
RLI Corp.	RLI	M	\$61.92	\$6.64	\$5.70	10.6x	9.1x	16%	1.5	\$4.19	\$4.40	14.8x	14.1x	\$38.52	1.6x	10.9%
The Travelers Companies ²	TRV	M	\$58.38	\$5.79	\$7.47	8.6x	7.8x	10%	0.5	\$4.25	\$6.10	13.7x	9.6x	\$59.91	1.0x	10.4%
Average						9.4x	7.5x	29%	1.5			13.0x	11.7x		1.2x	10%
Median						9.3x	7.5x	23%	1.5			12.8x	11.6x		1.1x	10%

¹ Price-to-cash-flow based on current price divided by four-year cash flow: t= -1, 0, 1, 2

² Travelers data only goes back through 2002

Source: William Blair & Company, L.L.C. estimates

Assuming and Initiating Coverage on Four Top Franchises in the Commercial P&C Industry

We would stay away from most of the commercial insurance stocks, based on deteriorating fundamentals. Declining cash flow, combined with stable to moderately rising stock prices, means that the stocks are expensive on a historical basis. On average, these stocks are trading at a 9.4-times price-to-cash-flow multiple, which is at the higher end of the historical range. Our 15-year study shows that when commercial insurers are trading more than 1 standard deviation above their historical median, the stocks tend to underperform. The group is trading at an average market-to-book-value multiple of 1.2 times, which suggests the stocks are appropriately valued. However, given that we expect returns on equity to decline to 8%-9% over the next several years, the market-to-book multiple has the potential to slide from current levels.

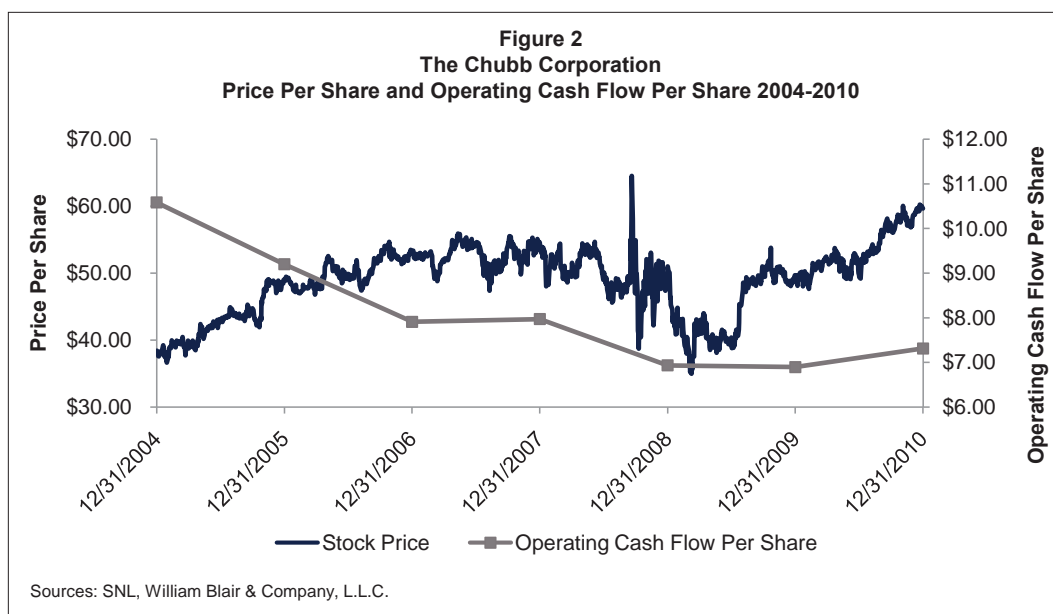
We are initiating coverage of Chubb and assuming coverage of HCC with Underperform ratings. Exposure to long-tail liability lines could cause a greater negative swing in cash flow for these companies. In addition, these stocks are trading at cash flow multiples materially above their recent median ranges. Negative catalysts for the stocks will be increasing paid losses, particularly in liability lines, and lack of evidence of a near-term turn in the commercial pricing cycle.

We are initiating coverage of RLI and Travelers with Market Perform ratings, based on their having less proportional long-tail casualty exposure and balanced business mixes. However, we believe returns at these companies will also likely decline over the next two years.

Potential positive catalysts for the group include a turn in the commercial line pricing cycle; however, we do not anticipate that occurring until at least 2013, and the majority of stock returns tend to lag several years behind cycle inflection points.

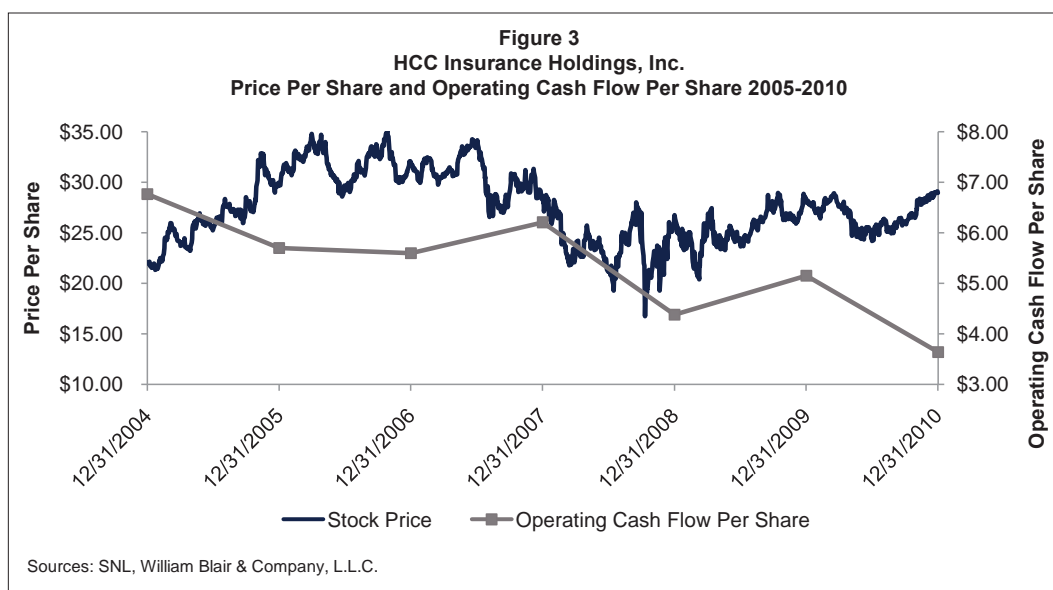
The Chubb Corporation—Underperform rating. Core operating cash flow has declined by 40% from 2006 to 2010 and we expect it to decline by another 25% through 2012. Going forward, we expect the deterioration already seen in cash flow to become more visible in operating results. We expect the calendar-year loss ratio to increase—from 58% in 2010 to an estimated 63% in 2012. Our forecast has operating earnings per share sliding from \$5.90 in 2010 to \$5.30 in 2012 (\$0.54 below consensus). Higher catastrophes or less favorable development have the potential to reduce 2012 EPS even further.

Chubb's cash flow multiple suggests that the stock is overvalued. The stock is trading at 9.4 times cash flow, which is a 30% premium to its five-year median cash flow multiple. The stock has increased from \$50 per share in 2006 to \$60 per share in 2010, while cash flow per share has declined from \$8.35 to \$7.31. On a historical basis, Chubb's cash flow multiple is 1.5 standard deviations above its 10-year median multiple—our historical study shows that stocks tend to have negative returns in the subsequent year after the multiple is more than 1 standard deviation above the median.



HCC Insurance Holdings, Inc.—Underperform rating. Cash flow per share has declined from \$6.21 in 2007 to \$3.64 in 2010, and we forecast the slide to continue in 2012 to \$3.23. Paid losses, a major determinant of cash flow, should continue to increase, reflecting deteriorating results in recent accident years. Return on equity (ROE), which lags cash flow, should also decline. We expect ROE to drop from 11% in 2010 to 8% in 2013, reflecting lower profitability in current accident years. Our 2012 and 2013 operating earnings per share estimates of \$2.78 and \$2.68 are 12% below consensus.

The stock is trading at 9.2 times average four year operating cash flow, a 60% premium to historical valuation levels. Our 15-year cash flow valuation study shows that stocks underperform when the cash flow multiple is materially above the median. HCC appears adequately valued on a market-to-book basis at a multiple of 1.1 times. This compares with a current peer average of 1.2 times. On the surface, this valuation seems appropriate given that ROEs have averaged 11% in the last two years. However, since ROEs are forecast to decline to 8% by 2013, the price-to-book ratio could slide even further.



RLI Corp.—Market Perform rating. We forecast operating earnings per share to be to \$4.19 in 2011 and \$4.40 in 2012; however, this could be conservative, depending on how reserves develop over the next two years. Our estimates assume return on equity around 11% and that book value per share will grow from \$37 to \$44 over the next three years. Organic premium growth could exceed our estimates, particularly with the recent Contractors Bonding and Insurance Company (CBIC) acquisition.

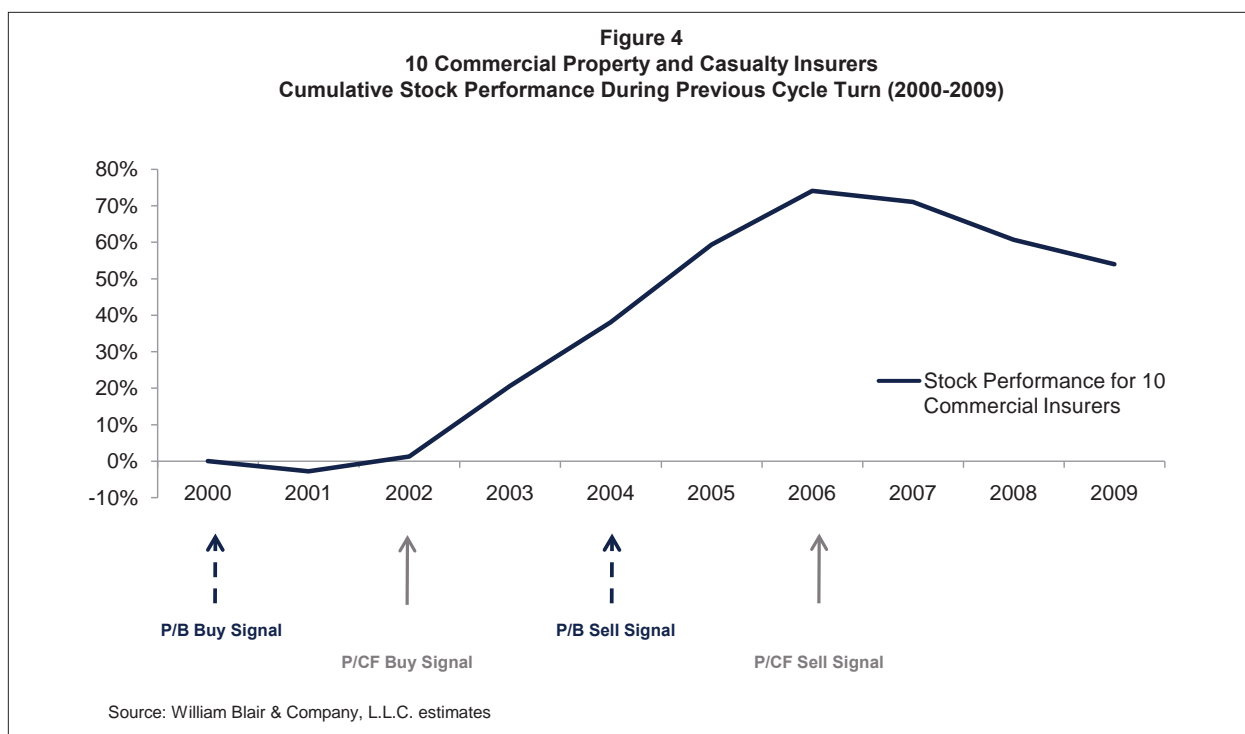
RLI is trading at 10.6 times its four-year cash flow. While slightly above its historical median trading average, the stock looks like a relative value compared with its peer group. However, a valuation in line with historical levels suggests that upside will likely be limited in the near term.

The Travelers Companies, Inc.—Market Perform rating. We forecast operating earnings per share of \$4.25 in 2011 and \$6.10 in 2012; however, this could be conservative depending on how reserves develop over the next two years. Our estimates assume return on equity of 7.3% for 2011 and 10.4% for 2012.

Travelers is the most attractively valued among the group, although we believe upside will be limited in the near term. The stock is the only one with a price-to-cash-flow (P/CF) multiple below its five-year median. Travelers' P/CF multiple of 8.6 times is 10% above its five-year median of 7.8 times. In comparison, the other three stocks are trading at an average of 35% above their respective five-year medians. Typically, the valuation needs to move below the historic median before the potential for positive returns materially improves.

Potential Positive Catalyst for Commercial P&C Stocks: Short-Term Move on Future Cycle Turn

Commercial insurance stocks could appreciate on prospects of a turn in the commercial line pricing cycle. The market typically has “head fakes,” or false cycle turns—and we may even be experiencing one now. Some market proponents believe that the high level of recent catastrophe losses could provide momentum for an overall turn in the commercial pricing cycle. We see this as highly unlikely—the commercial market is mainly liability-oriented and the reinsurers have much less influence on core commercial lines than several decades ago. Even when the cycle turns, which we believe could happen in 2013 or 2014, most of the stock returns for underwriters will occur three to four years later, as ROEs lag the cycle upturn. The majority of the stocks' appreciation related to the last favorable underwriting cycle occurred in 2002 to 2005. This was effectively three years after the hard market had begun. The stocks would likely move in late 2012 or early 2013 if there were a turn, but then would be flat for several years until the higher prices actually began to translate into higher return on equity. Our view is there is no need to take the risk on the early side, since investors will have plenty of time to take advantage of upside.

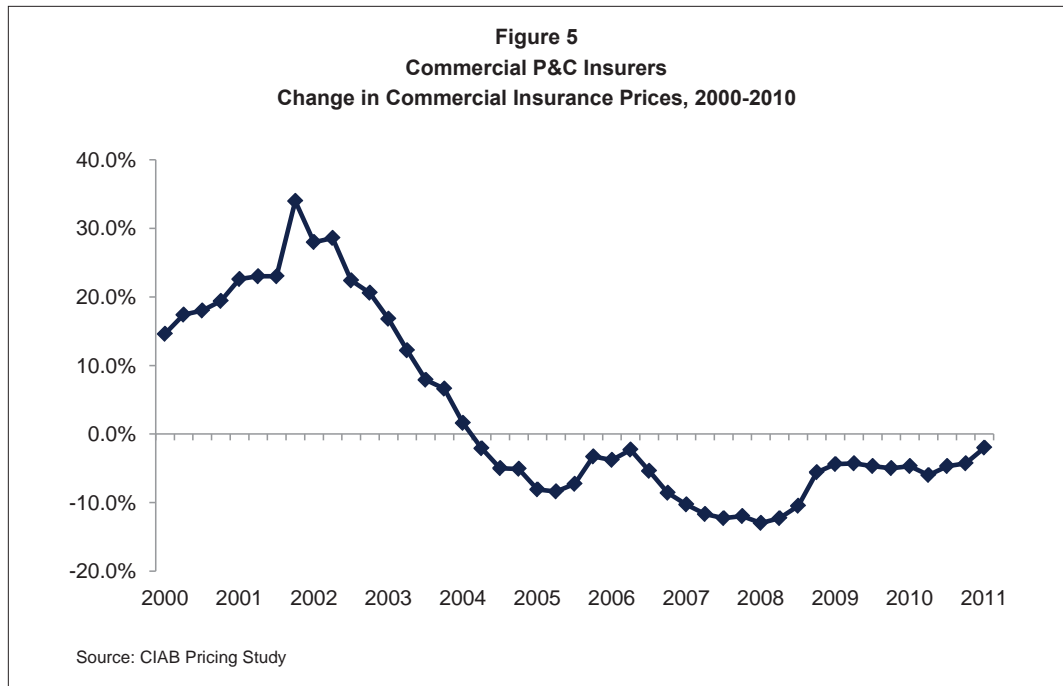


Merits of Cash Flow Analysis

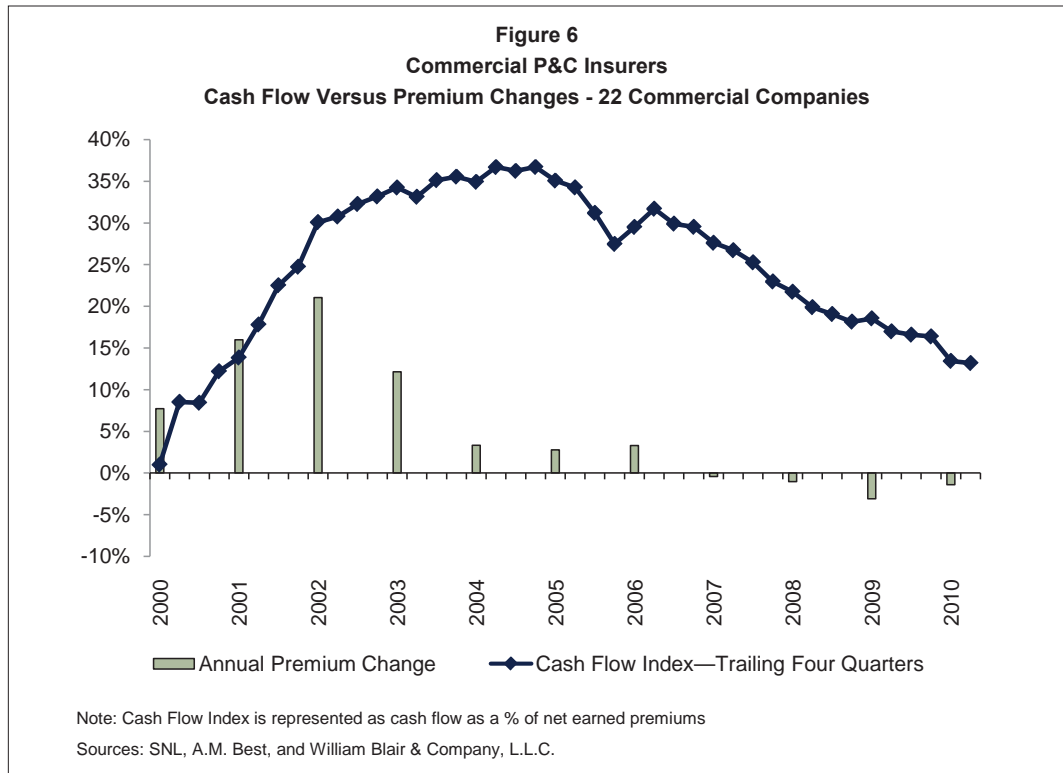
Relationship Between Pricing and Cash Flow

The major factor driving commercial P&C stocks and valuations is the industry pricing cycle. Pricing levels, along with changes in terms and conditions, determine premium growth and underwriting margins, which in turn are the major drivers of cash flow and ultimately earnings. The P&C pricing cycle is dictated by competitive levels within the industry. Pricing tends to go down (the market softens) when the industry has too much capital and insurers push down premium rates in an attempt to grow market share. Prices go up (the market hardens) when insurance capital is contracting and insurers are forced to raise prices to stem losses and increase returns. In the last three decades, the downcycles have been elongated and upcycles were relatively short. Since 1980, the only two hard markets existed from 1984 to 1986 and from 2000 to 2003. However, returns can be significant during these periods. Commercial insurance stocks were up by an average of 20% per year during the last upturn in the pricing cycle, as measured by the 10 companies in our historical study.

Cash flow moves ahead of the pricing cycle, which can help investors get a better sense for inflection points. On an industrywide basis, aggregate cash flow levels decline materially 12 to 18 months before premiums increase. We use an index of the largest publicly traded commercial insurers, whose cash flow trends we track on a quarterly basis. Historical data shows that cash flow levels drop before pricing improvement and increase before pricing declines. The key ratio to examine is cash flow as a percentage of premiums. Ratios above 25% tend to lead to a softening market, and ratios below 10% indicate the potential for a hardening market. In our opinion, there is typically a 12- to 18-month lag from when cash flow passes the inflection point until premiums begin to change direction.

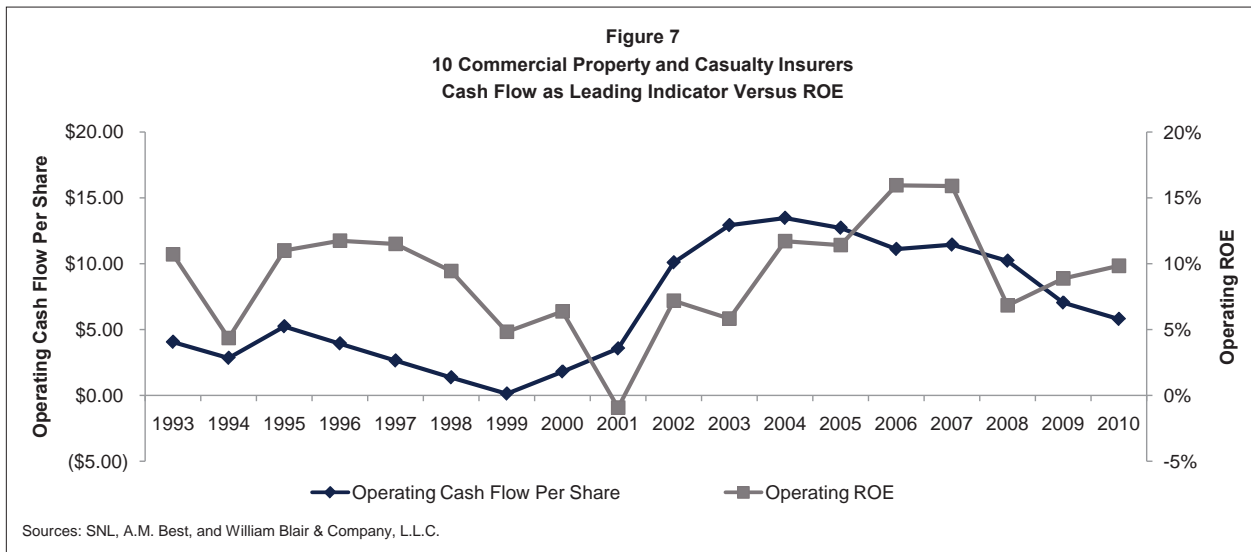


The current down cycle started in 2004; the industry is in the middle of the eighth year of declining prices. This reduction in prices is having a material impact on commercial insurer cash flows. The fourth quarter 2010 data from our cash flow index showed a significant deterioration in cash flow trends. The best barometer is looking at the cash flow ratio (cash flow as a percent of premiums) on an average trailing-four-quarter basis. This helps take out seasonal bias, which is significant in the business. The average cash flow ratio declined from a fourth quarter 2009 level of 18% all the way down to 13% at fourth quarter 2010 and compares with 16% in third quarter 2010. This suggests a favorable turn in the cycle is possible by 2013 or 2014.



The trend also holds true on a company-specific basis, where shifts in cash flow signal changes in financial momentum. Cash flow declines significantly at the end of the soft cycle and then recovers quickly as pricing improves. In contrast, earnings and ROE measures tend to be lagging indicators of performance. In the cycle upturns, ROE takes three to four years after pricing turns before returning to historical average levels and four to six years to reach peak levels. It is not uncommon for commercial insurers to report ROE below 5% or even a negative return in the first or second year of an upturn.

The last cycle is a good example: 1999 was the bottom of the cycle and pricing turned positive in 2000. On average, cash flow for our 10 index companies declined from \$2.64 in 1997 to \$1.36 in 1998 and \$0.13 in 1999, and then grew to \$1.81 in 2000 and \$3.56 in 2001. In contrast, ROE was relatively flat in 1999 and 2000 and then dropped from 6% in 2000 to -1% in 2001. Average ROEs did not pick up until 2004 and then peaked in 2006.

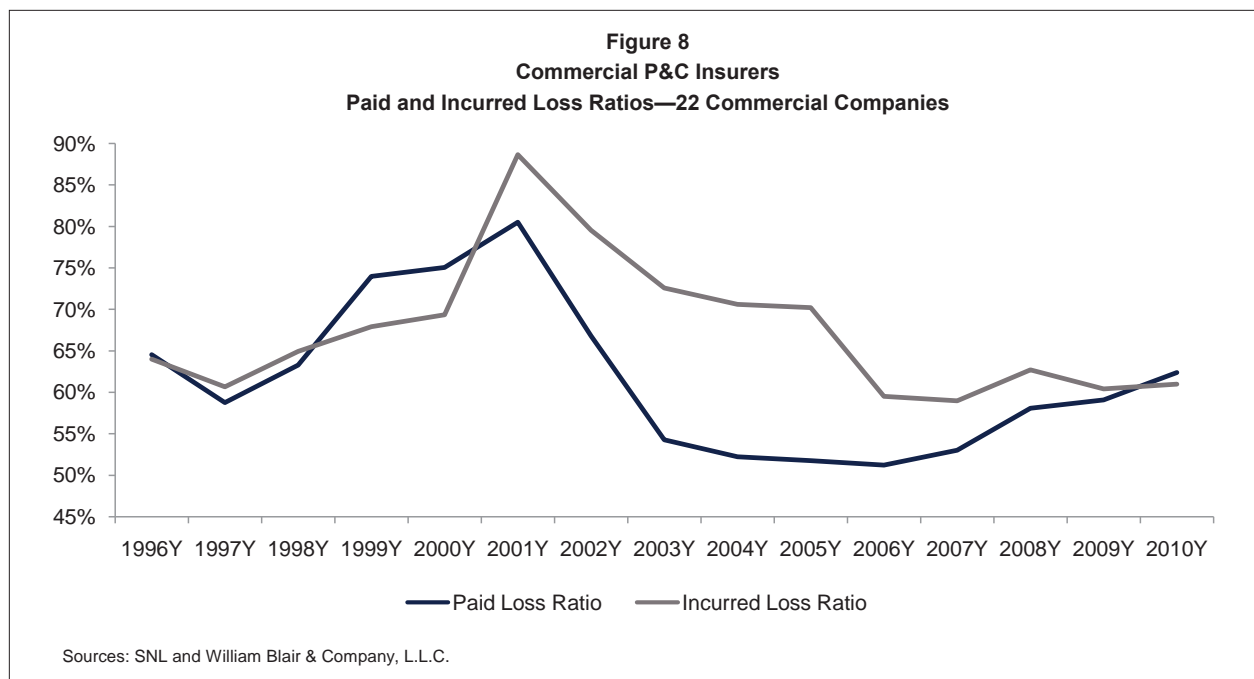


Cash Flow Is a Leading Indicator of Future Results

Cash flow is a leading indicator of commercial insurance results (i.e., earnings and returns) and thus provides a significant advantage in understanding when to buy and sell the stocks. Cash flow reflects current-day economics of P&C results and provides the best indications of near- and long-term prospects. In contrast, reported earnings are oriented toward trailing results. The leading nature of cash flow inherently reflects the natural lag between the revenue and cost recognition in the insurance business. Claim losses are the moving average of prior and current underwriting years (accident years). Reported EPS tend to reflect the average and are generally more reactive when underwriting trends are reaching inflection points.

Cash flow, in contrast to reported earnings, is mainly driven by paid losses. Paid losses more closely reflect the current economics of the insurer for the following reasons.

1. Paid losses on prior years reflect a moving average of the past, but the trend is leading compared with incurred losses.
2. Paid losses for the most part are not subjectively estimated, but reflect actual payments.
3. Paid losses on recent accident years provide a strong indication of the current loss trends, as they are not inhibited by prior-year results.



In addition, cash flow is predictable and lends itself to future forecasts. The main determinant of P&C cash flow is paid claim losses. Premiums, investment income, and expenses are also significant components, but these are more stable over time. Paid losses follow relatively defined patterns (e.g., two years after an underwriting year has been booked, paid claims typically pay out within a certain range). The majority of the paid losses for the current calendar year (for example, 2010) are derived from the current accident year plus the three to five prior accident years (i.e., 2006-2010). Given that P&C companies provide 10 years of data on each accident year, paid losses and therefore cash flow estimates have the potential to be relatively accurate.

Table 2
Insurance Industry
Paid Loss Ratios by Accident Year (%)

Accident Year	12 Months	24 Months	36 Months	48 Months	60 Months	72 Months	84 Months	96 Months	108 Months	120 Months
2001	35.72	53.30	62.36	67.92	71.19	73.01	74.68	75.71	76.43	76.88
2002	30.53	44.83	52.11	56.89	60.10	62.02	63.53	64.30	64.87	
2003	27.48	40.07	46.14	50.26	52.91	54.81	55.76	56.44		
2004	26.42	38.90	44.36	48.16	50.59	52.18	52.83			
2005	28.04	41.99	48.19	52.38	54.84	56.23				
2006	25.58	37.39	43.17	47.00	49.27					
2007	26.89	40.83	47.48	51.65						
2008	31.95	48.10	54.99							
2009	30.51	44.63								
2010	30.95									

Source: SNL

Cash Flow Projections

Cash flow is determined mainly by premiums, expenses, net investment income, and paid losses. The major difference between cash flow and earnings is paid versus incurred losses. Earnings are based on incurred losses. Calendar losses are losses incurred by an insurance company by payments of claims, revaluations of claims already in the company's books,

and any negative or positive changes in loss reserves in a particular calendar year. Paid losses are the portion of the incurred losses actually paid out by the insurer. Importantly, the paid loss calculation on our cash flow does not include reserve development from current or prior years. However, it includes an estimate for future paid losses on existing underwriting years. Therefore, the major difference in cash flow per share and reported earnings per share is reserve development (i.e., a lagging trend), versus estimate of future paid losses (i.e., a leading trend). The difference becomes more significant when underwriting trends are shifting, as the paid loss trend reacts more quickly.

To project cash flow, we use operating cash flow provided from operating activities, as defined under GAAP, as our base. For all historical years, this number is taken directly from 10-Qs and 10-Ks. We analyzed each line item and created a model to project cash flows for upcoming fiscal years. One stark difference between our model and what is shown in a 10-K is that we calculate operating cash flow from the ground up, while the 10-K discloses adjustments to net earnings to get to cash. The core items for cash flow are shown in table 3.

There are some differences from actual cash. For example, we use incurred instead of paid underwriting and other expense and taxes. Using the amount incurred for these items is easier for data modeling purposes, and the paid number generally is not materially different from the incurred amount over the course of a year. What this core operating cash flow number represents is the cash received from net written premiums, net investment income, and other operating income, minus paid losses, expenses, and taxes.

To get to total operating cash flow, as is reported in GAAP statements, other adjustments such as agency balances, premiums receivable, prepaid reinsurance premiums, accrued expenses and other liabilities are included. This other adjustments bucket can be volatile at times, so it is important to not only look at the total operating cash flow, but also the core operating cash flow. The section "Derivation of Operating Cash Flow" includes a detailed example.

Table 3	
Commercial P&C Insurers	
Modeled Core Items for Cash Flow	
	Net Written Premiums
-	Paid Losses
-	Incurred Underwriting and Other Expense
+	Depreciation and Amortization
-	Interest Expense
+	Net Investment Income
+	Other Operating Income
-	Incurred Taxes
=	<u>Core Operating Cash Flow</u>
+	<u>Other Adjustments</u>
=	Total Operating Cash Flow

Source: William Blair & Company, L.L.C.

Price-to-Cash-Flow Valuation Metric

Summary

Trends in cash flow are good predictors of movements in commercial P&C stocks. Our analysis shows that shifts in cash flow are significantly correlated to future stock returns. In addition, cash flow has proved to be a better predictive measure than ROE- and earnings-based measures. The price-to-cash-flow metric can be used to analyze general commercial insurance market conditions, as well as to identify ideal entry and exit strategies for individual stocks.

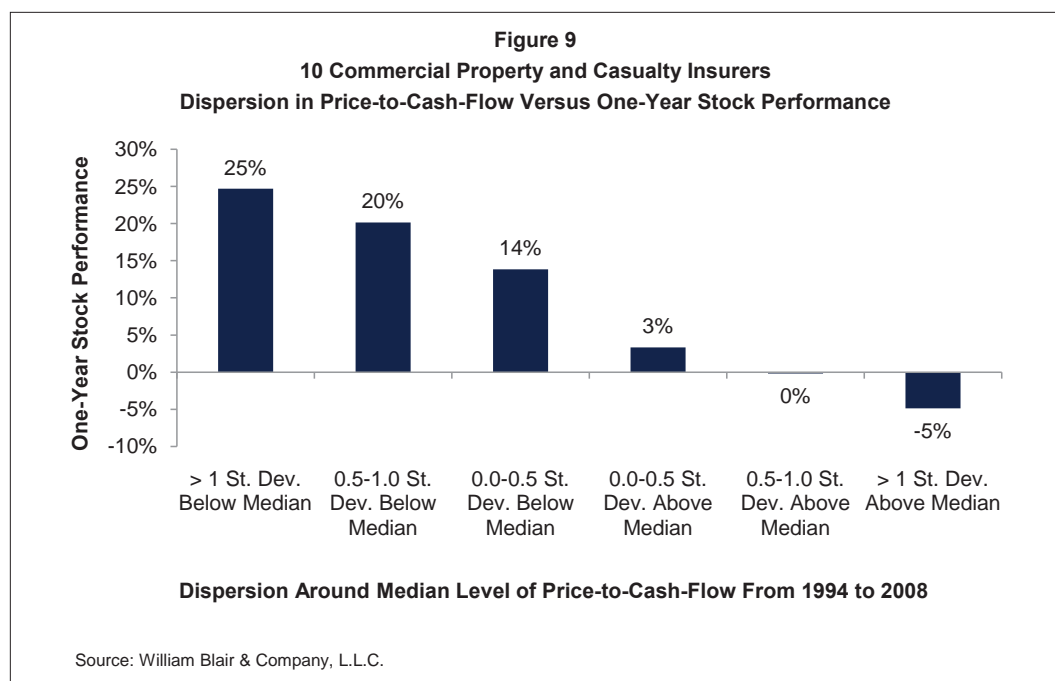
Methodology

We use a price-to-cash-flow (P/CF) valuation metric as the measure to predict future stock performance. Our historical analysis shows that this measure indicates when to buy or sell insurance stocks. Our methodology is based on back-testing P/CF ratios for 15 years using 10 midsize to large commercial insurers. The ratio we are focused on is based on average cash flow over a four-year period—the previous year, current year, and the two years following. The calculation includes past and future cash flow to acknowledge that valuations are based on past performance and investor expectations of future trends. The period included in the analysis spans from 1993 to 2010, with 15 total four-year periods within that time frame. For example, if one were to examine the ratio in 2005, the average four-year cash flow would be calculated by using the cash flow from 2004, 2005, 2006, and 2007. When examining the ratios today, we use historical cash flow for 2010 and our estimated cash flow for the remainder of 2011, and for 2012 and 2013.

To aggregate an industry valuation study from the results of 10 diverse commercial P&C insurers, we looked at each stock separately, versus its own historical performance. For example, for HCC, we took a median and standard deviation for the 15 readings of P/CF that we had created, based on the methodology described above. Each year, or observation, is then placed on a distribution curve based on the number of standard deviations the observation is away from the 15-year mean. By “standardizing” the P/CF ratio into a measure of the dispersion around the median, instead of an absolute multiple, we are able to compare companies and effectively aggregate the 10 companies in the universe to look at trends across the industry. Thus, while our industry-aggregated data can help make suggestions about whether the industry is looking over- or undervalued currently, the underlying model relies heavily on how each individual stock is performing, versus its own historical average.

Results From Historical Back-Testing

We then compared these values for price-to-average-four-year-cash-flow ratios to the stock’s performance over the following 12 months, to gauge how predictive the level of the P/CF ratio was in identifying periods of outperformance and underperformance for commercial P&C insurers. Figure 9 shows the average performance for the following 12 months when a stock’s valuation, using the P/CF ratio, falls into certain dispersion patterns around the median. This figure represents 150 observations across the 10-stock universe (10 stocks, each for 15 periods).



The results show that when the P/CF ratio is greater than one standard deviation below the median P/CF ratio, the average return for the next year is 25%. When it is more than one standard deviation above the median P/CF ratio, returns have averaged -5% for the following year. The number of standard deviations above or below the median is inversely correlated with the performance of the stock, thus the correlation is negative. For example, based on our data set, if a stock was trading at a P/CF valuation lower than the median value, one would expect the performance level for that stock to be positive. The overall correlation for the index is -0.49, which indicates a fairly strong negative relationship between the two variables we are examining. On an individual stock basis, the correlations range from -0.65 (RLI) to -0.39 (Harleysville Group). For each company, the inverse relationship holds between P/CF and performance, but it is stronger for certain stocks than for others, given certain idiosyncratic factors that have occurred historically for individual equities.

This methodology can also be used to help sort the most-attractive stocks in the industry. Table 4, on the following page, shows the stocks in our commercial P&C insurance universe, in descending order by year, based on P/CF valuation methodology. The values listed are the number of standard deviations each stock is away from its own median P/CF value, during each calendar year.

Table 4
10 Commercial Property and Casualty Insurers
Commercial Universe Sorted by Decreasing Price-to-Cash-Flow Ratio

	Stock Position	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	
Most Overvalued	1	NAVG	CNAF	HCC	WRB	NAVG	HGIC	HGIC	HGIC	HGIC	HGIC	MKL	RLI	CINF	RLI	RLI	
	2	CB	NAVG	CNAF	MKL	HCC	MKL	CNAF	CNAF	CNAF	CNAF	MKL	HGIC	CINF	RLI	MKL	MKL
	3	CB	WRB	NAVG	CINF	SIGI	SIGI	CB	CB	MKL	NAVG	NAVG	CINF	MKL	CINF	WRB	
	4	WRB	HCC	WRB	SIGI	CINF	WRB	HCC	CINF	NAVG	HCC	RLI	HGIC	HGIC	HGIC	HGIC	
	5	SIGI	SIGI	RLI	HGIC	WRB	CNAF	SIGI	HCC	HCC	SIGI	CINF	SIGI	HGIC	WRB	CB	
	6	HGIC	CB	SIGI	NAVG	CNAF	CB	MKL	SIGI	SIGI	WRB	SIGI	WRB	HGIC	CB	SIGI	
	7	CNAF	RLI	CINF	HCC	MKL	CINF	WRB	MKL	WRB	RLI	WRB	NAVG	HCC	SIGI	NAVG	
	8	MKL	MKL	CB	CNAF	RLI	HCC	CINF	WRB	CINF	CINF	HCC	HCC	NAVG	NAVG	CNAF	
	9	CINF	HGIC	MKL	CB	CB	NAVG	NAVG	NAVG	RLI	CNAF	CNAF	CNAF	CB	CNAF	CINF	
	10	RLI	CINF	HGIC	RLI	HGIC	RLI	RLI	RLI	CB	CB	CB	CB	CNAF	HCC	HCC	

Source: William Blair & Company, L.L.C.

Table 5
10 Commercial Property and Casualty Insurers
Price-to-Cash-Flow Ratio—Number of Standard Deviations From Historical Median by Company

	Stock Position	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Most Overvalued	1	1.15x	0.84x	2.13x	2.84x	2.92x	2.01x	1.84x	1.90x	0.68x	-0.03x	-0.16x	0.20x	0.70x	1.16x	1.68x
	2	0.00x	0.81x	1.37x	2.70x	2.42x	1.99x	1.37x	1.37x	-0.12x	-0.41x	-0.26x	0.00x	0.68x	0.97x	0.91x
	3	0.00x	0.70x	1.33x	2.57x	2.19x	1.53x	1.02x	0.16x	-0.43x	-0.47x	-0.40x	0.00x	0.38x	0.88x	0.65x
	4	-0.01x	0.56x	0.70x	2.56x	1.51x	1.42x	0.70x	0.11x	-0.45x	-0.66x	-0.41x	-0.11x	0.00x	0.43x	0.62x
	5	-0.39x	-0.17x	0.70x	2.08x	1.49x	1.37x	0.59x	0.06x	-0.50x	-0.67x	-0.49x	-0.27x	0.00x	0.35x	0.13x
	6	-0.59x	-0.32x	0.47x	1.52x	1.37x	1.16x	0.34x	-0.11x	-0.56x	-0.84x	-0.50x	-0.28x	0.00x	0.12x	0.13x
	7	-0.64x	-0.46x	0.03x	1.52x	1.37x	0.76x	-0.01x	-0.23x	-0.76x	-0.91x	-0.67x	-0.35x	-0.25x	0.04x	0.07x
	8	-0.72x	-0.51x	-0.04x	1.37x	1.13x	0.66x	-0.03x	-0.42x	-0.79x	-0.95x	-0.69x	-0.56x	-0.27x	0.00x	0.00x
	9	-1.11x	-0.61x	-0.21x	1.34x	0.47x	0.22x	-0.41x	-0.45x	-1.15x	-1.00x	-1.10x	-0.83x	-0.34x	-0.17x	-0.10x
	10	-1.40x	-0.79x	-0.53x	1.17x	-0.17x	0.00x	-0.83x	-1.02x	-1.50x	-1.90x	-1.62x	-1.11x	-0.45x	-0.24x	-0.24x

Note: Matches ticker list from Table 4
 Source: William Blair & Company, L.L.C.

Based on the ordering presented above, we can then take a look at how the one-year returns compare along the P/CF scale. Though the trend is not perfect, over the course of the 15 years, stocks toward the bottom of the table, or those deemed most undervalued based on the P/CF ratio, tend to modestly outperform those at the top of the table, which is what we would expect. So, while this relative comparison is not absolute in every year, we believe it can be used as a guide to help parse out which commercial P&C insurers look relatively attractive.

Table 6
10 Commercial Property and Casualty Insurers
One-Year Performance Based on Decreasing Price-to-Cash-Flow Ratio

		Stock Position	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	Avg. Performance for Each Position
Decreasing P/CF Valuation	Most Overvalued	1	22%	-6%	-11%	-39%	-17%	26%	-18%	11%	-25%	20%	-13%	13%	-13%	8%	-13%	-4%
		2	25%	4%	19%	-14%	-18%	17%	-25%	-12%	-6%	35%	11%	1%	1%	-39%	14%	1%
		3	25%	-6%	3%	-15%	-25%	41%	-20%	-24%	23%	-2%	33%	1%	2%	-26%	-21%	-1%
		4	43%	22%	30%	-15%	-22%	38%	2%	-2%	35%	4%	20%	31%	2%	-2%	-8%	12%
		5	41%	7%	30%	-11%	-22%	0%	-10%	-11%	29%	37%	6%	8%	2%	4%	-4%	7%
		6	33%	11%	42%	-37%	-5%	27%	-1%	16%	29%	35%	20%	9%	2%	-7%	-28%	10%
		7	12%	34%	19%	-25%	16%	27%	14%	14%	32%	11%	51%	10%	-11%	0%	-14%	13%
		8	35%	19%	27%	-3%	-17%	22%	-4%	11%	11%	11%	34%	8%	35%	-16%	12%	12%
		9	33%	-6%	35%	-13%	-14%	37%	33%	14%	34%	11%	22%	23%	3%	-19%	-10%	12%
		Most Undervalued	10	30%	4%	26%	2%	8%	31%	1%	24%	30%	13%	27%	8%	-16%	-7%	5%

Note: Green shade is better performance, red shade is worse performance. Colors based on sliding scale from best to worst.
 Note: Matches ticker list from Table 4
 Source: William Blair & Company, L.L.C.

Based on that same chart, it also becomes clear that during certain years, all stocks, regardless of their relative valuation versus their competitors, move in the same direction. That again brings up the issue of aggregating by industry versus examining the data on an individual company basis. While this tool can be used to draw conclusions across the industry and to compare stocks against each other, the main valuation method is versus the stock's own historical metrics; that will be the clearest way to determine future performance levels for each individual company. In table 7, this issue is laid out: During years when the aggregated industry P/CF is far below its median P/CF level, all of the stocks perform well (highlighted in green). In years when the overall P/CF is far above its median P/CF level, the stocks tend to perform fairly poorly (highlighted in red).

Table 7
10 Commercial Property and Casualty Insurers
Performance by Year at Industry Level

		Stock Position	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Decreasing P/CF Valuation	Most Overvalued	1	22%	-6%	-11%	-39%	-17%	26%	-18%	11%	-25%	20%	-13%	13%	-13%	8%	-13%
		2	25%	4%	19%	-14%	-18%	17%	-25%	-12%	-6%	35%	11%	1%	1%	-39%	14%
		3	25%	-6%	3%	-15%	-25%	41%	-20%	-24%	23%	-2%	33%	1%	2%	-26%	-21%
		4	43%	22%	30%	-15%	-22%	38%	2%	-2%	35%	4%	20%	31%	2%	-2%	-8%
		5	41%	7%	30%	-11%	-22%	0%	-10%	-11%	29%	37%	6%	8%	2%	4%	-4%
		6	33%	11%	42%	-37%	-5%	27%	-1%	16%	29%	35%	20%	9%	2%	-7%	-28%
		7	12%	34%	19%	-25%	16%	27%	14%	14%	32%	11%	51%	10%	-11%	0%	-14%
		8	35%	19%	27%	-3%	-17%	22%	-4%	11%	11%	11%	34%	8%	35%	-16%	12%
		9	33%	-6%	35%	-13%	-14%	37%	33%	14%	34%	11%	22%	23%	3%	-19%	-10%
		Most Undervalued	10	30%	4%	26%	2%	8%	31%	1%	24%	30%	13%	27%	8%	-16%	-7%
Average Valuation Level			-0.37x	0.01x	0.60x	1.47x	1.97x	1.11x	0.46x	0.14x	-0.56x	-0.78x	-0.63x	-0.33x	0.04x	0.35x	0.39x
Average Return			30%	8%	22%	-17%	-12%	26%	-3%	4%	19%	17%	21%	15%	-3%	-10%	-7%

Source: William Blair & Company, L.L.C.

Comparison to Other Valuation Techniques

We believe the P/CF ratio is an effective tool for valuing commercial insurance stocks. We examined price-to-current-book-value and price-to-forward-earnings ratios as alternative valuation metrics, to distinguish how valuable other commonly cited ratios were in predicting future stock appreciation. We used the same universe of companies over the same time frame.

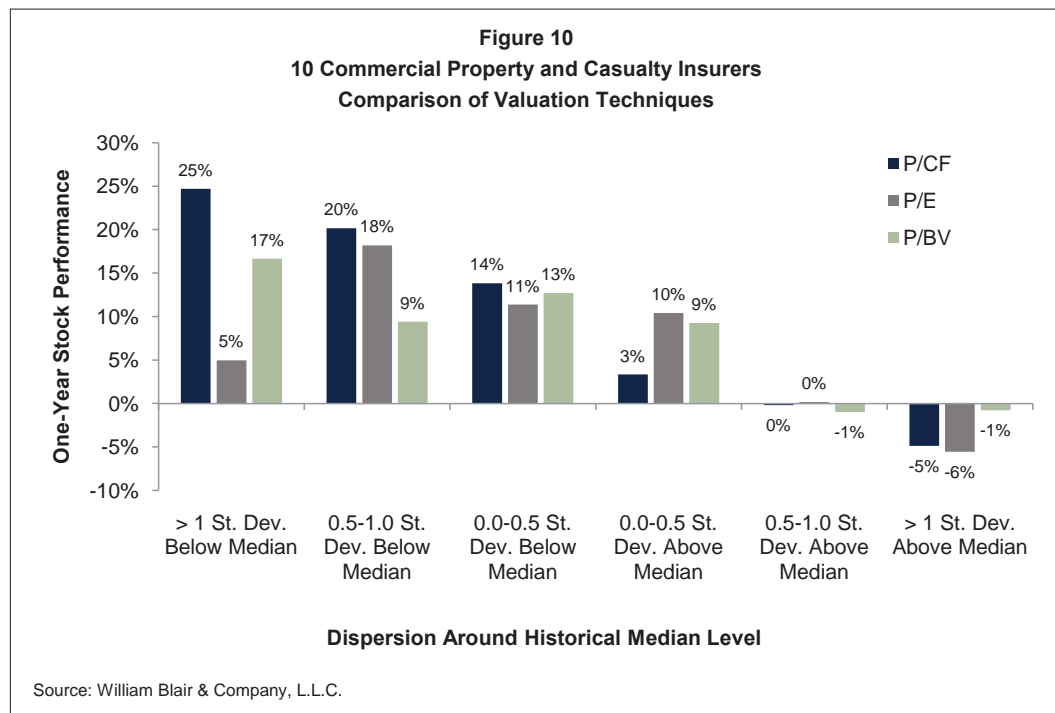


Figure 10 illustrates how our study found that P/CF has been a better predictor of one-year stock returns for 10 commercial insurers than P/BV and P/E. When the P/CF ratio was more than 1 standard deviation below the historical median, the average one-year stock performance was 25%. This compares with 5% for P/E and 17% for P/BV. When the ratio was 0.5-1.0 standard deviations below the median, P/CF showed an average one-year stock performance of 20% compared with 18% for P/E, and 9% for P/BV. When the ratios were 1 standard deviation above the median, P/CF showed a -5% return, compared with -6% for P/E and -1% for P/BV.

The lower predictability of P/E and P/BV ratios on stock returns reflects again the lagging nature of both book value and ROE. Book value has proved to be a valuable metric historically for valuing insurance stocks, but it tends to work better over a longer period.

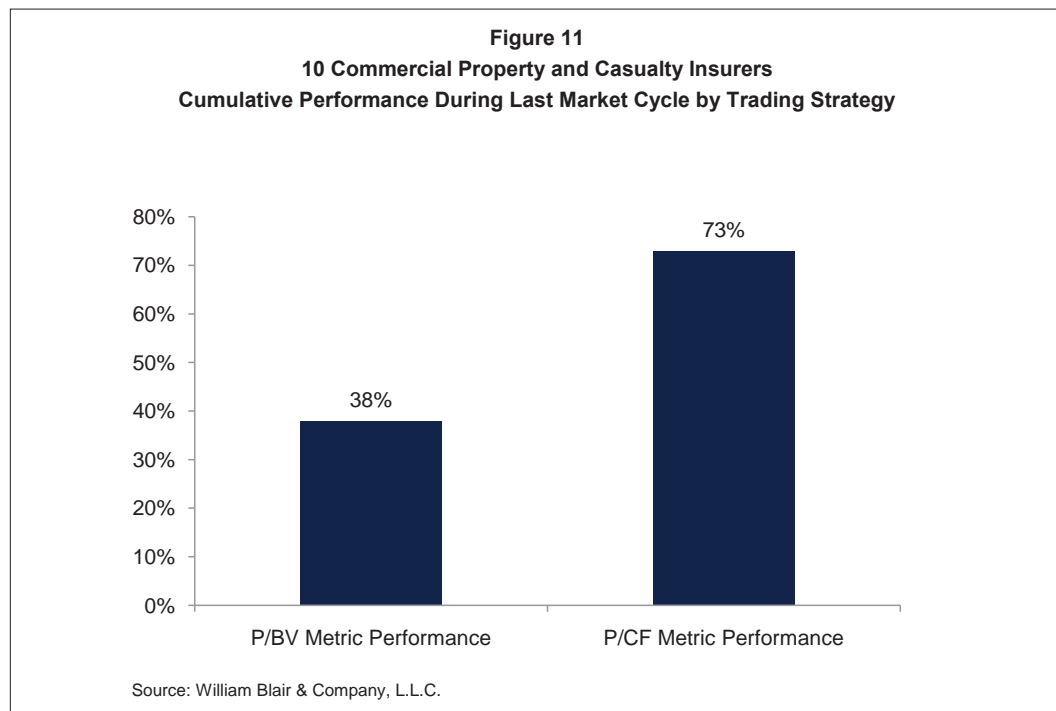
How to Use the P/CF Ratio to Value Stock

Correlation, or predictive capability, is particularly significant during pricing cycle inflections. Given that cash flow tends to be a leading indicator for P&C insurance stocks, the P/CF measure is an essential tool to inform investing decisions for commercial insurers during turns in the pricing cycle.

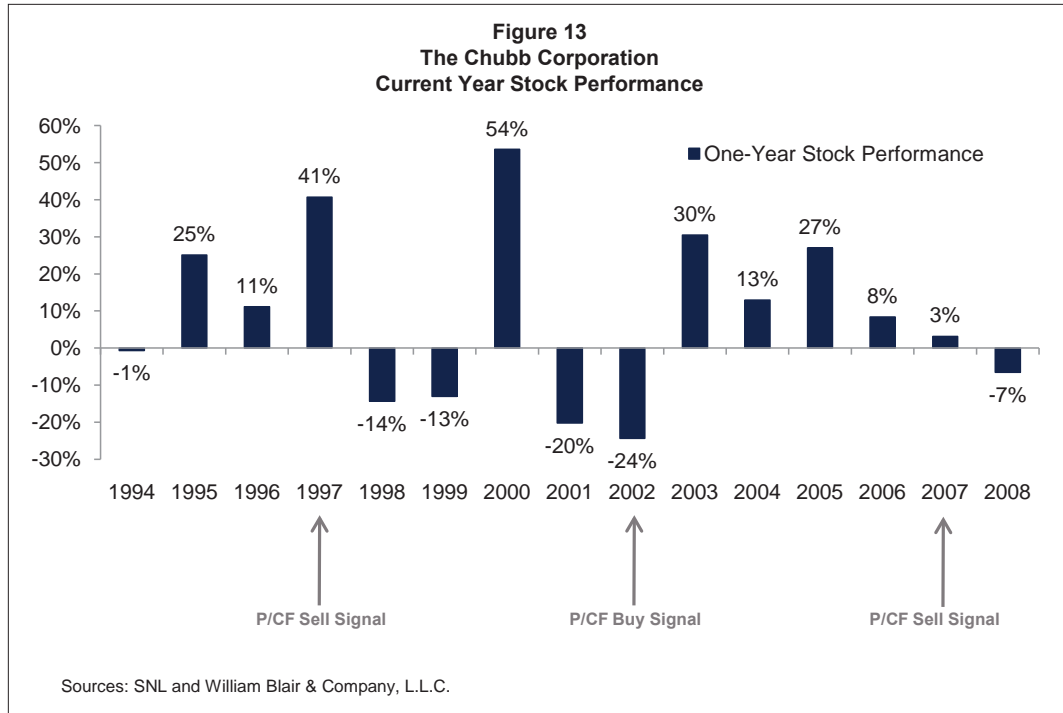
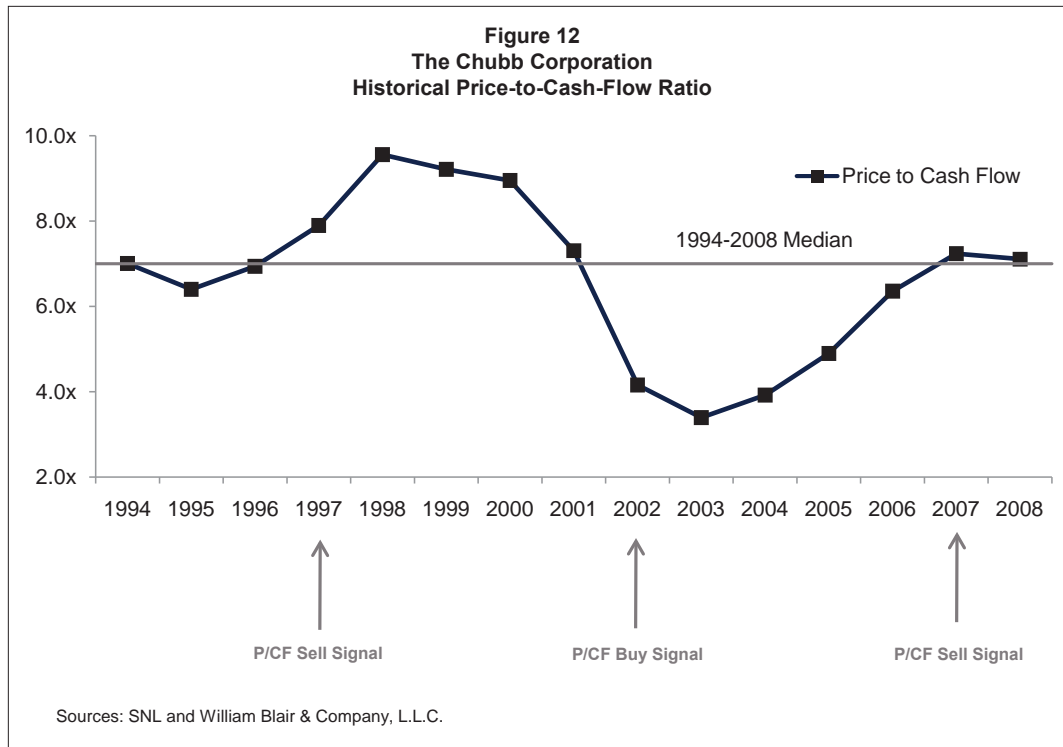
The cash trends we modeled highlighted opportune times to buy and sell insurance stocks during the last transition from a soft market to a hard market over a six-year time frame, and are depicted in figure 12, on page 20. The correlation from 2000 to 2006 P/CF ratio and one-year-forward returns was -0.57, stronger than the overall 15-year average of -0.49. P/CF levels averaged 0.3 standard deviations above the median in 2000 and 2001, suggesting it was a good time to remain out of commercial insurance stocks. Average one year forward returns were 1% during that time frame, with only half the stocks in the universe showing any positive returns over the following two years. The average P/CF ratio began declining

in 2002 to 0.56 standard deviations below the median, and remained below the median through 2006. Subsequent one-year forward returns, starting in 2002, averaged roughly 18% annually through 2006.

The correlation for P/BV and one-year-forward returns was only -0.16 during the same period. In 2000, a low market-to-book-value multiple was suggesting a good buying period, although the stocks did not have good returns until 2003. In addition, the methodology suggested the stocks were overvalued by 2004, missing the additional two years of gains that occurred after that sell signal. By buying based on P/BV ratios, investors would have missed the majority of the gains in the most recent cycle turn.



On an individual stock basis, the trends are even stronger. Chubb is a good example; from 1994 to 2008, the four-year P/CF ratio ranged from a low of 3.4 times to a high of 9.6 times. The 15-year median was 7.0 times, with a standard deviation of 2.0 times. When underwriting results were weakening, from 1994 to 2000, the measure averaged 8.0 times, or roughly 0.5 standard deviations above the median, and when underwriting results began to strengthen from 2002 to 2005, the measure averaged 4.1 times, or 1.3 standard deviations below the median. If one used a buy and hold strategy from 1994 to 2008, the annualized return would be 6%. However, using a simplified strategy of selling the stock when the P/CF ratio was greater than 0.5 standard deviations above the historical median (1997) and buying the stock when the P/CF ratio was greater than 0.5 standard deviations below the median (2002) would have produced annual returns of 13%.



Derivation of Operating Cash Flow

The key to projecting forward cash flow is forecasting future paid losses. Most of the items listed in table 3 are available in any standard earnings model, except paid losses. Paid losses do not directly tie to either GAAP earnings or non-GAAP earnings, so they are not modeled with any kind of frequency in the investment community. We used schedule P paid and reported triangles to project accident-year paid loss ratios at subsequent reporting periods to then sum to a calendar-year amount. The reported schedule P triangles were also analyzed and reserve picks were made to determine the redundancy/deficiency of the current loss reserves to help model how much will actually be paid out on the current incurred loss reserve. The chain ladder method was the primary method of projecting individual paid losses by accident year; however, manual adjustments were made when taking into account the reported triangle as well as macro industry trends. For companies that cede a significant portion of their premium to Bermuda/international, the historical calendar-year statutory paid loss ratio was back-tested with the GAAP paid loss ratio, and if there were major differences, an adjustment was made to the selected statutory paid loss ratio for projected years to make it consistent with GAAP (all items we model for cash flow are on a GAAP basis). Since all the other items come directly from the earnings model, once the paid losses are projected, the core operating cash flow is left.

The other cash flow adjustments are modeled based on judgment and three- to five-year averages. These are different for each company and are taken into account when comparing one company's cash flow versus another. Summing the core operating cash flow and the other adjustments, we arrive at total operating cash flow.

Table 8, on the following page, shows how the paid loss projections for Chubb Corporation were selected. First, the paid loss triangle was analyzed (along with reported triangle and various metrics such as paid/incurred ratio) and link ratios were selected based on one-, three-, and five-year (without high/low) averages. These selected link ratios were then applied to the most recently reported paid loss ratios to get the projected cumulative paid loss ratios at each reporting date. The shaded area in the paid loss ratio section of the table contains the paid loss ratio projection for calendar 2011. The incremental differences between the numbers in the shaded cells and the previous reporting date were multiplied by the earned premium to get a total paid loss. Furthermore, prior-year paid loss was estimated for calendar 2011, and this was added to the total paid loss for calendar 2011. The statutory paid losses are then divided by projected statutory earned premium for 2011 to get the statutory paid loss ratio.

Table 8
The Chubb Corporation
Paid Loss Projection

Accident Year	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Statutory Earned Premium	5,704,294	6,933,211	8,688,110	9,862,966	10,258,243	9,955,080	9,767,292	9,554,389	9,227,142	8,930,685

Accident Year	2011E	2012E	2013E	2014E
Statutory Earned Premium	9,185,307	9,355,105	9,637,456	9,926,579

Paid Loss Link Ratios									
Accident Years	12-24	24-36	36-48	48-60	60-72	72-84	84-96	96-108	108-120
2001	1.804	1.402	1.154	1.131	1.048	1.044	1.031	1.021	1.014
2002	1.944	1.298	1.190	1.102	1.086	1.052	1.020	1.016	
2003	1.725	1.259	1.178	1.092	1.067	1.032	1.024		
2004	1.750	1.230	1.152	1.086	1.041	1.025			
2005	1.826	1.267	1.145	1.068	1.060				
2006	1.848	1.286	1.146	1.101					
2007	1.799	1.232	1.150						
2008	1.676	1.195							
2009	1.764								

Paid Loss Development	12-24	24-36	36-48	48-60	60-72	72-84	84-96	96-108	108-120	Tail Factor
Selected	1.782	1.242	1.150	1.120	1.070	1.034	1.025	1.018	1.014	1.089
Developed to Ultimate	3.636	2.040	1.643	1.428	1.275	1.192	1.152	1.124	1.104	1.089

Paid Loss Ratios										
Accident Years	12 Months	24 Months	36 Months	48 Months	60 Months	72 Months	84 Months	96 Months	108 Months	120 Months
2001	21.3%	38.5%	54.0%	62.3%	70.5%	73.8%	77.1%	79.5%	81.1%	82.2%
2002	15.0%	29.2%	37.9%	45.1%	49.7%	54.0%	56.8%	57.9%	58.9%	59.7%
2003	14.4%	24.8%	31.3%	36.8%	40.2%	42.9%	44.3%	45.4%	46.2%	
2004	13.6%	23.8%	29.2%	33.7%	36.6%	38.1%	39.0%	40.0%		
2005	13.5%	24.7%	31.3%	35.8%	38.3%	40.6%	42.0%			
2006	12.0%	22.2%	28.5%	32.7%	36.0%	38.5%				
2007	13.5%	24.3%	29.9%	34.4%	38.5%					
2008	18.7%	31.3%	37.4%	43.0%						
2009	14.1%	24.8%	32.0%							
2010	18.4%	32.8%								
2011E	19.0%									

Accident Year	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011E
2011E CY Inc. Paid Ratio	0.8%	0.8%	1.0%	1.4%	2.5%	4.1%	5.6%	7.2%	14.4%	19.0%
Multiplied by Earned Premium	56,929	70,839	94,826	143,098	250,807	402,905	537,099	662,811	1,286,162	1,745,208

2011E Prior Year Paid Loss	361,980
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2011 Paid Loss Projection	
Calendar Year	2011E
Statutory Paid Losses	5,612,665
Statutory Paid Loss Ratio	61.1%

Sources: SNL, company reports, and William Blair & Company, L.L.C.

Table 9 shows the calculation of operating cash flow from 2009 to 2012E. All of the line items in this exhibit are taken from the GAAP earnings model, with the exception of the paid loss ratio, which was calculated above. Following the equation from table 3, we calculated the core operating cash flow and total operating cash flow. We project Chubb to have a declining cash flow and declining cash flow per share through 2012. The cash flow per share is not declining at the same rate as operating cash flow, due to a large number of projected share buybacks. This declining cash flow should affect ROE going forward, as the higher rate of paid losses leads to declining reserve releases and higher incurred loss ratio picks.

Table 9
The Chubb Corporation
Operating Cash Flow 2009-2012
(dollars in thousands)

Line Item	2009	2010	2011E	2012E
Net Written Premiums (\$000)	\$11,077,000	\$11,236,000	\$11,539,750	\$11,747,980
Net Premiums Earned	\$11,331,000	\$11,215,000	\$11,534,750	\$11,747,980
GAAP Paid Loss	\$6,006,000	\$6,354,000	\$7,048,288	\$7,454,116
<i>Paid Loss Ratio</i>	53.0%	56.7%	61.1%	63.5%
Underwriting & Other Expense	\$3,499,000	\$3,549,000	\$3,666,707	\$3,758,241
<i>Underwriting & Other Expense Ratio</i>	30.9%	31.6%	31.8%	32.0%
Interest Expense	\$248,000	\$248,000	\$243,000	\$250,000
Net Investment Income	\$1,549,000	\$1,558,000	\$1,533,084	\$1,592,523
Depreciation and Amortization (Cash Flow)	\$69,000	\$63,000	\$63,000	\$63,000
Other Revenues	\$13,000	\$13,000	\$13,390	\$13,792
Foreign Currency Adjustment	\$369,000	-\$30,000		
Taxes	\$779,000	\$814,000	\$613,838	\$545,373
Core Operating Cash Flow	\$1,807,000	\$1,935,000	\$1,577,390	\$1,409,565
Core Operating Cash Flow Per Share	\$5,118.98	\$6,016.79	\$5,462.82	\$5,227.87
Total Cash Flow Adjustments	\$259,000	\$447,000	\$231,400	\$231,400
Total Operating Cash Flow	\$2,435,000	\$2,352,000	\$1,808,790	\$1,640,965
Total Cash Flow Per Share	\$6,898.02	\$7,313.43	\$6,264.21	\$6,086.10
Average Shares Outstanding	353	322	289	270

Sources: SNL, company reports, and William Blair & Company, L.L.C.

Price-to-Cash-Flow Valuation Methodology and Back Testing

Hypothesis

We believe that investors should be valuing commercial P&C insurance companies using a P/CF ratio, rather than other conventional valuation metrics like P/BV and P/E. We believe that cash flow is a leading indicator, and it better reflects the health of the company than a metric like book value. By modeling cash flow two years out, we should be able to accurately predict stock prices, before the upside is reflected in book value or earnings.

Summary

Our cash flow valuation methodology shows how investors have implicitly valued insurance cash flow streams on a historical and current basis. The method averages past and future cash flows for a set time, dividing by average shares outstanding, and then compares the result with current valuation.

Figure 14
Commercial P&C Insurers
Price-to-Cash-Flow Ratio Calculation

$$\text{P/CF Ratio} = \frac{P_0}{CF_{-1} + CF_0 + CF_1 + CF_2}$$

Where P_0 = Average Price During Current Year

Where T_0 = Current Year

Source: William Blair & Company, L.L.C.

The calculation includes past and future cash flow to acknowledge that valuations are based on both past results and investor expectations of future trends.

Definition of Operating Cash Flow Per Share

Cash flow is determined mainly by premiums, expenses, net investment income, and paid losses. The major difference between cash flow and earnings is paid versus incurred losses. Earnings are based on incurred losses. To project cash flow, we started with operating cash flow provided from operating activities, as defined under GAAP, as our base. For all historical years, this number is taken directly from 10-Qs and 10-Ks. We analyzed each line item and created a model to project cash flows for upcoming fiscal years. One stark difference between our model and a 10-K is that we calculate operating cash flow from the ground up, while the 10-K discloses adjustments to net earnings to get to cash. We then divide by the average number of diluted shares outstanding to get to our cash flow per share figure. The core items that go into the calculation for operating cash flow are shown in table 10.

Table 10
Commercial P&C Insurers
Modeled Core Items for Cash Flow

	Net Written Premiums
-	Paid Losses
-	Incurred Underwriting & Other Expense
+	Depreciation and Amortization
-	Interest Expense
+	Net Investment Income
+	Other Operating Income
-	Incurred Taxes
=	Core Operating Cash Flow
+	Other Adjustments
=	Total Operating Cash Flow

Source: William Blair & Company, L.L.C.

Sample

The historical sample for this study comprised 10 publicly traded commercial property-and-casualty companies that have been public since 1990 and have had relatively consistent insurance-oriented operations during the past 20 years (i.e., results do not include material non-insurance operations).

Table 11
10 Commercial Property and Casualty Insurers
Insurance Companies Included in Historical Analysis

Company	Ticker	Current Price	Market Cap (\$M)
The Chubb Corporation	CB	\$62.61	\$18,269
Cincinnati Financial Corp.	CINF	\$29.18	\$4,727
CNA Financial Corporation	CNA	\$29.05	\$8,047
HCC Insurance Holdings, Inc.	HCC	\$31.50	\$3,583
Harleysville Group Inc.	HGIC	\$31.17	\$839
Markel Corp.	MKL	\$396.81	\$3,880
Navigators Group Inc.	NAVIG	\$47.00	\$814
RLI Corp.	RLI	\$61.92	\$1,286
Selective Insurance Group Inc.	SIGI	\$16.27	\$864
W.R. Berkley Corporation	WRB	\$32.44	\$4,540

Source: SNL

Data Collected

To test the theory, we compiled cash flow, ROE, operating earnings, average shares outstanding, and price per share for each of the companies in the sample over the 15 periods in the study. To study the data across multiple companies, we wanted to be able to examine the data on a relative basis. We employed the use of a median and standard deviation so that we could look at how a stock was valued versus its own historical levels. There were two reasons for using the relative valuation approach, as opposed to a more-absolute, numerical approach. First, we recognize that all stocks have different growth trajectories, different capital structures, and different historical levels for success, so the baseline valuations will not be the same across all stocks. Thus, by examining each stock versus its own historical median valuation level and standard deviation, one gets a better sense for its current valuation level than by simply looking at the absolute multiple that it is trading at.

The second reason for using a relative valuation metric is so that we can aggregate the valuation metrics across the 10 different stocks in our commercial P&C insurance universe, and still come up with a methodology that can be applied to the industry as a whole.

The reason we chose to use a median, instead of a straight average, was our attempt to mitigate—as much as possible—the presence of outlier statistics within the data. For instance, if a company had negative cash flow figures for a year, the P/CF ratio would basically be irrelevant. To solve this problem, we examined the data set for outliers that registered more than 3 standard deviations away from the median, either positively or negatively, and recorded those figures at the 3 standard deviation mark. We believe cleaning the data is critical to providing the best possible source for evaluating our hypothesis. All of the steps described above were used for each valuation metric tested: P/E, P/CF, and P/BV. We also undertook a similar approach for performance metrics, to ensure that outliers did not affect the overall validity of the study.

Time Frame

To adequately back test our hypothesis regarding the valuation of commercial insurance companies, we examined data across multiple insurance pricing cycles and multiple stock market cycles. We chose the period between 1993 and 2010 for the study, as that is the period with the most-reliable data for the companies we had chosen.

An integral part of the methodology that we are putting forward revolves around the fact that the P/CF ratio is not only a current valuation metric, but also incorporates the past and future projections. The ratio we are focused on is based on average cash flow over a four-year period including the previous year, current year, and the two years following. So within the period chosen, 1993-2010, there are a total of 15 four-year periods that we are using for the analysis. For example, if one were to examine the ratio in 2005, the average-four-year cash flow would be calculated by using the cash flow from 2004, 2005, 2006, and 2007. When we examine the ratios today, we are using historical cash flow for 2010 and our estimated cash flow for 2011, 2012, and 2013.

We chose a four-year period because it seemed to best pick up the trends and changes going on in the marketplace. We knew at the outset that any valuation metric would have to be forward looking, so it was clear that there must be forecasting of at least one to two years forward. We tested different lengths of time for each series, but the data results suggested that four-year cash flow was the most-appropriate metric.

As we are projecting forward cash flows, we believe one-year forward returns are the most-powerful comparison to see how effective the valuation tool is at predicting performance. Considering that the insurance market is cyclical, and the cycles tend to be somewhat prolonged (the current “soft” market has lasted nearly seven years now), it is important to discover the inflection points as early as possible, as stocks tend to have big moves quickly afterwards.

The Chubb Corporation

Initiating Coverage With an Underperform Rating

Top-tier specialty P&C insurer with strong brand identity. The Chubb Corporation functions as a property-and-casualty (P&C) insurance holding company that underwrites and sells insurance across personal, commercial, and specialty insurance segments. Chubb has historically been a strong underwriter and has one of the most revered brands in the industry, particularly in personal insurance.

Significant exposure to cyclically weak casualty markets. Chubb has a relatively sizable exposure to the deeply cyclical casualty market, particularly in professional liability. Professional lines, workers' compensation, and other casualty lines compose more than half of premiums and, importantly, roughly \$15 billion of the \$20 billion in total reserves. Professional liability has experienced significant price declines in the last decade and has the potential for a negative swing in profitability. Chubb's professional liability results are beginning to show some cracks, and we expect paid loss ratios and profitability to deteriorate over the next three years.

Declining cash flow suggests materially lower core earnings power. Core operating cash flow has declined by 40% from 2006 to 2010 and we expect it to decline by another 25% through 2012. Going forward, we expect the deterioration already seen in cash flow to become more visible in operating results. We expect the calendar-year loss ratio to increase—from 58% in 2010 to an estimated 63% in 2012. Our forecast has earnings per share sliding from \$5.90 in 2010 to \$5.30 in 2012 (\$0.54 below consensus). Higher catastrophes or lower development have the potential to reduce 2012 EPS even further.

Price-to-cash-flow valuation suggests the stock is overvalued. The stock is trading at 9.4 times cash flow, which is a 30% premium to its five-year median cash flow multiple. The stock has increased from \$50 per share in 2006 to \$60 per share in 2010 while cash flow per share has declined from \$8.35 to \$7.31. Chubb's cash flow multiple is 1.5 standard deviations above its 10-year median multiple. Our historical study shows that stocks tend to have negative returns when the multiple is more than 1 standard deviation above the median. The market-to-book-value multiple (1.2 times) also has the potential to decline as the ROE moves toward 8%.

Catalysts that could prompt us to be more positive on the stock include an early-cycle turn or a potential acquisition. It appears that a turn in the cycle is at least on the horizon. However, the majority of the stock appreciation related to the last favorable underwriting cycle took place in 2002-2005, effectively three years after the hard market had begun. Also, the company's strong brand position makes it an attractive acquisition target, but we do not believe that event is likely in the near term.

The Chubb Corporation is a top-tier P&C insurance holding company that underwrites and sells insurance across personal, commercial, and specialty insurance segments.

Financial | Property & Casualty Insurance

Stock Rating: **Underperform**
Company Profile: **Core Growth**

Symbol: CB (NYSE)
Price: \$62.61 (52-Wk.: \$49-\$66)
Market Value (mil.): \$18,270
Fiscal Year End: December
Long-Term EPS Growth Rate: 10%
Dividend Yield: 2.5%

Estimates	2010A	2011E	2012E
EPS	\$5.90	\$5.40	\$5.30
BVPS	\$48.29	\$53.70	\$57.85
CFPS	\$7.31	\$6.26	\$6.09
ROE	12.2%	10.1%	9.2%

Valuation			
FY P/E	10.6x	11.6x	11.8x
FY P/B	1.3x	1.2x	1.1x
P/CF (4-yr)	9.4x	9.4x	NA

Trading Data		
Shares Outstanding (mil.)		293
Float (mil.)		292
Average Daily Volume (mil.)		2.0

Introduction

We are initiating coverage of The Chubb Corporation with an Underperform rating and Core Growth company profile. Chubb has historically been a strong underwriter and has one of the best brands in all of P&C insurance, particularly in its personal insurance segment. Over the past 15 years, the company has maintained a combined ratio under the industry average and has operated with a strong underwriting profit since 2004. However, exposure to the commercial underwriting cycle, a near-term headwind that is hurting underwriters industrywide, should depress returns for the near future. Chubb, in particular, has large casualty and professional liability books, which is translating into higher paid loss ratios and declining levels of cash flow. This deterioration should become more visible in operating earnings over the next two years.

Given that the stock is trading at the upper end of its historical cash flow multiple range, future returns will likely be disappointing. The stock has become more expensive in the last several years, as the shares have appreciated while cash flow had declined. The result is that Chubb's cash flow multiple has increased from an average of 7.2 times in 2007 and 2008 to a current value of 9.4 times. The cash flow multiple of 9.4 times suggests returns will be flat to negative for the next few years. On a market-to-book basis, the stock appears appropriately valued at 1.2 times given an average 2009 to 2010 returns on equity of 13%. However, we expect returns on equity to decline to 8% over the next several years, which should translate into lower market-to-book multiples. Negative catalysts for the stock will be increasing paid losses, particularly in liability lines, and lack of evidence of a near-term turn in the commercial pricing cycle.

Investment Highlights

One of the Few Good Brands in Insurance

Chubb has one of the few recognizable brands in the P&C insurance industry. The overall property-and-casualty market is large, but highly fragmented and defined by commodity-oriented products. Only a few companies have developed a true brand, including Allstate, Geico, and State Farm. Chubb is unusual in that it has developed a strong brand in both personal lines and the commercial insurance segment. Hartford and Travelers have also developed an element of brand, but not to the same extent as Chubb. Chubb's personal lines brand is truly unique within the industry. The name has become almost synonymous with higher-end home insurance; the Chubb Masterpiece policy covers a significant portion of this market. Unlike a company such as Geico, Chubb has established its brand without heavy spending on advertising. Geico typically spends more than 5% of its annual expenses on advertising; Chubb spends less than half that amount. The company has built its presence in the high-end market through unique policy design and a sterling reputation for claim service. One of the benefits of a strong brand is Chubb's ability to charge a premium price for its homeowners' product. Chubb's pricing is often 10% or more above the next highest competitor. Allstate and State Farm, the industry titans, do not have this capability and typically must price in line with the market. The ultimate benefits for Chubb's brand strength show up in higher profit margins over time. Table 12, on the following page, shows that Chubb's homeowners' loss ratio over the last five years has beaten the industry average by 16%.

Table 12
The Chubb Corporation
Statutory Loss and Loss Adjustment Expense (LAE) Ratio for Homeowners' Line

2010 Rank	Company	Direct Premiums Written (\$000)	Market Share (%)	Loss Ratio					Average
				2006	2007	2008	2009	2010	
1	State Farm Mutl Automobile Ins (SNL P&C Group)	\$15,672,281	21.9	63.1	69.4	99.2	83.2	79.2	78.8
2	Allstate Corp. (SNL P&C Group)	\$6,865,832	9.6	52.0	66.1	94.6	78.2	81.6	74.5
3	Zurich Financial Services Ltd (SNL P&C Group)	\$4,703,100	6.6	56.3	64.2	86.5	67.7	65.7	68.1
4	Liberty Mutual Holding Co. (SNL P&C Group)	\$3,729,987	5.2	59.1	60.2	83.5	73.3	72.2	69.7
5	Travelers Cos (SNL P&C Group)	\$3,295,031	4.6	41.4	49.9	65.3	56.1	69.3	56.4
6	USAA Insurance Group (SNL P&C Group)	\$3,175,416	4.4	52.0	62.0	89.4	69.1	73.0	69.1
7	Nationwide Mutual Group (SNL P&C Group)	\$2,832,201	4.0	53.7	60.1	85.2	74.8	75.8	69.9
8	Chubb Corp. (SNL P&C Group)	\$1,763,926	2.5	44.5	49.5	55.6	50.7	69.8	54.0
9	American Family Mutual Ins Co. (SNL P&C Group)	\$1,514,843	2.1	NA	91.8	NA	81.7	86.1	86.5
10	Citizens Property Ins Corp.	\$1,156,647	1.6	NA	NA	NA	NA	NA	NA
Group Average				52.7	63.7	82.4	70.5	74.7	68.8

Source: SNL

Chubb also has a good name in the long-tailed casualty business and the professional liability segment, in particular. The company's stronger-than-average balance sheet and conservative reputation give it a good presence with both large and middle-market corporate customers. Chubb has an AA rating from Standard & Poor's and an "A+" rating from A.M. Best. This strength plays well in the long-tailed lines of business, where customers are concerned with an insurer's ability to pay claims up to 10 years in the future, or even longer. However, unlike the homeowners' business, it is unclear if the brand translates into premium pricing for the commercial insurance business. Most commercial markets are heavily competitive, with a large number of insurers lining up to compete for a given risk. In addition, the brokers in the commercial markets tend to have incentive to obtain the best price. As shown in table 13, Chubb's other liability loss ratio is more in line with the industry average.

Table 13
The Chubb Corporation
Statutory Loss and LAE Ratio for Other Liability

2010 Rank	Company	Direct Premiums Written (\$000)	Market Share (%)	Loss Ratio					Average
				2006	2007	2008	2009	2010	
1	American International Group (SNL P&C Group)	\$7,036,951	14.2	73.8	73.0	80.3	93.6	131.1	90.4
2	Zurich Financial Services Ltd (SNL P&C Group)	\$3,059,397	6.2	96.6	NA	84.9	98.2	73.9	88.4
3	Travelers Cos (SNL P&C Group)	\$2,969,486	6.0	80.3	76.9	55.9	58.6	57.3	65.8
4	Chubb Corp. (SNL P&C Group)	\$2,702,255	5.5	75.7	69.7	68.6	66.8	66.1	69.4
5	ACE Ltd. (SNL P&C Group)	\$2,605,703	5.3	65.0	88.1	58.9	74.6	89.9	75.3
6	CNA Financial Corp. (SNL P&C Group)	\$2,322,862	4.7	76.4	86.9	76.9	78.2	81.8	80.0
7	Liberty Mutual Holding Co. (SNL P&C Group)	\$2,196,430	4.4	73.0	87.9	56.4	89.3	81.6	77.6
8	XL Group plc (SNL P&C Group)	\$1,383,778	2.8	53.5	62.0	55.4	83.4	77.4	66.3
9	Nationwide Mutual Group (SNL P&C Group)	\$1,364,516	2.8	65.5	67.5	62.5	71.9	58.2	65.1
10	W.R. Berkley Corp. (SNL P&C Group)	\$947,297	1.9	59.8	54.2	63.1	53.3	58.5	57.8
Group Average				72.0	74.0	66.3	76.8	77.6	73.6

Source: SNL

Historically One of the Better Underwriters

Chubb has historically been one of most consistent among larger commercial multiline insurers. Overall, Chubb does not have a "swing for the fences" mentality. Results have been helped by its conservative strategy and management philosophy. Chubb tends to grow organically, but does not overreach for growth. Over the last six years, Chubb has averaged a premium decline of 2%, slightly worse than its peers' average.

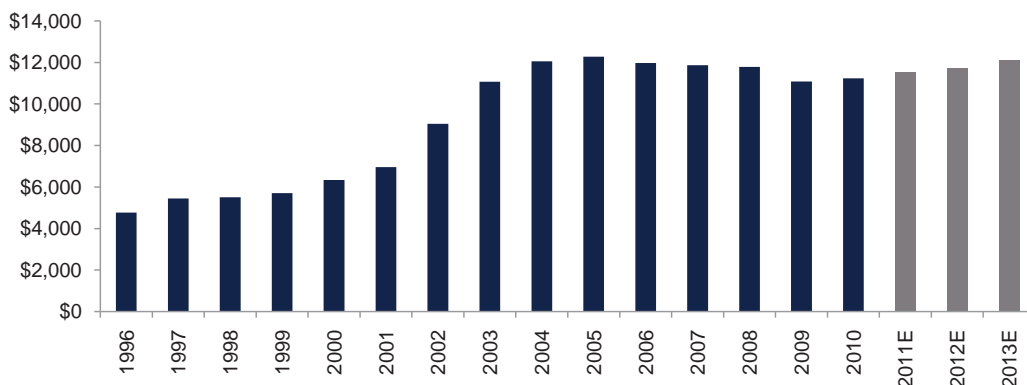
Table 14
The Chubb Corporation
Gross Premiums Written—Annual Percentage Change

Ticker	2005	2006	2007	2008	2009	2010	Average
ACE	3%	2%	8%	4%	1%	2%	3%
CB	-2%	-2%	-2%	-3%	-6%	-1%	-2%
CINF	2%	3%	-1%	-3%	-4%	2%	0%
CNA	-12%	-1%	-3%	-5%	-5%	-4%	-5%
HCC	-2%	-6%	-6%	-3%	3%	-6%	-3%
TRV	21%	-3%	2%	0%	-1%	1%	3%
WRB	13%	0%	-5%	-10%	-5%	0%	-1%
Peer Average	3%	-1%	-1%	-3%	-2%	-1%	-1%

Sources: SNL and Thompson

The other factor affecting Chubb's long-term growth is that for the most part, the company avoids acquisitions. It is one of the few larger public insurers that has not made a major acquisition in the last 20 years. The Executive Risk deal in 1999, which complemented its already-large professional liability book, represented less than 10% of previous premium levels.

Figure 15
The Chubb Corporation
Net Premiums Written
(in millions)



Sources: SNL, company reports, and William Blair & Company, L.L.C.

Chubb has stayed with its core markets for the last two decades, a unique characteristic for a commercial insurer. This perseverance has resulted in strong customer relationships, as Chubb does not typically move in and out of product lines, has better-than-average underwriting data, and has developed a good knowledge of the market. In contrast, many of its peers move in and out of markets as they stretch for growth or attempt to revamp corporate strategy. The result of the stable strategy and long-term focus on core markets is superior long-term underwriting profitability. Chubb's 5-, 10-, and 15-year combined ratios are below its peer averages.

Table 15
The Chubb Corporation
Average GAAP Combined Ratio Peer Comparison

Company	3-Year	5-Year	10-Year	15-Year
ACE Limited	89.4	88.8	94.4	93.5
Cincinnati Financial Corporation	102.3	98.3	97.0	99.2
CNA Financial Corporation	100.4	103.0	116.6	115.4
HCC Insurance Corporation	84.6	84.0	88.5	91.1
Travelers Companies, Inc.	91.4	90.0	98.1	NA
W.R. Berkley Corporation	93.9	91.6	94.1	98.0
The Chubb Corporation	88.3	86.9	95.0	98.6
Group Average	92.9	91.8	97.6	99.3

Source: SNL

Investment Risks

Large Exposure to Cyclically Soft Casualty Markets, and the Professional Liability Segment in Particular

Longer-tail casualty tends to be more underpriced in a soft market, as the profit realization lag is the longest. During the last soft cycle, casualty lines had average adverse development of more than 25% for four years between 1999 and 2002, which is a sign that the business was drastically underpriced when it was originally written.

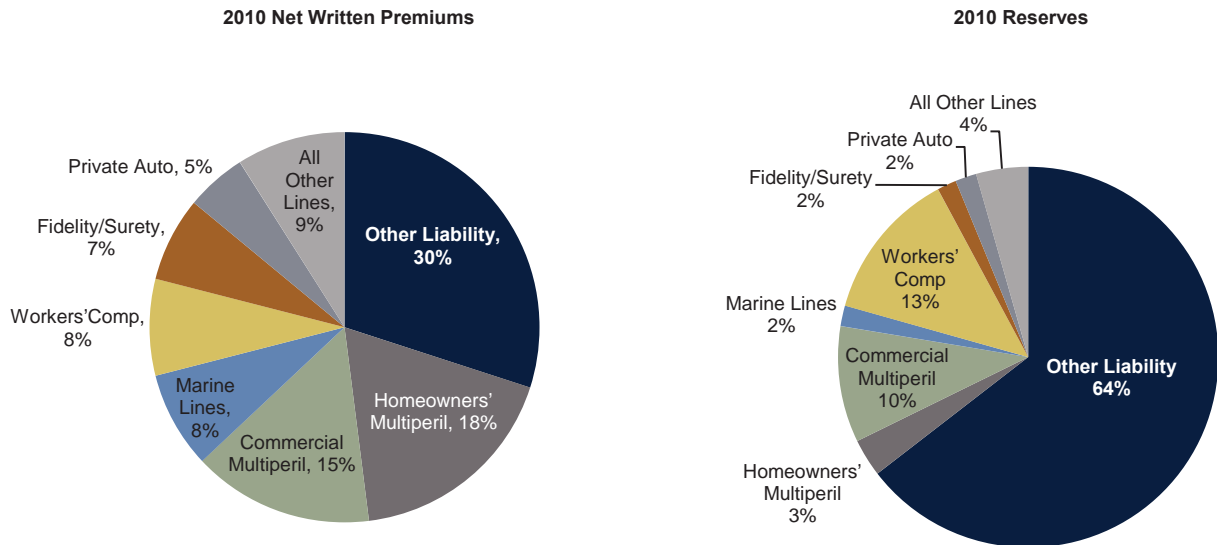
Table 16
Insurance Industry
Other Liability: Claims Made Incurred Loss Ratio Development

Accident Year	12 Months	24 Months	36 Months	48 Months	60 Months	72 Months	84 Months	96 Months	108 Months	120 Months	Adverse Development
1999	68.4%	70.1%	79.4%	87.5%	94.0%	97.1%	102.7%	106.9%	107.4%	108.9%	40.5%
2000	71.1%	69.5%	75.9%	83.2%	92.8%	102.4%	106.9%	108.1%	110.0%	110.2%	39.1%
2001	74.2%	74.8%	82.3%	92.6%	102.8%	104.6%	105.1%	105.7%	106.6%	105.7%	31.5%
2002	68.9%	68.7%	77.8%	88.6%	92.9%	94.6%	94.8%	94.1%	93.9%		24.9%
2003	66.3%	63.9%	64.7%	64.4%	64.6%	64.6%	64.7%	64.8%			-1.5%
2004	65.9%	58.2%	55.6%	53.9%	49.3%	47.2%	46.9%				-19.0%
2005	63.1%	57.7%	55.7%	51.0%	48.1%	47.1%					-16.1%
2006	64.2%	63.3%	59.6%	55.6%	53.4%						-10.8%

Source: SNL

Chubb has a relatively sizable exposure to these deeply cyclical lines. Professional lines, workers' compensation, and other casualty lines constitute more than half of premiums and, importantly, roughly \$15 billion of \$20 billion in total reserves.

Figure 16
The Chubb Corporation
Reserve Analysis by Line of Business



Sources: SNL and William Blair & Company, L.L.C.

Professional liability trends are of concern for the industry and for Chubb, the second-largest competitor in the market. Professional liability has experienced the most significant price declines in the last decade and has the potential for a negative swing in profitability. After experiencing significant hardening after the tech bubble losses of 1999 to 2000, market pricing has declined since 2004, with the soft market currently in its eighth year. On average, pricing is down by 40% since 2004. Reduced market pricing was predicated on a decline in claim activity. Legislative changes and several major court decisions made it harder to get class-action status, which effectively raised the bar for securities related lawsuits.

On the surface, professional liability loss ratios remain palatable on a historical basis. Calendar-year loss ratios are averaging in the 70% range for 2008 to 2010 on an industrywide basis, well below historical highs. The pendulum, however, appears to be swinging in the other direction. In addition to claims from the financial crisis, the orientation of claims is also changing:

- **Focus has moved from frequency to severity.** The plaintiff bar is focused on the larger security class action cases with better chance of success. This has resulted in higher average defense costs. On an anecdotal basis, there are a number of cases where the legal costs alone have exhausted the first layer of coverage.
- **The nature of the claims has shifted.** Securities class-action lawsuits of larger public companies remain significant, but employment practices liability insurance (EPLI) claims in particular have jumped to high levels. In addition, the small to midsize professional liability market, once viewed as a safe haven, has seen a dramatic increase in filed claims. This market was particularly hard-hit during the recession, with bankruptcies and fraud moving unprecedented levels of activity in middle-market companies.
- **New areas are popping up.** Mergers and acquisitions have become an area of focus for the plaintiff lawyers. Given that M&A has picked up in recent years, this is an area to watch.

Chubb is one of largest competitors in the professional liability market, with \$2.4 billion of premiums and \$7.4 billion of reserves. The company has a well-diversified book with a good contingent of small- to middle-market clients. Chubb is one of the few insurers to compete in primary lines, but it also goes up to other layers. Executive Risk, which was more of an excess player and middle-market competitor, augmented the company's diversification. Chubb takes large lines being primarily in the first layer; the average size of its lines for public company risks tends to be over \$10 million (before reinsurance). The company has been more conservative in recent years. For example, the unit moved away from healthcare-related risks. However, given its size and presence in most market segments, we expect Chubb to accrue its share of losses in financial services from the recent financial crisis, the growing rash of claims from the middle-market segment (EPLI and other), and an increasing level of claims related to merger-and-acquisition activity.

Chubb's professional liability results are beginning to show some cracks, and we expect segment profitability to deteriorate materially over the next three years. For example, the paid loss ratio for 36 months in the other liability line went from 17% in 2004 and 2005 (i.e., before the crisis) to 26.5% in 2008, which is a key year because it was in the middle of the crisis. Our expectation is that the paid loss ratio trend will continue to rise in this line over the next two years.

Table 17
The Chubb Corporation
Paid Loss Ratios (%) by Accident Year—Other Liability: Claims Made
Paid Losses (Schedule P, Part 3)/Net Premiums Earned (Schedule P, Part 1)

Accident Year	12 Months	24 Months	36 Months	48 Months	60 Months	72 Months	84 Months	96 Months	108 Months	120 Months
2001	5.74	21.49	37.91	56.26	75.80	83.20	90.05	95.75	100.67	103.87
2002	3.84	22.97	46.35	67.11	80.04	94.32	103.70	107.75	110.95	
2003	2.16	10.52	21.33	33.78	41.24	49.55	53.95	57.36		
2004	1.59	9.16	16.51	25.82	31.36	34.53	36.77			
2005	1.57	7.99	18.47	26.24	30.88	35.52				
2006	1.83	10.83	23.60	32.48	40.63					
2007	1.79	10.19	22.01	31.05						
2008	4.26	13.87	26.51							
2009	2.11	11.40								
2010	3.25									

Source: SNL

Declining Cash Flow Suggests Materially Lower Core Earnings Power

Core operating cash flow has declined by 40% from 2006 to 2010 and we expect it to decline by another 25% through 2012. Lower cash flow has primarily been a result of declining prices, reflecting that the property-and-casualty market downshifted into the soft portion of the competitive cycle. This decline has to date manifested itself in the form of higher paid losses, which jumped from 49% in 2006 to 57% in 2010.

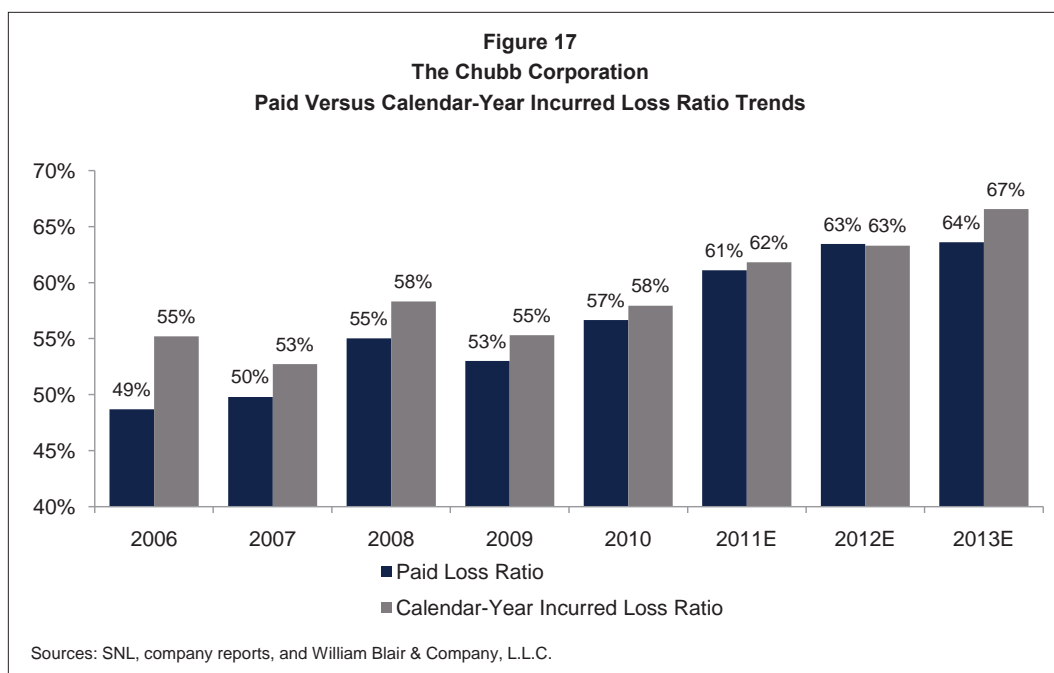
Our forecast calls for cash flow per share to decline from \$7.31 in 2010 to \$6.09 in 2012. The key to our forecast is that we expect relative paid losses to continue to rise and for the trend to even accelerate into 2012. Our forecast assumes that paid losses rise from 57% in 2010 to 64% in 2012, before stabilizing around that level. Underlying our forecast is the assumption that the P&C market will remain soft until at least 2013, suggesting premium growth will be limited to the low-single-digit range in the near term. Our forecast assumes Chubb's premiums written will grow by an average of 3% annually from 2010 to 2012.

Table 18
The Chubb Corporation
Cash Flow Projections 2009-2012
(dollars in thousands except per share data and share count)

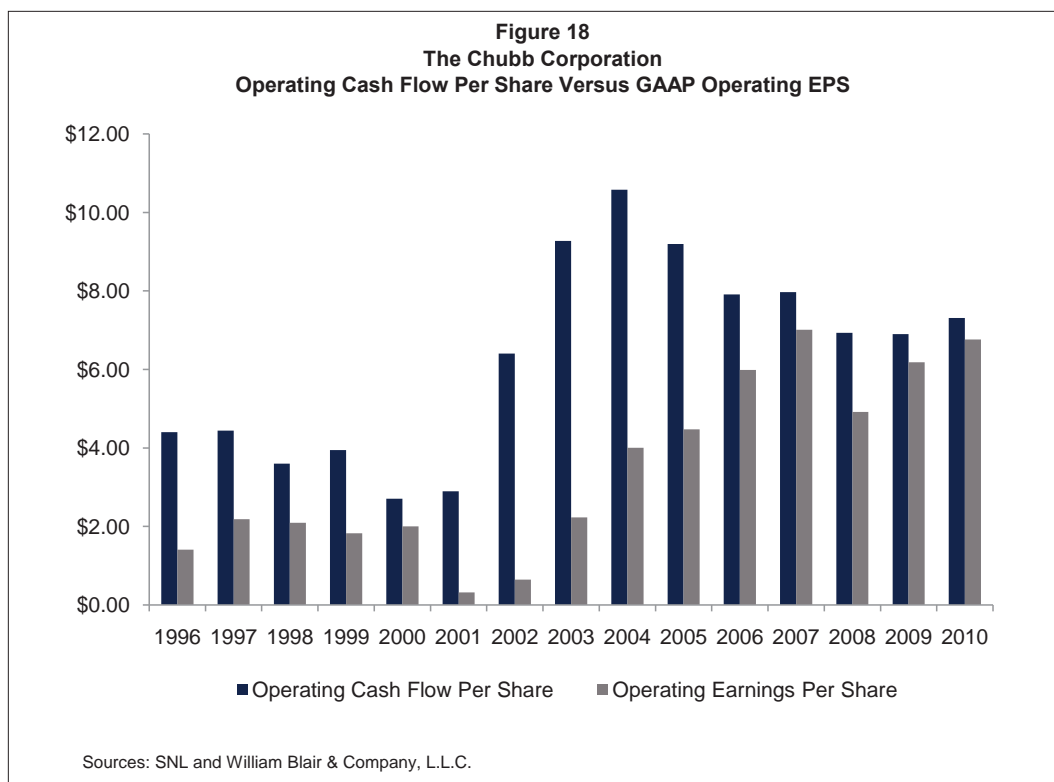
Line Item	2009	2010	2011E	2012E
Net Written Premiums	11,077,000	11,236,000	11,539,750	11,747,980
Paid Loss	6,006,000	6,354,000	7,048,288	7,454,116
<i>Paid Losses as % of Earned Premium</i>	<i>53.0%</i>	<i>56.7%</i>	<i>61.1%</i>	<i>63.5%</i>
Underwriting & Other Expense	3,499,000	3,549,000	3,666,707	3,758,241
Interest Expense	248,000	248,000	243,000	250,000
Net Investment Income	1,549,000	1,558,000	1,533,084	1,592,523
Depreciation and Amortization	69,000	63,000	63,000	63,000
Other Revenues	13,000	13,000	13,390	13,792
Taxes	779,000	814,000	613,838	545,373
Core Operating Cash Flow	2,176,000	1,905,000	1,577,390	1,409,565
Core Operating Cash Flow Per Share	\$6.16	\$5.92	\$5.46	\$5.23
Total Cash Flow Adjustments	259,000	447,000	231,400	231,400
Total Cash Flow	2,435,000	2,352,000	1,808,790	1,640,965
Total Cash Flow Per Share	\$6.90	\$7.31	\$6.26	\$6.09
Average Shares Outstanding (millions)	353	322	289	270
Average Operating ROE	14%	12%	10%	9%

Sources: SNL, company reports, and William Blair & Company, L.L.C.

The deterioration has not been nearly as visible in reported results. In that same period, operating earnings have only decreased by 20%, and the calendar-year loss ratio is only up 3%, from 55% to 58%. Catastrophes in 2010 were 4 loss ratio points higher than in 2006, which affects both paid losses and calendar-year incurred losses. For the calendar-year loss ratio, increasing catastrophe losses account for all of the increase from 2006 to 2010. The impact on paid losses is less straightforward, as the 2006 paid loss ratio likely includes 2005 catastrophes. On balance, if catastrophe losses are factored in, the disparity between paid and calendar year actually widens.



Going forward, we expect the deterioration already seen in cash flow to more heavily affect operating results. Our estimates forecast that operating earnings per share will come down from \$5.90 in 2010 to \$5.30 in 2012, a figure that assumes catastrophe losses will be \$0.35 less in 2012 than in 2010. The key is that we expect the calendar-year loss ratio to increase from 58% to 63%, which is supported by the already big jump in the paid loss ratio, as paid losses tend to lead incurred losses. Similarly, cash flow per share tends to lead earnings per share due to the distinction between paid and incurred losses.



The major factor pushing up future calendar-year loss ratios is that we believe accident-year loss ratio should continue to rise. Our forecast assumes that noncatastrophe accident-year loss ratios move from 59% in 2010 to 62% in 2012. The higher accident-year loss ratio is a function of continued declines in pricing; pricing was down 5% in 2010 and is expected to be down 2% to 4% in 2011 and 2012. In addition, claims activity is picking up after a benign period during the recession. The exception is professional liability claim activity, which was high between 2007 and 2009 due to the financial crisis. As discussed above, this area has the potential to remain active. If claims activity gains momentum across sectors, our accident-year estimates are likely optimistic.

The other issue is favorable reserve development, which has reduced the calendar-year loss ratio by 7% in both 2009 and 2010. Our forecast assumes favorable development of 5% in 2011 and 3% in 2012. Development in prior years has been supported by redundancies from the last hard market. The 2004 and 2005 accident years have yielded an average of 20 points of favorable development (as a percentage of initial incurred) and 2006 has yielded 11 points. Given that paid-to-ultimate ratios are almost 83% and 87% for 2004 and 2005, the majority of this development has likely been realized and there should be some left from 2006. However, we would not expect 2007 to 2010 to yield the same level of favorable development. These years represent the heart of the soft market and also contain financial crisis claims.

It is very early to assess reserve adequacy for the long tailed lines for 2007 to 2010. The average paid-to-ultimate ratio for the largest reserve line, other liability: claims made (37% of total), is only at an average of 25% for 2007 to 2010. However, the reserve triangles show that 2008 and 2009 accident-year paid losses are exhibiting deterioration. The paid loss ratio for the other liability: claims made line is up by an average of 43% for accident years 2008/2009 at latest report date compared with accident year 2005. The favorable development in the other liability: claims made line has noticeably slowed since the 2005 accident year, as the 2006 and 2007 accident years at their respective latest report dates have an average of 9 points less favorable development compared with the 2004 and 2005 accident years (at 48 and 60 months). The 2008 accident year has experienced 1 point of adverse development through 36 months, compared with 2004 and 2005 accident years averaging 7 points of favorable development at the 36-month mark. Again it is very early in actuarial terms, but the jump in paid losses suggests that the redundancies in the current year may be materially less than the 2004-2005 accident years. The company, at a minimum, will likely wait longer to release the reserves given increasing paid losses.

Table 19
The Chubb Corporation
Statutory Incremental Paid Loss Ratio Projections

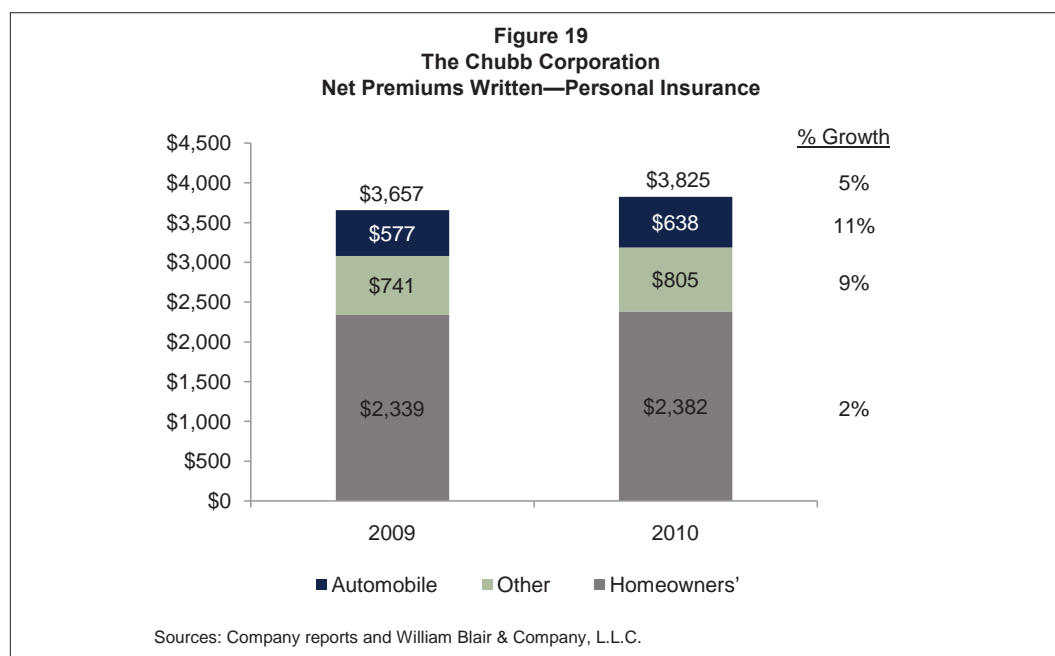
Accident Year	12 Months	24 Months	36 Months	48 Months	60 Months	72 Months	84 Months	96 Months	108 Months	120 Months
2001	21.3%	17.2%	15.5%	8.3%	8.2%	3.4%	3.3%	2.4%	1.6%	1.1%
2002	15.0%	14.2%	8.7%	7.2%	4.6%	4.3%	2.8%	1.2%	1.0%	0.8%
2003	14.4%	10.4%	6.4%	5.6%	3.4%	2.7%	1.4%	1.1%	0.8%	0.6%
2004	13.6%	10.2%	5.5%	4.4%	2.9%	1.5%	0.9%	1.0%	0.7%	0.6%
2005	13.5%	11.2%	6.6%	4.5%	2.5%	2.3%	1.4%	1.0%	0.8%	
2006	12.0%	10.2%	6.3%	4.2%	3.3%	2.5%	1.3%	1.0%		
2007	13.5%	10.8%	5.6%	4.5%	4.1%	2.7%	1.4%			
2008	18.7%	12.6%	6.1%	5.6%	5.2%	3.4%				
2009	14.1%	10.7%	7.2%	6.0%	4.6%					
2010	18.4%	14.4%	7.9%	6.1%						
2011E	19.0%	14.9%	8.2%							
2012E	19.5%	15.3%								
2013E	20.0%									

Sources: SNL and William Blair & Company, L.L.C.

Key Factors to Watch

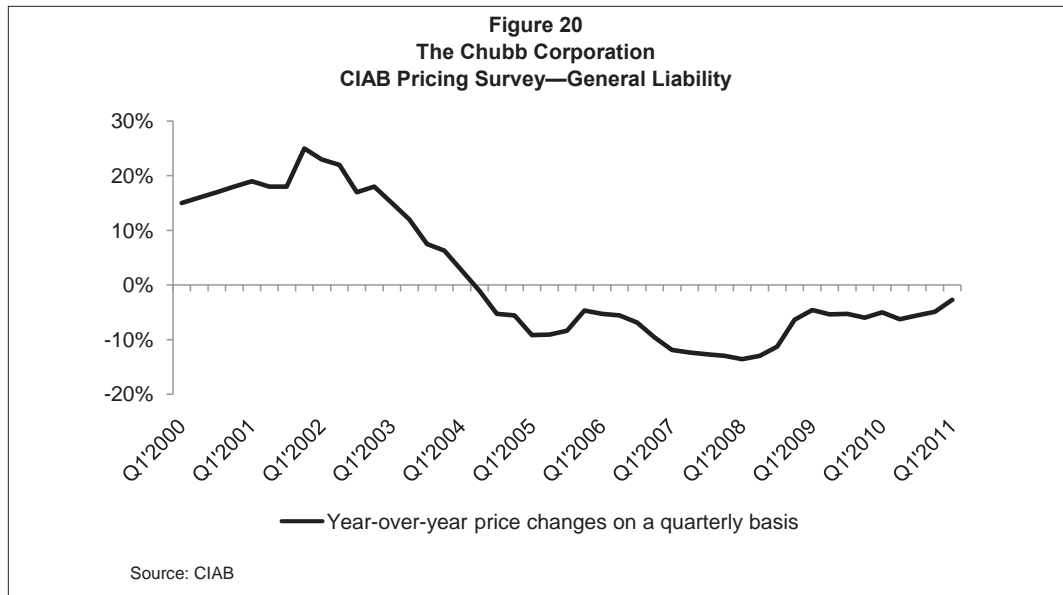
Shift in Personal Insurance Segment Away From Traditional Homeowners' Offerings

Chubb has recently placed a renewed emphasis on non-homeowners' products within the personal insurance segment, which is providing better-than-average growth while the commercial and specialty segments have been shrinking. The personal insurance segment comprises roughly one-third of premiums and 28% of underwriting profits. Historically, this unit was mainly focused on homeowners' insurance, with this product contributing more than 70% of segment premiums. In recent years, the company has been leveraging the Chubb brand to grow into related products. Auto insurance premiums grew by 11% last year and other personal lines grew by 9%. The net effect is that personal insurance has moderately increased on a relative basis, from 31% of premiums written in 2007 to 34% in 2010. We expect commercial lines to remain in a challenging environment and for the personal insurance segment to continue its growth trajectory.



General Liability Rates Continue to Decline

Directors' and officers' (D&O) insurance rates have been declining since the end of 2003. Similar to other commercial property-and-casualty lines, the rate of deterioration has slowed in recent quarters. A return to positive territory could help profitability in future underwriting years. However, given the level of excess capital and relatively high level of industry cash flow, we do not believe industry pricing will materially improve until 2013.



Accident-Year Loss Ratios Continue to Deteriorate

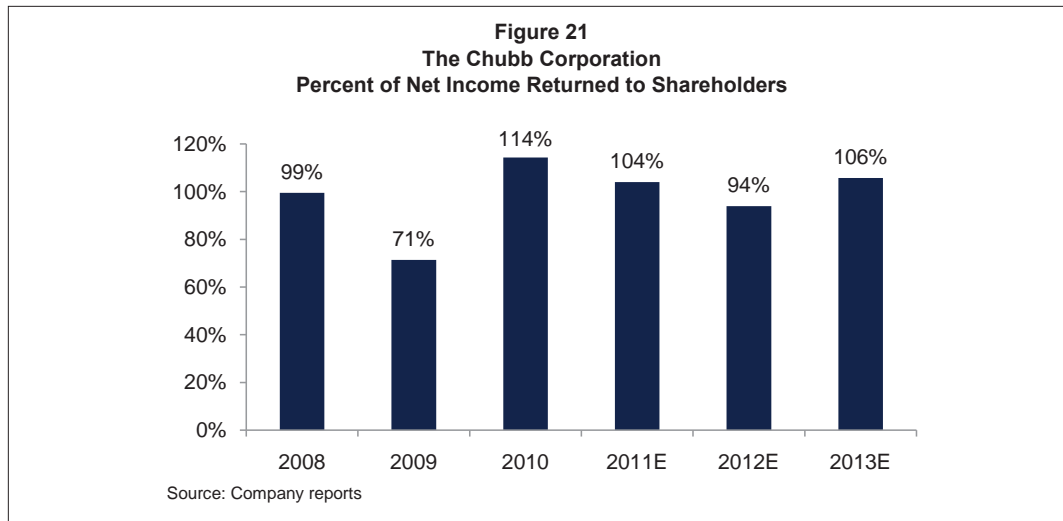
Across the industry, commercial-line accident-year loss ratios have exhibited material deterioration. This mainly reflects the six-year drop in pricing that has averaged between 30% and 50% in most property-and-casualty lines. Chubb has followed this trend, with overall U.S. accident-year loss ratios increasing from 48% to 59% from 2006 to 2010, and less favorable development on the initial loss picks, a declining trend since 2004.

We expect loss ratio deterioration to continue. Pricing is more stable in 2011 compared with 2010, but is still negative in most lines. The personal lines segment should be the exception. Claim activity, which was benign with the recession, appears to be picking up. This means that the 2009 and 2010 accident-year loss ratios could be understated on an industrywide basis, and 2011 should be worse.

Capital Management Continues to Be Aggressive

Chubb has been in a return-of-capital mode over the last few years. From 2008 to 2010, the company has repurchased 85 million shares at a cost of \$4.4 billion. At the same time, annual dividends have increased from \$1.31 per share to \$1.48. In aggregate, combining buybacks and dividends, Chubb has returned \$5.8 billion to shareholders over the last three years. The high level of return on capital reflects a healthy ROE, averaging 14%, and lack of capital deployment opportunities.

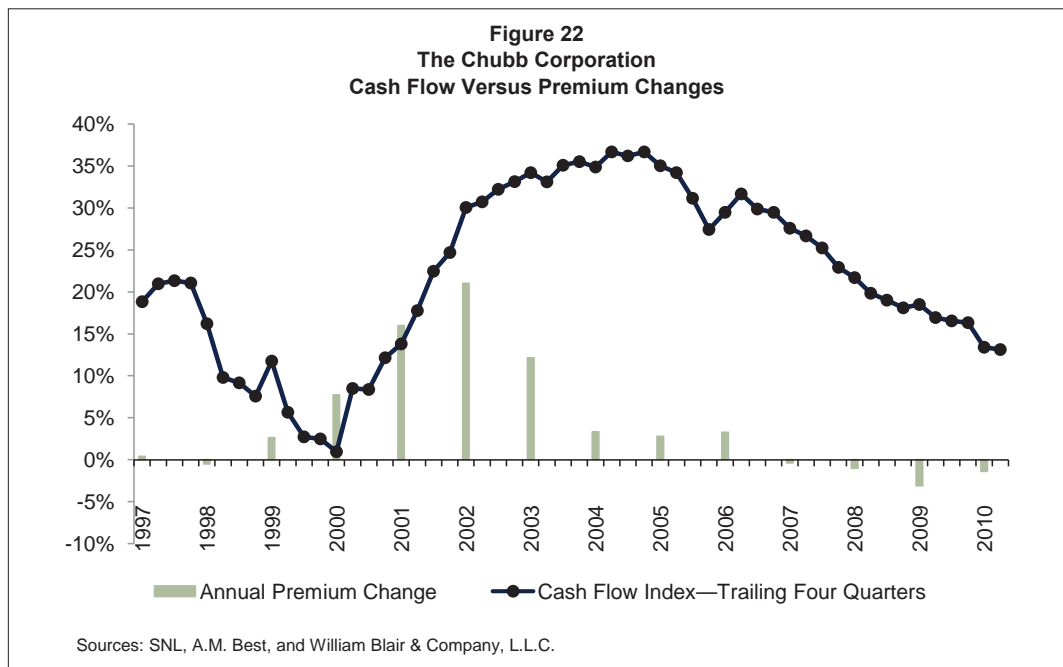
If ROE begins to decline in 2012 and 2013, the company may be less aggressive in returning capital. On average, the company has returned 95% of \$6.2 billion in earnings to shareholders from 2008 to 2010. Our forecast suggests that net income will decline from an average of \$2.1 billion in 2008-2010, to \$1.5 billion in 2011-2013. If the return ratio stays level between 95% and 100%, this suggests that annual capital returned to shareholders will decline from an average of \$2.0 billion for 2008-2010, to \$1.5 billion from 2011 to 2013.



Catalysts That Could Prompt Us to Be More Positive On the Stock

Short-Term Move on Potential Cycle Turn

Chubb's stock could increase on prospects of a turn in the commercial-line pricing cycle. The market typically has "head fakes," or false cycle turns—and we may even be experiencing one now. Some market proponents believe that the high level of recent catastrophe losses could provide momentum for an overall turn in the commercial pricing cycle. We see this as highly unlikely—the commercial market is mainly liability-oriented and the reinsurers have much less influence on core commercial lines than several decades ago. Even when the cycle turns, which we believe could happen in 2013 or 2014, most of the stock returns for underwriters occur four to five years later, as ROEs lag the cycle upturn. The majority of the stock appreciation related to the last favorable underwriting cycle occurred in 2002 to 2005. This was effectively three years after the hard market had begun. The stock would likely move in late 2012 or early 2013 if there was an actual turn, but then would be flat for several years until the higher prices actually began to translate into higher return on equity. Our view is there is no need to take the risk on the early side, since investors will have plenty of time to take advantage of upside.



Potential Takeover Target

Chubb is one of the highest-quality franchises. As the valuation remains stagnant or declines, the company could become an attractive target for a major international insurer or even a private equity buyer. However, given the long-term nature of management, we would be surprised if the company takes a low-ball offer at the wrong time in the cycle.

Financial Projections

Table 20
The Chubb Corporation
Premium Flows and Key Ratios
(dollars in thousands)

	2008	2009	2010	2011E	2012E
Net Premiums Earned	\$11,828	\$11,331	\$11,215	\$11,535	\$11,748
<i>Premium Growth</i>	-1%	-4%	-1%	3%	2%
Underwriting Income	\$1,361	\$1,631	\$1,222	\$790	\$589
<i>Underwriting Income Growth</i>	-2.5%	19.8%	-25.1%	-35.4%	-25.4%
Loss Ratio	58.3%	55.3%	57.9%	61.8%	63.3%
Expense Ratio	30.1%	30.5%	31.1%	31.3%	31.5%
Combined Ratio	88.4%	85.8%	89.1%	95.2%	94.8%
Operating EPS	\$5.58	\$6.14	\$5.90	\$5.40	\$5.30
<i>EPS Growth</i>	-13.0%	10.2%	-4.0%	-8.5%	-1.9%
Operating ROAE	15.2%	13.9%	12.2%	10.1%	9.2%
Cash Flow Per Share	\$6.94	\$6.90	\$7.31	\$6.26	\$6.09
Book Value Per Share	\$36.62	\$44.29	\$48.29	\$53.70	\$57.85

Sources: Company reports and William Blair & Company, L.L.C.

Summary

We forecast earnings per share to decline from \$5.90 in 2010 to \$5.40 in 2011 and \$5.30 in 2012. Estimates are extremely sensitive to positive reserve development, which we believe will decline from roughly \$750 million in 2010 to \$324 million by 2012, as severe casualty losses from 2007 to 2010 begin to hit the books. We estimate ROE to decline from 12% to 9%, while book value per share will continue to grow from \$48 in 2010 to \$58 in 2012. We expect roughly 2% to 3% per year in top-line premium growth, which will help mitigate some of the loss deterioration as the calendar-year loss ratio moves from 58% to 63% between 2010 and 2012.

Upside/Downside Potential

A turn in the pricing cycle would be the biggest source of upside compared with our estimates. Our estimates currently assume continued pressure on pricing, as there have been no convincing signs of a turn in the cycle, and we estimate 2013 to be a more likely time for the beginning of a hard cycle. A successful use of excess capital could also help ROE and increase EPS above our current estimates. From a downside perspective, the biggest risks to earnings are further increases in the loss ratio, particularly in the casualty segment, and an even more-exaggerated decline in reserve development during 2011 or 2012. If 2012 favorable development was 2%, compared with our 3% forecast, this would bring earnings per share below \$5.00.

Key Earnings Factors

Premium growth. We expect gross premiums written to increase by an average of 3% annually over the next three years. This result would begin to reverse the recent trend in declining premiums that has occurred since 2004. Our forecast falls in line with the expected sector average of 0% to 5% growth in premiums. Growth should be driven by increases in the personal and commercial insurance segments, as we expect rates to begin to stabilize

and exposures to continue to improve as economic growth resumes. We expect the specialty insurance segment to struggle over the next several years, since it has increased exposure to harder-hit industries, such as construction and financial services.

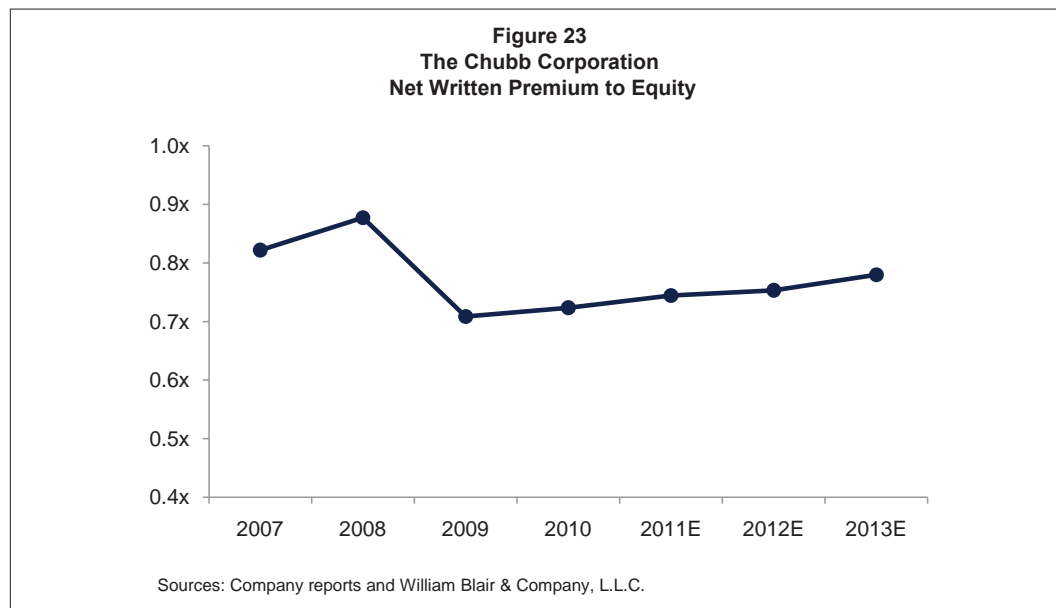
Investment income. Our forecast assumes that investment income will grow slowly through 2013, as continued pressure on yields and a slow-to-recover economy continue to hurt growth in the portfolio. If interest rates begin to increase in 2012, there could be additional upside in investment income.

Loss ratio. We forecast that the accident-year loss ratios will continue to increase as catastrophe losses and the soft market continue to put pressure on underwriting margins. Our forecast has the noncatastrophe accident-year loss ratio gradually increasing from 58.9% in 2010 to 63.1% in 2013. Calendar-year loss ratios are projected to grow even faster, due to declining levels of reserve development. We project reserve development to decline from \$746 million in 2010 to \$61 million in 2013, due to heavier losses in the underwriting accident years between 2007 and 2010. This decline pushes calendar-year loss ratios from 57.9% in 2010 to 66.6% in 2013.

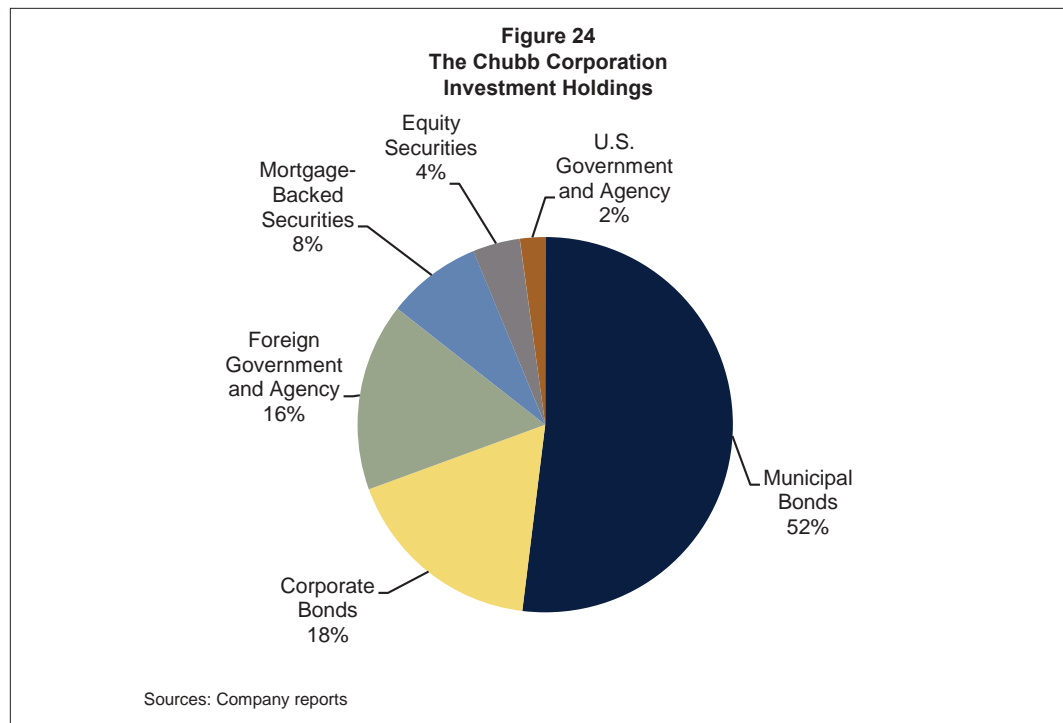
Expense ratio. We believe the expense ratio will remain relatively flat, because we expect management to more actively manage expenses as the loss ratio begins to creep upward over the next few years. We are expecting the expense ratio to be roughly 31% over the next three years.

Balance Sheet

We expect Chubb to continue to underwrite on a well-capitalized basis. Net premiums written to GAAP equity should stay in the 0.7- to 0.8-times range over the next two years, which is very conservative, but admirable in the current market environment. We would expect this ratio to pick up as we begin to see a turn in the cycle over the next few years.



Chubb’s investment portfolio contains high-quality fixed-income securities, with higher-than-average exposure to tax-efficient municipal bonds and foreign government debt. Based on the current market conditions and future expectations, we estimate the yield on investments to remain between 3.5% and 4.0% for the near term.

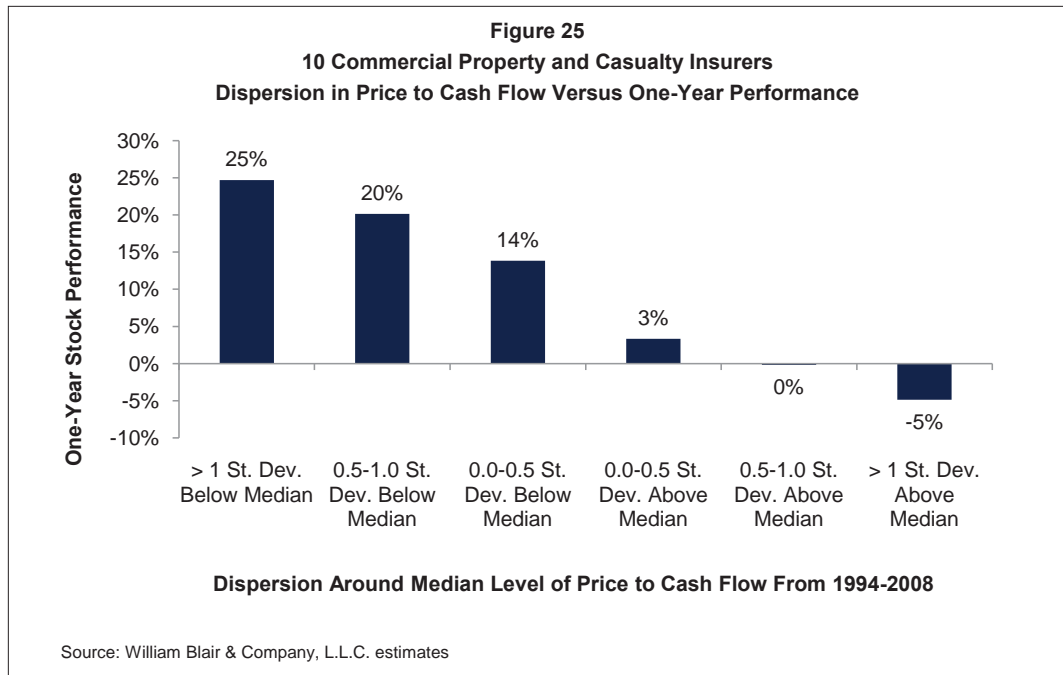


Valuation

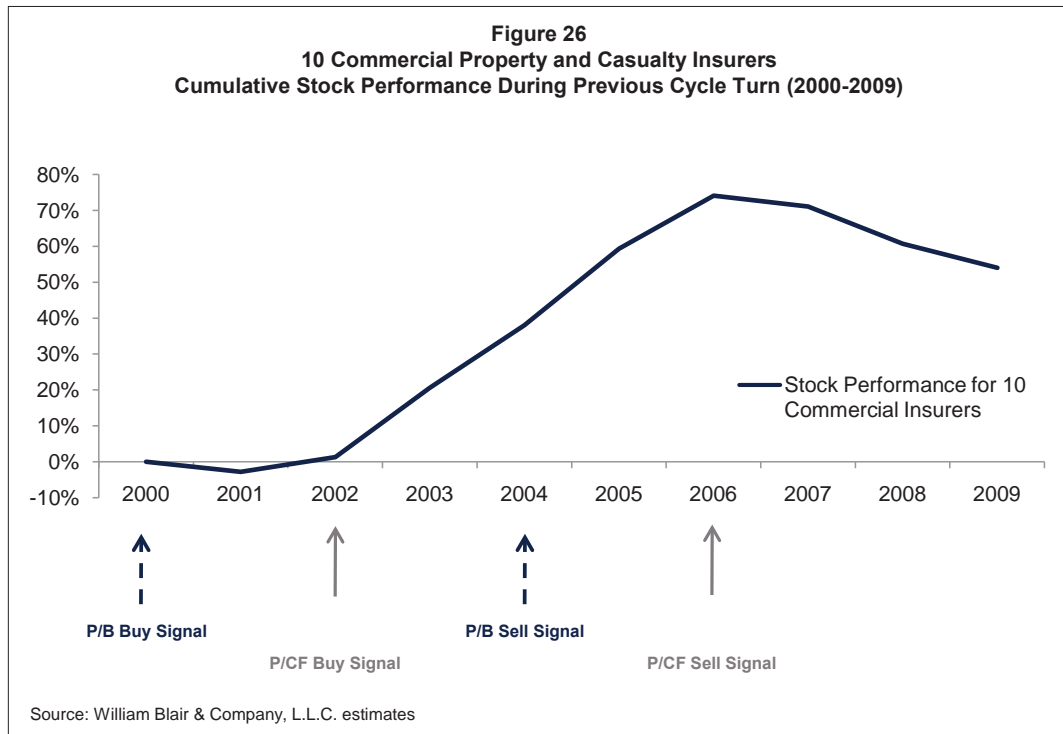
Overall Cash Flow Theory

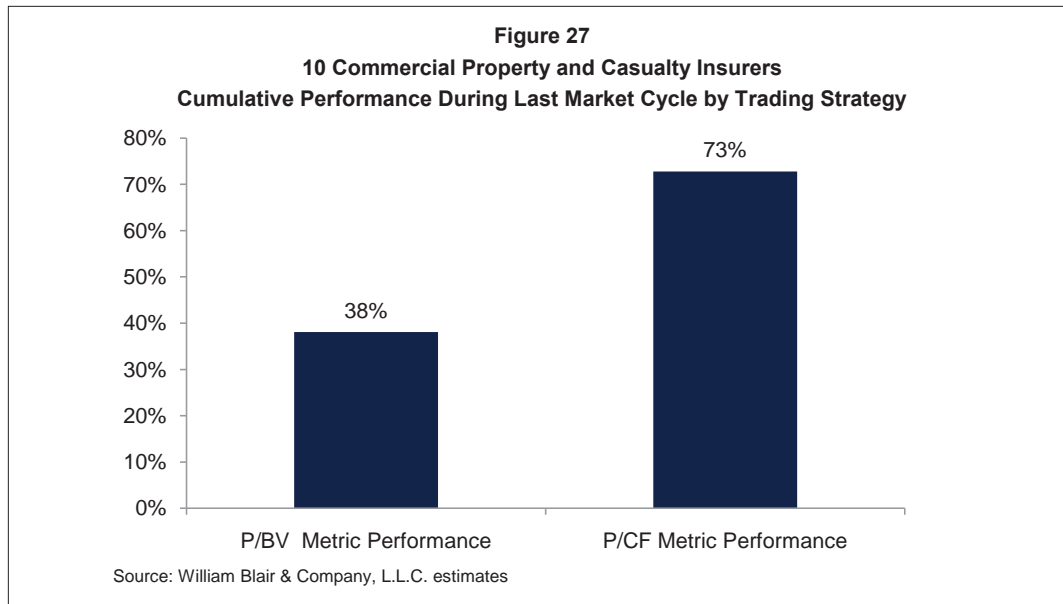
Cash flow has shown to be a good indicator and is highly correlated to future stock movements. We use price-to-cash-flow (P/CF) as the measure to predict stocks. Our historical analysis shows that this measure clearly indicates when to buy or sell insurance stocks. Our methodology is based on back-testing P/CF ratios for 15 years using 10 midsize to large commercial insurers. The ratio we are focused on is based on average operating cash flow over a four-year period including the previous year, current year, and the two years following.

The results show that when the P/CF ratio is greater than one standard deviation below the median P/CF ratio, the average return for the next year is 25%. When it is more than one standard deviation above the median P/CF ratio, returns have averaged -5% for the following year. The number of standard deviations above or below the median is inversely correlated with the performance of the stock; thus, the correlation is negative. For example, based on our data set, if a stock was trading at a P/CF valuation lower than the median value, one would expect the performance level for that stock to be positive. The overall correlation for the index is -0.49, which indicates a fairly strong negative relationship between the two variables we are examining.



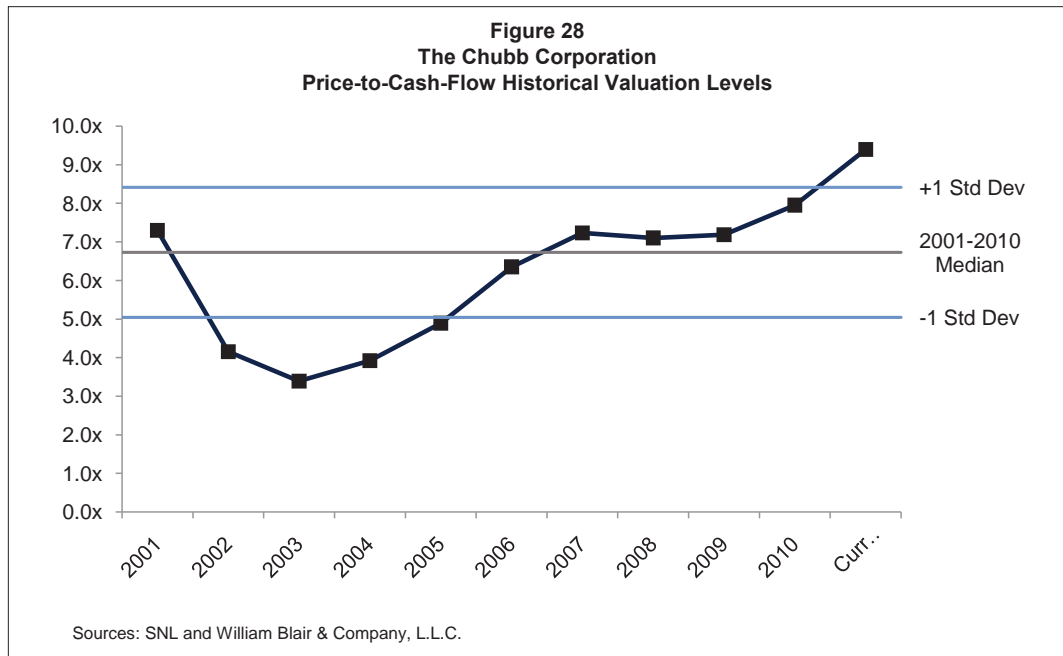
Cash flow valuations have proved particularly useful in cycle turns. In contrast, earnings and return on equity measures tend to be lagging indicators of performance. Figure 26 shows that P/CF valuation signaled a strong buying opportunity going into 2003 and that investors should sell in 2006. In contrast, market-to-book timing was too early on both entry and exit points. Returns using P/CF entry and exit points were almost double that of market-to-book entry and exit points.





Comparison Universe

Chubb’s cash flow multiple suggest that the stock is overvalued. The stock is trading at 9.4 times cash flow, which is a 30% premium to its 5-year median cash flow multiple. In the last 5 years, Chubb has traded in a range of 6 times to 8 times. The rising cash flow multiple is mainly due to cash flow declining combined with moderate increases in the level of Chubb’s stock price. The stock has increased from \$50 per share in 2006 to \$60 per share in 2010 while cash flow per share has declined from \$8.35 to \$7.31. On a historical basis, Chubb’s cash flow multiple is 1.5 standard deviations above its 10 year median multiple. Our data shows that stocks tend to have negative returns in the year subsequent to exhibiting a cash flow multiple is more than one standard deviation above the median.



In the last 15 years, Chubb’s price-to-cash-flow has ranged from 10 times to 3 times with a median of 7 times. Excluding the current year, Chubb’s highest multiple were recorded in 1998 through 2000, prior to the last cycle turn. The one-year forward performance averaged 7% during this time period, but the stock was down by more than 10% in two of the three

Table 21
The Chubb Corporation
Cash Flow Valuation Comparison

Company	Ticker	Rating	Current Price	Cash Flow Valuation			Current Valuation vs. 5 Year Median			Earnings Valuation				Book Valuation		
				Cash Flow Per Share 2011	Cash Flow Per Share 2012	Price to Cash Flow ¹	2006-2010 Median	Current Valuation vs. 5 Year Median	Number of Std. Deviations from 10 Year Median	EPS 2011E	EPS 2012E	PE 2011	PE 2012	Current Book Value	Current Price To Book	2012 ROE
The Chubb Corporation	CB	U	\$62.61	\$6.26	\$6.09	9.4x	7.3x	30%	1.5	\$5.40	\$5.30	11.6x	11.8x	\$53.26	1.2x	9%
HCC Insurance	HCC	U	\$31.50	\$3.25	\$3.23	9.2x	5.7x	60%	2.6	\$2.66	\$2.78	11.8x	11.3x	\$28.99	1.1x	9%
RLI Corp.	RLI	M	\$61.92	\$6.64	\$5.70	10.6x	9.1x	16%	1.5	\$4.19	\$4.40	14.8x	14.1x	\$38.52	1.6x	11%
The Travelers Companies ²	TRV	M	\$58.38	\$5.79	\$7.47	8.6x	7.8x	10%	0.5	\$4.25	\$6.10	13.7x	9.6x	\$59.91	1.0x	10%
Average						9.4x	7.5x	29%	1.5			13.0x	11.7x		1.2x	10%
Median						9.3x	7.5x	23%	1.5			12.8x	11.6x		1.1x	10%

Note¹: Price-to-cash flow based off current price divided by four-year cash flow. t= -1,0,1,2

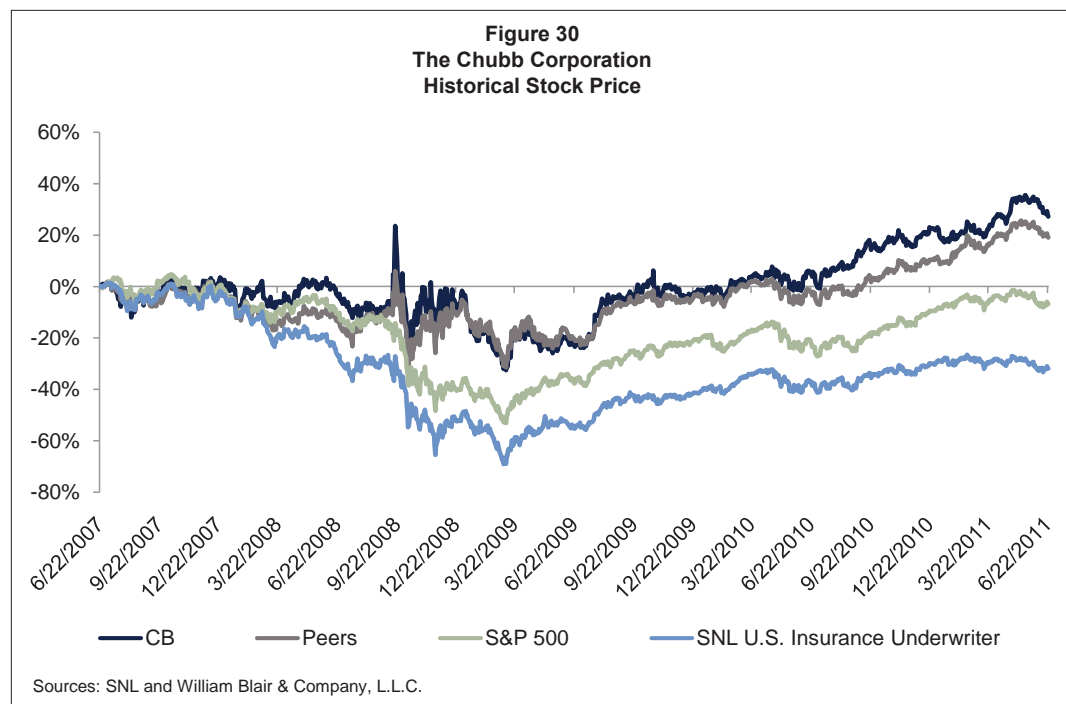
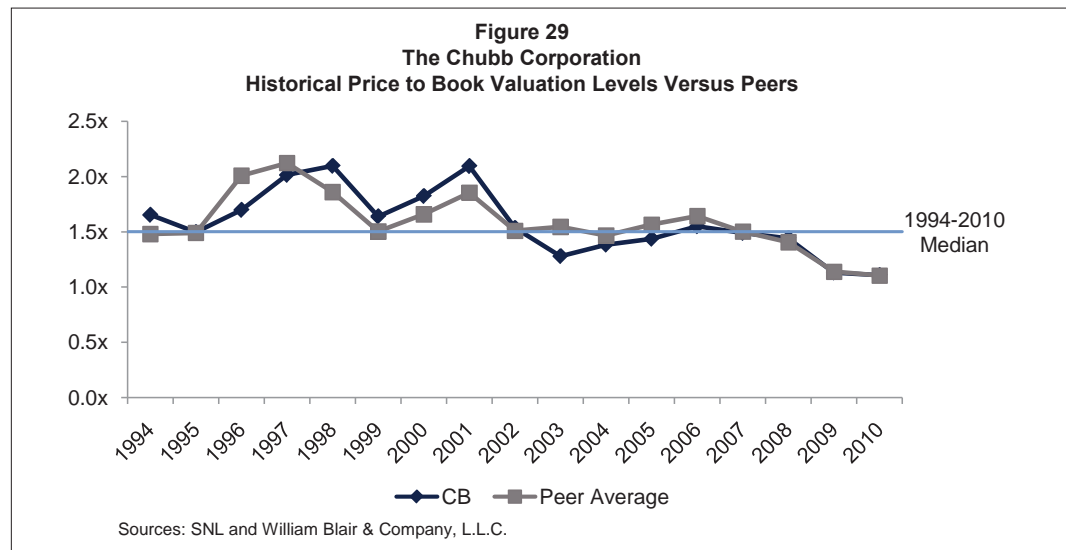
Note²: Travelers data only goes back through 2002

Source: William Blair & Company, L.L.C. estimates

years. In contrast, the price-to-cash-flow metric ranged from 3 times to 4 times from 2002 to 2004 toward the end of the last hard market. Subsequently, the stock averaged one-year forward returns of 23%. In recent years, the price-to-cash-flow metric has increased as the stock bounced back from the 2007-2009 market fallout, and cash flow has declined, reflecting more challenging underwriting conditions. The current 9.4 multiple is the highest since 1998.

Market-to-Book

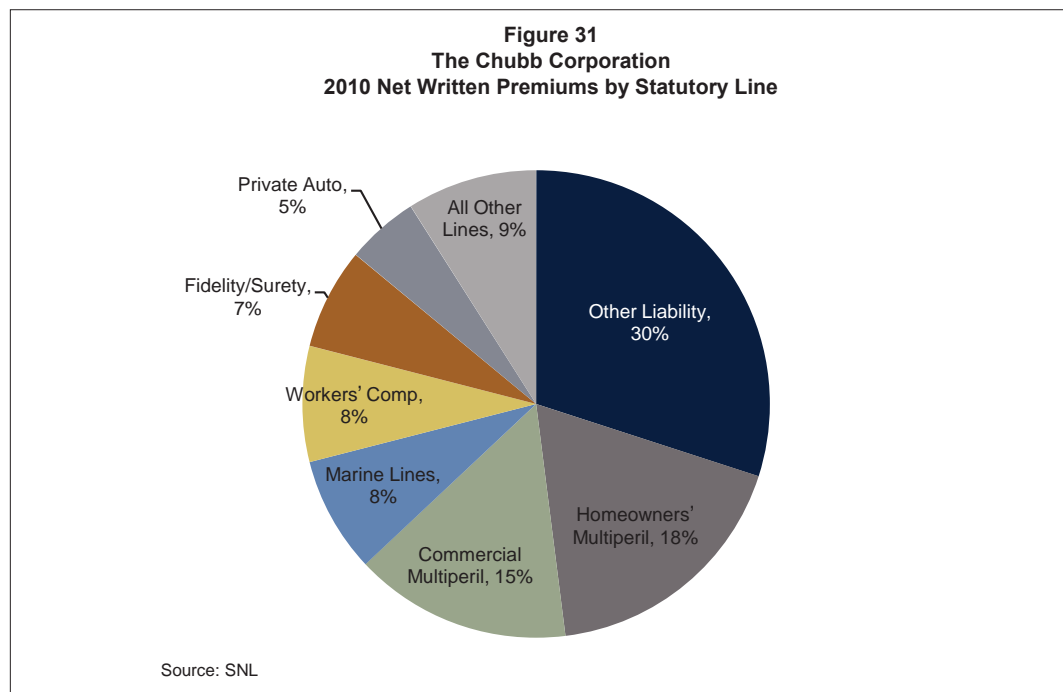
In line with its peers, Chubb's market-to-book valuation, currently at 1.2 times, has moved to low levels on a historical basis. The market-to-book averaged 1.6 times over the last 15 years, but only 1.3 times in the last 5 years. On a relative basis, the stock usually trades in a range from 90% to 115% of peer-market-to-book ratios. Currently, Chubb is trading on par with the peer average of 1.2 times. The stock appears appropriately valued given average 2009 to 2010 returns on equity of 14%. However, given that we expect returns on equity to decline to 8% over the next several years, market-to-book has the potential to decline from current levels.



Corporate Profile

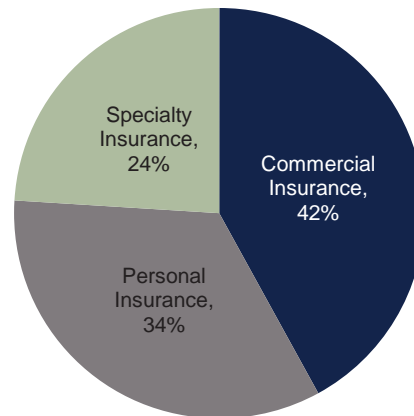
Chubb Corporation, founded in 1882, is an international specialty property-and-casualty insurance holding company that underwrites and sells a diverse array of insurance products. Chubb has offices in North America, Europe, Asia, South America, and Australia, and is recognized as the 12th largest U.S. P&C insurance group by A.M. Best. The company, with 2010 written premiums of \$11.9 billion and net income of \$2.2 billion, displays results across three underwriting business segments: personal insurance, commercial insurance, and specialty insurance. Chubb is one of the highest-rated P&C firms in the United States, with an AA rating from S&P and an A+ rating from A.M. Best. Through the development of innovative and tailored insurance policies and best-in-class service and claims handling, Chubb has established itself as a premium player with strong brand equity and loyalty.

Chubb does this by employing experts across several niche product offerings to add additional value for the insured. Some examples include life sciences, cultural and educational institutions, marine cargo, D&O, errors and omissions (E&O), employment practices liabilities, high-net-worth homeowners', collector cars, yachts, antiques, and jewelry. The major types of insurance offered by statutory line are other liability (which constitutes 30% of net written premiums), homeowners' multiperil (18% of written premiums), commercial multiperil (15% of written premiums), marine lines (8% of written premiums), workers' comp (8% of written premiums), fidelity/surety (7% of written premiums), and all other lines (14% of written premiums).



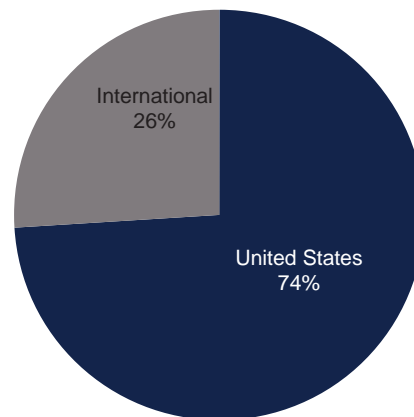
Chubb offers insurance policies across commercial lines, personal lines, and specialty, and this diversity has helped mitigate tough overall market conditions. The commercial business is the largest at 42% of net premiums written, followed by personal at 34% of net premiums written, and specialty at 24% of net premiums written. For the company as a whole, 74% of net written premiums were written in the United States, while 26% were written internationally.

Figure 32
The Chubb Corporation
2010 Net Written Premiums by Business Component



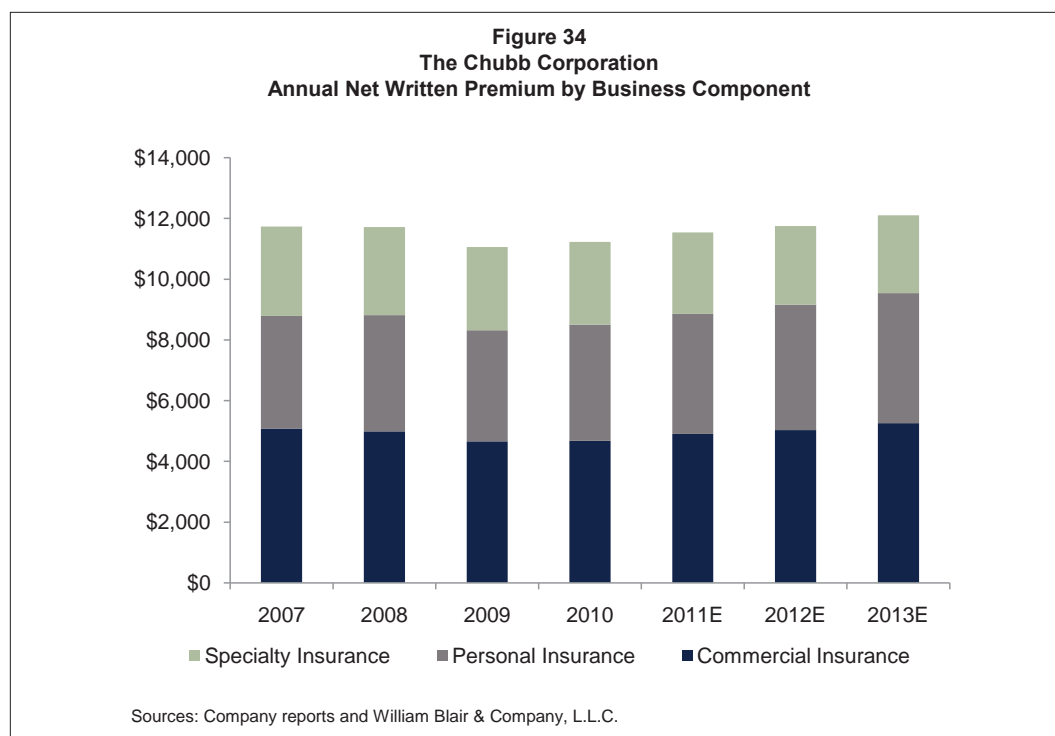
Sources: Company reports

Figure 33
The Chubb Corporation
2010 Net Written Premiums by Geography



Sources: Company reports

We expect nearly all of the premium growth that we are projecting between 2007 and 2013 to come from the personal and commercial insurance segments. Both commercial and specialty segments are expected to be essentially flat over the same seven-year period, mainly because of huge declines in pricing observed during the continued soft-market cycle. The personal insurance segment tends to be slightly more profitable than the commercial segment, and the claims are much shorter-tailed. However, the segment also has a decent amount of catastrophe exposure, so the change in business mix should not have a drastic effect on the overall variability of results.



Structurally, Chubb writes insurance policies on a direct basis through multiple insurance companies and underwriting agencies across the United States and globally. Chubb also ceded roughly 10% of its business in 2010 to reinsurers to diversify risk and limit maximum loss from catastrophic events. Chubb is subject to some credit risk from its reinsurers and tries to use only reinsurers with high creditworthiness. The company also assumed about \$391 million of reinsurance premiums during 2010.

Business Mix

Table 22
The Chubb Corporation
Business Mix
(dollars in thousands)

		2008	2009	2010	2008-2010 CAGR
Commercial	Net Premiums Written	\$4,993	\$4,660	\$4,676	-3.2%
	<i>% of Total</i>	43%	42%	42%	
	Underwriting Income	\$305	\$471	\$360	8.7%
	<i>% of Total</i>	24%	32%	31%	
	Combined Ratio	93.9	89.9	92.3	
Personal	Net Premiums Written	\$3,826	\$3,657	\$3,825	0.0%
	<i>% of Total</i>	33%	33%	34%	
	Underwriting Income	\$494	\$581	\$325	-18.8%
	<i>% of Total</i>	38%	39%	28%	
	Combined Ratio	87.1	84.1	91.5	
Specialty	Net Premiums Written	\$2,899	\$2,739	\$2,727	-3.0%
	<i>% of Total</i>	25%	25%	24%	
	Underwriting Income	\$484	\$436	\$485	0.1%
	<i>% of Total</i>	38%	29%	41%	
	Combined Ratio	83.3	84.1	82.2	
Total	Net Premiums Written	\$11,718	\$11,056	\$11,228	-2.1%
	Underwriting Income	\$1,282	\$1,488	\$1,171	-4.5%
	Combined Ratio	88.7	86.0	89.3	

Sources: Company reports

Chubb Personal Insurance

Table 23
The Chubb Corporation
Personal Insurance Segment Product Mix 2010

Product	Net Premiums Written	% of Net Premiums	Combined Ratio
Automobile	\$638	16.7%	90.8%
Homeowners'	\$2,382	62.3%	91.7%
Other	\$805	21.0%	91.2%
Total	\$3,825	100.0%	91.5%

Sources: Company reports

The personal insurance segment is composed of homeowners' insurance; auto insurance; and other policies, including accident and health, excess liability, and yacht. It represents 34% of total net premiums written. Combined ratios for this segment have been running in the mid-80s to low 90s over the last three years. Chubb is most known for its high-net-worth homeowners' policies, known as the Masterpiece brand, and this business is one of its most profitable lines, as it can price the line at a premium to the marketplace. The majority of the business is primary coverage, and the claims tend to be short- to medium-tailed. The business is sold primarily through independent agents and specialty retail brokerage.

The homeowners' business, in particular, has historically been prone to severe catastrophe loss; for example, catastrophe loss accounted for 15.6% of the combined ratio (91.7%) for homeowners' insurance during 2010. Chubb mitigates some of this risk through the purchase of reinsurance and catastrophe bonds, but large-scale catastrophes can still have a significant impact on operating results.

Chubb Commercial Insurance

Table 24
The Chubb Corporation
Commercial Insurance Segment Product Mix 2010

Product	Net Premiums Written	% of Net Premiums	Combined Ratio
Multiple Peril	\$1,094	23.4%	94.7%
Casualty	\$1,532	32.8%	91.7%
Workers' Compensation	\$756	16.2%	93.4%
Property and Marine	\$1,294	27.7%	90.5%
Total	\$4,676	100.0%	92.3%

Sources: Company reports

The commercial insurance segment represents 42% of total net premiums written for Chubb. The segment is pretty evenly split across multiple peril, casualty, workers' compensation, and property and marine. The segment has been very competitive recently and is heavily dependent on exposure units for growth. With the recent recession, exposure has been decreasing for the last several years, which has slowed growth rates in the segment. The commercial insurance segment is also prone to catastrophe losses because of its exposure to the property-and-marine business. Catastrophic losses had a 5.4% impact in 2010, 1.8% in 2009, and 8.1% in 2008, so there is a wide degree of variability in the margin line of the segment. Chubb mitigates some of this risk through the purchase of reinsurance and catastrophe bonds, but as with the personal business, large-scale catastrophes can have a significant impact on operating results. Combined ratios for the segment have been running in the low to mid-90s over the last three years.

Chubb Specialty Insurance

Table 25
The Chubb Corporation
Specialty Insurance Segment Product Mix 2010

Product	Net Premiums Written	% of Net Premiums	Combined Ratio
Professional Liability	\$2,398	87.9%	87.8%
Surety	\$329	12.1%	41.3%
Total	\$2,727	100.0%	82.2%

Sources: Company reports

The majority of the specialty insurance segment is the professional liability line, but surety lines are also included in this segment. The specialty insurance segment represents roughly 24% of net premiums written, and the combined ratios have been running in the low to mid-80s over the last three years. D&O and E&O are two of the major product lines in professional liability, and those lines have been struggling with a competitive pricing environment over the last several years. Additionally, many of the professional liability lines are written for the financial services industry, which reported large losses during the financial crisis, hurting profitability somewhat in the overall specialty insurance segment.

The surety lines business, which provides compensation to a party if a second party fails to meet an obligation, is heavily dependent on the construction industry, which has suffered severely during the economic downturn. The surety business is characterized by infrequent losses, but losses that can be very severe when they occur.

Marketing and Distribution

The company offers its products mainly through independent agents and brokers, both in the United States and abroad. Within the United States, the company's largest state of business is New York, with written premiums for the year ended 2010 accounting for 15.3% of the total, California at 11.2%, and Texas at 6.7%. Table 26 details the premiums written by state in 2010.

Table 26
The Chubb Corporation
U.S. Geographic Distribution by

State	2010
New York	15.3%
California	11.2%
Texas	6.7%
Florida	5.5%
New Jersey	5.3%
Illinois	4.8%
Pennsylvania	4.5%
Massachusetts	4.0%
Connecticut	3.5%
Ohio	2.4%
All Other States	36.8%

Source: SNL

Table 27
The Chubb Corporation
Earnings Model

	2009	1Q'10	2Q'10	3Q'10	4Q'10	2010	1Q'11	2Q'11E	3Q'11E	4Q'11E	2011E	2012E	2013E
Net Premiums Written	11,077	2,765	2,886	2,732	2,853	11,236	2,859	2,960	2,800	2,920	11,540	11,748	12,103
Net Premiums Earned	11,331	2,782	2,799	2,798	2,836	11,215	2,854	2,960	2,800	2,920	11,535	11,748	12,103
% Change	-4%	-2%	-1%	-1%	0%	-1%	3%	5.8%	0.1%	3.0%	3%	2%	3%
Noncatastrophe Accident-Year Losses	6,939	1,606	1,647	1,664	1,694	6,611	1,715	1,776	1,708	1,781	6,981	7,283	7,640
Noncatastrophe Accident-Year Loss Ratio	61.2%	57.7%	58.8%	59.5%	59.7%	58.9%	60.1%	60.0%	61.0%	61.0%	60.5%	62.0%	63.1%
<i>Favorable Development</i>	762	220	180	200	146	746	220	178	112	88	597	324	61
<i>As % of Loss Ratio</i>	6.7%	7.9%	6.4%	7.1%	5.1%	6.7%	7.7%	6.0%	4.0%	3.0%	5.2%	2.8%	0.5%
<i>Catastrophe Losses</i>	91	344	193	58	39	634	270	340	137	0	748	478	480
<i>As % of Loss Ratio</i>	0.8%	12.3%	6.9%	2.1%	1.4%	5.7%	9.5%	11.5%	4.9%	0.0%	6.5%	4.1%	4.0%
Losses and Loss Expenses	6,268	1,730	1,660	1,522	1,587	6,499	1,765	1,939	1,733	1,694	7,131	7,437	8,058
<i>Calendar-Year Loss Ratio</i>	55.3%	62.2%	59.3%	54.4%	56.0%	57.9%	61.8%	65.5%	61.9%	58.0%	61.8%	63.3%	66.6%
Change in Unpaid Losses and Loss Expenses	262	298	-26	-59	-68	145	298						
Paid Loss and Loss Expenses	6,006	1,432	1,686	1,581	1,655	6,354	1,467						
<i>Paid Loss Ratio</i>	53.0%	51.5%	60.2%	56.5%	58.4%	56.7%	51.4%						
Operating Costs	3,377	862	889	864	881	3,496	904	918	882	905	3,609	3,700	3,736
<i>Expense Ratio</i>	30.5%	31.2%	30.8%	31.6%	30.9%	31.1%	31.6%	31.0%	31.5%	31.0%	31.3%	31.5%	30.9%
Change in Deferred Policy Acquisition Costs	27	-22	-21	7	6	-30	-25	-20	10	10	-25	-10	-10
Dividends to Policyholders	28	8	8	6	6	28	8	8	7	7	30	32	34
Underwriting Income	1,631	204	263	399	356	1,222	202	116	168	304	790	589	284
<i>Combined Ratio</i>	85.8%	93.4%	90.1%	86.0%	86.8%	89.1%	93.5%	96.5%	93.4%	89.0%	93.1%	94.8%	97.5%
Net Investment Income	1,549	387	385	390	396	1,558	381	383	383	387	1,533	1,593	1,681
<i>Yield</i>	3.8%	3.7%	3.6%	3.7%	3.7%	3.7%	3.6%	3.6%	3.6%	3.6%	3.6%	3.6%	3.8%
Other Income	-3	-7	4	-2	7	2	5	0	0	0	5	0	0
Property and Casualty Income	3,177	584	652	787	759	2,782	588	498	551	691	2,328	2,182	1,965
Corporate and Other	-238	-63	-40	-57	-60	-220	-63	-60	-60	-60	-243	-250	-260
Consolidated Income Before Tax	2,939	521	612	730	699	2,562	525	438	491	631	2,085	1,932	1,705
Tax Expense	771	140	152	193	180	665	120	114	128	164	526	502	443
<i>Tax Rate</i>	26.2%	26.9%	24.8%	26.4%	25.8%	26.0%	22.9%	26.0%	26.0%	26.0%	25.2%	26.0%	26.0%
Consolidated Operating Income	2,168	381	460	537	519	1,897	405	324	363	467	1,559	1,430	1,262
Operating Earnings Per Share	\$6.14	\$1.14	\$1.41	\$1.69	\$1.69	\$5.90	\$1.35	\$1.12	\$1.27	\$1.67	\$5.40	\$5.30	\$4.95
Realized Investment Gains After Tax	15	83	58	35	101	277	104	20	20	20	164	80	80
Net Income	2,183	464	518	572	620	2,174	509	344	383	487	1,723	1,510	1,342
Net Income Per Share	\$6.18	\$1.39	\$1.59	\$1.80	\$2.02	\$6.76	\$1.70	\$1.19	\$1.34	\$1.74	\$5.97	\$5.60	\$5.27
Effect of Catastrophes Per Share	-\$0.17	-\$0.67	-\$0.38	-\$0.12	-\$0.08	-\$1.28	-\$0.59						
Diluted Weighted Average Shares Outstanding	353.0	335.0	326.7	317.3	307.4	321.6	300.0	290.0	285.0	280.0	288.8	269.6	254.8
Common Shares Outstanding (Millions)	332.0	326.8	314.5	304.9	297.3	297.3	292.5	287.5	282.5	277.5	277.5	262.5	248.5
Average Book Value Per Share (Calculated)	\$44.29	\$46.99	\$47.55	\$50.36	\$50.52	\$48.29	\$51.93	\$53.40	\$54.18	\$55.37	\$53.70	\$57.85	\$60.93
Book Value Per Share (Reported)	\$47.09	\$48.17	\$49.39	\$52.41	\$52.24	\$52.24	\$53.26				\$0.00	\$0.00	\$0.00
Operating ROAE	13.9%					12.2%					10.1%	9.2%	8.1%

Sources: Company reports and William Blair & Company, L.L.C.

Management

John D. Finnegan, Chairman, President, and Chief Executive Officer

Mr. Finnegan joined the firm in 2002 as president and CEO, and was named chairman of the board in December 2003. Previously, Mr. Finnegan had worked as president and chairman of GMAC and served in various other capacities within General Motors.

Richard G. Spiro, Executive Vice President and Chief Financial Officer

Mr. Spiro joined Chubb as CFO in September 2008. Before Chubb, Mr. Spiro worked in the FIG group at Citigroup Global Markets Inc., where he served as head of North America and managing director for financial services investment banking.

Paul J. Krump, Executive Vice President of Chubb Corporation and President of Commercial and Specialty Lines

Mr. Krump was promoted to president of commercial and specialty lines in January 2011. Previously, he had worked as chief underwriting officer for the organization. He also served as the chief operating officer of Chubb Commercial Insurance since 2001. Mr. Krump joined Chubb in 1982 as an underwriting trainee.

Dino E. Robusto, Executive Vice President of Chubb Corporation and President of Personal Lines and Claims

Mr. Robusto was promoted to president of personal lines and claims in January 2011. In 2008, Mr. Robusto has name chief administrative officer, and has also functioned as chief claims officer since 2006. Mr. Robusto joined Chubb in 1986 as a commercial insurance underwriter.

Maureen A. Brundage, EVP and General Counsel

Ms. Brundage has served as general counsel since 2005. Prior to joining Chubb, she was a partner at New York law firm White & Case LLP, where she led the U.S. securities practice and co-chaired the global securities practice.

HCC Insurance Holdings, Inc.

Assuming Coverage With Underperform Rating

Strong niche positions. A key theme to the company's strategy has been to build significant share in niche markets. For example, HCC has an estimated market share of roughly 20% in the medical stop loss business. The advantages of being a dominant competitor include a strong knowledge of and data about the business, deep ties with specialized distribution, and better retention of clients.

Professional liability is a concern. Despite historically good underwriting standards, the professional liability segment is a concern. Premiums increased materially from 2005 to 2008, but have recently been receding. We expect the industry as well as HCC to experience development on prior underwriting years and increased accident-year loss ratios. The Professional liability segment has experienced significant price declines in the last decade and could see a negative swing in profitability.

Declining cash flow suggests lower core earnings. Core operating cash flow has declined by 45% from 2007 to 2010. Lower cash flow is a result of reduced insurance rates due to the property-and-casualty market downshifting into the soft portion of the competitive cycle. This decline has to date manifested itself in the form of higher paid losses, which jumped from 49% in 2007 to 60% 2010. The deterioration has not been nearly as visible in reported results. In that same period, operating earnings have only decreased by 22% and the calendar-year loss ratio is flat at 59%. We estimate that operating earnings per share will come down from \$2.96 in 2010 to \$2.78 in 2012, and this assumes catastrophe losses will be \$0.15 less in 2012 (our earnings per share estimate is 10% below consensus).

Cash flow valuation suggests stock is overvalued. The stock is trading at 9.2 times forward cash flow, a 60% premium to historical valuation levels. Our 15-year cash flow valuation study shows that stocks underperform when the cash flow multiple is materially above the median. HCC appears adequately valued on a price-to-book basis at a multiple of 1.1 times. This compares with a current peer average of 1.2 times. On the surface, this valuation seems appropriate given that ROEs have averaged 11% in the last two years. However, since ROEs are forecast to decline to 8% by 2013, the price-to-book ratio could slide even further.

Catalysts that could prompt us to be more positive on the stock include an early cycle turn and a medical stop loss rebound. HCC's stock could increase on prospects of a turn in the commercial line pricing cycle. However, the majority of share appreciation occurs late/post cycle turn. In better times, the medical stop loss business can produce a loss ratio in the low-60% range, or 10 points better than the current average.

Founded in 1974, HCC Insurance Holdings, Inc. is an international specialty property-and-casualty insurance holding company that underwrites and sells niche insurance products through a group of major subsidiaries known as HCC Insurance Group.

Financial | Property & Casualty Insurance

Stock Rating: **Underperform**
Company Profile: **Core Growth**

Symbol: HCC (NYSE)
Price: \$31.50 (52-Wk.: \$24-\$33)
Market Value (mil.): \$3,582
Fiscal Year End: December
Long-Term EPS Growth Rate: 7%
Dividend Yield: 1.8%

Estimates	2010A	2011E	2012E
EPS	\$2.96	\$2.66	\$2.78
BVPS	\$28.9	\$30.8	\$33.1
CFPS	\$3.64	\$3.25	\$3.23
ROE	10.6%	9.0%	8.7%

Valuation			
FY P/E	10.6x	11.8x	11.3x
FY P/B	1.09x	1.02x	0.95x
P/CF (4-yr)	8.3x	9.2x	NA

Trading Data		
Shares Outstanding (mil.)		114.1
Float (mil.)		112.5
Average Daily Volume (thous.)		706

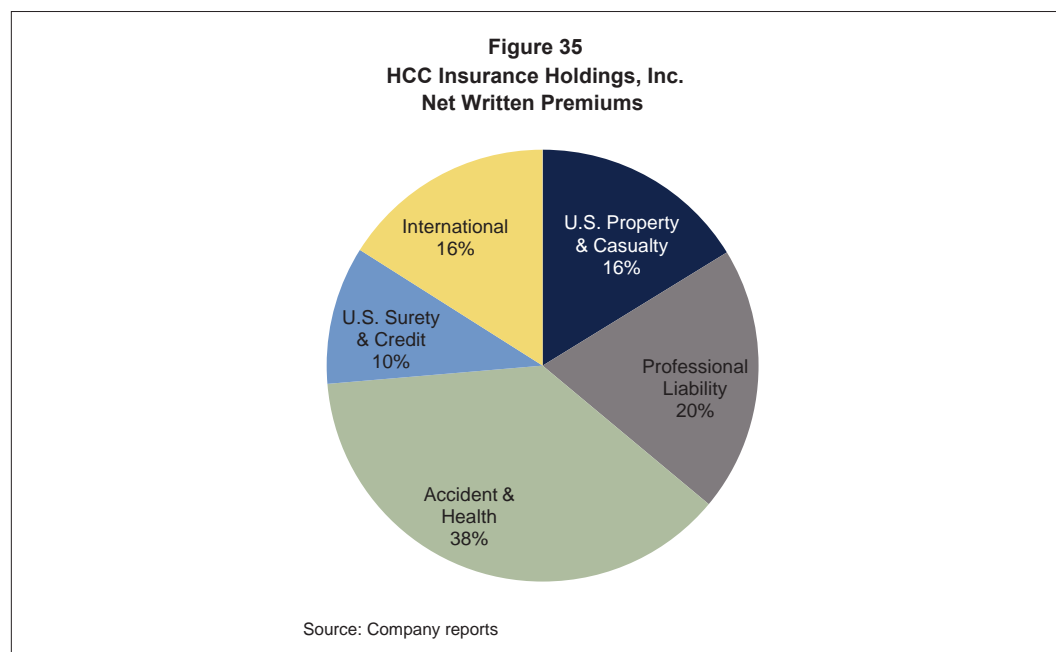
Introduction

We are assuming coverage of HCC Insurance Holdings with an Underperform rating. While HCC is historically one of the higher-quality franchises in the commercial property-and-casualty sector, we expect results to deteriorate over the next several years, reflecting a material increase in exposure to professional liability lines and also a degree of uncertainty surrounding the core medical stop loss segment. Declining cash flow levels suggest that ROE will decline over the next several years, as paid losses will likely continue to increase for the near term. The stock looks appropriately valued on a price-to-book basis, but this is somewhat deceiving. The stock is trading at a historically high cash multiple, which suggests that underperformance is likely. Negative catalysts for the stock should be further increases in paid claims and ultimately deteriorating ROE; the latter is not likely until 2012, but we expect continued near-term evidence of higher paid claims.

Investment Thesis

Strong Positions in Niche Markets

A key theme to the company's strategy has been to build significant share in niche markets. Unlike many insurers that are small to midsize competitors in large markets, HCC focuses on market segments where the company can have significant presence. The company has little exposure to commodity middle-market property-and-casualty lines, such as workers' compensation or commercial multiperil (CMP). Historically, strong markets include medical stop loss, aviation, and surety. For example, HCC is one of the largest competitors in the medical stop loss business, with an estimated market share of roughly 20%. In the last several years, HCC materially increased its positioning in professional liability and began building up an international property treaty business.



The advantages of being a dominant competitor are severalfold. The company has strong knowledge of and data about the business, deep ties with specialized distribution, and better retention of clients. For example, the company's dominant position in the stop loss business provides significant benefits. The business is highly actuarial-driven, and as a longstanding competitor, HCC has superior data, which enables better pricing decisions. In addition, distribution is specialized, with a combination of third-party administrators and health-oriented brokers controlling the business. As an established player in the sector, HCC at least gets

a look at most of the business in its preferred segments. The line exhibits an element of cyclicity similar to other insurance products, although HCC has consistently produced a combined ratio below 90%.

Historically One of the Better Underwriters

HCC has historically been one of the most-profitable underwriters in the property-and-casualty industry. The combined ratio averaged 84% in last five years and 89% in the last 10 years, compared with industry averages of 90% and 92%. In particular, underwriting profits have performed well in the last two years, while other peers' results have deteriorated. The surety and credit and international lines have held up relatively well, averaging loss ratios of 28% and 41%, respectively, in the last two years.

Table 28
HCC Insurance Holdings, Inc.
Combined Ratio Comparison

	Average Combined Ratio	
	5-Year	10-Year
HCC	84.0%	88.5%
AFSI	82.9%	93.1%
TWGP	88.1%	85.8%
OB**	95.9%	97.1%
NATL	86.4%	87.1%
RLI	80.5%	86.6%
SIGI	99.3%	100.1%
THG**	97.4%	99.0%
WRB	91.6%	94.1%
Average	89.6%	92.4%

** 2004-2010 for 10-year average

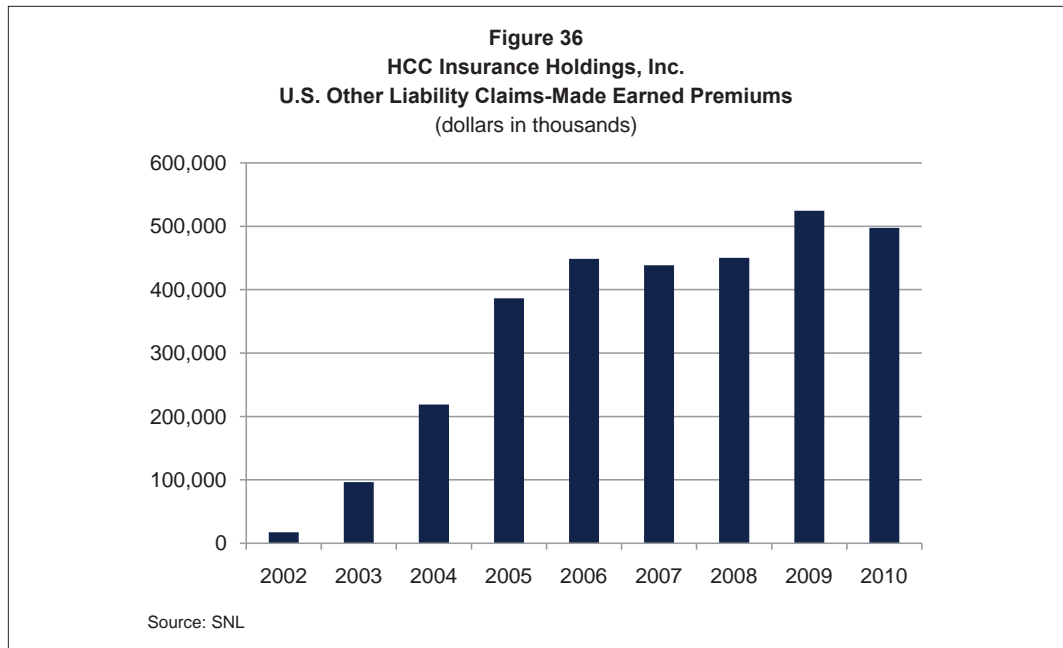
Source: SNL

Professional Liability Is a Concern

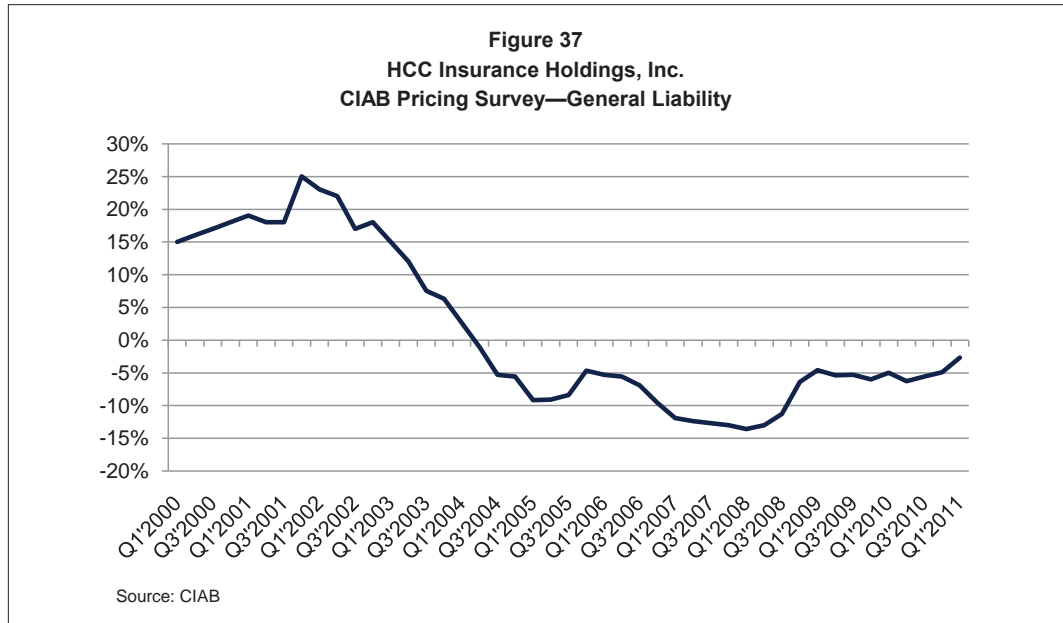
Despite historically good underwriting standards, the professional liability segment is a concern. Between 2005 and 2008, the older reporting segment of HCC called diversified financial products (largely represented by professional liability) had net written premiums increase from \$676 million to \$872 million. That is a 29% cumulative increase over three years, although recently it has been receding. The growth included expanding into the primary or other lower layers, which generally require higher limits and are more exposed to losses. The benefit of the lower layers is that premiums are higher and insurers can be more active in underwriting specific risks. Professional liability accounts for only 20% of premiums, but represents 43% of reserves.

HCC primarily underwrites directors' and officers' (D&O) insurance for public companies, although private entities make up a significant portion of the business. The company underwrites a fair amount of financial institution insurance, which carries a large limit. This unit focuses on investment banks, depository institutions, brokers, and investment advisors. In addition, HCC specializes in professional liability products for investment advisors, mutual funds, hedge funds, funds of funds, real estate investment trusts, private real estate funds, and private equity partnerships.

Another portion of the book is crime business coverage, including large account errors and omissions (E&O) liability and employment practice liability insurance (EPLI) for some D&O policyholders. Another product is low-limit E&O business for numerous classes of professional services, including engineers and related construction practices, representing the largest concentration of insured professionals.

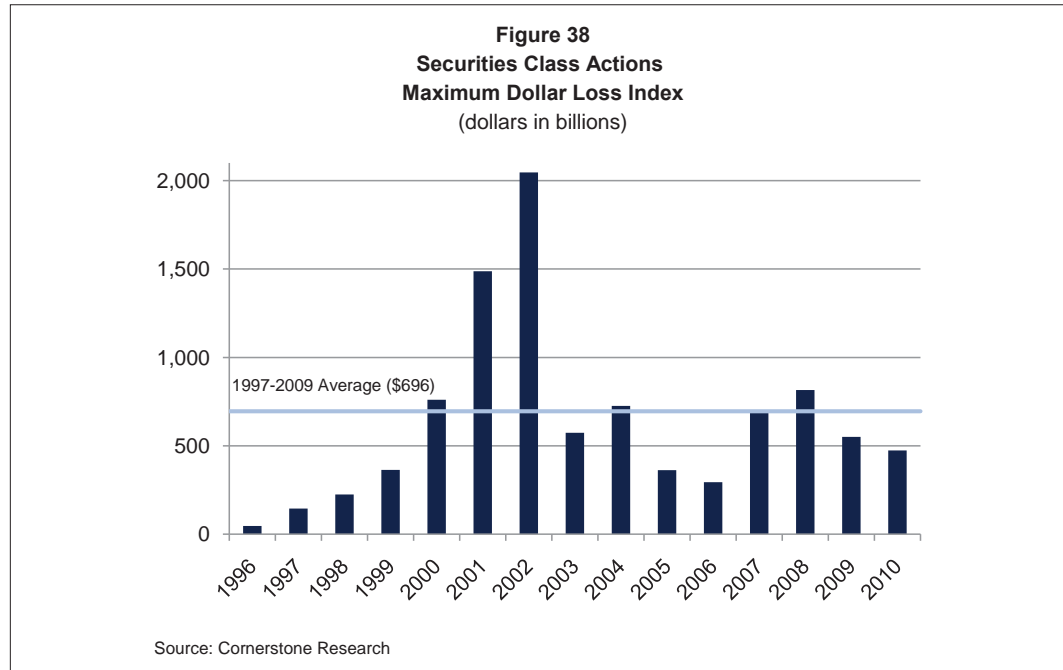


Going forward, we expect the industry as well as HCC to experience development on prior underwriting years and increased accident years. Professional liability has experienced a significant level of price declines in the last decade and has the potential for a significant swing in profitability. Pricing improved with the 2000 to 2003 hard market, after the segment had experienced significant losses from the tech bubble of 1999 to 2000. However, pricing since 2005 has declined materially and the rate of deterioration has been as bad as or worse than most other property-and-casualty lines of business.



In addition to lower pricing, claim activity has the potential to rise. As premiums began to slide in 2007, claim activity began to pick up for the first time in over five years. Changes in litigation trends made it harder to get class action status, and the bar was raised for securities-related lawsuits. The result is that the number of securities-related class action suits declined from 2002 to 2006. The number of claims has begun to pick up with the financial crisis and ensuing recession; however, the nature of the claims has also changed. One shift is an increase toward larger potential claims. The plaintiff bar is focused on the larger cases with better

chance of success. On an anecdotal basis, there are a number of cases where the legal costs have exhausted the first-layer limits. In addition, plaintiff lawyers have shifted away from federal and into state courts; in certain areas, the state courts have been more flexible.



The other factor is that the nature of claims being lobbed at professional liability policies has shifted. Securities class action suits on larger public companies still remain significant, but EPLI claims have been high in recent years. In addition, the small to midsize professional liability market, once viewed as a safe haven, has experienced an increase in filed claims. This market was particularly hard hit by the recession, with bankruptcies and fraud moving to unprecedented levels. HCC has smaller exposure to the private market, but it is still significant. A more recent trend has been an increase in claims related to mergers and acquisitions.

Professional liability results have a significant lag. It typically takes four to six years to have material data that will provide an accurate measure of underwriting profitability. This is mainly because professional liability related litigation is complex and takes time to work through the courts and move to settlement. The profitability lag is further compounded by the severity nature of the line. Because settlements can be large, the predictability of losses can vary widely until enough claims have settled. This means that accident-year profitability can vary materially from the original estimation—positively or negatively. On an industrywide basis, the 1999 to 2002 accident years averaged 34 points of adverse development. The 2003 to 2006 period is averaging 11.8 points of favorable development. We expect the results of the 2007 to 2010 period to have a more significant impact on 2012 and 2013 underwriting profitability.

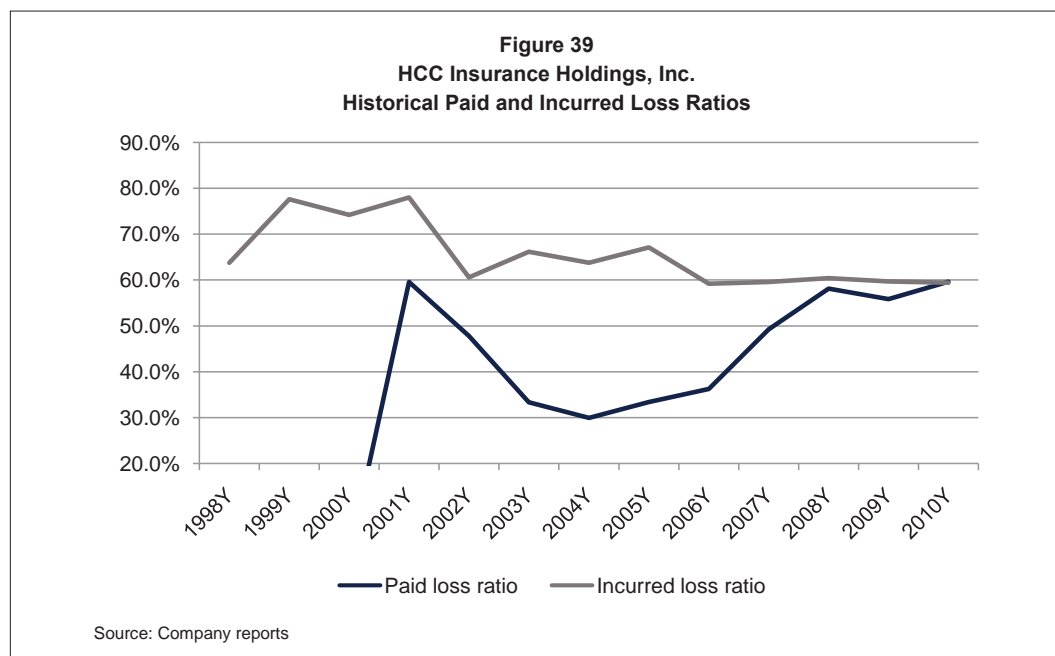
Table 29
Insurance Industry
Other Liability: Claims Made Incurred Loss Ratio Development

	12	24	36	48	60	72	84	96	108	120	Adverse development
1999	68.4%	70.1%	79.4%	87.5%	94.0%	97.1%	102.7%	106.9%	107.4%	108.9%	40.5%
2000	71.1%	69.5%	75.9%	83.2%	92.8%	102.4%	106.9%	108.1%	110.0%	110.2%	39.1%
2001	74.2%	74.8%	82.3%	92.6%	102.8%	104.6%	105.1%	105.7%	106.6%	105.7%	31.5%
2002	68.9%	68.7%	77.8%	88.6%	92.9%	94.6%	94.8%	94.1%	93.9%		24.9%
2003	66.3%	63.9%	64.7%	64.4%	64.6%	64.6%	64.7%	64.8%			-1.5%
2004	65.9%	58.2%	55.6%	53.9%	49.3%	47.2%	46.9%				-19.0%
2005	63.1%	57.7%	55.7%	51.0%	48.1%	47.1%					-16.1%
2006	64.2%	63.3%	59.6%	55.6%	53.4%						-10.8%

Source: SNL

Declining Cash Flow Suggests Lower Core Earnings Power

We expect the deterioration already seen in cash flow to become more visible in operating results. We estimate that operating earnings per share will come down from \$2.96 in 2010 to \$2.78 in 2012, and this assumes catastrophe losses will be \$0.15 less in 2012. Core operating cash flow has declined by 45% from 2007 to 2010. Lower cash flow is a result of reduced prices, reflecting that the property-and-casualty market has downshifted into the soft portion of the competitive cycle. This decline has to date manifested itself in the form of higher paid losses, which jumped from 49% in 2007 to 60% in 2010. The deterioration has not been nearly as visible in reported results. In that same period, operating earnings have only decreased by 22% and the calendar-year loss ratio is flat at 59%.



The key is that we expect the calendar-year loss ratio to increase from 59% to 61%, which is supported by the already big jump in the paid loss ratio (i.e., the trend in paid losses tends to lead the trend in incurred). One factor is that accident-year loss ratios should continue to rise. The higher accident-year loss ratio is a function of continued price declines—down 5% in 2010 and expected to be down 2% to 4% in 2011 and 2012. In addition, claim activity is picking up after a benign period during the recession. The exception is professional liability claim activity, which was high during 2007 to 2009 due to the financial crisis. As discussed above, this area has the potential to remain active. If claims activity gains momentum across sectors, our accident-year estimates are likely conservative.

The other issue is that favorable reserve development, which has averaged 2.5 points of earned premium for the last three years, is beginning to recede. Development in prior years has been supported by redundancies from the last hard market. For example, the other liability: claims made line has averaged 23 points of redundancies (as a percentage of initial incurred) for the 2004 to 2006 accident years. In contrast, 2007 to 2009 accident years for the same line have averaged deficiencies (as a percentage of initial incurred) of 14 points so far. Ultimately, as development recedes and accident-year losses increase, investors should see that core earnings power is materially less than in recent years.

Table 30
HCC Insurance Holdings, Inc.
Other Liability: Claims Made Paid Loss Ratio Development

	12	24	36	48	60
2006	0.8%	7.3%	16.3%	23.9%	27.7%
2007	1.2%	8.1%	19.7%	28.6%	
2008	1.4%	10.9%	25.8%		
2009	3.4%	16.6%			
2010	2.3%				

Source: SNL

Table 31
Insurance Industry
Other Liability: Claims Made Paid Loss Development

	12	24	36	48	60
2006	3.4%	11.7%	23.2%	30.8%	36.5%
2007	3.6%	14.0%	24.8%	34.5%	
2008	5.2%	18.1%	31.2%		
2009	4.4%	17.1%			
2010	4.2%				

Source: SNL

Table 32
HCC Insurance Holdings, Inc.
Cash Flow Summary
(dollars in thousands, except per share data)

Line Item	2007	2008	2009	2010	2011E	2012E
Net Written Premiums	1,985,609	2,060,618	2,046,289	2,026,197	2,106,850	2,205,352
Paid Loss	978,154	1,084,778	1,137,779	1,218,080	1,281,367	1,353,668
<i>Paid Losses as % of Earned Premium</i>	49.3%	58.1%	55.8%	59.7%	61.6%	62.3%
Underwriting & Other Expense	531,504	542,096	568,042	578,050	588,698	614,625
Interest Expense	16,270	20,362	16,164	21,348	21,511	21,511
Net Investment Income	210,069	144,284	192,523	203,711	209,902	220,020
Depreciation and Amortization	15,982	14,308	16,221	17,380	17,380	17,380
Taxes	188,351	130,118	164,683	144,731	134,120	145,899
Core Operating Cash Flow	600,389	515,539	451,034	329,911	342,815	341,429
Core Operating Cash Flow Per Share	\$5.13	\$4.46	\$3.99	\$2.89	\$3.00	\$2.99
Total Cash Flow Adjustments	126,047	-9,571	131,763	85,289	27,603	27,603
Total Operating Cash Flow	726,436	505,968	582,797	415,200	370,419	369,032
Total Operating Cash Flow Per Share	\$6.21	\$4.38	\$5.15	\$3.64	\$3.25	\$3.23
Average Shares Outstanding (thousands)	116,997	115,474	113,100	114,100	114,100	114,100
Operating ROE	17.2%	12.7%	12.3%	10.6%	9.0%	8.7%

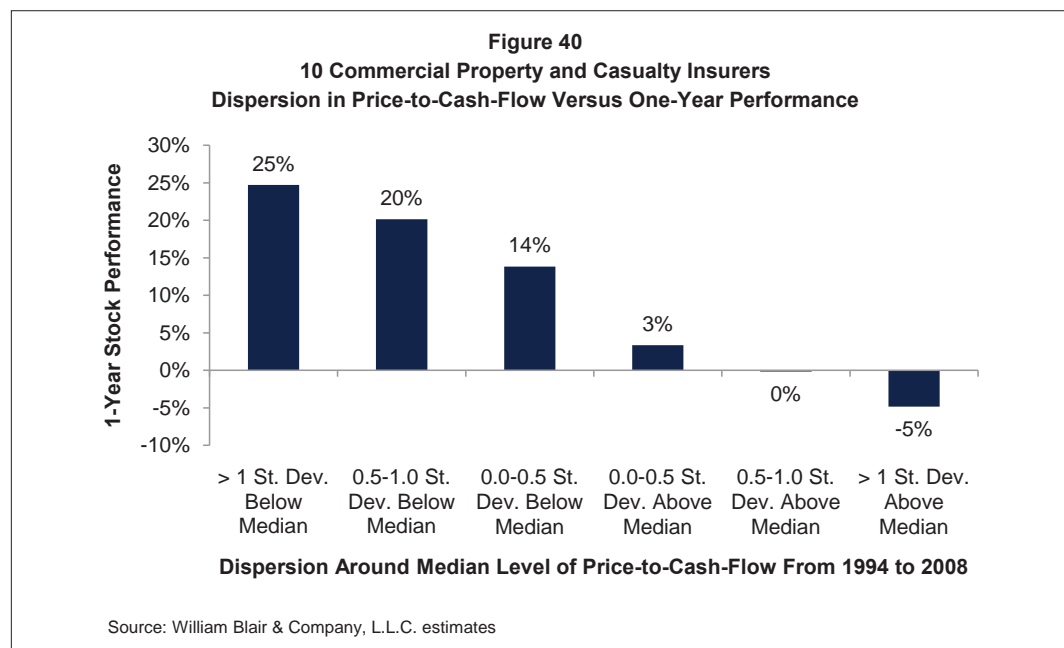
Sources: SNL, company reports, and William Blair & Company, L.L.C.

Valuation Framework

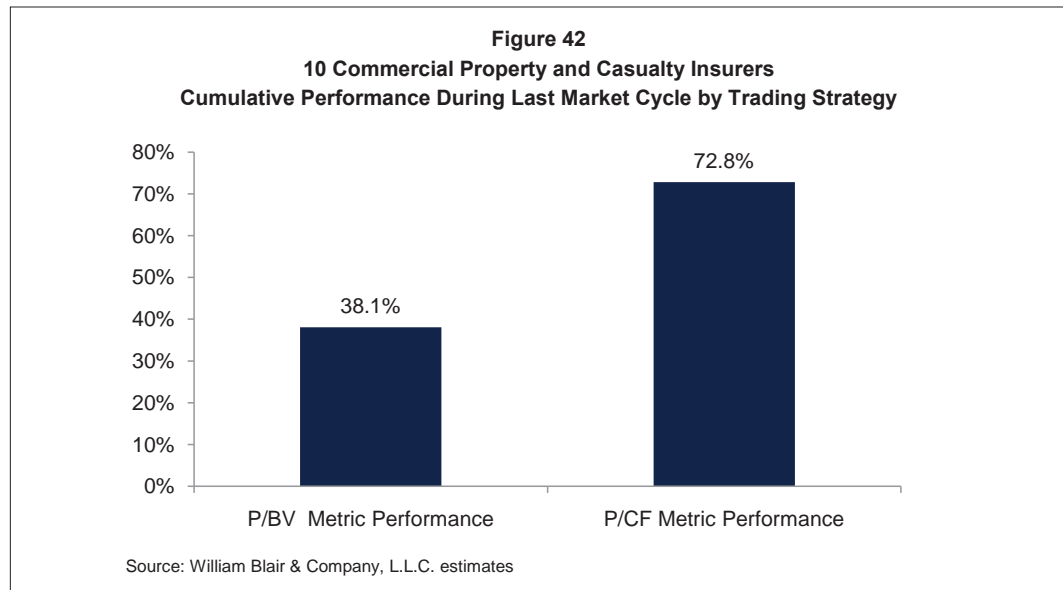
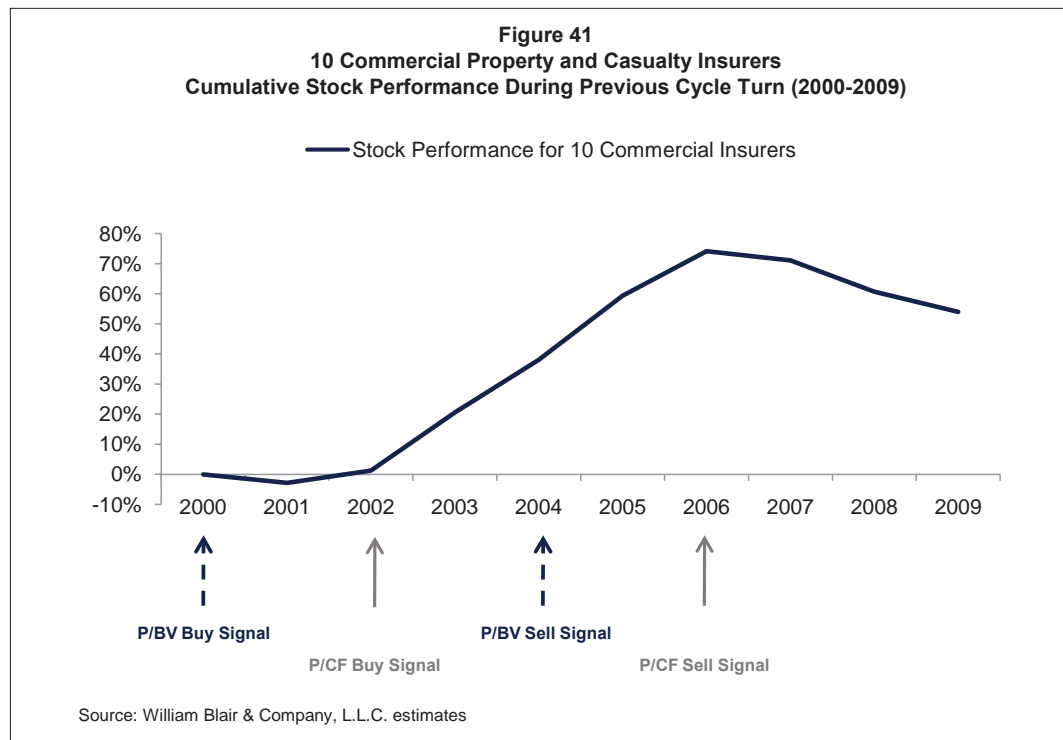
Overall Cash Flow Theory

Cash flow has proven to be a good indicator and is highly correlated to future stock movements. We use price-to-cash-flow (P/CF) as the measure to predict stocks; our historical analysis shows that this measure clearly indicates when to buy or sell insurance stocks. Our methodology is based on back-testing P/CF ratios for 15 years using 10 midsize to large commercial insurers. The ratio we are focused on is based on average cash flow over a four-year period, including the previous year, current year, and the two years following.

The results show that when the P/CF ratio is greater than one standard deviation below the median P/CF ratio, the average return for the next year is 25%. When it is more than one standard deviation above the median P/CF ratio, returns have averaged -5% for the following year. The number of standard deviations above or below the median is inversely correlated with the performance of the stock, thus the correlation is negative. For example, based on our data set, if a stock was trading at a P/CF valuation lower than the median value, one would expect the performance level for that stock to be positive. The overall correlation for the index is -0.49, which indicates a fairly strong negative relationship between the two variables we are examining.



Cash flow valuations have proved particularly useful in cycle turns. In contrast, earnings and ROE measures tend to be lagging indicators of performance. Figure 41, on the following page, shows that P/CF valuation signaled a strong buying opportunity going into 2003 and that investors should sell in 2006. In contrast, price-to-book timing was too early on both entry and exit points. Returns using P/CF entry and exit points were almost double those of price-to-book entry and exit points.



Comparison Universe

HCC, on a P/CF basis, is overvalued compared with peers on a historical basis. The stock is trading at 9.2 times cash flow, which is a sizable 60% premium to its five-year average cash flow multiple. The premium to recent history is well above the level of the other commercial insurers in this report as well as the other commercial competitors. On average, the other three are trading at only a 10% premium. On a historical basis, the analysis also suggests the company is fully valued. HCC's current P/CF multiple is 2.6 standard deviations above its long term median. Based on historical trends, this signifies that performance will likely be flat at best.

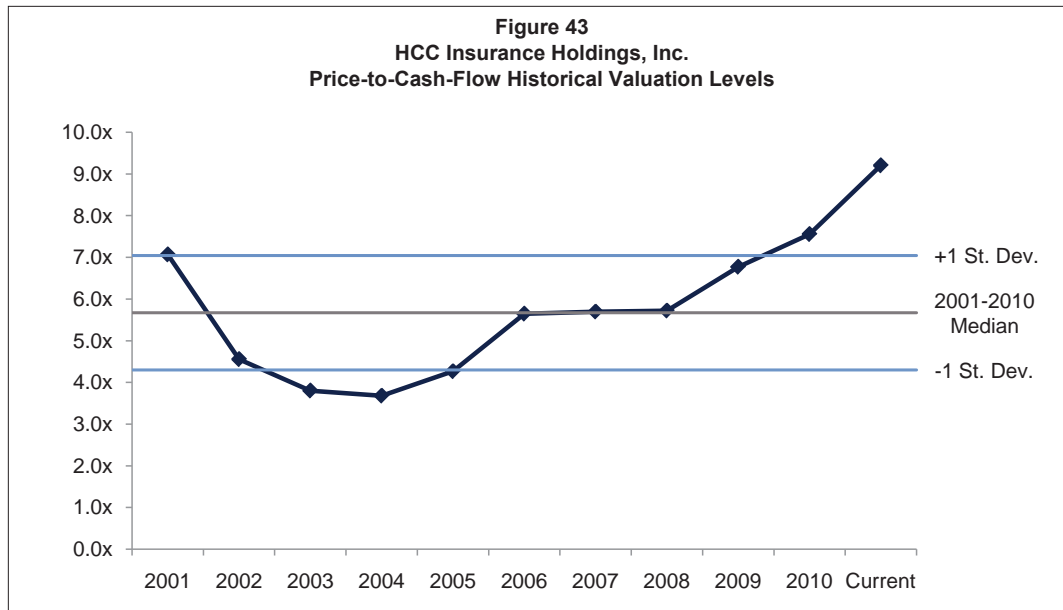
Table 33
HCC Insurance Holdings, Inc.
Cash Flow Valuation Comparison

Company	Ticker	Rating	Current Price	Cash Flow Valuation					Earnings Valuation				Book Valuation			
				Cash Flow Per Share 2011	Cash Flow Per Share 2012	Price to Cash Flow ¹	2006-2010 Median	Current Valuation vs. 5 Year Median	Number of Std. Deviations from 10 Year Median	EPS 2011E	EPS 2012E	PE 2011	PE 2012	Current Book Value	Current Price To Book	2012 ROE
The Chubb Corporation	CB	U	\$62.61	\$6.26	\$6.09	9.4x	7.3x	30%	1.5	\$5.40	\$5.30	11.6x	11.8x	\$53.26	1.2x	9%
HCC Insurance	HCC	U	\$31.50	\$3.25	\$3.23	9.2x	5.7x	60%	2.6	\$2.66	\$2.78	11.8x	11.3x	\$28.99	1.1x	9%
RLI Corp.	RLI	M	\$61.92	\$6.64	\$5.70	10.6x	9.1x	16%	1.5	\$4.19	\$4.40	14.8x	14.1x	\$38.52	1.6x	11%
The Travelers Companies ²	TRV	M	\$58.38	\$5.79	\$7.47	8.6x	7.8x	10%	0.5	\$4.25	\$6.10	13.7x	9.6x	\$59.91	1.0x	10%
Average						9.4x	7.5x	29%	1.5			13.0x	11.7x		1.2x	10%
Median						9.3x	7.5x	23%	1.5			12.8x	11.6x		1.1x	10%

Note¹: Price to Cash Flow Based off Current Price Divided by 4 year cash flow: t= -1,0,1,2

Note²: Travelers data only goes back through 2002

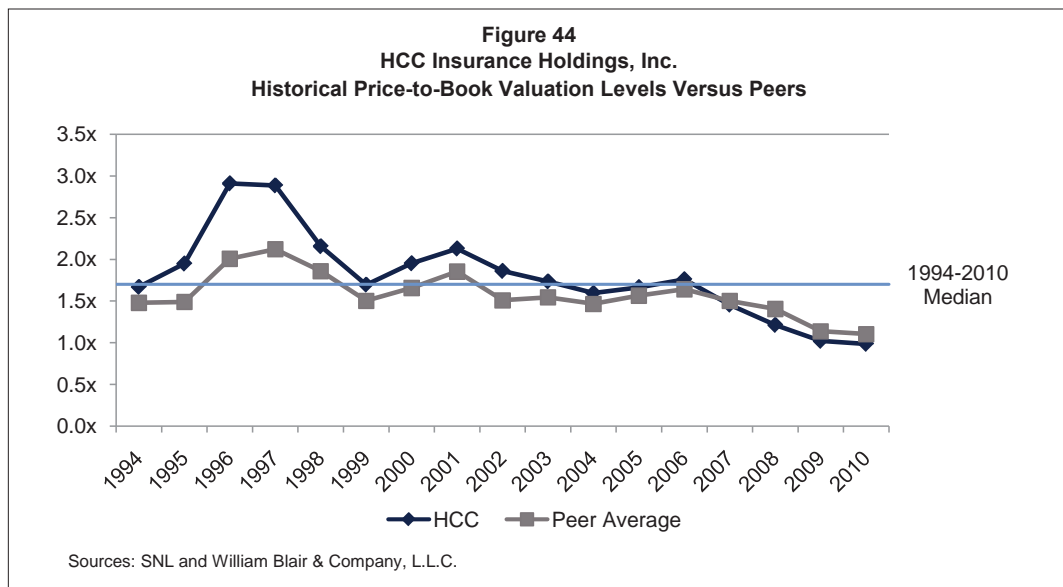
Source: William Blair & L.L.C. estimates.



In the last 15 years, HCC's price to cash flow multiple has ranged from 18 to 4 times, with a median of 7 times. Excluding several peak years, the range has actually been closer to 10 to 4 times. As we would expect, the ratio was relatively high at the bottom of the last cycle and declined to favorable levels in 2003 to 2004 when cash flow was very high. The price-to-cash-flow ratio increased in recent years as the stock bounced back from the 2007 to 2009 market fallout and as cash flow has been declining to reflect more challenging underwriting conditions.

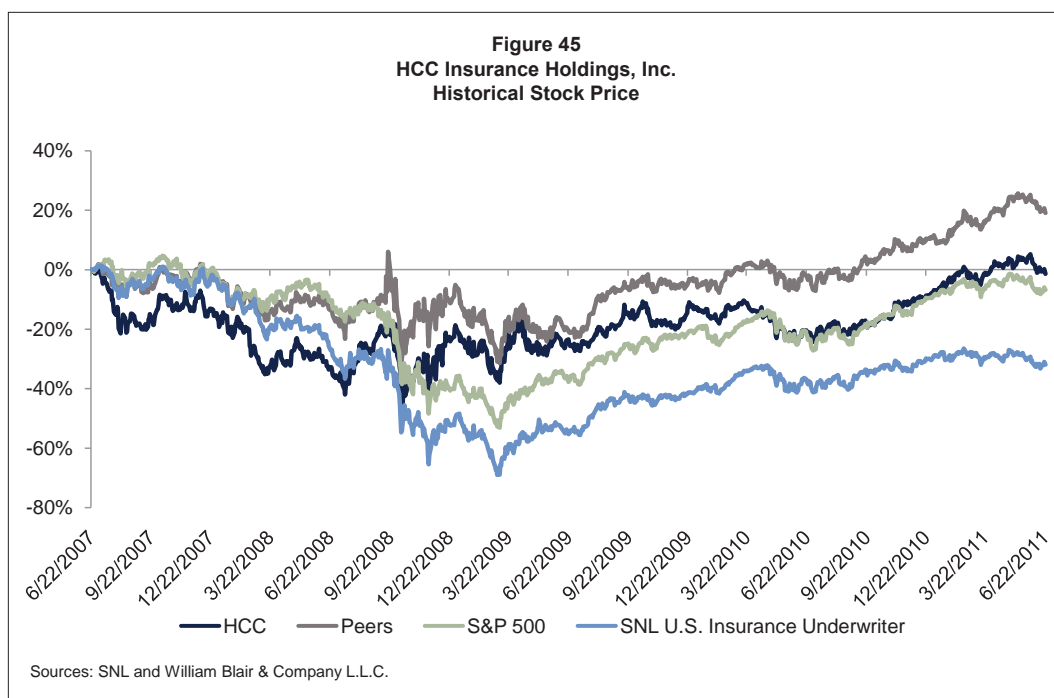
Price to Book

HCC appears adequately valued on a price-to-book basis at a multiple of 1.1 times. This compares with a current peer average of 1.2 times. On the surface, this valuation seems appropriate given that ROEs have averaged 11% in the last two years. However, since ROEs are forecast to decline to 8% by 2013, we believe the price-to-book ratio could slide even further.



Stock Performance

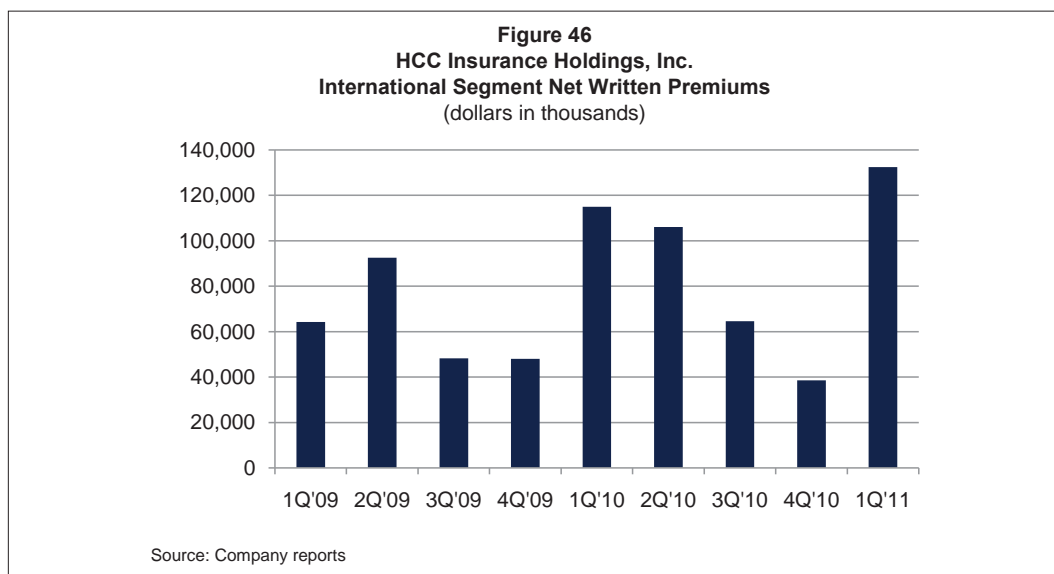
HCC has underperformed by 2% in the last 12 months. We expect the stock to underperform on a relative basis going forward as we believe there is potential for cash flow to decline further over the next several years.



Key Factors to Watch

International Market Becoming Larger Part of Mix

The international segment's net written premiums increased from \$275 million in 2008 to \$324 million in 2010, and grew by 15% in the first quarter of 2011. Property treaty has experienced major growth, with net written premiums of \$59.9 million in 2010, compared with \$284,000 in 2009. Property treaty mainly comprises a diverse set of non-peak zone international treaty reinsurance arrangements. The shift toward the international market has positive and negative implications. The business by nature diversifies away from the core U.S. commercial cycle. In addition, with a property orientation the segment has a shorter tail, which means that future profits should be more visible. Recent worldwide catastrophic activity has created the potential for higher insurance rates and higher returns. However, the downside is that it has the potential to add earnings volatility. The last few quarters have been affected by catastrophe losses.



Medical Stop Loss Market

The medical stop loss market is a relatively concentrated niche market. HCC is one of the three largest companies in the space. The product provides coverage against catastrophic or larger losses for self-insured medical plans. This is in contrast to insured or indemnity plans, where health insurers (e.g., UnitedHealth Group or Blue Cross Blue Shield) incur the underwriting risk. The business has a relatively short tail, as most medical claims are paid in a 12- to 15-month window and are actuarial oriented, as there are large data sets. Medical stop loss insurance is provided on an individual risk or aggregate basis, although the individual business makes up the majority of the market.

Medical stop loss has several distinct advantages, but also significant risks. The sector has less competition than the typical insurance line and is highly specialized. In addition, the ability to have an extensive database and strong ties to the distribution translate into barriers to entry and ultimately into competitive advantages. One significant negative is exposure to rising healthcare costs. Insurers have the ability to price and underwrite, as the line is relatively short tailed, but spikes in healthcare costs can affect short-term profitability.

The new healthcare legislation may be a double-edged sword for the sector. The combination of minimum loss ratio targets combined with greater benefit costs has the potential to make traditional indemnity plans less feasible, as their margins are being effectively squeezed. This may push additional plans to self-insure and thus increase the overall market. There are early indications that this trend is occurring, HCC reported an 8.2% increase in premiums in the first quarter of 2011 compared with first quarter 2010. The downside is that a push toward self-insurance may spur health insurers to move into the medical stop loss market.

HCC, with over \$700 million in annual premiums, is one of the top two players in the market. The company focuses on the middle-market, self-insured plans, with an average of 400 lives, and tends to avoid the larger market. The majority of the business is in the individual market, with typical limits well below the \$100,000 level. In the last 10 years, HCC's profitability has followed the sector's typical cycle. Loss ratios declined to the very profitable average of 61.9% in 2002-2003, but then began to rise in 2004 as the market became competitive and medical costs continued to increase.

Table 34
HCC Insurance Holdings, Inc.
Accident and Health Segment Earned Premiums and Loss Ratio
(dollars in thousands)

	Reporting Segment								
	Accident & Health			Group Life Accident & Health					
	2010	2009	2008	2007	2006	2005	2004	2003	2002
Net Earned Premiums	760,034	741,539	711,297	758,516	591,070	504,382	343,913	290,009	240,070
Net Loss Ratio	73.3%	72.9%	72.4%	76.4%	73.1%	71.6%	66.7%	61.6%	62.2%

Source: Company reports

The line went from having moderately favorable development in 2008 (\$12 million) to adverse results in 2010 (\$10 million). The 2010 adverse development was primarily from the last several underwriting years. The higher segment loss ratio in 2010 compared with 2009 reflected increased losses in the medical stop loss product.

The segment is HCC's largest and results are quickly visible. A change in the market can have a near-term effect on earnings. The company is attempting to get rates several points ahead of trend, but it is unclear if this will be sufficient. Our bull case shows premiums up by 15% and losses down by 500 basis points; this would add \$0.26 to 2012 earnings. The bear case shows premiums growing by 7%, but losses increasing by 300 basis points; this

would reduce earnings per share by \$0.16. In our current model, we assume accident and health loss ratios will be stable at 73% for 2011, 72.7% for 2012, and decline to 72.2% by 2013, which could be optimistic.

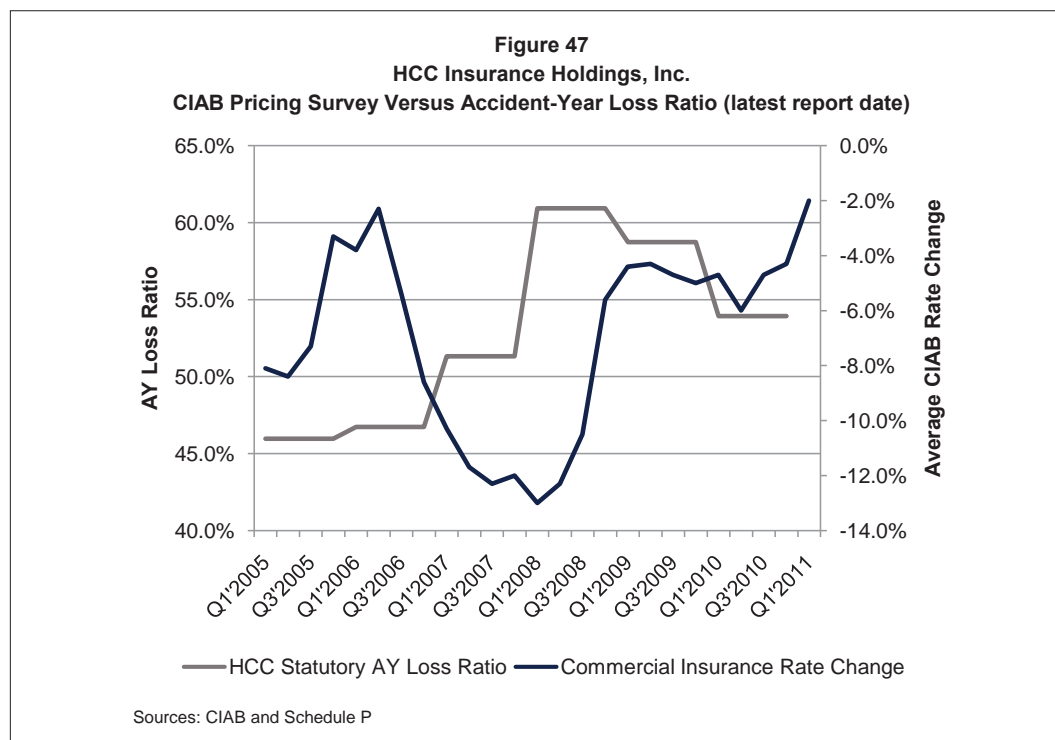
Table 35
HCC Insurance Holdings, Inc.
Accident and Health Scenario Analysis
(dollars in thousands, except per share data)

Accident & Health	2012E		
	Current	Bull	Bear
Gross Written Premiums	863,543	978,675	863,543
% change	7.2%	15.0%	7.2%
Net Written Premiums	863,038	978,111	863,038
Net Earned Premiums	835,531	912,524	835,531
% change	5.5%	13.4%	5.5%
Net Loss Ratio	72.7%	68.0%	76.0%
Earnings Per Share	\$2.78	\$3.04	\$2.62
Scenario Impact	NA	\$0.26	(\$0.16)

Source: William Blair & Company, L.L.C. estimates

Deteriorating Accident-Year Loss Ratios

Across the industry, commercial line accident-year loss ratios have exhibited material deterioration. This mainly reflects the six-year drop in pricing that has averaged between 30% and 50% in most property-and-casualty lines.



We expect loss ratio deterioration to continue. Pricing is more stable in 2011, compared with 2010, but is still negative in most lines. The international segment possibly will be the exception; these lines constitute 16% of HCC's premiums. Claim activity, which was benign with the recession, appears to be picking up. This means that the 2009 and 2010 accident loss ratio years could be understated on an industrywide basis.

Table 36
HCC Insurance Holdings, Inc.
Statutory Incremental Paid Loss Ratio Projections

Accident Year	12 Months	24 Months	36 Months	48 Months	60 Months	72 Months	84 Months	96 Months	108 Months	120 Months
2001	27.6%	19.1%	7.6%	2.5%	-28.7%	-26.2%	2.3%	2.4%	0.3%	0.7%
2002	19.4%	17.4%	2.4%	2.6%	1.4%	1.2%	2.6%	0.4%	1.0%	2.4%
2003	11.9%	8.4%	4.7%	2.7%	2.4%	1.8%	0.4%	2.0%	1.1%	1.8%
2004	12.2%	8.2%	4.1%	5.6%	2.3%	1.0%	2.3%	5.1%	1.3%	2.1%
2005	9.0%	9.0%	7.0%	7.2%	4.0%	3.0%	5.2%	6.3%	1.7%	
2006	7.8%	9.2%	8.8%	5.3%	2.9%	0.3%	4.5%	5.5%		
2007	7.1%	9.1%	8.4%	5.7%	2.7%	0.3%	4.4%			
2008	9.3%	12.1%	10.4%	7.2%	3.5%	0.4%				
2009	9.7%	13.3%	10.8%	7.7%	3.8%					
2010	8.6%	11.1%	9.5%	6.6%						
2011E	9.0%	11.6%	9.7%							
2012E	9.2%	11.9%								
2013E	9.3%									

Sources: SNL, William Blair & Company, L.L.C. estimates

Catastrophe Exposure

HCC is not a property-catastrophe-oriented company, but its business mix does have exposure to catastrophic events. A growing international segment in energy, marine, and property brings increased exposure to weather events. The company expanded into the property treaty book in late 2009. The business focuses on property catastrophe treaty, property risk and engineering treaty, and property terrorism treaty, with 40% in North America and 60% international. The main business is higher layer property catastrophe protection. Property treaty and energy premiums should equal 5% to 7% of premiums in 2011.

Catastrophes are not viewed as a material capital risk for the company, but they have the potential to add moderate quarterly earnings volatility. HCC had \$22.5 million of catastrophe losses in 2010 and had \$51.5 million in the first quarter of 2011. Considering that these have been relatively active years, our forecast includes 10 points of catastrophe losses in the international segment for 2012 and 2013. But again, this could vary materially, depending on specific events and the degree to which HCC continues to increase its exposure.

Major Risks

Short-Term Move on Potential Cycle Turn

HCC's stock could increase on prospects of a turn in the commercial line pricing cycle. The market typically has "head fakes" or false cycle turns—and we may even be experiencing one now. Some market proponents believe that the high level of recent catastrophe losses could provide momentum for an overall turn in the commercial pricing cycle. We see this as highly unlikely—the commercial market is mainly liability-oriented and the reinsurers have much less influence on core commercial lines than several decades ago. Even when the cycle turns, which we believe could happen in 2013 or 2014, most of the stock returns for underwriters occur three to four years later, as ROEs lag the cycle upturn. The majority of the stock appreciation related to the last favorable underwriting cycle occurred in 2002 to 2005. This was effectively 3 years after the hard market had begun. The stock would likely move in late 2012 or early 2013 if there was an actual turn, but then would be flat for several years until the higher prices actually began to translate into higher return on equity. Our view is there is no need to take the risk on the early side, since investors will have plenty of time to take advantage of upside.

Favorable Rebound in Medical Stop Loss Business

The medical stop loss business has been soft over the last several years. In better times, this business can produce a loss ratio in the low-60% range, or 10 points better than the current average. We forecast that the loss ratio will stay at 70% to 73% for the next several years. However, if the company can increase pricing or the medical trends improve, our estimate could prove conservative. Given the size of the book, with \$654 million in 2010 premiums, a material shift could result in upside to our cash flow projections and our earnings estimate.

Expansion of the Property Treaty

The property treaty segment, at 3% of net written premiums, is a relatively small part of the overall mix; however, given weather volatility, HCC may have the potential to materially grow this book of business in the next 12 to 18 months. If the company increases the book by over 100% and the weather/catastrophic losses improve from the challenging 2010/2011 experience, this line could materially improve cash flow and generate earnings above our estimates.

Financial Projections

Table 37
HCC Insurance Holdings, Inc.
Premium Flows and Key Ratios
(dollars in thousands)

	2008	2009	2010	2011E	2012E
Net Premiums Earned	\$2,007,774	\$2,037,235	\$2,041,924	\$2,079,538	\$2,171,125
% growth	1.1%	1.5%	0.2%	1.8%	4.4%
Loss Ratio	60.4%	59.7%	59.4%	61.3%	60.2%
Expense Ratio	25.0%	24.3%	25.2%	25.2%	25.2%
Combined Ratio	85.4%	84.0%	84.6%	86.5%	85.4%
Paid Loss Ratio	58.1%	55.8%	59.7%	61.6%	62.3%
Operating EPS	\$2.80	\$3.09	\$2.96	\$2.66	\$2.78
EPS Growth	-15.4%	10.5%	-4.3%	-10.0%	4.5%
Cash Flow Per Share	\$4.38	\$5.15	\$3.64	\$3.25	\$3.23
Operating ROAE	12.7%	12.3%	10.6%	9.0%	8.7%
Book Value Per Share	\$22.86	\$26.80	\$28.89	\$30.84	\$33.09

Sources: Company reports and William Blair & Company, L.L.C.

Summary

We forecast earnings per share to decline from \$2.96 in 2010 to \$2.78 in 2012. We estimate that the ROE declines from 11% in 2010 to 9% in 2012 and 8% in 2013. While premium growth should begin to pick up after several soft years, similar to the rest of the industry, we expect profitability from recent underwriting lines to deteriorate. This should be particularly pronounced in long-tailed casualty lines, including professional liability.

Upside/Downside Potential

Our estimates are already below consensus, but material downside is still possible. Our forecast assumes that the professional liability calendar loss ratio will increase from 62% in 2010 to 70% in 2012. During the trough of the last cycle, professional liability loss ratios reached 90%-plus. The product has changed and courts have made large jury awards tougher; however, there are different issues arising (significant merger-and-acquisition activity and an uptick in EPLI suits). An additional 10 points on the professional lines loss ratio would reduce earnings per share by roughly \$0.35. Another factor is the growing property treaty segment. Our 2011 estimates assume 20 points of catastrophe losses in the international segment, due to the Japan earthquake and other weather-related activity. Our model

assumes only 10 points of catastrophe activity in 2012. A loss year similar to 2011 would reduce our EPS estimate by roughly \$0.25. A potential upside factor would be a favorable rebound in the medical stop loss business.

Key Earnings Factors

Premiums growth. We expect gross premiums written to show a moderate rebound of 3% to 5% in 2011 and 2012, compared with flat 2009 and 2010 levels. Several segments should experience better growth levels. Our forecast assumes the international segment will increase by 15% for the next two years, as the company takes advantage of the opportunity in the property treaty area. Another area of potential growth will be medical stop loss; pressure from federal healthcare legislation may increase the market for self-insured plans. We model medical stop loss gross premiums to increase 6% to 8% for the next two years. However, slow to negative growth in U.S. property-and-casualty and professional liability should hold down overall growth, as these markets remain competitive.

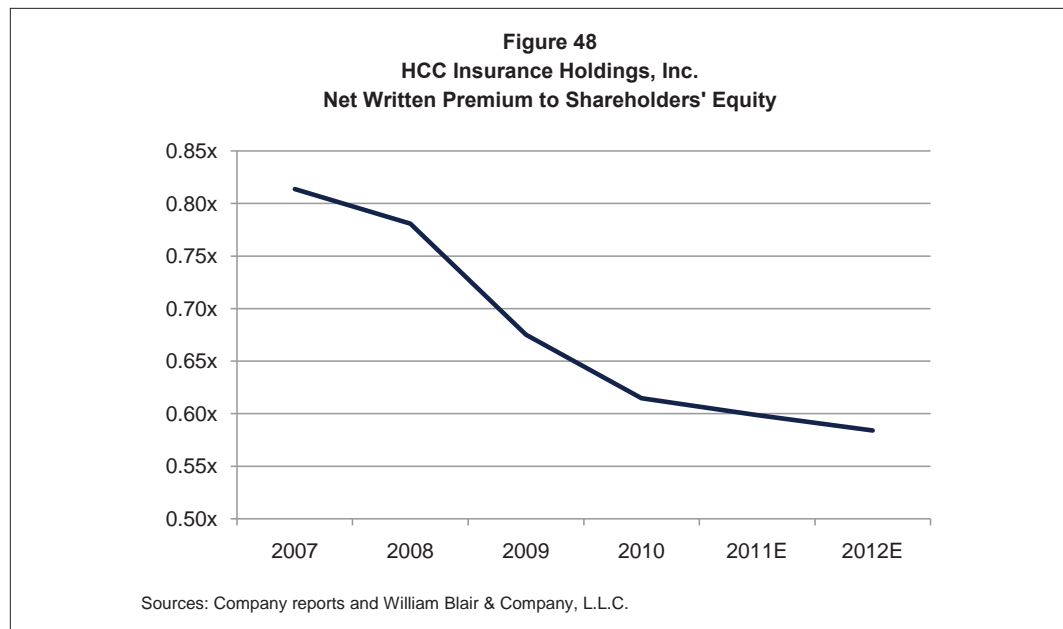
Investment income. Our forecast assumes that investment income will grow slowly through 2012, as continued pressure on yields and a slow-to-recover economy continue to hurt growth in the portfolio. If interest rates begin to increase in 2012, there could be additional upside in investment income. We expect investment income to grow by 3% in 2011 and 6% in 2012.

Loss ratio. We forecast that the loss ratios will continue to increase, as catastrophe losses and the soft market put further pressure on underwriting margins. Our forecast has the loss ratio gradually increasing from 58% (excluding catastrophe) in 2010 to 61.5% in 2012. The majority of the increase is expected to come from the professional liability and to a lesser extent the U.S. property-and-casualty segments. Our forecast calls for professional liability to move from 62% in 2010 to 70% in 2012, due to material price declines and the potential for rising claim activity from a number of pockets. We also expect U.S. property-and-casualty loss ratio to increase from 56% to 62%, due to the lagged impact of the soft pricing environment.

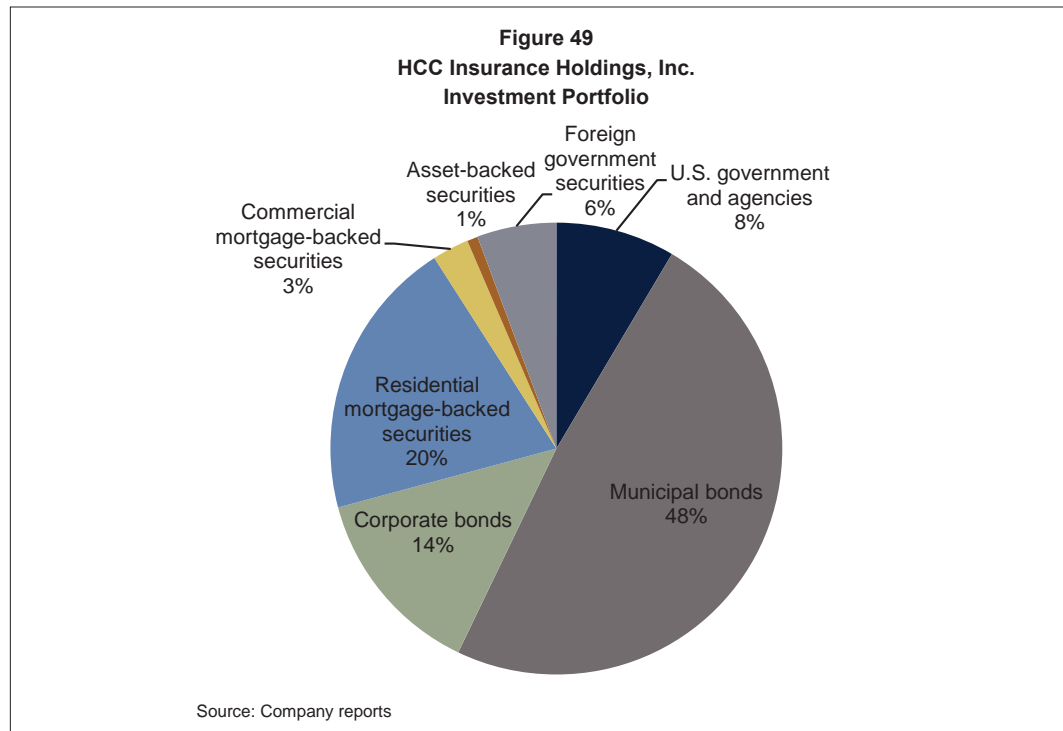
Expense ratio. We expect the expense ratio to remain relatively flat in the 29% to 30% range over the next two years. There has been some pressure on commission rates in 2009 and 2010, but we expect this to ebb as the market stabilizes in the next two years. HCC is disciplined from an expense management standpoint; thus, we expect overhead expenses to remain relatively constant at 12% to 13% of premiums.

Balance Sheet

We expect HCC to continue to underwrite on a well-capitalized basis. Net premiums written to GAAP equity should stay in the 0.55- to 0.65-times range over the next two years, which is conservative but admirable in the current market environment. The company is slightly more leveraged on a gross basis, with an expected gross premium to GAAP equity at 0.6-0.8 times. We believe these are acceptable ranges given the current market environment, but expect them to pick up as the cycle begins to turn over the next few years.



HCC's investment portfolio contains high-quality fixed-income securities, equity investments, and short-term investments. The fixed income portfolio, which constitutes 95% of investments, has an average rating of AA+ and average duration of 5.4 years; the portfolio carries an average yield of 4%. Notable concentrations include municipal bond at 47% and the next highest is residential MBS at 20%.



Corporate Profile

Founded in 1974, HCC Insurance Holdings, Inc. is an international specialty property-and-casualty insurance holding company that underwrites and sells niche insurance products through a group of major subsidiaries known as HCC Insurance Group. HCC has offices in the United States, the United Kingdom, Spain, and Ireland. The company, with 2010 written premiums of \$2.6 billion and net income of \$345 million, displays results across five underwriting business segments including U.S. property and casualty, professional liability, accident and health, U.S. surety and credit, and international. HCC is one of the highest-rated property-and-casualty firms in the United States, with an AA rating from S&P and an A+ rating from A.M. Best. The company has also grown substantially through acquisitions, completing more than 40 transactions since its founding.

HCC offers more than 100 product lines in the specialty commercial market. The diversity across major product lines has helped mitigate tough overall market conditions; several of the product lines, including energy, property treaty, and medical stop loss, have seen positive developments for both demand and pricing over the last several years, despite the current soft market conditions. This diversity gives the company operational flexibility to shift the underwriting focus to more-profitable areas during tough market conditions by altering the amount of gross premiums written or the amount of reinsurance secured for each product line.

The company also benefits from an excellent risk selection process, which helps it maintain superior loss ratio performance, despite the soft pricing market. These strategies underpin the corporate focus on growing net earnings and book value as opposed to stealing market share or writing more premiums.

HCC serves these markets through a product management organization that the company groups into five components in its reports. The major underwriting groups include U.S. property and casualty, professional liability, accident and health, U.S. surety and credit, and international. Each underwriting segment within the organization is headed by a manager, who has the sole responsibility of achieving that product line's planned results; this enables the customization of insurance products to meet the needs of its clients. The accident and health segment is the largest, constituting 30% of gross premiums written in 2010. Professional liability is the next-largest segment, at 23% of written premiums, followed by U.S. property and casualty (21% of written premiums), international (18% of written premiums), and U.S. surety and credit (8% of written premiums).

Table 38
HCC Insurance Holdings, Inc.
Gross Written Premiums by Segment

	2009	2010	YoY Growth
U.S. Property and Casualty	603,408	538,475	-10.8%
Professional Liability	639,469	596,291	-6.8%
Accident and Health	745,035	761,729	2.2%
U.S. Surety and Credit	203,522	226,866	11.5%
International	337,562	453,478	34.3%
Total	2,559,791	2,578,908	0.7%

Source: Company reports

Structurally, HCC writes insurance policies on a direct basis through 11 separate insurance companies and 10 underwriting agencies. HCC companies write multiple lines of insurance in all 50 states and for 180 counties globally.

HCC also ceded roughly 20% of its business in 2010 to reinsurers to diversify risk and limit maximum loss from catastrophic events. The company is subject to some credit risk from its reinsurers and it tries to only use reinsurers with an A.M. Best rating of A- or better. HCC also assumed about \$310 million of reinsurance coverage during 2010.

Business Mix

Table 39
HCC Insurance Holdings, Inc.
Business Mix

		2009	2010
U.S. Property and Casualty	Net Earned Premiums	379,439	339,513
	Net Loss Ratio	53.1%	56.3%
Professional Liability	Net Earned Premiums	444,534	425,226
	Net Loss Ratio	62.2%	62.4%
Accident & Health	Net Earned Premiums	741,539	760,034
	Net Loss Ratio	72.9%	73.2%
U.S. Surety & Credit	Net Earned Premiums	182,627	199,908
	Net Loss Ratio	29.9%	26.5%
International	Net Earned Premiums	256,122	316,186
	Net Loss Ratio	36.9%	45.4%
Exited Lines	Net Earned Premiums	32,974	1,057
	Net Loss Ratio	NM	NM
Total	Net Earned Premiums	2,037,235	2,041,924
	Net Loss Ratio	59.7%	59.4%
	Net Expense Ratio	24.3%	25.2%

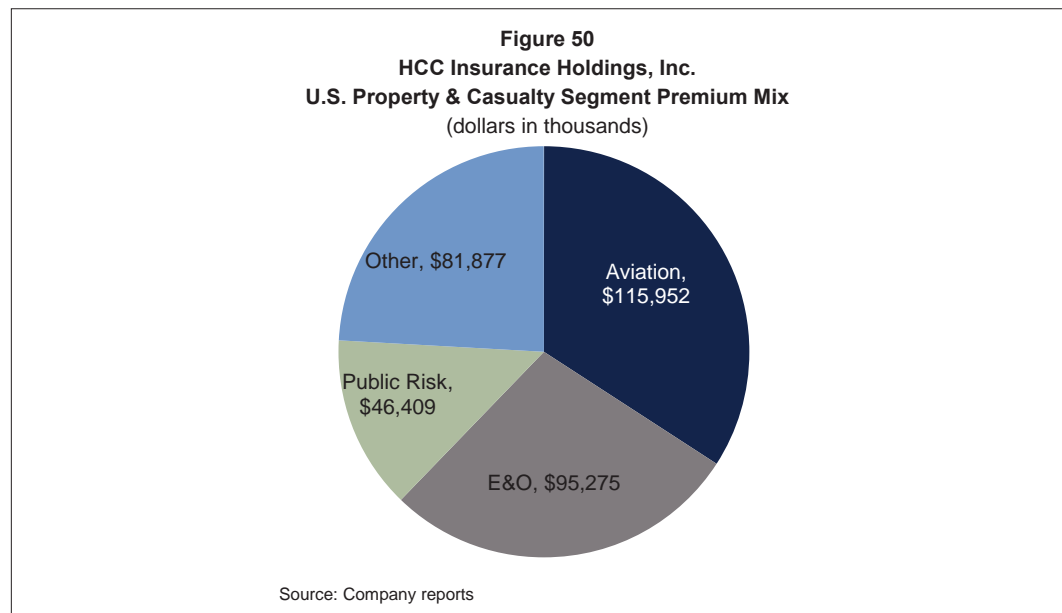
Source: Company reports

Table 40
HCC Insurance Holdings, Inc.
Business Mix Summary

Line of Business	Products	Underwriting	Duration	Speed of Claim Reporting	Reserve Volatility
U.S. Property & Casualty	Aviation	Direct and subscription	Medium	Fast	Medium
	E&O liability	Direct	Medium	Moderate	Medium
	Other liability	Direct and assumed	Medium	Moderate	Medium
	Property	Direct and assumed	Short	Fast	Low
Professional Liability	D&O liability	Direct and subscription	Medium to long	Moderate	Medium to high
	E&O liability	Direct	Medium	Moderate	Medium
Accident & Health	Medical stop loss	Direct	Short	Fast	Low
	Other medical	Direct and assumed	Short	Fast	Low to medium
U.S. Surety & Credit	Surety	Direct	Medium	Fast	Low
	Credit	Direct	Medium	Fast	Low
International	Energy	Subscription	Medium	Moderate	Medium
	Property	Subscription	Short	Fast	Low
	Property treaty	Assumed	Short	Fast	Low
	Surety & credit	Direct	Medium	Fast	Low
	Marine	Subscription	Medium	Moderate	Medium
	Accident & health	Direct and assumed	Medium to long	Moderate	Medium to high
	E&O liability	Direct	Medium	Moderate	Medium
	Other liability	Direct and assumed	Medium	Moderate	Medium
Exited Lines	Accident & health	Assumed	Long	Slow	High
	Medical malpractice	Direct	Medium to long	Moderate	Medium to high

Source: Company reports

U.S. Property and Casualty



The U.S. property and casualty segment includes specialty lines of insurance for aviation, E&O liability, public risk, employment practices liability, disability, and many other specialty lines. The majority of the business is primary coverage, and the claims tend to be short- to medium-tail in duration. The business is sold primarily through wholesale and specialty retail brokerage.

The company has several specialties within this segment. Aviation has been a historically successful product line for HCC, going back to the company's founding in 1974. It provides customized coverage for both the private and commercial marketplace, within the United States as well as in nearly 60 countries worldwide for accounts like national armed forces, law enforcement agencies, and regional airlines. The E&O business writes coverage for more than 100 different types of professional service providers, with the largest concentration in architects, engineers, and construction practices. The E&O business is produced through both wholesale and specialty retail brokers and is underwritten on both an admitted and surplus lines basis. The public risk business provides risk management and insurance services to municipalities and regional authorities with populations of less than 50,000 people in the United States.

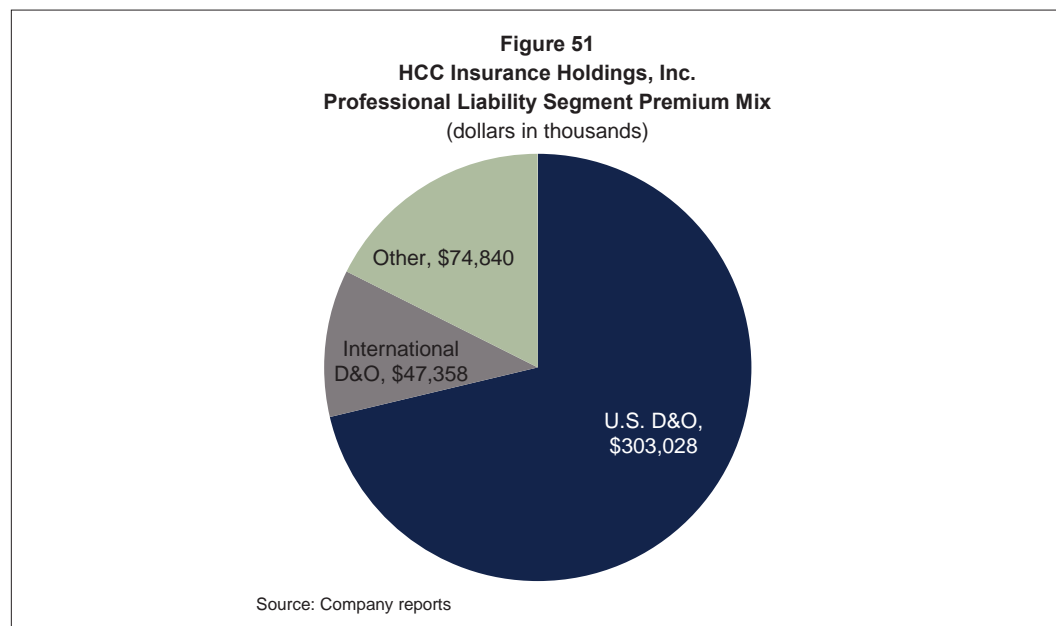
Table 41
HCC Insurance Holdings, Inc.
U.S. Property & Casualty Business Summary
(dollars in thousands)

		2009	2010
Aviation	Net Written Premiums	124,336	110,539
	Net Earned Premiums	129,626	115,952
	Net Loss Ratio	56.6%	55.0%
E&O	Net Written Premiums	109,026	81,443
	Net Earned Premiums	118,834	95,275
	Net Loss Ratio	61.50%	79.20%
Public Risk	Net Written Premiums	48,524	46,844
	Net Earned Premiums	39,986	46,409
	Net Loss Ratio	66.30%	61.80%
Other	Net Written Premiums	100,921	89,995
	Net Earned Premiums	90,993	81,877
	Net Loss Ratio	31.20%	28.40%
Total	Net Written Premiums	382,807	328,821
	Net Earned Premiums	379,439	339,513
	Net Loss Ratio	53.1%	56.3%

Source: Company reports

The U.S. property-and-casualty segment had a net loss ratio of 56.3% in 2010 compared with 53.1% in 2009. This was entirely driven by the E&O segment, which saw an increase in net loss ratio from 61.5% to 79.2%. Aviation, public risk, and other had modest declines in their net loss ratio. Net written premiums in the U.S. property-and-casualty segment declined 14.1% from 2009 to 2010, with broad declines across all segments with the exception of public risk, which had a decline of 3%. E&O net written premiums dropped 25% compared with 2009.

Professional Liability



The professional liability segment consists almost exclusively of the D&O insurance line. Business is written for both public and private companies that span many different industries, with a particular concentration in financial institutions such as investment banks and investment advisors. The majority of the business is sourced from major brokers and tends to be large-limit in nature (greater than \$10 million), while claims tend to be high-severity and long-tailed in nature. Most of the operations in this segment were started in 2002 through the acquisition of MAG Global Financial Products, which is now known as HCC Global.

Table 42
HCC Insurance Holdings, Inc.
Professional Liability Business Summary
(dollars in thousands)

		2009	2010
U.S. D&O	Net Written Premiums	316,468	288,306
	Net Earned Premiums	306,621	303,028
	Net Loss Ratio	62.2%	60.8%
International D&O	Net Written Premiums	53,952	39,307
	Net Earned Premiums	59,082	47,358
	Net Loss Ratio	53.3%	60.8%
Other	Net Written Premiums	76,660	73,949
	Net Earned Premiums	78,831	74,840
	Net Loss Ratio	68.9%	70.0%
Total	Net Written Premiums	447,080	401,562
	Net Earned Premiums	444,534	425,226
	Net Loss Ratio	62.2%	62.4%

Source: Company reports

The professional liability segment saw net written premiums decline 10.2% over the past year. The net loss ratio held steady at 62.4% compared with 62.2%. U.S. D&O represents 72% of the net written premiums in HCC's professional liability segment. International D&O is 10% of professional liability and had a decline in net written premiums in the past year of 27.1%. The net loss ratio for international increased from 53.3% to 60.8%; however, that is in line with U.S. D&O. The movement of the net loss ratio for professional liability has a significant impact on HCC's bottom-line earnings, so it is a key segment to watch.

Accident and Health

HCC specializes in writing medical stop loss, shorter-term domestic and international medical, HMO reinsurance, and medical excess coverage. Claims for this segment tend to be reported and settled quickly. The segment has grown both organically, driven by innovative new product offerings, and via numerous acquisitions.

Medical stop loss (MSL), which provides protection for catastrophic losses to employers that self-fund their employee benefit plans, is the largest line in the segment. The MSL unit works exclusively on catastrophic health claims and works directly with the plan employers and plan administrators on the claims and the programs. The other large lines in this segment are HMO reinsurance, which is coverage for high-severity claims incurred by HMOs, and international travel accident coverage, which provides health insurance to travelers when they are in countries not covered by their main health insurance policies.

Table 43
HCC Insurance Holdings, Inc.
Accident & Health Segment Business Summary
(dollars in thousands)

		2009	2010
Medical Stop Loss	Net Written Premiums	633,571	654,335
	Net Earned Premiums	633,572	654,335
	Net Loss Ratio	71.6%	73.6%
Other	Net Written Premiums	110,983	107,038
	Net Earned Premiums	107,967	105,699
	Net Loss Ratio	80.5%	71.0%
Total	Net Written Premiums	744,554	761,373
	Net Earned Premiums	741,539	760,034
	Net Loss Ratio	72.9%	73.2%

Source: Company reports

The accident and health segment had a slight increase in net written premiums of 2.2% in 2010. The overall net loss ratio was steady, only increasing 0.3 points. One concern is that the medical stop loss net loss ratio increased from 71.6% to 73.6% over the past year; if this upward direction in loss ratio were to continue, it would have a big impact on earnings, as the segment is the biggest block of premiums for HCC. The overall accident and health loss ratio year-over-year comparison was helped by a decline in the other segment, which had its loss ratio decline from 80.5% to 71.0%.

U.S. Surety and Credit

HCC's surety business focuses on contract and commercial surety bonds and bail bonds. The business tends to be characterized by small limits and small premiums and overall generally has lower loss ratios, because the product is a bond that pays out to a third party rather than an insurance policy that pays out to the policyholder. However, these lower loss ratios are offset by higher expense ratios, due to higher acquisition costs, and a complex, lengthy claims process.

The credit insurance business deals primarily with export trade transactions, as well as structured trade transactions. The business tends to be large-limit and large-premium in nature, and both businesses are medium-tailed for claims settlement.

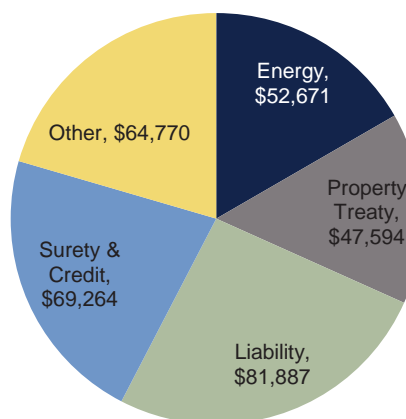
Table 44
HCC Insurance Holdings, Inc.
U.S. Surety & Credit Segment Business Summary
 (dollars in thousands)

		2009	2010
Surety	Net Written Premiums	153,479	167,764
	Net Earned Premiums	147,803	160,373
	Net Loss Ratio	22.8%	22.8%
Credit	Net Written Premiums	35,729	44,609
	Net Earned Premiums	34,824	39,535
	Net Loss Ratio	59.9%	51.5%
Total	Net Written Premiums	189,208	209,373
	Net Earned Premiums	182,627	199,908
	Net Loss Ratio	29.9%	26.5%

Source: Company reports

International

Figure 52
HCC Insurance Holdings, Inc.
International Segment Earned Premium Mix
 (dollars in thousands)



Source: Company reports

HCC's international business is composed of four major lines of business, including energy, property treaty, liability, and surety and credit, along with several other smaller lines. The energy business focuses on all facets of the energy business from exploration to refining, including offshore risks. Coverage includes physical damage, liability, business interruption, and other ancillary coverage. The energy business is medium-tailed in nature, and policies tend to be large-limit and large-premium-oriented. The property treaty business was acquired in 2009, and provides reinsurance for mainly property-and-catastrophe-related risk. Roughly 40% of the portfolio is from North America, with the balance spread internationally. Claims tend to be short-tailed, and the business is characterized by large limits and large premiums.

The liability business is centered in the United Kingdom, and includes professional indemnity, employers' liability, and public liability. The coverage tends to focus on small and midsize businesses, premiums are small, and claims tend to be long-tailed in nature. The surety and credit segment focuses on performance bonds, customs bonds, pension bonds, and environment bonds mainly in the United Kingdom and Ireland. The business tends to be midsize limits and premiums, with a short-tailed claims cycle.

Table 45
HCC Insurance Holdings, Inc.
International Segment Business Summary
(dollars in thousands)

		2009	2010
Energy	Net Written Premiums	49,435	53,063
	Net Earned Premiums	49,099	52,671
	Net Loss Ratio	25.7%	22.2%
Property Treaty	Net Written Premiums	284	59,878
	Net Earned Premiums	51	47,594
	Net Loss Ratio	0.0%	58.2%
Liability	Net Written Premiums	78,472	79,959
	Net Earned Premiums	82,137	81,887
	Net Loss Ratio	25.7%	43.3%
Surety & Credit	Net Written Premiums	68,887	64,847
	Net Earned Premiums	68,162	69,264
	Net Loss Ratio	50.9%	41.7%
Other	Net Written Premiums	55,982	66,597
	Net Earned Premiums	56,673	64,770
	Net Loss Ratio	46.1%	61.3%
Total	Net Written Premiums	253,060	324,344
	Net Earned Premiums	256,122	316,186
	Net Loss Ratio	36.9%	45.4%

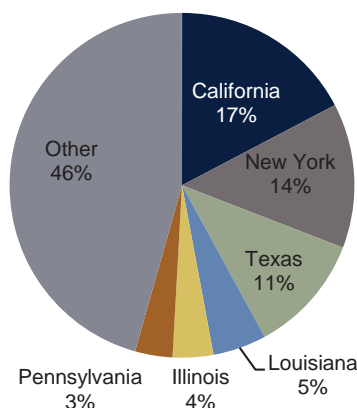
Source: Company reports

The international segment saw net written premiums increase 28% year-over-year in 2010. The net loss ratio increased from 36.9% to 45.4%. Property treaty is a new business segment that only had \$284,000 in premiums in 2009 compared with \$60 million for 2010. Property treaty had a loss ratio of 58.2% for 2010 and 126.7% for the first quarter of 2011 (\$16 million earned premium). The first quarter of 2010 also was difficult for property treaty, as it had a loss ratio of 177.0% (on \$6.8 million of earned premium). The first quarter 2011 property treaty net written premiums were \$61 million, larger than the entire 2010 year; for quarter-over-quarter comparisons, the first quarter of 2010 had \$35 million in net written premiums.

Marketing and Distribution

The company offers its products through independent agents and brokers, managing general agents (MGAs), and directly to consumers. HCC insurance subsidiaries are licensed in all 50 states, and internationally in the United Kingdom, Spain, and Ireland. The company's largest state of business is California, with written premiums for year-end 2010 accounting for 13.0%, Texas at 10.7%, and 6.2% in New York. Figure 53 details the premiums written by state in 2010.

Figure 53
HCC Insurance Holdings, Inc.
U.S. Gross Written Premium Geographic Distribution



Source: SNL

Table 46
HCC Insurance Holdings, Inc.
Earnings Model
(dollars in thousands)

	2007	2008	2009	2010	1Q'11	2Q'11E	3Q'11E	4Q'11E	2011E	2012E	2013E
Gross written premium	2,451,179	2,498,763	2,559,791	2,578,908	649,208	718,144	656,295	621,451	2,645,098	2,753,227	2,868,563
Net written premium	1,985,609	2,060,618	2,046,289	2,026,197	538,884	571,138	509,591	487,238	2,106,850	2,205,352	2,297,267
Net earned premium	1,985,086	2,007,774	2,037,235	2,041,924	508,480	519,722	524,696	526,639	2,079,538	2,171,125	2,250,862
Net investment income	206,462	164,751	191,965	203,819	51,595	51,714	52,703	53,890	209,902	220,020	226,712
<i>% yield</i>			3.6%	3.6%	3.6%	3.6%	3.6%	3.6%	3.5%	3.6%	3.6%
Other operating income	96,780	57,214	82,669	44,832	7,321	9,374	7,888	9,797	34,380	34,380	34,380
<i>% change</i>		-40.9%	44.5%	-45.8%	-59.2%	0.0%	0.0%	0.0%	-23.3%	0.0%	0.0%
Total revenue	2,288,328	2,229,739	2,311,869	2,290,575	567,396	580,810	585,287	590,326	2,323,819	2,425,524	2,511,953
Loss and loss adjustment expense, net	1,183,947	1,211,873	1,215,759	1,213,029	347,586	313,945	304,048	308,415	1,273,994	1,324,312	1,405,078
<i>% loss ratio</i>	59.6%	60.4%	59.7%	59.4%	68.4%	60.4%	57.9%	58.6%	61.3%	61.0%	62.4%
Policy acquisition costs, net	279,753	303,816	308,554	322,046	83,378	83,954	82,082	82,612	332,026	346,653	359,396
<i>% policy acquisition cost ratio</i>	14.1%	15.1%	15.1%	15.8%	16.4%	16.2%	15.6%	15.7%	16.0%	16.0%	16.0%
Other operating expense	241,642	233,509	259,488	256,004	64,312	64,161	61,774	68,235	258,482	269,875	279,809
<i>% other operating expense ratio</i>	12.2%	11.6%	12.7%	12.5%	12.6%	12.3%	11.8%	13.0%	12.4%	12.4%	12.4%
Interest expense	10,304	16,288	16,164	21,348	5,553	5,237	5,280	5,441	21,511	21,511	21,511
Total expense	1,715,646	1,765,486	1,799,965	1,812,427	500,829	467,298	453,185	464,702	1,886,014	1,962,352	2,065,795
Operating earnings before income tax expense	572,682	464,253	511,904	478,148	66,567	113,512	132,102	125,624	437,805	463,173	446,158
Income tax expense	185,825	141,323	162,357	140,643	17,180	35,756	41,612	39,572	134,120	145,899	140,540
<i>Tax rate</i>	32.4%	30.4%	31.7%	29.4%	25.8%	31.5%	31.5%	31.5%	30.6%	31.5%	31.5%
Operating earnings	386,857	322,930	349,547	337,505	49,387	77,756	90,490	86,052	303,685	317,273	305,618
Operating earnings per share	\$3.31	\$2.80	\$3.09	\$2.96	\$0.43	\$0.68	\$0.79	\$0.75	\$2.66	\$2.78	\$2.68
<i>% change</i>		-15.4%	10.5%	-4.3%	-27.8%	-4.9%	-2.2%	-9.1%	-10.0%	4.5%	-3.7%
Realized investment gains net of tax	8,572	-18,162	7,849	7,868	-363	1,950	1,950	1,950	5,487	7,800	7,800
OTT impairment credit losses net of tax			-3,529	-276	-2,034	0	0	0	-2,034	0	0
Net earnings	395,429	304,768	353,868	345,096	46,990	79,706	92,440	88,002	307,138	325,073	313,418
Net earnings per share	\$3.38	\$2.64	\$3.13	\$3.02	\$0.41	\$0.70	\$0.81	\$0.77	\$2.69	\$2.85	\$2.75
Basic average shares outstanding (millions)	112.9	114.8	112.2	113.9	113.8	113.8	113.8	113.8	113.8	113.8	113.8
Diluted average shares outstanding (millions)	117.0	115.5	113.1	114.1	114.1	114.1	114.1	114.1	114.1	114.1	114.1
Cash dividends per share	0.42	0.47	0.520	0.560	0.145	0.145	0.145	0.145	0.580	0.600	0.640
Operating ROE		12.7%	12.3%	10.6%	6.0%	9.3%	10.6%	9.9%	9.0%	8.7%	7.8%
Book value per average diluted share	20.86	22.86	26.80	28.89	28.99	29.55	30.21	30.84	30.84	33.09	35.20
GAAP net loss ratio	59.6%	60.4%	59.7%	59.4%	68.4%						
GAAP net expense ratio	23.8%	25.0%	24.3%	25.2%	26.3%						
GAAP combined ratio	83.4%	85.4%	84.0%	84.6%	94.7%						
Paid loss ratio	47.9%	58.1%	55.8%	59.7%	58.4%						
Accident year loss ratio	60.9%	64.5%	62.3%	60.4%	66.6%						
Accident year combined ratio	84.7%	89.5%	86.6%	85.6%	92.9%						

Sources: Company reports and William Blair & Company, L.L.C. estimates

Management

John N. Molbeck, Jr., Chief Executive Officer

Mr. Molbeck has been chief executive officer of HCC Insurance Holdings since May 2009, and also served as president of the company until May of this year. Prior to this, he served as chief operating officer of HCC Insurance Holdings from 2006 to May 2009 and also from 1997 to 2002. He was the chief executive officer of Jardine Lloyd Thompson LLC from 2003 to 2005.

Robert A. Rosholt, Chairman

Mr. Rosholt has been the chairman of the board of HCC Insurance Holdings, Inc. since May 2011. He also served as a member of the board of directors for Abercrombie & Fitch from June 2008 to September 2010. Prior to his retirement in 2008, he had served as the chief financial officer for Nationwide Mutual Insurance Company since 2002. Mr. Rosholt worked as the executive vice president and chief of operations at the risk services unit of Aon Corporation from 2000 to 2002. Before joining Aon Corporation, Mr. Rosholt served as chief financial officer at First Chicago Corporation and its successor companies, including Bank One, from 1974 to 2000.

Christopher J.B. Williams, President

Mr. Williams was appointed president of HCC as of May 2011, and has been a member of the board of directors since May 2007. From 1992 to 2005, he was the national director for life, accident & health at Willis Re. Prior to this, he had various roles at insurance brokers and underwriters in the property and casualty, accident and health, sport disability, and medical stop loss business lines. He started his career in 1975 at an Australia-based property-and-casualty insurance broker.

W. Tobin Whamond, Executive Vice President and Chief Operating Officer

Mr. Whamond has held his current position of executive vice president since May 2009 and has been the COO since August 2010. He served as the chief financial officer of HCC from August 2009 to 2010. Before joining HCC, he worked in various roles at Wachovia Capital Markets, LLC from 2002 to March 2009, including managing director of mergers and acquisitions, and head of financial institutions M&A. He worked in the investment banking division of Goldman Sachs & Co. from 1993 to 2002, CS First Boston Corp. from 1990 to 1993, and Drexel Burnham Lambert, Inc. from 1988 to 1990.

Brad T. Irick, Executive Vice President and Chief Financial Officer

Mr. Irick has served as executive vice president of HCC since May 2010 and CFO since August 2010. Previously, he worked for PricewaterhouseCoopers LLC for 18 years, where he served as audit and advisory partner for several multinational public insurance company clients. Mr. Irick began his career as an accountant at KPMG.

Randy D. Rinicella, Senior Vice President and General Counsel

Mr. Rinicella has served as senior vice president, general counsel, and secretary of HCC since 2007. Before this, he was vice president, general counsel, and secretary of Dresser-Rand Group, Inc. from 2005 to 2007.

RLI Corp.

Initiating Coverage With a Market Perform Rating

Top-tier specialty P&C insurer. RLI Corp. (RLI) functions as a specialty property-and-casualty (P&C) insurance holding company that underwrites and sells niche commercial insurance products across property, casualty, and surety business lines. RLI should continue to be one of the top-performing niche P&C insurers over the long term. RLI has grown book value by 14% annually over the last decade.

Highly profitable underwriter. The company has created a competitive advantage through the development of a performance-based compensation program that attractively awards underwriting profitability for product managers. The model attracts experienced entrepreneurs with good books of business and essentially locks them up for several years due to the staged payout structure. The company has had a combined ratio well below 100 for the past 15 years, and has beaten commercial competitors by an average of 15 margin points over that time frame.

Upside to earnings possible. We forecast operating earnings per share to be to \$4.19 in 2011, \$4.40 in 2012, and \$4.61 in 2013; however, this could be conservative, depending on how reserves develop over the next two years. Our estimates assume return on equity around 11%, and that book value per share will grow from \$37 to \$44 over the next three years. Organic premium growth could exceed our estimates, particularly with the recent Contractors Bonding and Insurance Company (CBIC) acquisition.

Cash flow valuation reasonable, but not attractive. RLI is currently trading at 10.6 times its current price to four-year cash flow. While slightly above its historical median trading average, the stock looks like a relative value compared with its peer group. However, current valuation levels suggest that upside will likely be limited in the near term.

Risks include a continued deterioration in the loss ratio, catastrophe exposure and a continued economic slowdown. Rising severity in the casualty business, combined with downward pressure on pricing, has created an increasingly difficult environment for profitably underwriting new business in the segment. The loss ratio has increased each year since 2007, and we are projecting that trend to continue through 2013. RLI also has significant catastrophe exposure for wind and quake, which could cause some short-term pain if it gets hit with a major event. There is some additional downside risk through 2013, as economic conditions continue to be a source of slowing premium growth. However, management has a long and successful track record of maintaining underwriting profitability, and we believe the company can successfully expand its product offerings to mitigate any declines from a weak economy.

RLI Corp. is a top-tier specialty insurance holding company that underwrites and sells niche commercial insurance products across property, casualty, and surety business lines.

Financial | Property & Casualty Insurance

Stock Rating: **Market Perform**
Company Profile: **Core Growth**

Symbol: RLI (NYSE)
Price: \$61.92 (52-Wk.: \$51-\$62)
Market Value (mil.): \$1,292
Fiscal Year End: December
Long-Term EPS Growth Rate: 15%
Dividend Yield: 2.0%

Estimates	2010A	2011E	2012E
EPS	\$5.29	\$4.19	\$4.40
BVPS	\$37.26	\$39.46	\$41.46
CFPS	\$4.78	\$6.64	\$5.70
ROE	13.8%	10.9%	10.9%

Valuation

FY P/E	11.7x	14.8x	14.1x
FY P/B	1.7x	1.6x	1.5x
P/CF (4-yr)	10.7x	10.6x	NA

Trading Data

Shares Outstanding (mil.)	21.1
Float (mil.)	14.5
Average Daily Volume (thous.)	75.4

Introduction

We are initiating coverage of RLI Corp. with a Market Perform rating and Core Growth company profile. RLI should continue to be one of the top-performing niche P&C insurers over the long term with a diverse book of business and better-than-average underwriting performance. Over the past 15 years, the company has maintained a combined ratio under 100 and has beaten competitors by nearly 15 margin points over that time period. During the last decade, the company has grown book value by 14% annually. While we believe exposure to the commercial underwriting cycle should depress returns below historical levels in the near term, we are confident in RLI's ability to maintain good underwriting margins and continue its strong performance in appropriately selecting risk. Based on our cash flow valuation metric, we believe RLI remains reasonably priced, but not attractive, at 10.6 times price to four-year average operating cash flow. In general, we believe this stock is safer than peers, but upside will likely be limited by a challenging operating environment.

Investment Highlights

Unique Management Incentive Structure

RLI operates on a decentralized basis with managers of separate business/product lines having significant incentives to produce a high level of long-term profitability. Each business is effectively run as a separate niche. The company operates mainly in the excess and surplus (E&S) market, which comprises dozens of small niche markets. The core business lines or profit centers include transportation, professional services, executive products, casualty brokerage, reinsurance, West Coast property, marine, E&S property, and surety.

Product Line	Manager	Location	Years of Industry Experience
CASUALTY			
RLI Executive Products Group	Chad S. Berberich	Dallas, TX	14
RLI Transportation	David A. Dunn	Atlanta, GA	34
RLI Specialty Markets (Personal and Commercial Markets)	Richard W. Quehl	Peoria, IL	41
Casualty Brokerage	Paul J. Simoneau	Glastonbury, CT	33
RLI Professional Services Group	L. Leonard Waldhauser IV	Philadelphia, PA	17
PROPERTY			
RLI Re	J. Kevin Brawley	Stamford, CT	33
West Coast Property	Kevin McDonough	Los Angeles, CA	29
RLI Marine	Robert J. Schauer	New York, NY	23
E&S Property	Jeffrey S. Wefer	Chicago, IL	39
SURETY			
Surety	Roy C. Die	Houston, TX	23
Surety	David C. Sandoz	Peoria, IL	34

Source: SNL

The compensation system is similar to an investment bank in that it treats business generators as partners in the profits of the firm. Product line managers and underwriters get a share of the profits from their respective product line. These profit-sharing arrangements comprise a significant amount of—if not the majority of—compensation; they vary by product but are long term in nature and have a significant retention component.

Business leaders of each individual niche are incented to produce long-term profitability. On average, up to 80% of compensation for business heads is related to incentive compensation, based mainly on the performance of their individual division. The key metric is

combined ratio. Compensation is not based on the current level, but rather on an average of four to eight years. This is important because most commercial insurance products take from two to five years to show actual profitability.

The profits-sharing system has several distinct advantages. The model attracts experienced entrepreneurs with good books of business. Excess and surplus lines are heavily dependent on distribution and carrier relationships, and therefore seasoned managers with relationships are particularly important. The compensation structure also serves as both a talent filtering and a retention mechanism. Underwriters that lack confidence in their abilities to profitably underwrite business or who are not thinking about their books on a long-term horizon will not view the incentive structure as attractive and are less likely to join the firm. Once at the firm, the bonuses are paid out partly on an annual basis as a percentage of the total profitability, and the bonuses scale up over time as the manager becomes more established. Bonuses continue to be paid out after retirement but only if an underwriter does not leave the firm. In essence, underwriters with large and successful books of business are tied to the firm because they would be leaving too much money on the table to move to a different firm.

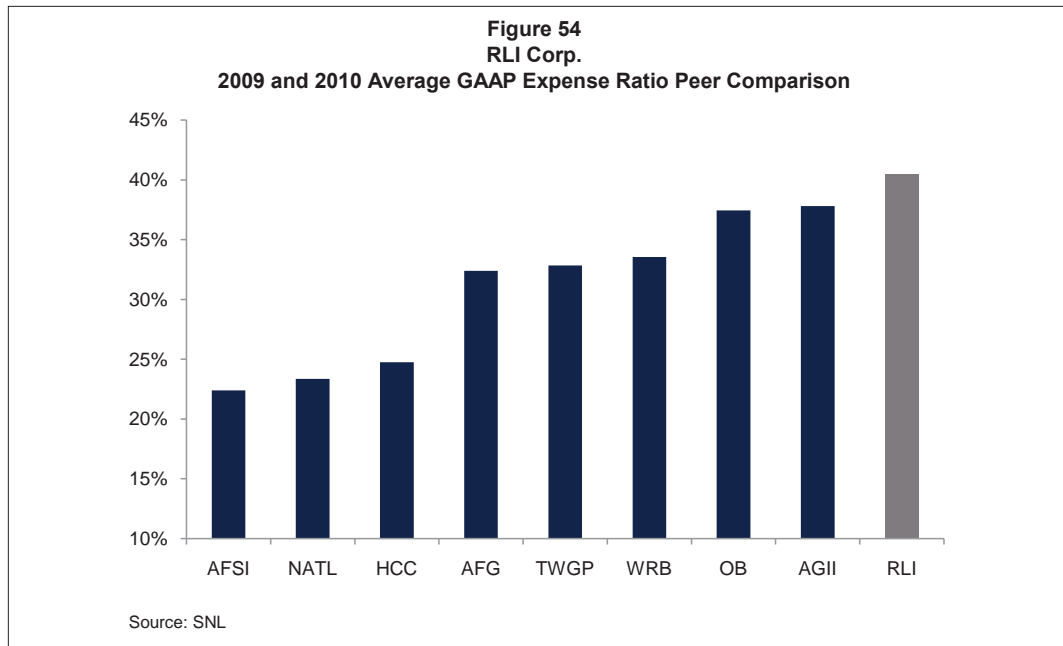
The system appears to be one of the driving factors in above-average profitability. Table 48 shows that RLI has not only exhibited better-than-industry-average profitability, but has materially outperformed other E&S insurers. The company's average combined ratio has beaten similar competitors by 15% over the past 15 years. In a true test, the gap between RLI and peers has actually widened as the market has deteriorated over the last several years.

Table 48
RLI Corp.
GAAP Combined Ratio Comparison

Company	2006	2007	2008	2009	2010	Average
AmTrust Financial Services, Inc.	91.9	83.2	74.4	79.8	85.3	82.9
HCC Insurance Holdings, Inc.	84.2	83.4	85.4	84.0	84.6	84.3
Tower Group, Inc.	87.6	83.7	82.4	88.3	93.7	87.1
OneBeacon Insurance	97.4	92.8	94.6	94.0	100.7	95.9
National Interstate Corporation	82.5	80.9	89.4	84.8	94.2	86.4
Selective Insurance Group	96.1	98.9	100.0	99.8	101.6	99.3
The Hanover Insurance Group	96.7	93.9	98.0	98.2	100.1	97.4
W.R. Berkley Corporation	88.0	88.1	93.1	94.2	94.5	91.6
RLI Corp.	84.1	71.4	84.2	82.3	80.7	80.5
Group Average	89.8	86.3	89.1	89.5	92.8	89.5

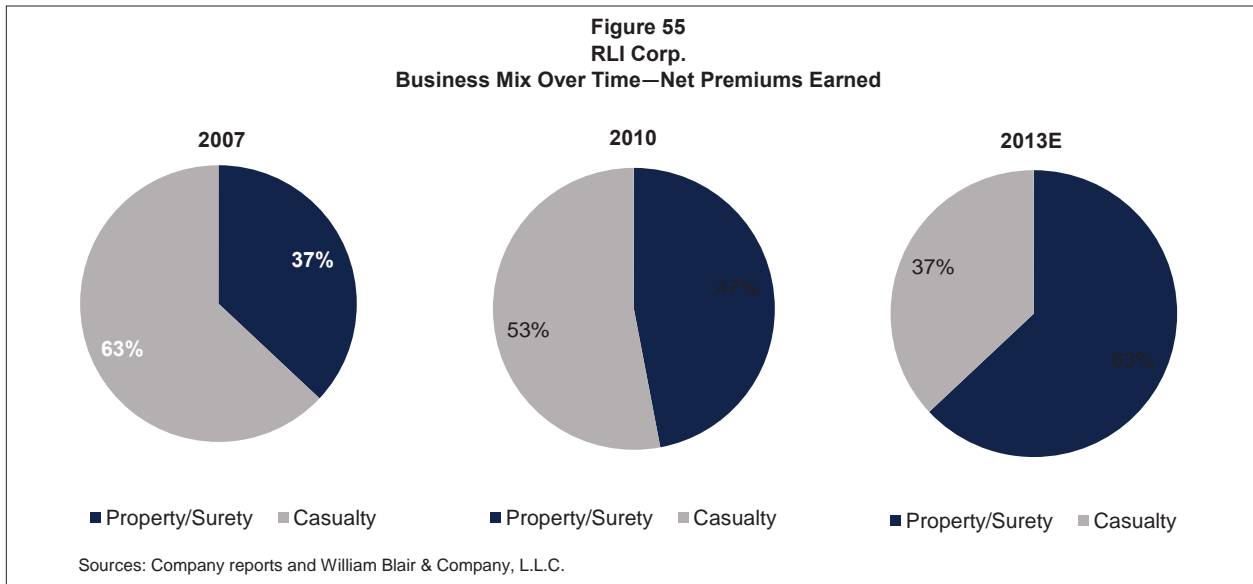
Source: SNL

Relatively high expense ratios are reflective of the compensation structure as well. Expense ratios have been among the highest of the specialty commercial insurers for the last several years, and we do not expect that to change. High expenses have not been a problem in the past, as shown in the combined ratio table. If loss ratios were to increase due to pricing pressure, catastrophe losses, or less-successful risk selection, there could be some pressure on overall combined ratios. But the incentive structure is such that rising loss ratios would yield a similar and somewhat offsetting drop in the compensation ratio, as managers would receive much smaller bonuses.



Higher-Than-Average Property/Surety Book Provides Insulation to Commercial Pricing Cycle

RLI runs a diversified underwriting platform that has lower-than-average exposure to the deeply cyclical, long-tailed casualty lines. Non-commodity property and a good-size surety book comprise 47% of premiums. In contrast, the most-commercial insurance operations have a far higher proportion of their premiums in casualty-related lines. In addition, the property and surety books are growing fairly rapidly, while the casualty book has been shrinking for the last few years, which has helped mitigate some of the concerns over an increasing loss ratio in the casualty business.



Even within the property-oriented areas, the company focuses on niche areas of expertise. RLI has good-size positions in unique markets, including commercial difference in condition, crop insurance, and specialized reinsurance (mining, power generation, and other lines that require technical expertise). The surety book is also niche-oriented, with a focus in energy and petrochemical areas. A major advantage of having a short-tail property orientation is

that results are more visible than long-tailed lines (i.e., actual results are realized more quickly). This characteristic greatly increases the ability to control and accurately set pricing and reserves.

Casualty lines represent only 53% of net earned premium mix in 2010, and there are no workers' compensation lines and only a small professional liability business. Casualty lines tend to exhibit a higher level of volatility throughout cycles and have relatively long liability tails, which means it takes a long time (up to 5 to 10 years) to see the true profitability of business. As a result, lines such as medical malpractice, workers' compensation, and excess liability are often mispriced. The industry tends to overshoot in a hard market and undershoot in a soft market. Given that we are on the seventh year of a soft market, the likelihood of deep casualty lines being underpriced is high. RLI's relatively low level of casualty exposure, particularly in the above mentioned products, should result in modest outperformance of the typical commercial insurer as casualty loss ratios are likely to continue to deteriorate over the next several years.

Superior Underwriting Results

The unique management structure, property orientation, and overall underwriting discipline has translated into one of the best underwriting track records among peer specialized competitors. RLI is one of the few public commercial insurers that has not had a combined ratio over 100 in the last 15 years, primarily due to below-average loss ratios. Importantly, combined ratios have actually declined in recent years, while specialty peers have moved up. Reserve redundancies have helped, but even core accident-year loss ratios are showing less deterioration than peer companies. We expect accident-year loss ratios to continue to hold up better than peers, helped by a shift of the overall book of business away from the casualty market. Our forecast calls for loss ratios to remain far below the sector average for the next two years.

Table 49
RLI Corp.
GAAP Loss Ratio Comparison

Company	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
AmTrust Financial Services, Inc.						41.6	52.9	67.5	65.0	65.7	63.9	62.4	54.3	57.1	63.2
HCC Insurance Holdings, Inc.		59.4	63.8	77.6	74.2	78	60.6	66.2	63.8	67.1	59.2	59.6	60.4	59.7	59.4
Tower Group, Inc.				77.1	79.4	76.6	62.9	65.7	59.4	58.8	60.3	55.2	51.7	55.6	60.7
OneBeacon Insurance									66.4	69.1	61.8	58.2	59.9	57.3	62.5
National Interstate Corporation						72.7	63	54.4	58.6	60.4	59.6	58.0	64.7	60.8	71.5
Selective Insurance Group	NA	68.2	70.2	74.1	74.8	74.3	72.3	70.5	65.7	63.9	64.0	65.9	67.3	67.9	69.3
The Hanover Insurance Group									69.1	73.8	62.4	61.1	65.4	64.3	65.4
W.R. Berkley Corporation		66.1	71.6	76.8	73.4	82.1	65	63.4	63.0	62.4	61.0	59.6	62.7	61.4	60.2
RLI Corp.	52.2	43.2	45.4	49.4	53.8	57.1	58.4	60.2	59.9	51.1	48.4	35.1	46.7	41.3	40.8
Group Average		59.2	62.8	71.0	71.1	68.9	62.2	64.0	63.4	63.6	60.1	57.2	59.2	58.4	61.4

Source: SNL

Better-Than-Average Cash Flow Trends Translate Into Stable Return on Equity

We expect RLI to exhibit superior cash flow trends in the next two to three years. We expect cash flow to decline by an average of 20% to 35% for commercial insurers over the next two years. In contrast, we expect RLI to be relatively flat, based on property and niche underwriting. To date, operating cash flow per share has only decreased 17% from 2007 to 2010, compared with the group decline of 24%.

Our forecast suggests operating cash flow per share will go from \$4.78 in 2010 to \$5.70 in 2012. The key to our forecast is that we expect moderate organic growth in net premiums earned over the next few years, averaging 5%. Importantly, we assume that paid losses only increase from 39% to 43% of premiums. In contrast, we expect paid losses for the industry to rise at a somewhat faster rate over the next several years.

Table 50
RLI Corp.
Statutory Incremental Paid Loss Ratio Projections

Accident Year	12 Months	24 Months	36 Months	48 Months	60 Months	72 Months	84 Months	96 Months	108 Months	120 Months
2001	11.5%	10.4%	8.1%	7.2%	4.4%	2.9%	3.1%	0.8%	0.6%	0.5%
2002	8.2%	8.6%	9.8%	6.4%	3.5%	2.5%	2.0%	0.7%	0.1%	0.4%
2003	7.5%	7.8%	5.5%	5.2%	3.8%	2.8%	1.3%	0.5%	0.3%	0.3%
2004	6.3%	8.4%	7.3%	6.3%	3.4%	2.0%	0.9%	0.5%	0.3%	0.3%
2005	6.7%	8.7%	5.5%	5.6%	3.4%	2.5%	1.5%	0.5%	0.3%	
2006	7.6%	7.2%	5.4%	4.8%	2.4%	2.2%	1.4%	0.5%		
2007	7.1%	7.6%	5.7%	4.9%	3.0%	4.7%	4.0%			
2008	8.0%	8.8%	5.6%	5.8%	5.9%	3.0%				
2009	7.1%	6.4%	6.5%	6.0%	6.0%					
2010	7.6%	8.9%	5.5%	6.0%						
2011E	7.5%	9.0%	5.5%							
2012E	7.5%	9.5%								
2013E	7.5%									

Sources: SNL and William Blair & Company, L.L.C.

Solid forecasts for cash flow suggest that return on equity should remain relatively stable. We expect return on equity to decline slightly to 11%, whereas we expect most commercial insurers' returns on equity to go down well below 10% by 2012. RLI has a higher probability of maintaining returns, based on its product mix and incentive system. The ability to maintain a combined ratio below 90%, through a performance-based compensation structure and a conservative underwriting philosophy, helps stabilize return on equity even during tough market environments. The other key factor aiding stability is a disciplined capital management system. Despite the company maintaining an "A+" rating from A.M. Best (higher than average), RLI continually modulates its capital base with healthy dividend and occasional share-buyback programs. Premium leverage has stayed at less than 1:1, despite premium growth being under pressure. Premiums written are down 14% between 2007 and 2010.

Table 51
RLI Corp.
Cash Flow Model 2009-2012
(dollars in thousands except per share data)

Line Item	2009	2010	2011E	2012E
Net Written Premiums	469,916	485,140	534,059	563,842
Paid Loss	202,347	191,620	212,443	237,868
<i>Paid Losses as % of Earned Premium</i>	<i>41.1%</i>	<i>38.8%</i>	<i>42.5%</i>	<i>43.1%</i>
Underwriting & Other Expense	209,729	204,653	205,255	228,631
Interest Expense	6,050	6,050	6,050	6,050
Net Investment Income	67,346	66,799	65,851	68,929
Depreciation and Amortization	3,284	3,037	3,037	3,037
Taxes	38,592	51,058	47,940	52,111
Core Operating Cash Flow	83,828	101,595	131,260	111,148
Total Cash Flow Per Share	\$3.94	\$4.85	\$6.17	\$5.22
Total Cash Flow Adjustments	43,931	-1,360	10,158	10,158
Total Cash Flow	127,759	100,235	141,418	121,306
Total Cash Flow Per Share	\$6.01	\$4.78	\$6.64	\$5.70
Average Shares Outstanding (thousands)	21,265	20,965	21,285	21,285
Average Operating ROE	13%	14%	11%	11%

Sources: SNL, company reports, and William Blair & Company, L.L.C.

Major Risks

Catastrophe Exposure

RLI has significant exposure on its property book to both wind and quake catastrophes. While this poses some risk to earnings and can definitely cause increased variability in future earnings periods, RLI has again been fairly conservative in its risk-taking. For both wind and quake, its maximum up-front exposures are the first \$25 million of claims, up to a maximum of roughly \$50 million-\$60 million, if the full loss layer of reinsurance is covered (typically up to \$325 million for a single event). While that could pose a risk to earnings, the full \$50 million would only be roughly half of projected annual earnings before taxes, so it is a manageable risk for the company.

Deteriorating Casualty Accident-Year Loss Trend

The good news is that RLI has trimmed casualty exposure by one-third in recent years, which have been poor underwriting years on a historical basis. The bad news is that general liability comprises 62% of total company reserves. On an industrywide basis, the market has deteriorated significantly due to material price competition. RLI has done better than average, but still general liability loss per accident year at 36 months has increased from 10.8% in 2005 to 14.5% in 2008. Recent movement in paid loss ratio suggests that this is not ending anytime soon. We forecast that casualty-line loss ratios will increase by an additional 5% to 10% over the next two years.

Table 52
RLI Corp.
Paid Loss Ratios (%) by Accident Year—Other Liability: Occurance
Paid Losses (Schedule P, Part 3)/Net Premiums Earned (Schedule P, Part 1)

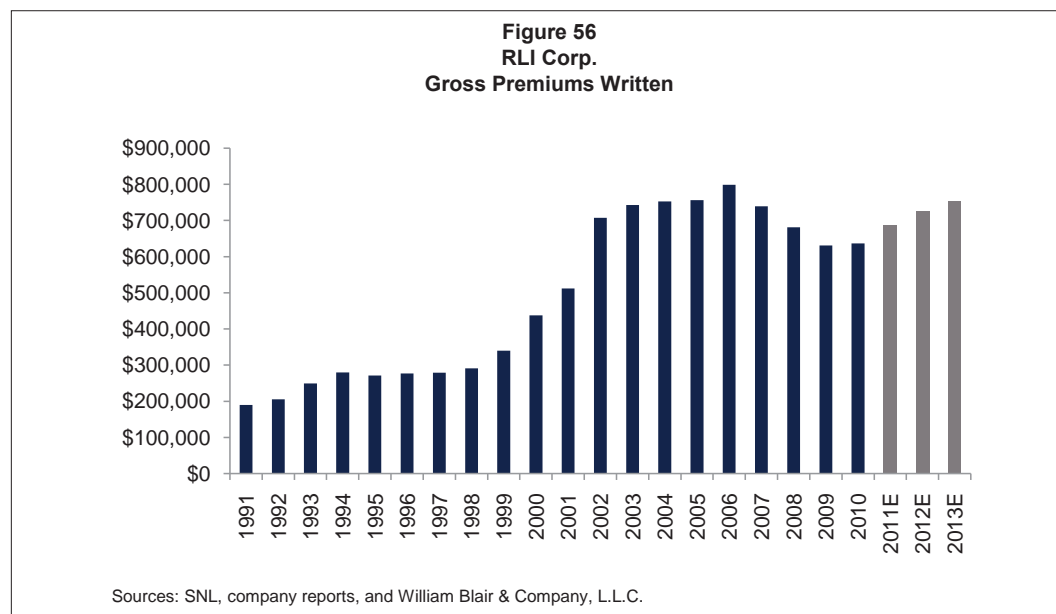
Accident Year	12 Months	24 Months	36 Months	48 Months	60 Months	72 Months	84 Months	96 Months	108 Months	120 Months
2001	2.58	9.20	17.56	28.33	35.73	42.91	49.97	52.39	54.03	55.27
2002	4.01	11.64	22.94	32.16	37.91	42.77	45.16	47.01	47.72	
2003	1.20	6.49	14.54	23.03	29.16	33.13	34.95	36.02		
2004	1.34	7.76	16.50	25.81	31.65	35.05	36.73			
2005	0.42	4.37	10.84	17.00	21.39	24.47				
2006	0.82	5.89	11.99	19.08	23.18					
2007	1.69	8.83	15.68	22.96						
2008	1.18	6.15	14.55							
2009	1.53	7.81								
2010	1.07									

Source: SNL

Key Factors to Watch

Top-Line Growth Has Slowed

RLI has historically been one of the higher-growth companies in the specialty commercial P&C insurance industry. Gross premiums written increased from \$190 million to \$438 million from 1991 to 2000, and then peaked at \$800 million in 2006. Gross premiums written have since fallen to \$636 million in 2010. We believe that trend will begin reversing in 2011, particularly with the acquisition of CBIC's book, and we are projecting that written premiums will grow to \$755 million by 2013. The rate of growth has slowed materially since the market began to soften in 2005 and 2006, and has fallen steadily with the decline in economic activity and insurance exposures over the last few years.



Premiums have declined an average of 5% per year from 2006 to 2010, compared with an average growth rate of 8% for peer competitors. The decline in premiums illustrates the company's disciplined risk selection process, as we expect 2007 to 2010 to potentially be the worst accident years of the current downcycle.

Table 53
RLI Corp.
Gross Premiums Written—Annual Percentage Change

Ticker	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	Average
THG	4%	-1%	-3%	0%	-2%	7%	4%	1%	6%	16%	3%
TWGP	129%	79%	26%	32%	69%	44%	21%	21%	69%	40%	53%
SIGI	10%	15%	16%	10%	7%	5%	3%	-2%	-3%	-1%	6%
OB					3%	-6%	-10%	6%	-4%	-23%	-6%
HCC	4%	15%	50%	14%	3%	10%	10%	2%	2%	1%	11%
WRB	22%	45%	32%	11%	8%	4%	-4%	-11%	-6%	4%	10%
NATL		24%	54%	20%	20%	13%	13%	10%	-9%	27%	19%
AFSI		106%	254%	116%	36%	84%	60%	32%	8%	30%	81%
RLI	17%	38%	5%	1%	0%	6%	-7%	-8%	-7%	1%	5%
Peer Average	31%	40%	54%	26%	16%	18%	10%	6%	6%	11%	20%

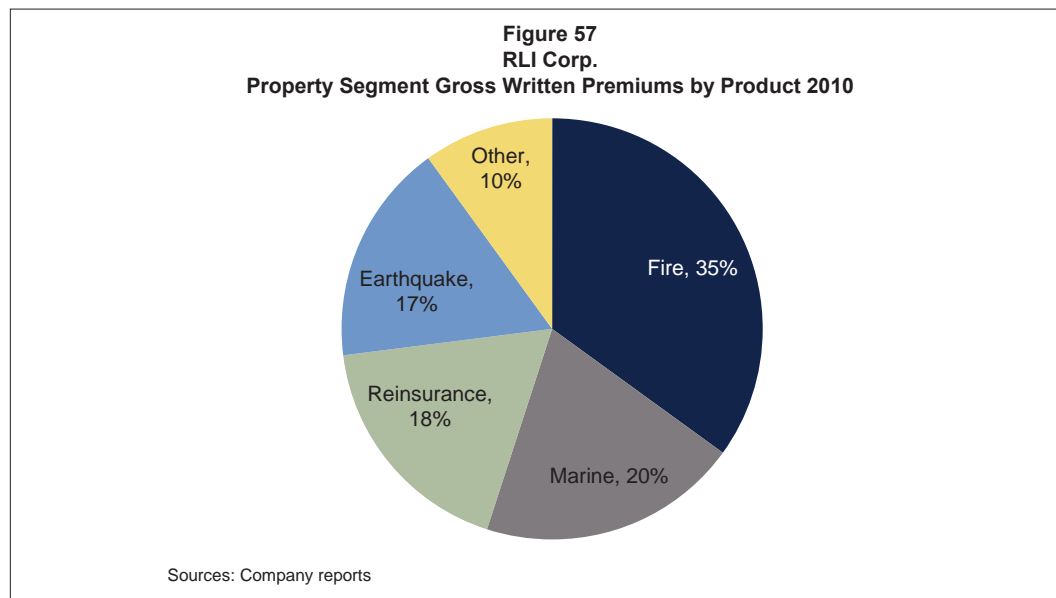
Sources: SNL

Expansion efforts and new product initiatives—particularly in the property and surety segments—have helped to mitigate some of the premium declines in the casualty segment. New product initiatives created over the last three years added more than \$75 million in gross premiums written during 2010. These new products include liability programs specifically targeted at architects and engineers, property facultative reinsurance, and crop reinsurance. In addition, the acquisition of Contractors Bonding and Insurance Corporation (CBIC) in April 2011 should begin hitting the income statement during the second quarter. The company had gross written premiums of \$61 million in 2010. In addition, the acquisition gives RLI the opportunity to leverage both an expanded distribution on the West Coast and CBIC’s packaged product approach to sales to greatly expand its historical surety business.

We would like written premiums to start to pick up over the next few years, and we expect management to be able to continue to do this through acquisitions of new teams and expanding into new product types. Any improvement in the economy or a turn in the pricing cycle should also provide a large boost to top-line growth in the coming years.

Improving Earthquake and Energy Market

Recent catastrophic activity has the potential to improve rates and profitability in the company’s earthquake and energy lines. The company has begun to observe an increase in interest in quake insurance, particularly in California, but that has yet to transition into increased demand. Loss volatility could increase demand and potentially market pricing within this sector of property insurance. Earthquake and energy are roughly 40% of the premiums for the property segment, but can provide a much more substantial contribution to overall corporate profitability, given that they only sustain losses in the event of a quake. These markets should continue to be highly profitable over time and could augment returns over the next several years.



Conservative Reserves

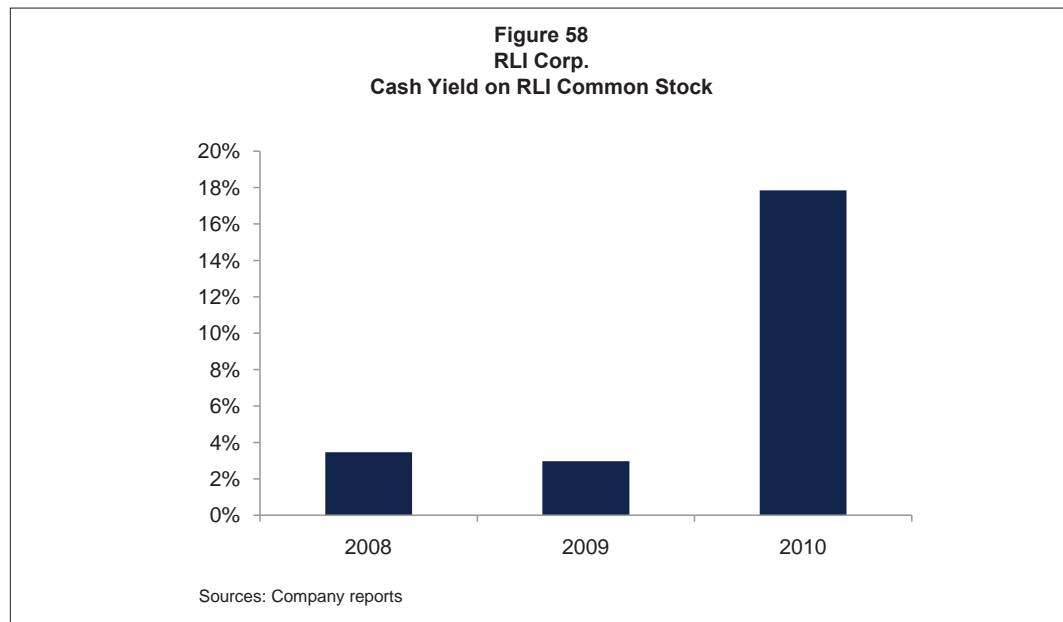
RLI has historically run one of the most-conservative balance sheets in the sector. Reserves are typically materially redundant and the capital base is more than \$800 million. Developments averaged 5% in 1999-2002, which is 10% better than overall industry development during the last downcycle. Favorable development has averaged 6% to 10% over the last several years, which we expect to decline slightly. More than 90% of the reserve base is dedicated to casualty lines, which we believe continue to be slightly over-reserved. Our analysis shows that RLI’s reserves are about 5% redundant going forward.

Capital Management

The company has been efficient at returning excess capital to shareholders over the last several years, returning more than \$560 million since 2005. Premium to surplus is below capacity, indicative of the firm’s conservative underwriting philosophy and key to maintaining its “A+” credit rating. We estimate that the company may have \$250 million to \$300 million in excess capital, given the current underwriting leverage (net written premiums to shareholders’ equity) of 0.6 times.

The company has paid a dividend for 35 consecutive years, and the dividend has grown substantially each of the last five years. In addition, a \$7 special cash dividend was paid out in 2010. The firm’s policy is to typically maintain a level of cash that adequately sustains operations and provides a cushion to invest in future growth opportunities. Management suggested specifically that it was maintaining additional cash reserves, as it wants to leverage the inflection point when the cycle begins to turn over the coming years.

We believe the company will likely continue to return capital in the form of dividends and/or could do acquisitions as a weakening market may present opportunities. Share buybacks do not appear especially attractive at current valuation levels, and dividends—and potentially special dividends—will probably be the most likely method to return cash to shareholders. Our forecast assumes that dividends will increase by 7% over the next three years, and there is a good chance that another special dividend could be issued to help manage excess capital.



RLI has historically not been an acquirer, but small deals are possible in the future. CBIC surety, which was acquired in April 2011, helps augment the surety practice with an additional \$60 million in annualized premium. We would not be surprised if several similar small deals were made, ideally with companies that have a great cultural fit with RLI.

Financial Projections

Table 54
RLI Corp.
Premium Flows and Key Ratios
(dollars in thousands)

	2008	2009	2010	2011E	2012E
Net Premiums Earned	\$528,764	\$491,961	\$493,382	\$499,827	\$551,697
Other Revenue	\$78,986	\$67,346	\$66,799	\$65,851	\$68,929
Total Underwriting Revenues	\$607,750	\$559,307	\$560,181	\$565,678	\$620,626
Revenue Growth	-2.5%	-8.0%	0.2%	1.0%	9.7%
Calendar-Year Loss Ratio	46.7%	41.3%	40.8%	44.9%	45.3%
Expense Ratio	37.5%	41.0%	39.9%	41.1%	41.4%
Combined Ratio	84.3%	82.4%	80.7%	86.0%	86.8%
Operating EPS	\$4.99	\$4.70	\$5.29	\$4.19	\$4.40
EPS Growth	-25.6%	-5.8%	12.5%	-20.7%	5.0%
Cash Flow Per Share	\$7.51	\$6.01	\$4.78	\$6.64	\$5.70
Operating ROAE	14.7%	13.3%	13.8%	10.9%	10.9%
Book Value Per Share	\$32.41	\$38.30	\$37.26	\$39.46	\$41.46

Sources: Company reports and William Blair & Company, L.L.C.

Summary

We forecast earnings per share to be to \$4.19 in 2011, \$4.40 in 2012, and \$4.61 in 2013; however, this could be conservative, depending on how reserves develop over the next two years. Estimates are extremely sensitive to positive reserve development, which we believe will decline by roughly 20% per year on an absolute basis through 2013. We estimate ROE to be around 11% and book value per share to grow from \$37 to \$44 over the next three years. We believe top-line growth will mainly be organic, especially as RLI ramps up underwriting in the surety segment by further leveraging the CBIC acquisition. We are estimating 5% annual growth in premiums earned over the next three years, with the majority coming in 2012 and 2013.

Upside/Downside Potential

A turn in the pricing cycle would be the biggest source of upside compared with our estimates. Our estimates currently assume continued pressure on pricing, as there have been no convincing signs of a turn in the cycle and we currently estimate 2013 to be a more likely time for the beginning of a hard cycle. A successful utilization of excess capital could also help ROE and increase EPS above our current estimates. From a downside perspective, the biggest risks to earnings are further increases in the loss ratio, particularly in the casualty segment, and an even more-exaggerated decline in reserve development during 2011 or 2012.

Key Earnings Factors

Premiums growth. We expect gross premiums written to increase by an average of 6% annually over the next three years. This forecast begins to reverse the recent trend in declining premiums that has occurred since 2006. Our forecast exceeds the expected sector average of 0% to 5% growth in premiums. Growth should be due to the recent acquisition of CBIC and the organic growth in the property and surety segments. Our expectation is that the casualty segment will be relatively flat over the next two years, as these markets remain competitive.

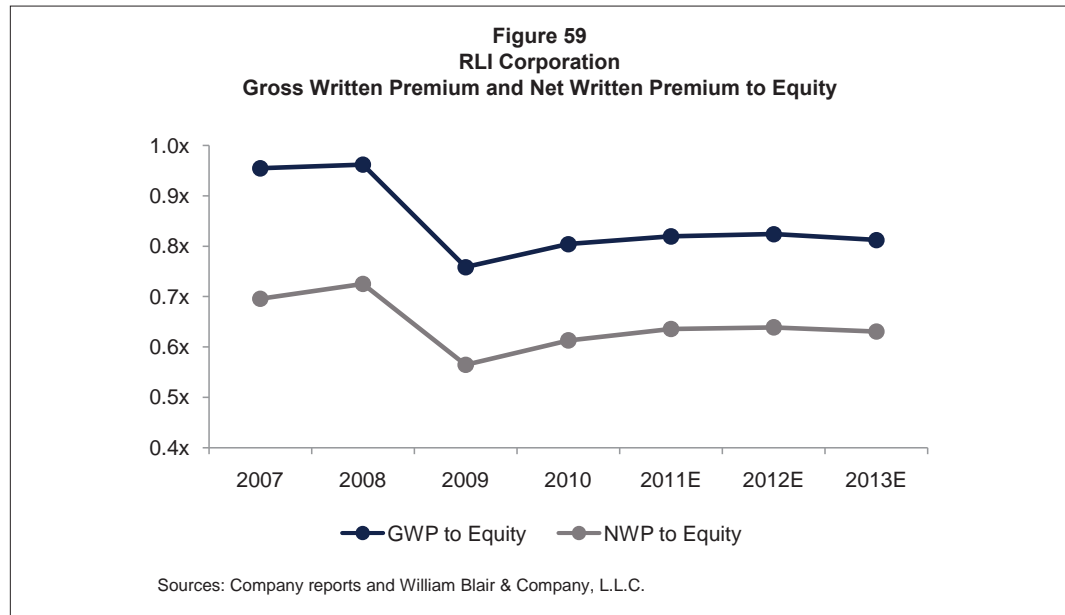
Investment income. Our forecast expects that investment income will grow slowly through 2013, as continued pressure on yields and a slow-to-recover economy continue to hurt growth in the portfolio. If interest rates begin to increase in 2012, there could be additional upside in investment income.

Loss ratio. We forecast that the accident-year loss ratios will continue to increase as catastrophe losses and the soft market continue to put pressure on underwriting margins. Our forecast has the accident-year loss ratio gradually increasing from 49.3% in 2010 to 50% in 2013. Calendar-year loss ratios are projected to grow even faster, due to declining levels of reserve development. We project reserve development to decline from \$42 million in 2010 to \$20 million in 2013, due to heavier losses in the underwriting accident years between 2007 and 2010. This decline pushes calendar-year loss ratios from 40.8% in 2010 to 46.5% in 2013.

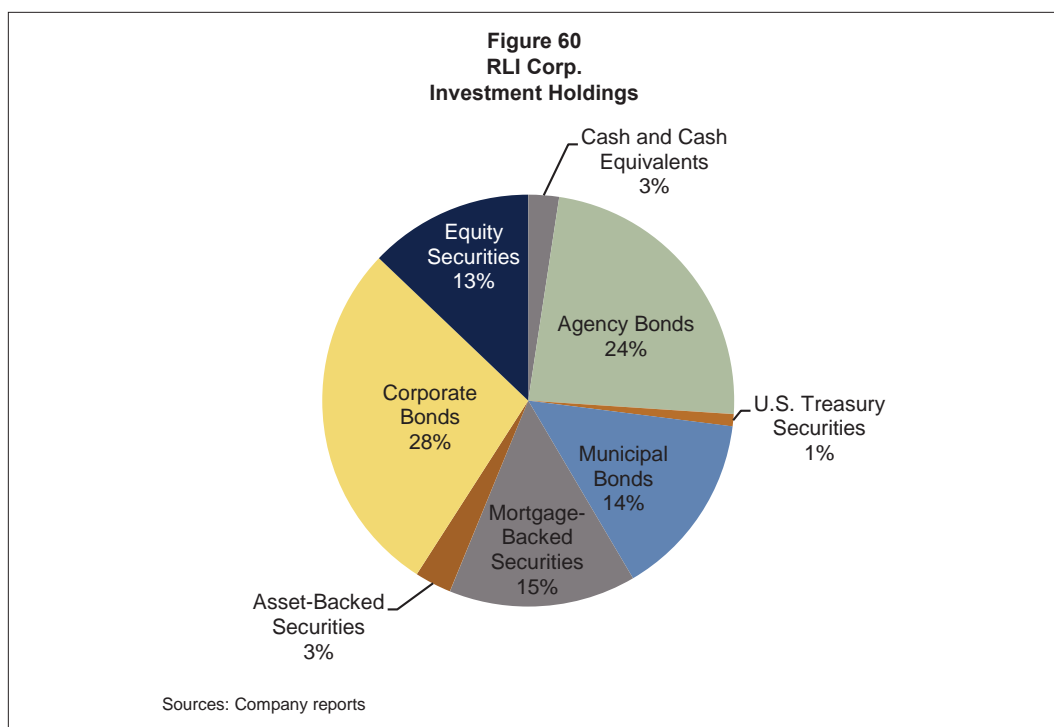
Expense ratio. We believe the expense ratio will have some upward bias over the next few years, as the company has spent money to position itself for the next wave of growth during the next cycle turn. We are expecting the expense ratio to be roughly 41% over the next few years. The expense ratio is heavily dependent on underwriting performance due to the incentive-based compensation structure; thus, too much upward bias in the loss ratios will have a somewhat offsetting effect through a lowered expense ratio.

Balance Sheet

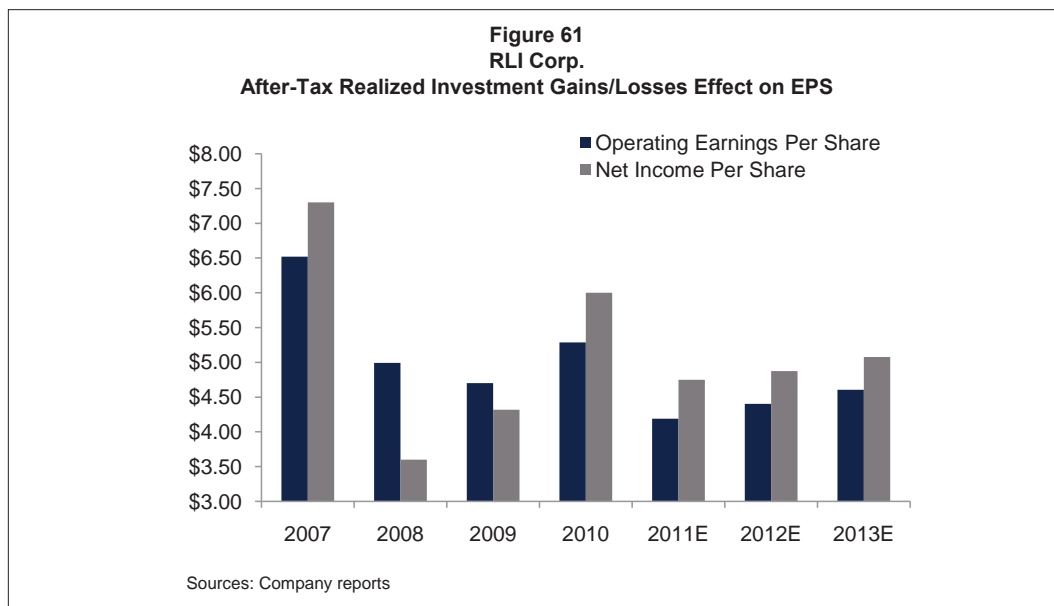
We expect RLI Corp. to continue to underwrite on a well-capitalized basis. Net premiums written to GAAP equity should stay in the 0.6 to 0.7 times range over the next three years, which is very conservative, but admirable in the current market environment. The company is slightly more levered on gross basis with an expected gross premium to GAAP equity of 0.7 to 0.8 times. We believe these are acceptable ranges given the current market environment, but we expect them to pick up as we begin to see a turn in the cycle over the next few years.



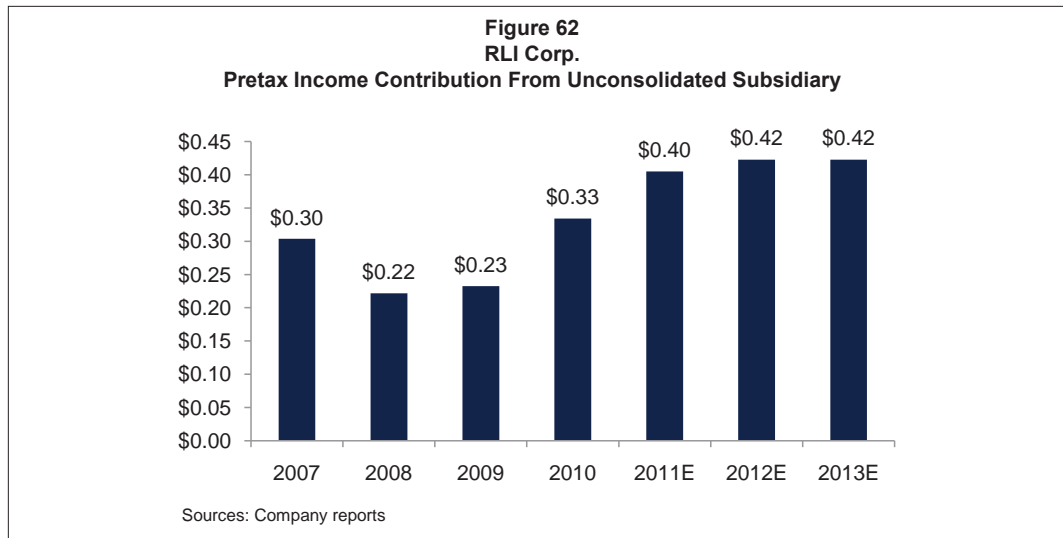
RLI’s investment portfolio contains high-quality fixed-income securities, equity investments, and short-term investments, and is somewhat aggressively positioned compared with its peers. Based on the current market conditions and future expectations, we estimate the yield on investments to remain around 3.5% for the near term.



RLI's investment income has beaten its peers' over the last several years, due to higher-yielding asset classes as well as a substantial allocation to equities. However, the investment profile also creates some fluctuations in earnings, based on realized capital gains and losses in both the equity and fixed income portfolios.



RLI also has a material stake of 40% in sunglasses manufacturer Maui Jim, an investment that stems from the history of RLI as a contact lens insurer. Earnings in the unconsolidated subsidiary have yielded an average of roughly \$0.30 of EPS per year over the last several years, and we expect that to grow to \$0.42 per year by 2013.

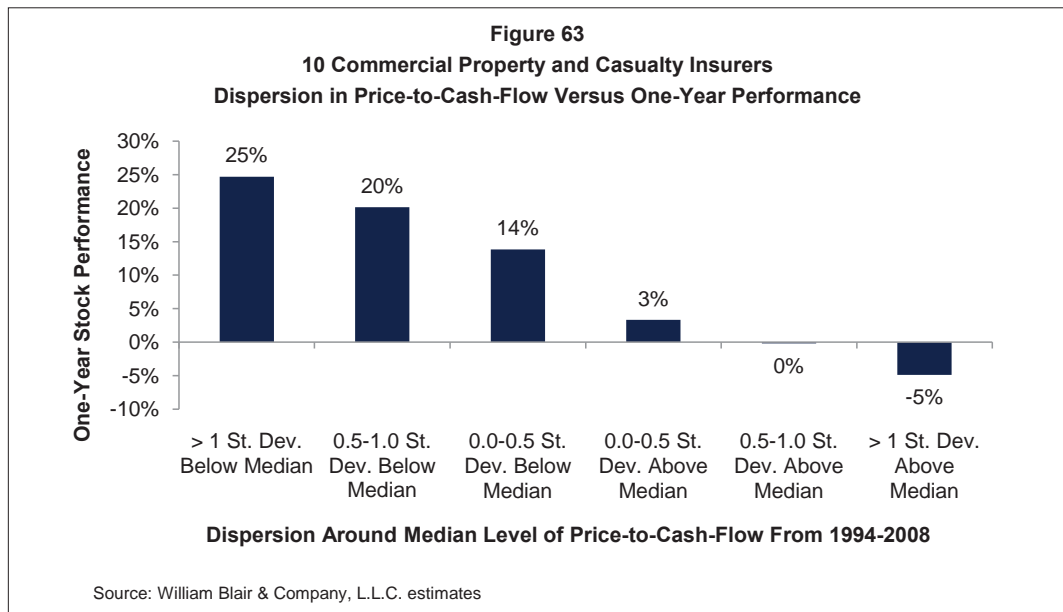


Valuation

Overall Cash Flow Theory

Cash flow has shown to be a good indicator and is highly correlated to future stock movements. We use price-to-cash-flow (P/CF) as the measure to predict stocks. Our historical analysis shows that this measure clearly indicates when to buy or sell insurance stocks. Our methodology is based on back-testing P/CF ratios for 15 years using 10 midsize to large commercial insurers. The ratio we are focused on is based on average operating cash flow over a four-year period, including the previous year, current year, and the two years following.

The results show that when the P/CF ratio is greater than one standard deviation below the median P/CF ratio, the average return for the next year is 25%. When it is more than one standard deviation above the median P/CF ratio, returns have averaged -5% for the following year. The number of standard deviations above or below the median is inversely correlated with the performance of the stock; thus, the correlation is negative. For example, based on our data set, if a stock was trading at a P/CF valuation lower than the median value, one would expect the performance level for that stock to be positive. The overall correlation for the index is -0.49, which indicates a fairly strong negative relationship between the two variables we are examining.



Cash flow valuations have proved particularly useful in cycle turns. In contrast, earnings and return on equity measures tend to be lagging indicators of performance. Figure 64 shows that P/CF valuation signaled a strong buying opportunity going into 2003 and that investors should have exited positions in 2006. In contrast, market-to-book timing was too early on both entry and exit points. Returns using P/CF entry and exit points were almost double that of market-to-book entry and exit points.

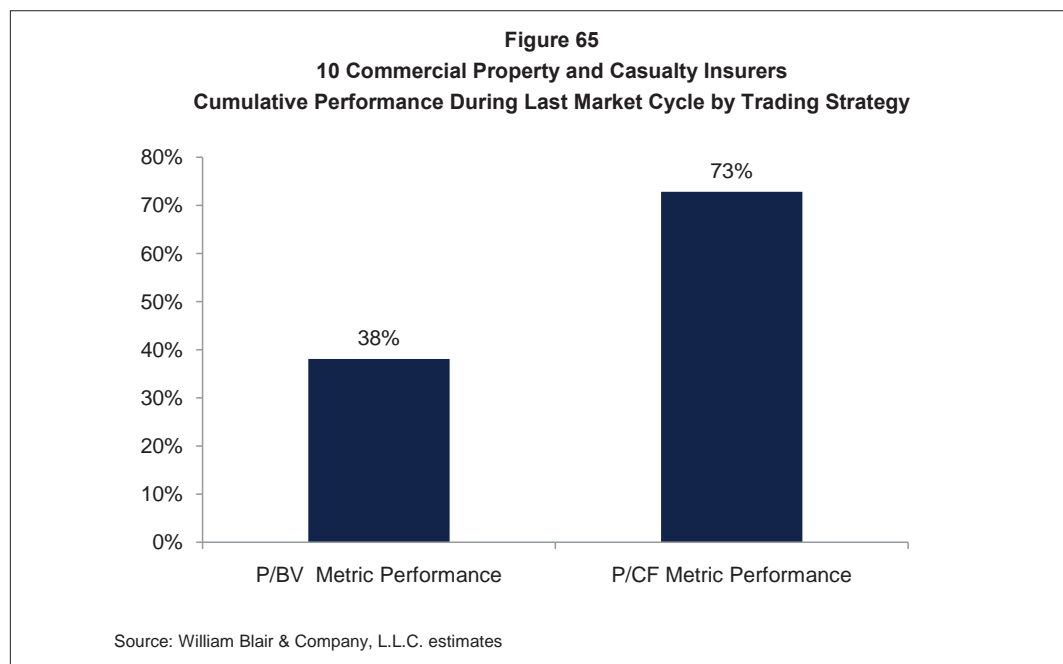
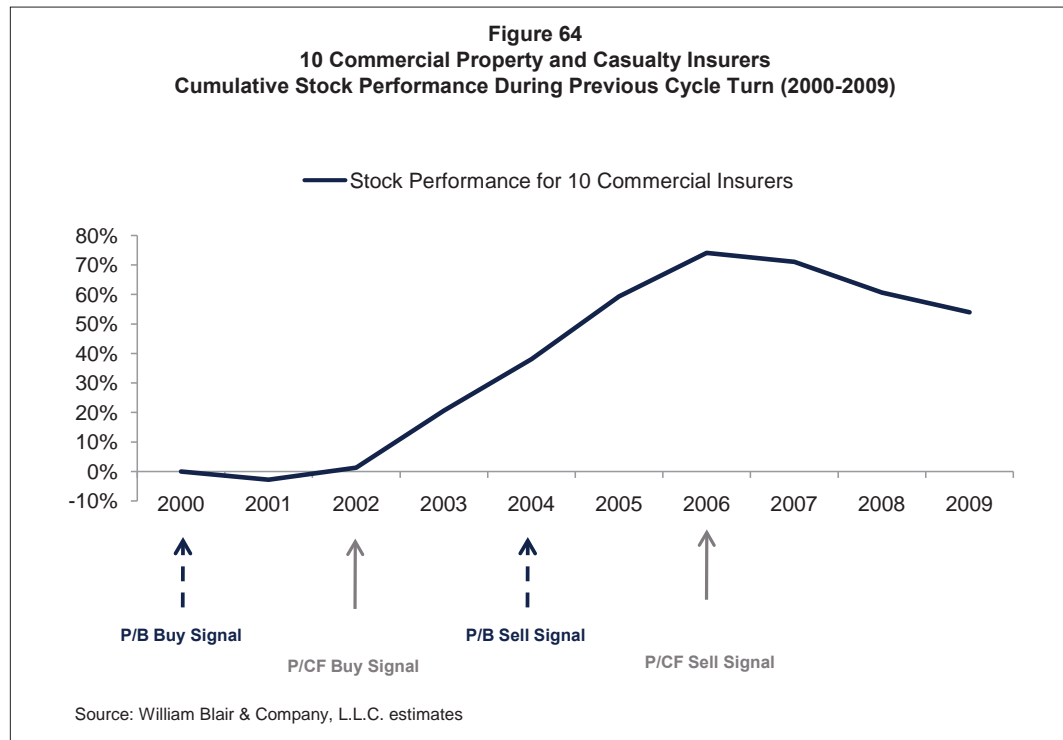


Table 55
RLI Corp.
Cash Flow Valuation Comparison

Company	Ticker	Rating	Current Price	Cash Flow Valuation				Earnings Valuation				Book Valuation				
				Cash Flow Per Share 2011	Cash Flow Per Share 2012	Price to Cash Flow ¹	2006-2010 Median	Current Valuation vs. Median	Number of Std. Deviations From 15-Year Median	EPS 2011E	EPS 2012E	PE 2011	PE 2012	Current Book Value	Current Price To Book	2012 ROE
The Chubb Corporation	CB	U	\$62.61	\$6.26	\$6.09	9.4x	7.3x	30%	1.5	\$5.40	\$5.30	11.6x	11.8x	\$53.26	1.2x	9.2%
HCC Insurance	HCC	U	\$31.50	\$3.25	\$3.23	9.2x	5.7x	60%	2.6	\$2.66	\$2.78	11.8x	11.3x	\$28.99	1.1x	8.7%
RLI Corp.	RLI	M	\$61.92	\$6.64	\$5.70	10.6x	9.1x	16%	1.5	\$4.19	\$4.40	14.8x	14.1x	\$38.52	1.6x	10.9%
The Travelers Companies ²	TRV	M	\$58.38	\$5.79	\$7.47	8.6x	7.8x	10%	0.5	\$4.25	\$6.10	13.7x	9.6x	\$59.91	1.0x	10.4%
Average						9.4x	7.5x	29%	1.5			13.0x	11.7x		1.2x	10%
Median						9.3x	7.5x	23%	1.5			12.8x	11.6x		1.1x	10%

Note¹: Price-to-cash-flow based off current price divided by four-year cash flow: t= -1,0,1,2

Note²: Travelers data only goes back through 2002

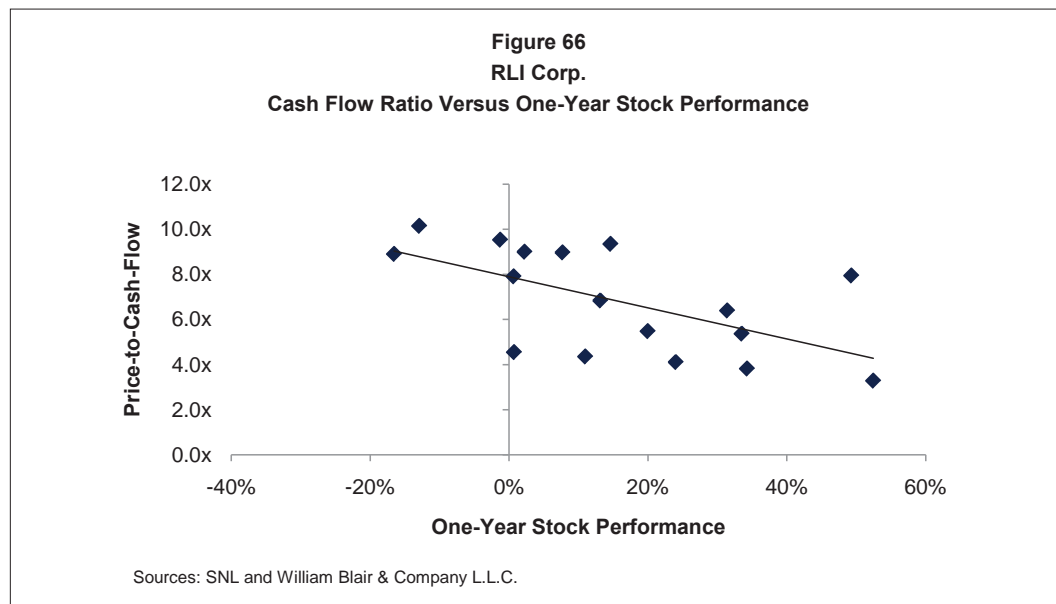
Source: William Blair & Company, L.L.C. estimates

Comparison Universe

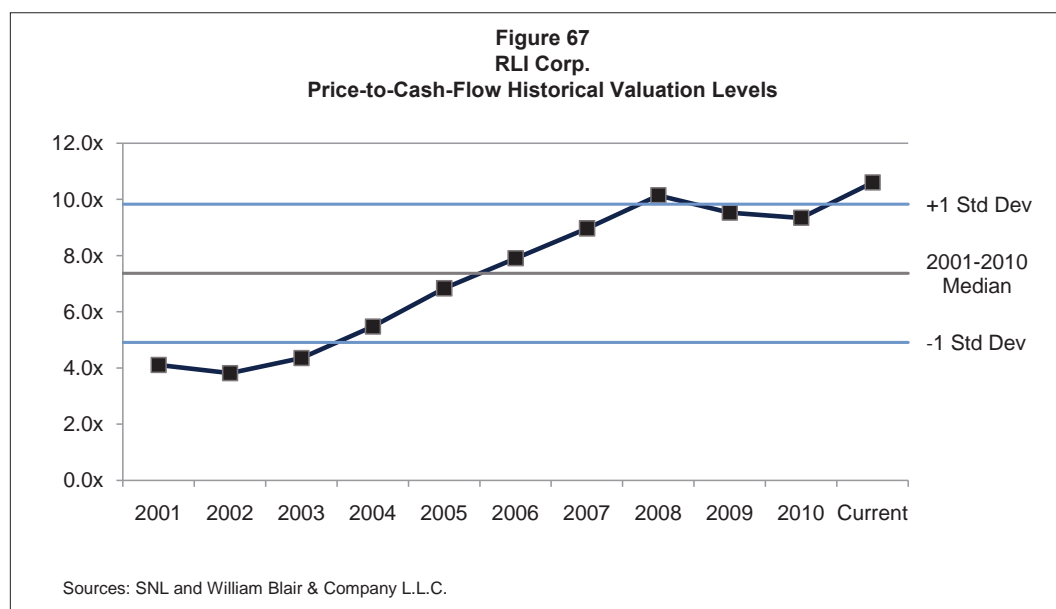
RLI, on a P/CF basis, is attractively valued compared with its peers. However, on a historical basis, the analysis suggests the company is fully valued. RLI's current price-to-cash-flow multiple of 10.6 times is trading at a modest 16% premium to the 2006-2010 median P/CF multiple. In comparison, the group is trading at a 29% premium to its five-year P/CF median, with the higher-valued stocks trading at 30% and 60% premiums, respectively.

Company-Specific Cash Flow Analysis

RLI performance has a relatively high correlation to the P/CF valuation multiple. The stocks one year returns and price to cash flow ratio have a correlation of -0.65.

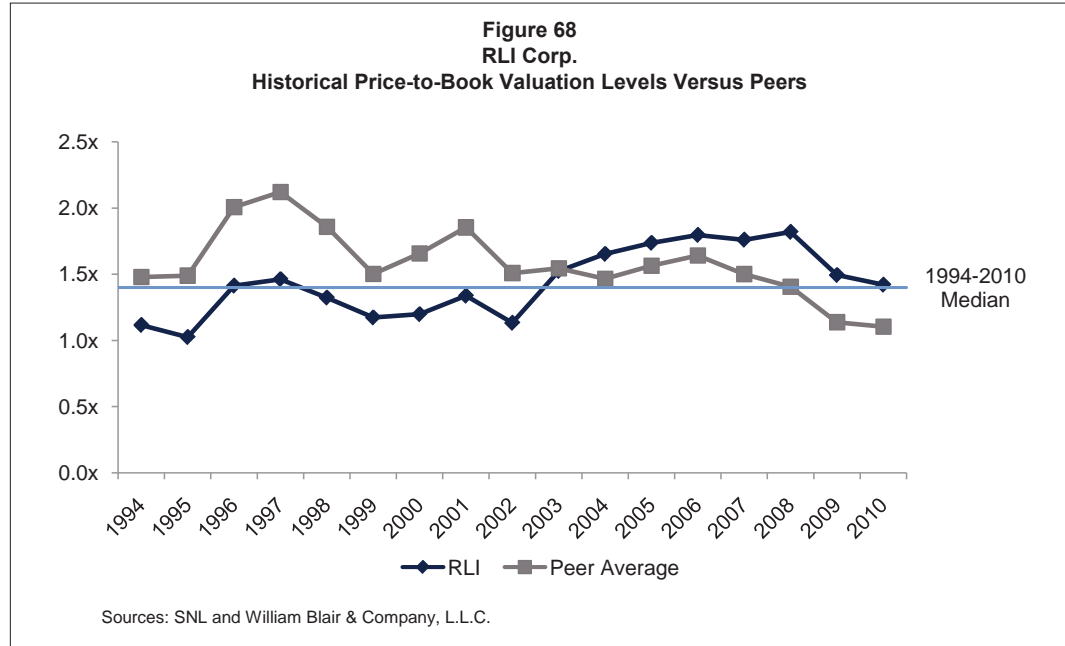


We note that RLI is trading at significant premium to its historical median, but we believe the premium will likely hold as a validation sign of its unique business model and greater consistency of results. Given that we expect cash flows to grow through 2012, we expect the multiple to stay in its current range over the next 12-18 months.



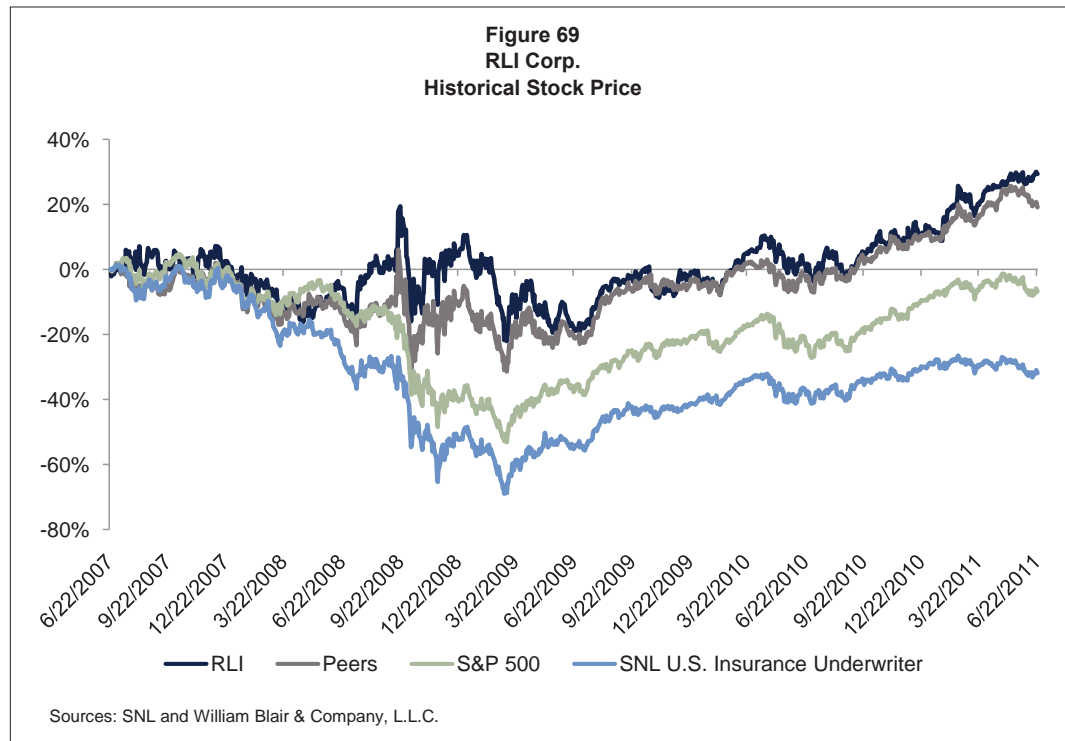
Market to Book

RLI appears expensive on a market-to-book basis. The stock is trading at 1.6 times compared with the peer average of 1.2 times. We do not believe that RLI is overvalued, however. In our view, growing cash flows will help maintain superior valuation multiples, which should translate into an ROE of 10% or better.



Stock Performance

RLI has outperformed by 6% in the last 12 months, and performed in line with peers over the last three years. The stock continues to do well on a relative basis, although in the future, this may mean more of a stable price, as we see downside potential for the others in the group where returns on equity have the potential to dip below 10% in the coming years.



Corporate Profile

RLI Corp., founded in 1965, functions as a specialty property-and-casualty insurance holding company that underwrites and sells niche insurance products through a group of major subsidiaries, known as RLI Insurance Group. The company started out as one of the original insurers for contact lenses; hence the name RLI (i.e., Replacement Lens Insurance, Inc.), but began diversifying into other types of insurance by the 1970s. In 1996, RLI sold its RLI vision unit to Maui Jim, a sunglasses manufacturer, but structured the deal such that the company remained a majority shareholder in Maui Jim. To this day, RLI Corp. still has financial ties to Maui Jim, and the company's financial results still reflect the ownership stake.

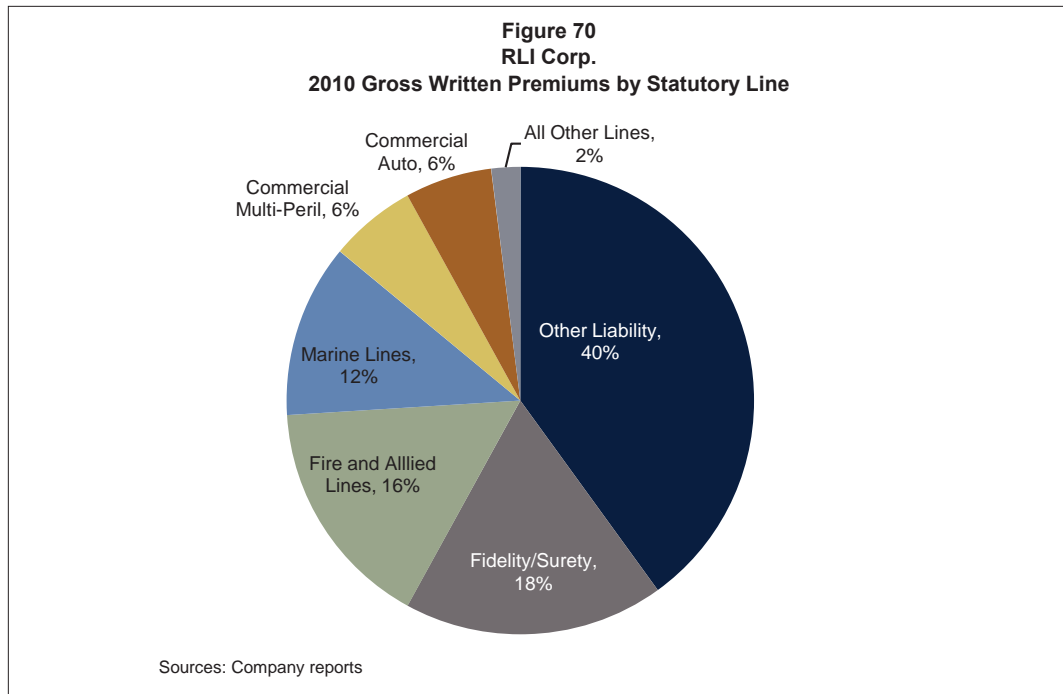
Table 56
RLI Corp.
Corporate Timeline

Year	Event
2011	Purchased Contractors Bonding Insurance Company
2008	Launched architects and engineers (A&E) professional liability division Opened fidelity division
2007	Opened reinsurance division
2005	Opened marine division
2004	Attained market cap of \$1 billion Received upgraded A.M. Best rating to A+
2001	Named Jonathan Michael as RLI Corp. president and CEO
1999	Acquired private holding company, parent of Underwriters Indemnity Company, offering surety bonds for oil, gas and energy industries Received upgraded S&P rating to A+
1997	Opened transportation insurance division
1996	Pioneered \$50 million alternative catastrophe financing program Merged RLI Vision Corp. with Hester Enterprises, maker of Maui Jim Sunglasses
1995	RLI Professional Technologies acquired Target Industries; renamed RLI Vision Corp.
1994	Retired founding product, contact lens insurance
1992	Established surety division
1987	Opened commercial casualty division
1984	Opened first branch office in Los Angeles to write DIC and property
1979	Formed Mt. Hawley Insurance Company, an excess and surplus lines carrier
1977	Began underwriting specialty commercial property and casualty coverages
1973	Renamed United Founders to RLI Insurance Company
1971	RLI common stock first traded on NASDAQ Issued 2.25 million in common stock at \$0.58 per share (split-adjusted)
1965	Private holding company formed and acquired United Founders Ins. Co. (formerly Main Mutual)
1961	Founded a contact lens insurance agency, Replacement Lens Inc.

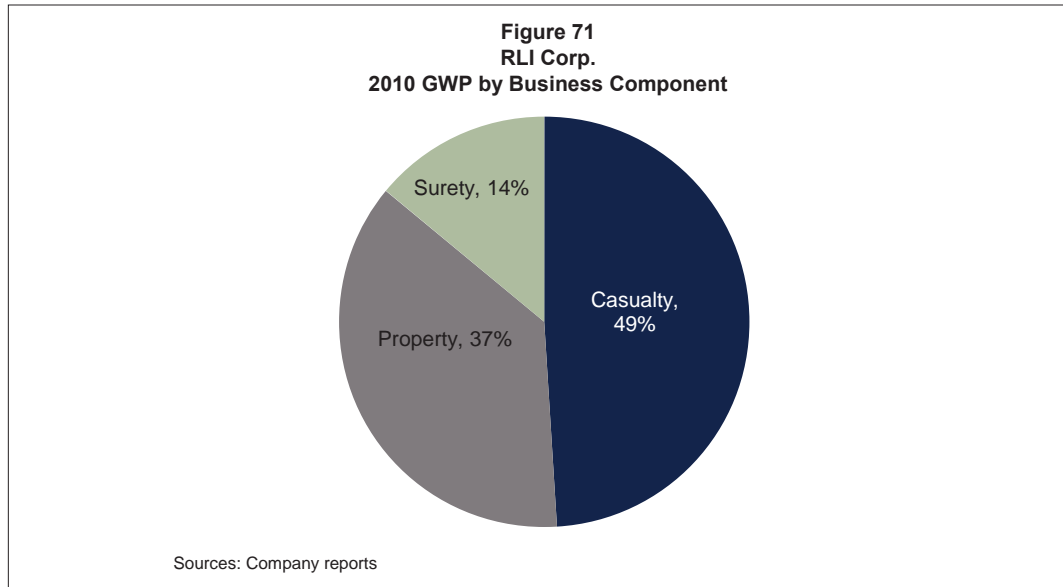
Sources: Company reports

RLI Corp. had 2010 written premiums of \$636 million and net income of \$127 million. The company is one of only a handful of insurers to provide niche commercial insurance nationwide. These markets are often too small, too remote, or too difficult to attract customers for major players in the property-and-casualty industry to take any interest.

RLI offers more than 30 product lines in the specialty commercial market. The major types of insurance offered by statutory line are other liability (which comprises 40% of total written premiums), fidelity/surety (18%), fire and allied lines (16%), marine lines (12%), commercial multi-peril (6%), commercial auto (6%), and all other lines (2%). The diverse nature of the insured lines is part of servicing niche insurance markets, but it offers diversification benefits.

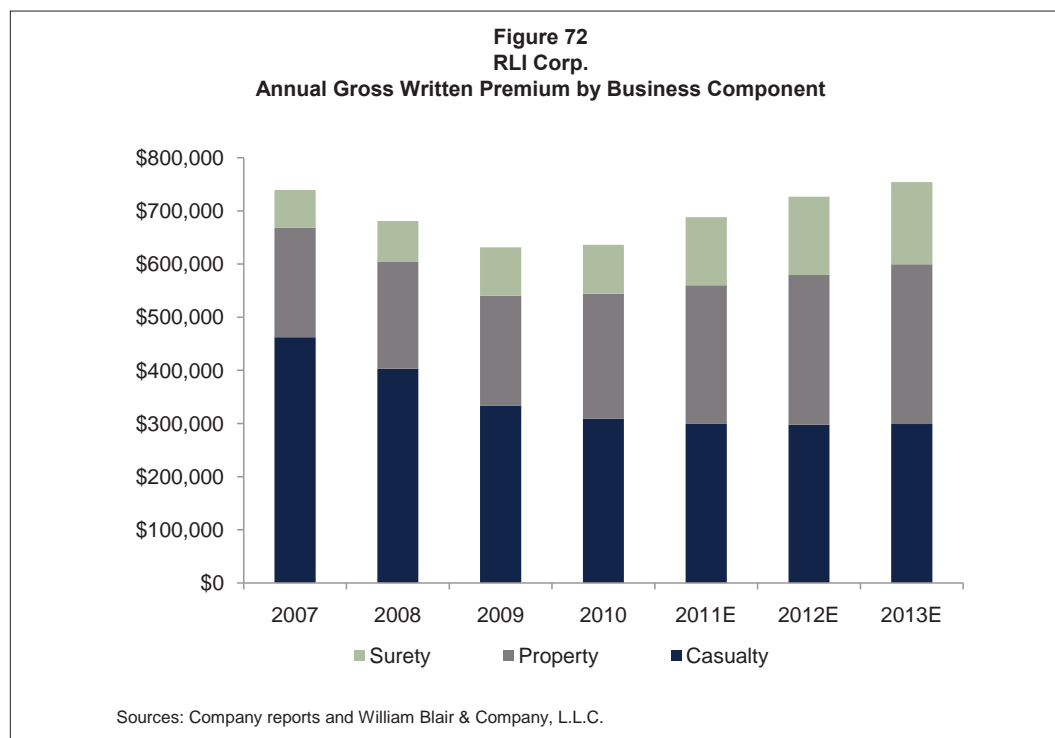


RLI offers this huge diversity of insurance lines by dividing operating results into three distinct business segments: casualty, property, and surety. The casualty business is the largest with 49% of gross premiums written in 2010. The property segment has grown substantially, to 37% of written premiums, while the surety segment is the smallest with 14% of premiums written in 2010.



Results have suffered industrywide due to the continued softening in the marketplace over the last several years, and for RLI in particular, written premiums are heavily dependent on customer revenues, values transported, miles traveled, and number of new products initiated. Thus, the downturn in the economy has negatively affected the number of insurance customers need to cover their activities, or the insured exposure base. However, expansion efforts and new product initiatives, particularly in the property and surety segments, have helped to mitigate declines in the casualty segment. New product initiatives created over the last three years added more than \$75 million in gross premiums written during 2010.

Casualty in particular has struggled recently due to its dependence on industries hit hard by the recession, like contractors and transportation. Casualty has continued to decline as a percentage of written premiums, and we expect that trend to continue through 2013. With the acquisition of CBIC, surety—which had already been growing at a steady clip—will become a much larger business for RLI.



Structurally, RLI Corp. writes insurance policies on a direct basis through three separate insurance companies: RLI, Mt. Hawley Insurance Company, and RLI Indemnity. RLI writes multiple lines of insurance in all 50 states. Mt. Hawley Insurance Company writes surplus lines insurance in all 50 states. RLI Indemnity Company has the authority to write multiple lines of insurance in 48 states.

RLI also ceded roughly 25% of its business in 2010 to reinsurers to diversify risk and limit maximum loss from catastrophic events. As books of business for specific products grow and mature, the company tends to retain more of the risk to increase profitability in the lines. However, as each product manager tends to think of his line as its own business, they want to balance the risk for that product specifically as opposed to at the overall corporate level, which tends to keep risk retention a bit lower than the industry average. RLI is subject to some credit risk from its reinsurers and generally only uses reinsurers with an A.M. Best rating of “A” or better. RLI also assumes some reinsurance in its facultative property business unit, primarily made up of short-tail property, catastrophe, and multi-peril crop and hail reinsurance, which it uses to reduce overall volatility and mitigate some of the risks associated with underwriting a new product line.

Business Mix

Table 57
RLI Corp.
Business Mix
(dollars in thousands)

		2008	2009	2010	2008-2010 CAGR
Casualty	Net Premiums Earned	\$313,481	\$265,021	\$231,119	-14.1%
	<i>% of Total</i>	59%	54%	47%	
	Underwriting Income	\$46,507	\$51,488	\$38,239	-9.3%
	<i>% of Total</i>	56%	59%	40%	
	Combined Ratio	85.2	80.6	83.4	
Property	Net Premiums Earned	\$146,863	\$155,303	\$181,645	11.2%
	<i>% of Total</i>	28%	32%	37%	
	Underwriting Income	\$15,813	\$23,261	\$34,085	46.8%
	<i>% of Total</i>	19%	27%	36%	
	Combined Ratio	89.3	85.0	81.2	
Surety	Net Premiums Earned	\$68,420	\$71,637	\$80,618	8.5%
	<i>% of Total</i>	13%	15%	16%	
	Underwriting Income	\$20,743	\$12,036	\$23,071	5.5%
	<i>% of Total</i>	25%	14%	24%	
	Combined Ratio	69.7	83.2	71.3	
Total	Net Premiums Earned	\$528,764	\$491,961	\$493,382	-3.4%
	Underwriting Income	\$83,063	\$86,785	\$95,395	7.2%
	Combined Ratio	84.2	82.3	80.7	

Sources: Company reports

Casualty

The casualty business consists largely of general liability, personal umbrella, transportation, executive products, commercial umbrella, multi-peril, and other specialty coverage lines. The casualty business is subject to the risk of estimating losses and related loss reserves because the ultimate settlement of a casualty claim may take several years to fully develop.

Table 58
RLI Corp.
Casualty Segment Product Mix 2010

Product	Net Premiums Earned	% of Net Premiums
General Liability	\$96,659	41.8%
Commercial and Personal Umbrella	\$61,370	26.6%
Commercial Transportation	\$40,262	17.4%
Executive Products	\$15,841	6.9%
Specialty Program Business	\$7,188	3.1%
Other	\$9,799	4.2%
Total	\$231,119	100.0%

Sources: Company reports

Many of the original casualty products are at the mature stage of their growth cycle, and the company is not forecasting significant growth going forward. However, it continues to make strategic investments in new initiatives and insurance lines that should provide some additional growth trajectory. These new products include professional liability for architects and engineers, environmental liability, REIT liability, railroad protective liability, cyber liability, and multi-peril packaged products.

Property

The property segment primarily includes commercial fire, earthquake, difference in conditions, marine, facultative, and assumed treaty reinsurance. Property lines are subject to intense variability introduced by natural disasters such as earthquakes, fires, and hurricanes. Major catastrophe exposure is primarily on the West Coast because of earthquake exposure, as well as in the Southeast for hurricane damage.

Table 59
RLI Corp.
Property Segment Product Mix 2010

Product	Net Premiums Earned	% of Net Premiums
Commercial Property	\$80,471	44.3%
Marine	\$47,981	26.4%
Crop Reinsurance	\$27,082	14.9%
Property Reinsurance	\$9,960	5.5%
Other Property	\$16,151	8.9%
Total	\$181,645	100.0%

Sources: Company reports

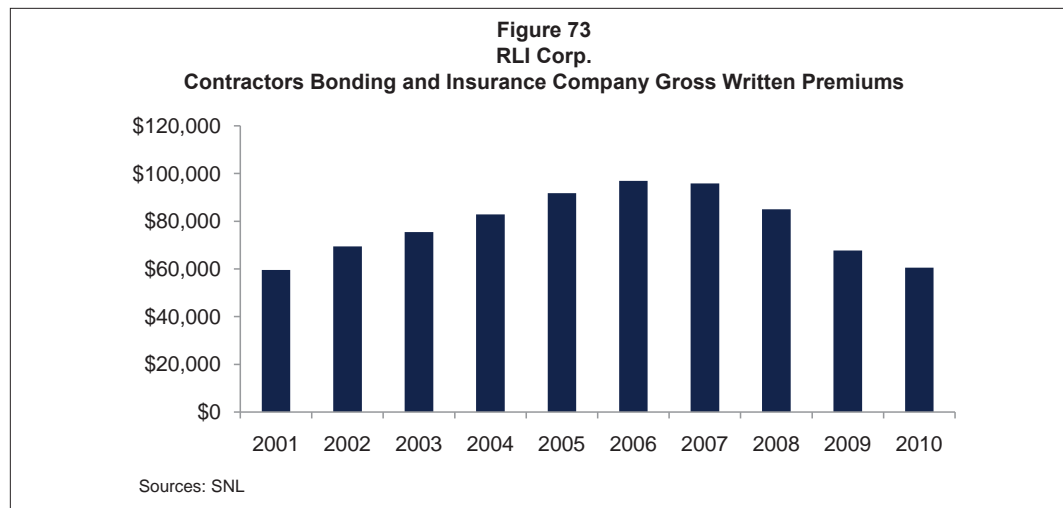
The firm limits net aggregate exposure to a catastrophic event by limiting the amount of premium written in a single area, purchasing reinsurance, and utilizing conservative underwriting programs. The lack of event activity in the United States during 2009 and 2010 has helped loss ratios significantly. However, catastrophe modeling firms like RMS have updated their models this year, which could have a significant effect on pricing demand and the risk selection process. There is a renewed emphasis on the higher loss potential of inland areas, which could change RLI's property book and the rates it is getting, particularly in Florida.

Surety

RLI specializes in writing small to large commercial and small contract surety coverages, and also those for energy, petrochemical, and refinery industries. The company also writes bonds, and offers fidelity and crime coverage for commercial properties and select financial institutions. The contract surety marketplace guarantees the construction work of a commercial contractor for a specific project.

RLI Corp. announced the acquisition of Contractors Bonding and Insurance Company (CBIC) in December 2010 for a purchase price of \$135 million; the transaction closed during April of 2011 and was paid for entirely with excess cash. CBIC writes predominantly surety and casualty products for contractors in the western United States, along with some multi-peril liability lines to the same companies. The company serves more than 30,000 contractors and more than 40,000 insurance agents and brokers nationwide, and is considered a leading writer of contractor license bonds on the West Coast. The company wrote \$61 million in gross premiums during 2010, and the acquisition should begin hitting RLI's income statements during the second quarter of 2011.

The CBIC acquisition was both a strategic acquisition and an example of a company that was a great fit with the culture of RLI. The acquisition achieved numerous goals set forth by management, including 1) increased exposure to the Northwest region, where RLI was historically underpenetrated; 2) a complementary book of business to its historical contractor book, as CBIC tended to work with smaller contractor clients; and 3) a way to further expand its contractor/surety business by mimicking CBIC's packaged product offerings that sell casualty lines to the same contractor clients. In addition, management believes that the CBIC team will fit in well with the merit-based culture at RLI.



Marketing and Distribution

The company offers its products through independent agents and brokers, wholesale brokers, and agencies. RLI insurance subsidiaries are licensed in all 50 states, the District of Columbia, and the Cayman Islands. The company's largest state of business is California, with written premiums for the year ended 2010 accounting for 17.3%, New York at 12.6%, and Florida at 11.8%. Table 60 details the premiums written by state in 2010.

Table 60
RLI Corp.
U.S. Geographic Distribution

State	2010
California	17.3%
New York	12.6%
Florida	11.8%
Texas	8.6%
Washington	4.8%
New Jersey	3.7%
Illinois	2.9%
Louisiana	2.6%
Pennsylvania	2.4%
Hawaii	2.4%
All Other States	31.0%

Sources: Company reports

Table 61
RLI Corp.
Product Distribution

	Product	Retail Agent/ Broker	Wholesale Broker	General Agency	Reinsurance Broker
Casualty	General Liability		X		
	Commercial & Personal Umbrella	X	X	X	
	Transportation	X			
	Executive Products	X	X		
	Professional Services	X			
Property	Commercial Property		X		
	Earthquake/DIC		X		
	Marine	X	X		
	Personal Lines	X		X	
	Reinsurance				X
Surety	Miscellaneous	X			
	Energy	X			
	Commercial	X			
	Contract	X			

Sources: Company reports

Table 62
RLI Corp.
Earnings Model

	2009	2010	1Q'11	2Q'11E	3Q'11E	4Q'11E	2011E	1Q'12E	2Q'12E	3Q'12E	4Q'12E	2012E	2013E
Gross premiums written	631,200	636,316	143,323	208,490	173,567	163,032	688,412	160,023	217,500	180,311	169,143	726,976	754,408
Net premiums written	469,917	485,141	112,635	165,515	132,748	123,161	534,059	125,013	172,106	138,088	128,634	563,842	585,801
Retention	74%	76%	79%	79%	76%	76%	78%	78%	79%	77%	76%	78%	78%
Net premiums earned	491,961	493,382	116,051	124,287	127,911	131,578	499,827	135,062	137,433	138,925	140,276	551,697	575,098
Net investment income	67,346	66,799	16,303	16,474	16,386	16,689	65,851	16,409	16,799	17,711	18,010	68,929	76,464
Yield	3.8%	3.6%	3.6%	3.6%	3.5%	3.5%	3.5%	3.5%	3.5%	3.6%	3.6%	3.5%	3.7%
Operating revenue	559,307	560,181	132,354	140,760	144,296	148,267	565,678	151,472	154,233	156,636	158,286	620,626	651,562
Accident year loss and settlement expenses	234,463	243,055	53,682	65,872	69,072	65,789	254,415	62,129	68,717	75,019	70,138	276,003	287,671
Accident year loss ratio	47.7%	49.3%	46.3%	53.0%	54.0%	50.0%	50.9%	46.0%	50.0%	54.0%	50.0%	50.0%	50.0%
Reserve development	31,075	41,723	6,811	7,000	7,000	9,000	29,811	5,000	7,000	5,000	9,000	26,000	20,000
As % of premiums earned	6%	8%	6%	6%	5%	7%	6%	4%	5%	4%	6%	5%	3%
Calendar year loss and settlement expenses	203,388	201,332	46,871	58,872	62,072	56,789	224,604	57,129	61,717	70,019	61,138	250,003	267,671
Calendar year loss ratio	41.3%	40.8%	40.4%	47.4%	48.5%	43.2%	44.9%	42.3%	44.9%	50.4%	43.6%	45.3%	46.5%
Policy acquisition costs	162,020	158,071	40,533	38,529	42,211	42,105	163,377	47,272	43,292	45,845	45,450	181,858	186,878
Policy acquisition expense ratio	32.9%	32.0%	34.9%	31.0%	33.0%	32.0%	32.7%	35.0%	31.5%	33.0%	32.4%	33.0%	32.5%
Other insurance expenses	39,768	38,584	9,615	9,943	10,872	11,447	41,878	11,345	10,995	11,809	12,625	46,773	48,756
Other insurance expense ratio	8.1%	7.8%	8.3%	8.0%	8.5%	8.7%	8.4%	8.4%	8.0%	8.5%	9.0%	8.5%	8.5%
Operating expenses	405,176	397,987	97,019	107,344	115,155	110,341	429,859	115,746	116,003	127,673	119,213	478,634	503,305
Expense ratio	41.0%	39.9%	43.2%	39.0%	41.5%	40.7%	41.1%	43.4%	39.5%	41.5%	41.4%	41.4%	41.0%
Combined ratio	82.4%	80.7%	83.6%	86.4%	90.0%	83.9%	86.0%	85.7%	84.4%	91.9%	85.0%	86.8%	87.5%
Interest expense on debt	6,050	6,050	1,512	1,513	1,512	1,513	6,050	1,512	1,513	1,512	1,513	6,050	6,050
General expenses	7,941	7,998	2,005	2,000	2,300	2,500	8,805	2,000	2,300	2,300	2,500	9,100	9,100
Total expenses	419,167	412,035	100,536	110,857	118,967	114,354	444,714	119,258	119,816	131,485	123,226	493,784	518,455
Equity in earnings of unconsolidated affiliate	5,052	7,101	2,616	2,000	2,000	2,000	8,616	2,250	2,250	2,250	2,250	9,000	9,000
Per share impact	\$0.23	\$0.33	\$0.12	\$0.09	\$0.09	\$0.09	\$0.40	\$0.11	\$0.11	\$0.11	\$0.11	\$0.42	\$0.42
Operating earnings before income taxes	145,192	155,247	34,434	31,904	27,330	35,913	129,580	34,464	36,667	27,400	37,311	135,842	142,107
Operating income tax expense	43,056	42,923	10,880	9,890	8,472	11,133	40,375	10,684	11,367	8,494	11,566	42,111	44,053
Tax rate	29.7%	27.6%	31.6%	31.0%	31.0%	31.0%	31.2%	31.0%	31.0%	31.0%	31.0%	31.0%	31.0%
Operating earnings	102,136	112,324	23,554	22,014	18,857	24,780	89,205	23,780	25,300	18,906	25,744	93,731	98,054
Operating earnings per share	\$4.70	\$5.29	\$1.11	\$1.03	\$0.89	\$1.16	\$4.19	\$1.12	\$1.19	\$0.89	\$1.21	\$4.40	\$4.61
Consensus			\$1.11	\$1.07	\$0.98	\$1.03	\$4.14	\$0.99	\$1.07	\$0.98	\$1.05	\$4.08	\$4.08
Net realized investment gains	-12,755	23,243	4,472	5,000	5,000	5,000	19,472	5,000	5,000	5,000	5,000	20,000	20,000
Realized investment gains after tax	-8,291	15,108	2,907	3,000	3,000	3,000	11,907	2,500	2,500	2,500	2,500	10,000	10,000
Net income	93,845	127,432	26,461	25,014	21,857	27,780	101,112	26,280	27,800	21,406	28,244	103,731	108,054
Net income per share	\$4.32	\$6.00	\$1.24	\$1.18	\$1.03	\$1.31	\$4.75	\$1.23	\$1.31	\$1.01	\$1.33	\$4.87	\$5.08
Common shares outstanding	21,265	20,965	21,055	21,055	21,055	21,055	21,055	21,055	21,055	21,055	21,055	21,055	21,055
Diluted weighted average shares outstanding	21,731	21,241	21,285	21,285	21,285	21,285	21,285	21,285	21,285	21,285	21,285	21,285	21,285
Dividends per share	\$1.08	\$8.15	\$0.29	\$0.29	\$0.30	\$2.00	\$2.88	\$0.30	\$0.30	\$0.31	\$2.00	\$2.91	\$2.93
Operating ROAE	13.3%	13.8%	11.5%	10.5%	8.8%	11.8%	10.9%	11.1%	11.5%	8.4%	11.7%	10.9%	10.8%
Book value per share	\$38.30	\$37.26	\$38.52	\$39.41	\$40.14	\$39.46	\$39.46	\$40.40	\$41.41	\$42.11	\$41.46	\$41.46	\$43.64

Sources: Company reports and William Blair & Company, L.L.C.

Management

Jonathan E. Michael, Chairman, President, and Chief Executive Officer

Mr. Michael joined RLI in 1982. Before being named CEO, he served in various roles at the company, including COO and CFO. Prior to this, Mr. Michael gained valuable insurance industry expertise working at Coopers & Lybrand, now part of PricewaterhouseCoopers LLP. Mr. Michael was named chairman of the board in May 2011, after prior Chairman and founder Gerald D. Stephens retired after being with the company since 1961.

Joseph E. Dondanville, Senior Vice President and Chief Financial Officer

Mr. Dondanville joined RLI in 1984. He served as chief accountant and comptroller before being named CFO in 1992. His experience prior to joining RLI includes several years at Arthur Andersen & Co.

Michael J. Stone, President and Chief Operating Officer—RLI and Mt. Hawley Insurance Companies

Mr. Stone joined RLI in 1996. He has served as vice president of claims for RLI and became president and COO for the insurance subsidiaries in 2002. His experience prior to joining RLI includes several years at Travelers Insurance Company.

Daniel O. Kennedy, Vice President, General Counsel, and Secretary

Mr. Kennedy joined RLI in 2006 as vice president, general counsel, and secretary. Before joining the company, he was a partner at Atlanta-based law firm Hunton & Williams LLP.

The Travelers Companies, Inc.

Initiating Coverage With a Market Perform Rating

Frequency-oriented business model. Travelers is unique for a large company in its focus on frequency-oriented business rather than large market business, which provides it with several advantages. The business profile has a relatively short liability tail for a commercial insurer, which means a higher level of transparency. The combination of having more visibility due to short-tail lines of business and predictive modeling results in the ability to better segment risks and price accurately. The company's frequency strategy should result in relatively stable underwriting margins as overall commercial property-and-casualty results deteriorate, reflecting seven years of a soft pricing environment.

Capital management. Travelers has been one of the most aggressive managers of capital. This means not only returning material levels of capital to shareholders, but also running the capital base at an efficient level to produce a strong return on equity. The company has returned an average of \$3.5 billion in share buybacks and an average of \$690 million in dividends the last three years. The combination has produced a three-year average annual cash yield on equity of 15.7%.

Earnings hurt by catastrophe losses in 2011. We forecast earnings per share of \$4.25 in 2011 and \$6.10 in 2012; however, this could be conservative depending on how reserves develop over the next two years. Our estimates assume return on equity of 7.3% for 2011 and 10.4% for 2012.

Valuation is attractive on a relative basis, but upside is likely limited. Travelers is the most attractively valued among the group, although we believe upside will be limited in the near term. The stock is the only one with a price-to-cash-flow (P/CF) under its five-year median. Travelers' P/CF multiple of 8.6 times is 10% above its five-year median of 7.8 times. In comparison, the other three stocks are trading at an average of 35% above their respective five-year medians. Typically, the valuation needs to move 0.5 standard deviations below the historical median before the potential for positive returns materially improves.

Risks include a continued exposure to workers' compensation and asbestos claims and deterioration in the loss ratio. Travelers is one of the largest competitors in the workers' compensation line, an area of the market that is exhibiting declining profitability levels. Travelers also has one of the largest asbestos exposures in the industry. While this issue has been dormant in recent years, it is worth keeping an eye on. Commercial lines have in the last three years shown significant deterioration in the accident-year loss ratio, reflecting a six-year drop in pricing that has averaged more than 30% in most lines.

The Travelers Companies, Inc., founded in 1853, is an international property-and-casualty insurance holding company that underwrites and sells a diverse array of insurance products to businesses, government agencies, and consumers.

Financial | Property & Casualty Insurance

Stock Rating: **Market Perform**
Company Profile: **Core Growth**

Symbol: TRV (NYSE)
Price: \$58.38 (52-Wk.: \$48-\$64)
Market Value (mil.): \$24,533
Fiscal Year End: December
Long-Term EPS Growth Rate: 15%
Dividend Yield: 2.8%

Estimates	2010A	2011E	2012E
EPS	\$6.26	\$4.25	\$6.10
BVPS	\$58.47	\$59.26	\$58.73
CFPS	\$6.33	\$5.79	\$7.47
ROE	11.4%	7.3%	10.4%

Valuation			
FY P/E	9.3x	13.7x	9.6x
FY P/B	1.00x	0.99x	0.99x
P/CF (4-yr)	8.6x	8.6x	NA

Trading Data		
Shares Outstanding (mil.)		434.4
Float (mil.)		416.9
Average Daily Volume (thous.)		3,480

Introduction

We are initiating coverage of The Travelers Companies with a Market Perform rating and Core Growth company profile. Travelers should have relatively consistent results compared with other large commercial insurers as the property-and-casualty market moves toward the trough of at least an eight-year downcycle. However, exposure from the soft pricing environment should still result in moderately declining return on equity through 2013. The company's diversified mix of business and focus on frequency-oriented business lines should translate into more muted downside. We expect the return on equity to decline from 12% in 2010 to a cyclical low of 9%-10% in 2012 and 2013. In contrast, we expect other commercial insurers to be at 8% or below. We believe Travelers is a relatively better stock, but we do not believe there are sufficient catalysts to generate material upside over the next 12 months. The valuation at a price of 0.97 times book value appears inexpensive, although on a cash flow basis, the multiple of 8.6 times is close to its historical median. We would be more constructive on the stock if the workers' compensation market turned ahead of the rest of the commercial market.

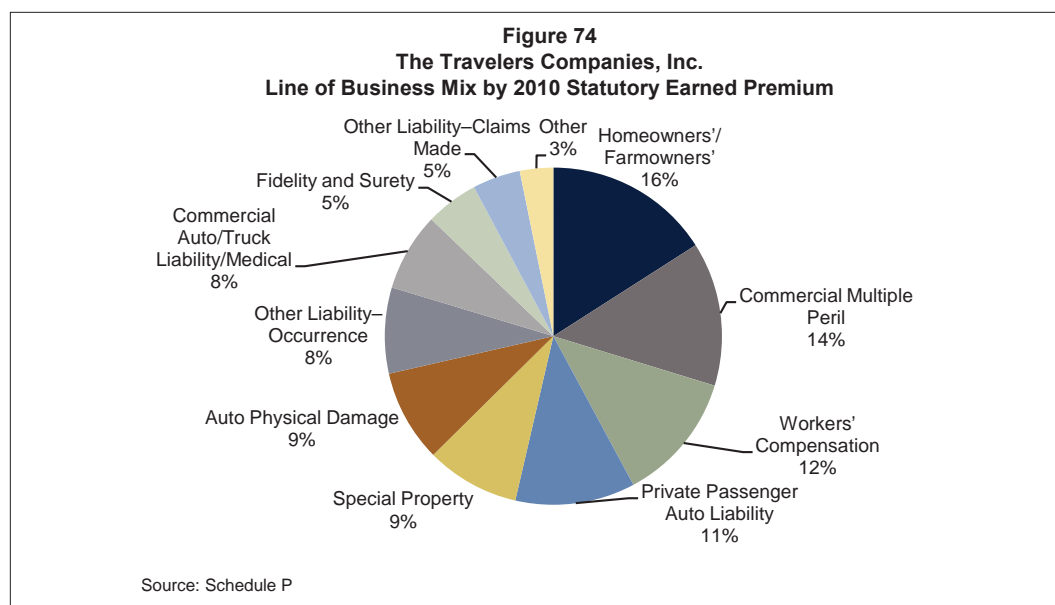
Investment Thesis

Diversified Platform Supports Solid Underwriting

Travelers has a relatively diverse portfolio of property-and-casualty-related businesses. The result is relative stability, with no one sector dominant; the company therefore has exhibited a degree of insulation from the dramatic swings that have typified the property-and-casualty industry. No one segment or line constitutes more than 20% of premiums. The company has a healthy mix of commercial and personal lines business, which inherently provides opportunity to serve a wide array of potential customers. In addition, given the diversification, the company has less pressure to chase the market down in any sector. A P&C company that is sharply defined in one market usually has no choice but to follow trends in that market. For example, most companies focused on workers' compensation, good or bad, are suffering from the prolonged market decline.

A major advantage of this strategy in the current market environment is lower-than-average exposure to long-tail commercial lines, which are less than one-third of Travelers' overall book. Workers' compensation and general liability, the more traditional mid- and long-tailed lines, only account for roughly 20% of premiums. We expect the longer-tailed liability lines to exhibit an increasing level of deterioration in the next several years. On the other hand, personal insurance, commercial property, and small/midsize accounts represent more than \$12 billion, or 60%, of premiums. These lines should be more stable and in general have greater visibility of results.

This mix of business, particularly the lack of major long-tailed liability exposure, should allow Travelers to fare better than average as the results of the eight-year downturn emerge. We expect return on equity to decline moderately over the next two years, but we expect the rest of the sector to be at 8% or below.



Frequency Orientation Drives More-Consistent Results

Travelers is unique for a large company in that it focuses more on frequency-oriented businesses and less on large market businesses. This means that Travelers writes a larger number of small to midsize policies that are generally short tailed and have lower limits. The larger commercial insurers, such as American International Group, ACE Limited, and Zurich, generally have a significant focus on the large and middle-market segment. In contrast, Travelers' large risk segment is only a small part of the overall business mix. The frequency-oriented segments include personal lines, workers' compensation, and commercial multiple peril. And even the specialty lines are more focused on middle-market risks.

There are several advantages to this frequency orientation. The business profile has a relatively short liability tail for a commercial insurer, which provides a higher level of transparency. Another positive is that predictive modeling is more applicable, as the policies form a relatively large data set. Travelers has invested significant time and resources in building technology and databases to segment risks, taking a page from the Progressive playbook. The combination of having more visibility due to short-tail lines of business and predictive modeling enables Travelers to better segment risks and price accurately. This creates a competitive advantage for the company, particularly in the commercial segment, where mispricing is the norm. The frequency strategy should result in better underwriting results relative to other commercial property-and-casualty insurers; however, we expect the seven years of soft pricing to still take its toll. Our forecast assumes that the commercial lines combined ratio increases from 91.3% in 2010 to 98.1% in 2012.

Table 63
The Travelers Companies, Inc.
Combined Ratio Volatility Comparison

	2006	2007	2008	2009	2010	5-Year Avg.	St. Dev.	St. Dev./ 5-Yr. Avg.	Rank
ACE	88.1	87.9	89.6	88.3	90.2	88.8	0.91	1.0%	2
CB	86.2	83.1	89.1	86.2	89.6	86.9	2.34	2.7%	4
CINF	94.3	90.3	100.6	104.5	101.7	98.3	5.20	5.3%	6
CNA	106.0	107.9	109.0	97.4	94.8	103.0	5.79	5.6%	7
HCC	82.9	83.5	85.1	84.0	84.6	84.0	0.78	0.9%	1
TRV	88.1	87.4	91.9	89.2	93.2	90.0	2.23	2.5%	3
WRB	88.0	88.1	93.1	94.2	94.5	91.6	2.92	3.2%	5

Sources: Company reports and William Blair & Company, L.L.C.

As illustrated in table 63, the volatility of Traveler's five-year combined ratio is low, with a coefficient of variation of 2.5% compared with a peer average of 3.0%. HCC and ACE had very low variation in their combined ratios, while CNA and Cincinnati Financial had significantly higher combined ratio variation relative to the group. Despite the low relative volatility, Traveler's combined ratio increased 5 points from 88.1% in 2006 to 93.2% in 2010. This is a trend to be concerned about, should it continue.

Capital Management

Travelers has been one of the most aggressive managers of capital. This means not only returning material levels of capital to shareholders, but also running the capital base at an efficient level to produce a strong return on equity. The company has returned an average of \$3.5 billion in share buybacks and an average of \$690 million in dividends the last three years. The combination has produced an average annual cash yield on equity of 15.7%.

The other key element is that managing capital has helped maintain returns in the cycle. Reductions in share count have helped EPS growth in the last several years, even as premium growth has been almost nonexistent. A lower capital base has also helped return on equity remain stable, despite premium leverage declining with the soft cycle. We expect total share buybacks in the next two years of \$5.1 billion (including the \$1.1 billion in first quarter 2011), reducing shares by 84.9 million since December 2010. This should help produce a stable ROE around 9%-10%.

Table 64
The Travelers Companies, Inc.
Three-Year Cash Yield
(dollars in millions)

	2008	2009	2010
Dividends	712	690	670
Shares Repurchased	2,122	3,300	5,000
Total Cash Outlay	2,834	3,990	5,670
Net Income	2,917	3,615	3,209
Average Shareholders' Equity	25,793	26,862	26,628
Cash Yield on Net Income	97.2%	110.4%	176.7%
Cash Yield on Equity	11.0%	14.9%	21.3%

Sources: Company reports

Cash Flow Per Share Should Exhibit Moderate Growth

Our forecast suggests cash flow per share will go from \$6.33 in 2010 to \$7.47 in 2012. The key to our forecast is that we expect moderate premium growth, an average of 3% to 4%, reflecting a continued soft market. Our paid loss assumptions are 72.2% for 2011 (heavily affected by catastrophes) and 68.1% for 2012. Our estimate assumes that total cash flow will actually be stable over the next two years at the \$3 billion level. However, an expected 17% reduction in the share count from share repurchases should result in growth in cash flow per share.

Table 65
The Travelers Companies, Inc.
Cash Flow Summary
(dollars in thousands, except per share data)

Line Item	2009	2010	2011E	2012E
Net Written Premiums	21,336,000	21,635,000	22,305,980	23,050,847
Paid Loss	12,918,000	13,697,000	15,832,723	15,441,145
<i>Paid Losses as % of Earned Premium</i>	<i>60.3%</i>	<i>63.9%</i>	<i>72.2%</i>	<i>68.1%</i>
Underwriting & Other Expense	7,179,000	7,208,000	7,383,968	7,612,641
Interest Expense	382,000	388,000	384,000	384,000
Net Investment Income	2,776,000	3,059,000	3,135,282	3,281,208
Depreciation and Amortization	797,000	812,000	812,000	812,000
Other Revenues	469,000	417,000	413,462	422,816
Taxes	1,089,000	1,090,000	498,330	875,323
Core Operating Cash Flow	3,810,000	3,540,000	2,567,702	3,253,762
Core Operating Cash Flow Per Share	\$6.70	\$7.34	\$6.00	\$7.88
Total Cash Flow Adjustments	421,000	-486,000	-92,333	-167,467
Total Operating Cash Flow	4,231,000	3,054,000	2,475,369	3,086,296
Total Operating Cash Flow Per Share	\$7.44	\$6.33	\$5.79	\$7.47
Average Shares Outstanding (thousands)	568,600	482,500	427,875	412,950
Operating ROE	13.4%	11.4%	7.3%	10.4%

Sources: SNL, company reports, and William Blair & Company, L.L.C.

Table 66
The Travelers Companies, Inc.
Statutory Incremental Paid Loss Ratio Projections

Accident Years	12 Months	24 Months	36 Months	48 Months	60 Months	72 Months	84 Months	96 Months	108 Months	120 Months
Prior Year										
2001	23.8%	18.5%	12.0%	7.7%	5.6%	3.0%	1.9%	1.3%	0.8%	1.0%
2002	19.1%	12.9%	7.7%	6.1%	4.4%	2.7%	1.7%	1.0%	0.6%	0.7%
2003	18.2%	12.9%	7.9%	4.7%	3.7%	2.0%	1.1%	0.8%	0.6%	0.7%
2004	17.8%	12.3%	5.9%	4.4%	2.5%	1.6%	1.1%	0.8%	0.5%	0.6%
2005	18.4%	13.4%	5.3%	3.6%	2.3%	1.5%	1.1%	0.8%	0.5%	
2006	17.3%	9.8%	5.2%	3.6%	2.7%	1.5%	1.0%	0.7%		
2007	18.2%	10.4%	5.7%	3.9%	2.8%	1.6%	1.1%			
2008	22.9%	12.3%	6.6%	4.7%	3.3%	2.0%				
2009	21.6%	12.3%	6.4%	4.6%	3.2%					
2010	24.0%	13.8%	7.1%	5.1%						
2011	26.0%	14.9%	7.7%							
2012	24.0%	13.8%								
2013	27.0%									

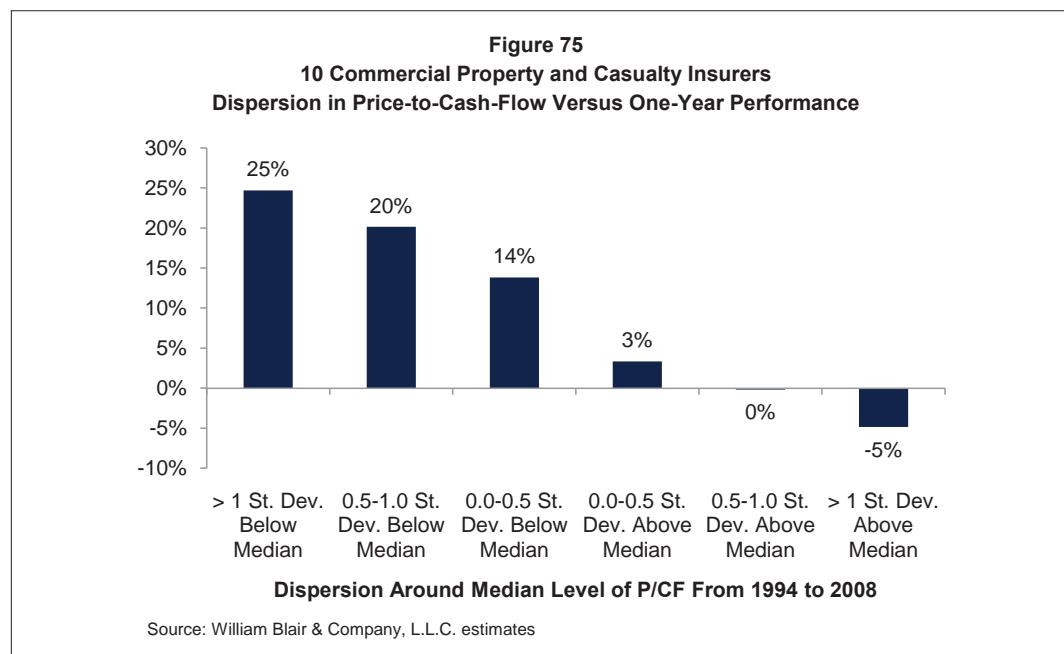
Sources: SNL and William Blair & Company, L.L.C. estimates

Valuation Framework

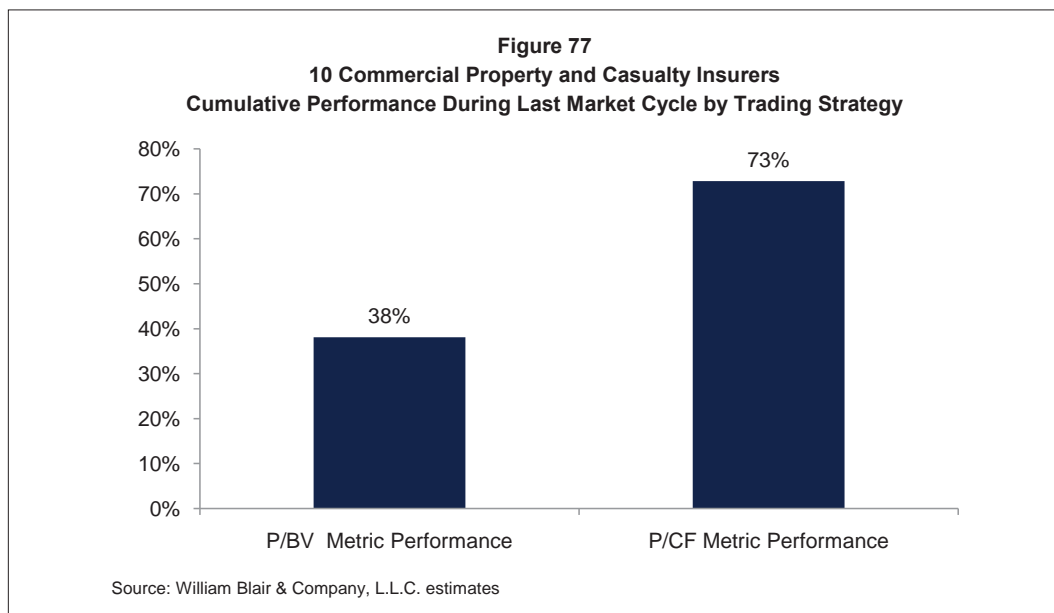
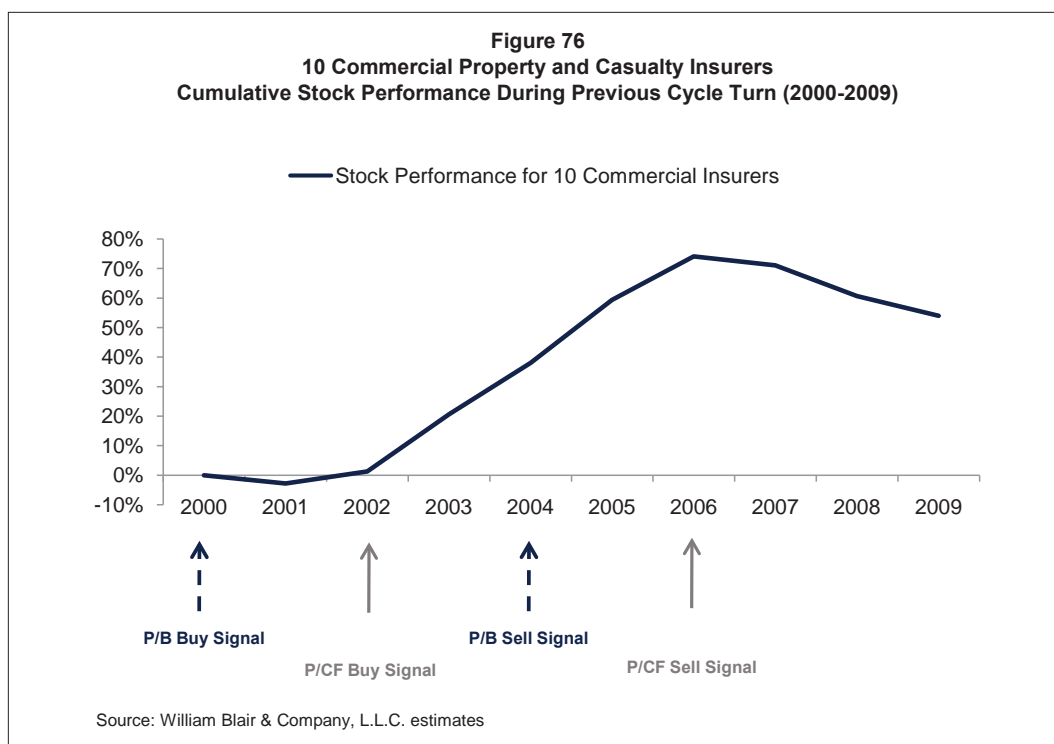
Overall Cash Flow Theory

Cash flow has shown to be a good indicator and is highly correlated to future stock movements. We use price-to-cash-flow (P/CF) as the measure to predict stocks. Our historical analysis shows that this measure clearly indicates when to buy or sell insurance stocks. Our methodology is based on back-testing P/CF ratios for 15 years using 10 midsize to large commercial insurers. The ratio we are focused on is based on average cash flow over a four-year period including the previous year, current year, and the two years following.

The results show that when the P/CF ratio is greater than one standard deviation below the median P/CF ratio, the average return for the next year is 25%. When it is more than one standard deviation above the median P/CF ratio, returns have averaged -5% for the following year. The number of standard deviations above or below the median is inversely correlated with the performance of the stock; thus, the correlation is negative. For example, based on our data set, if a stock was trading at a P/CF valuation lower than the median value, one would expect the performance level for that stock to be positive. The overall correlation for the index is -0.49, which indicates a fairly strong negative relationship between the two variables we are examining.



Cash flow valuations have proved particularly useful in cycle turns. In contrast, earnings and return on equity measures tend to be lagging indicators of performance. Figure 76 shows that P/CF valuation signaled a strong buying opportunity going into 2003 and that investors should sell in 2006. In contrast, price-to-book timing was too early on both entry and exit points. Returns using P/CF entry and exit points were almost double that of market-to-book entry and exit points.



Travelers is the most attractively valued among the group, although we believe upside will be limited in the near term. The stock is the only one with a P/CF under its five-year median. Travelers' P/CF multiple of 8.6 times is 10% above its 5-year median of 7.8 times. In comparison, the other three stocks are trading at an average of 35% above their respective five-year medians. This better-than-average valuation is mainly attributable to our expectation that Travelers' cash flow per share will actually increase moderately over the next two to three years. In contrast, several of the competitors will likely experience declining cash flow per share. However, given that the stock is trading close to its median P/CF, we believe upside is limited. Historically, property-and-casualty stocks have limited upside when they are trading close to their median. Typically, the valuation needs to move below 0.5 standard deviations before the potential for positive returns materially improves.

Table 67
The Travelers Companies, Inc.
Cash Flow Valuation Comparison

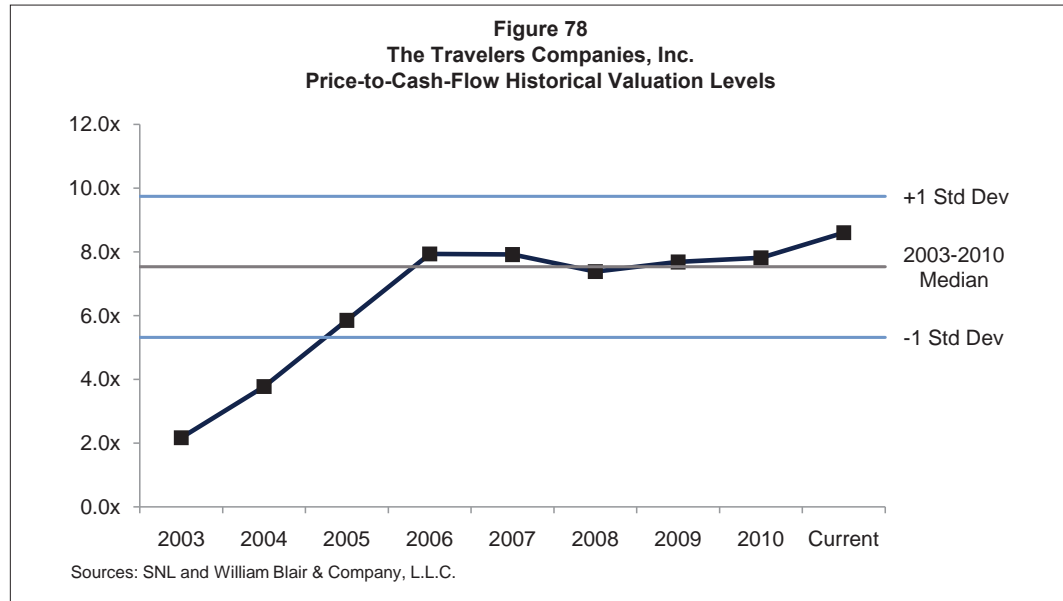
Company	Ticker	Rating	Current Price	Cash Flow Valuation						Earnings Valuation				Book Valuation		
				Cash Flow Per Share 2011	Cash Flow Per Share 2012	Price to Cash Flow ¹	2006-2010 Median	Current Valuation vs. 5 Year Median	Number of Std. Deviations from 10 Year Median	EPS 2011E	EPS 2012E	PE 2011	PE 2012	Current Book Value	Current Price To Book	2012 ROE
The Chubb Corporation	CB	U	\$62.61	\$6.26	\$6.09	9.4x	7.3x	30%	1.5	\$5.40	\$5.30	11.6x	11.8x	\$53.26	1.2x	9%
HCC Insurance	HCC	U	\$31.50	\$3.25	\$3.23	9.2x	5.7x	60%	2.6	\$2.66	\$2.78	11.8x	11.3x	\$28.99	1.1x	9%
RLI Corp.	RLI	M	\$61.92	\$6.64	\$5.70	10.6x	9.1x	16%	1.5	\$4.19	\$4.40	14.8x	14.1x	\$38.52	1.6x	11%
The Travelers Companies ²	TRV	M	\$58.38	\$5.79	\$7.47	8.6x	7.8x	10%	0.5	\$4.25	\$6.10	13.7x	9.6x	\$59.91	1.0x	10%
Average																
Median																

Note¹: Price to Cash Flow Based off Current Price Divided by 4 year cash flow: t- -1,0,1,2

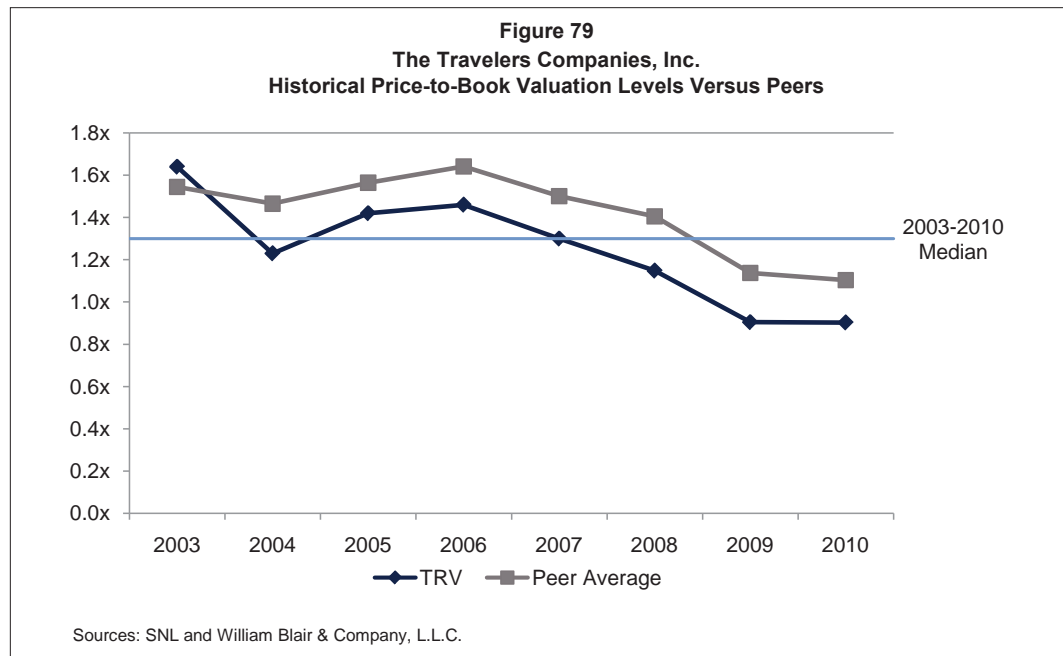
Note²: Travelers data only goes back through 2002

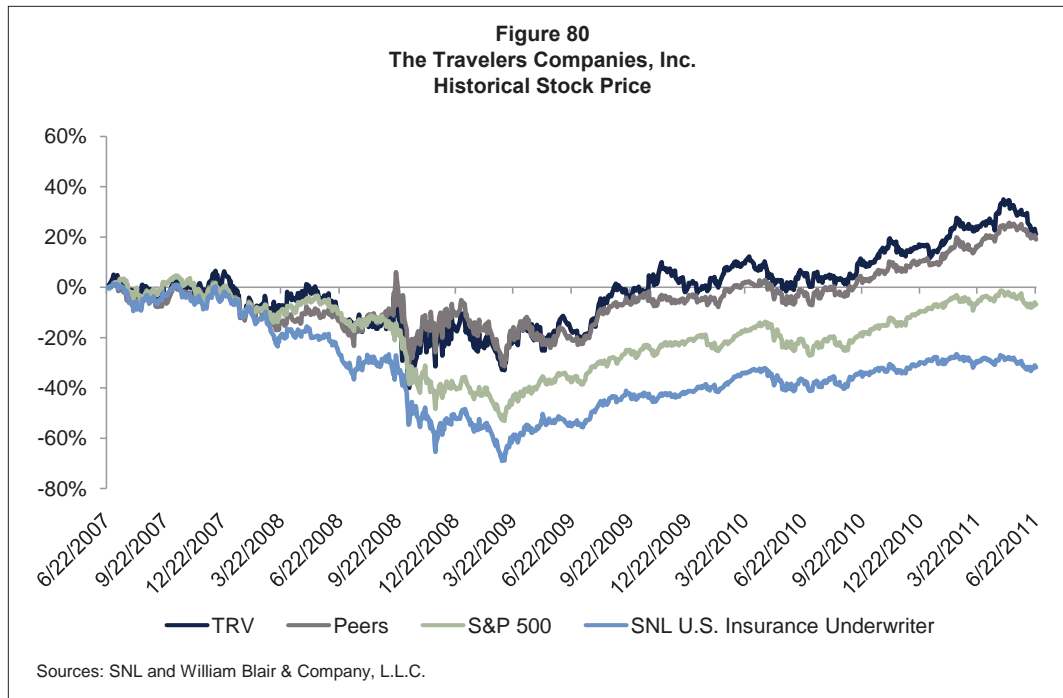
Source: William Blair & L.L.C. estimates.

Travelers has more of a limited trading history given that the company has been in its current form for less than a decade. The graph shows that the company had a very attractive P/CF in 2003 (2 times) and 2004 (4 times). The two-year average annual return was 71% for 2003-2004. However, returns were substantially less impressive from 2006 to 2010 as the average P/CF mainly stayed above 7 times.



Travelers—with a current price-to-book ratio of 1 times—is trading below its median level of 1.3 times and at a modest discount to peers. We believe the company has a better chance for more stable returns going forward. However, ROE will still likely show moderate erosion through 2013, going to 9%. Based on this scenario, we believe the price-to-book will likely stay at relatively depressed levels.



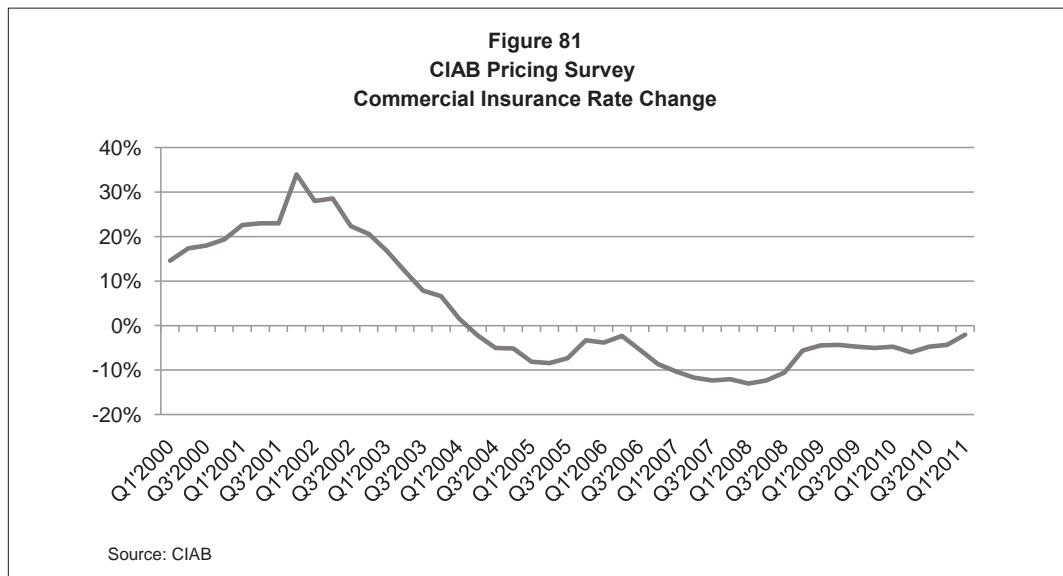


Travelers stock has had only modest returns in the last several years and had moderately underperformed peers. The stock is up less than 10% from its peak in late 2007 to 2008. On a relative basis compared with other peers, we believe performance could improve. However, as already discussed, there should be little in the way of positive momentum in the near future.

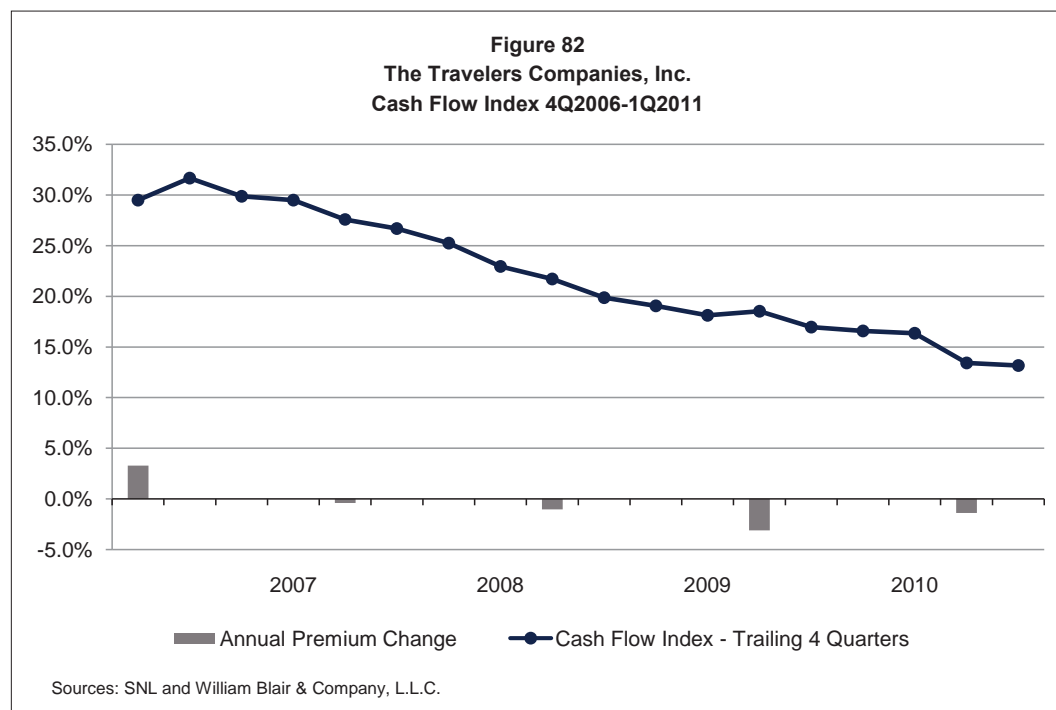
Key Factors/Risks to Watch

Commercial Insurance Rates

On average, commercial insurance rates (i.e., prices) have been more stable recently, but are still declining. Given the broad nature of Travelers' portfolio, the company has exposure to most lines of business. According to the Council of Insurance Agents & Brokers (CIAB), rates were down -10.4% in 2008, but down only -4.9% in 2010.



We expect rates to continue to decline in 2011 and 2012. Based on our cash flow benchmark series study, we believe that the pricing cycle could turn in 2013 or 2014. The study shows that cash flow is declining across the sector, which is a precursor of a better pricing environment. Once our cash index declines below 10%, this suggests that pricing will increase in 12 to 18 months. The index recently dipped below the 15% level.



Workers' Compensation

Travelers is one of the largest competitors in the workers' compensation line, an area of the market that is exhibiting declining profitability levels. The company is the third-largest provider of workers' compensation insurance in the market, with \$2.6 billion of net written premiums (up from \$2.1 billion in 2006). Travelers has a 7% share of the workers' compensation market in the United States.

Workers' compensation loss ratios are rising on an industrywide basis. The market is at the tail end of the favorable point in its underwriting cycle. Workers' compensation, similar to other commercial lines, had been highly unprofitable at the end of the last soft cycle. Subsequently, pricing increased and many competitors exited or at least reduced their activity in the market. These actions, combined with a number of legislative bills that helped limit claim levels, resulted in high levels of profitability starting in 2004.

Given the lag in results, as workers' compensation is a long-tailed line, insurers are still experiencing the benefits, but these are eroding. Accident-year loss ratios have been increasing. Pricing has been going down in most segments, with some reductions more aggressive than others, particularly in California and Florida. This was masked to some degree by benign loss activity, as claim frequency has been favorable in the last several years, but the effect of lower pricing is beginning to set in. In addition, claim activity has picked up as workers are less afraid to file, healthcare costs are rising, and a number of the California legislative improvements are being negated by court decisions.

Table 68
The Travelers Companies, Inc.
Workers' Compensation Accident-Year Incurred Loss Ratios

Accident Year	Travelers									
	12 Months	24 Months	36 Months	48 Months	60 Months	72 Months	84 Months	96 Months	108 Months	120 Months
2001	95.7%	94.2%	95.8%	95.9%	95.3%	98.9%	99.9%	103.2%	103.5%	101.2%
2002	81.6%	77.1%	81.6%	84.4%	85.6%	88.6%	87.7%	88.1%	86.2%	
2003	79.1%	70.7%	72.5%	73.5%	76.2%	77.7%	76.6%	75.0%		
2004	84.1%	77.4%	70.4%	67.9%	67.1%	65.8%	64.1%			
2005	79.0%	72.8%	69.1%	65.4%	64.4%	62.9%				
2006	81.1%	73.9%	68.3%	67.7%	65.5%					
2007	73.6%	72.0%	71.4%	69.5%						
2008	75.8%	76.7%	76.6%							
2009	75.5%	74.4%								
2010	77.9%									

Accident Year	Insurance Industry									
	12 Months	24 Months	36 Months	48 Months	60 Months	72 Months	84 Months	96 Months	108 Months	120 Months
2001	74.7%	76.9%	78.0%	78.9%	82.0%	82.8%	84.1%	84.7%	85.8%	86.8%
2002	68.5%	68.9%	69.6%	70.6%	71.2%	71.5%	71.7%	72.2%	72.6%	
2003	71.2%	67.1%	65.8%	66.1%	66.0%	66.4%	66.3%	66.3%		
2004	69.5%	64.6%	62.3%	60.2%	59.6%	59.2%	58.9%			
2005	67.5%	63.0%	59.2%	57.8%	57.1%	56.6%				
2006	67.5%	63.5%	61.9%	60.7%	60.2%					
2007	69.2%	67.9%	66.9%	66.7%						
2008	70.6%	71.3%	71.9%							
2009	73.4%	73.8%								
2010	76.6%									

Sources: SNL and Schedule P

Asbestos Reserves

Travelers has one of the largest asbestos exposures in the industry. While this issue has been dormant in recent years, it is worth keeping an eye on. The company has total reserves of \$2.5 billion. It is a challenge to gauge progress in this area, but the fact that net losses paid have come down from \$658 million in 2008 to \$350 million in 2010 signifies that it is not getting worse and the company has potentially worked through some of the larger cases.

Table 69
The Travelers Companies, Inc.
Asbestos Reserves
 (dollars in millions)

	Number of Policyholders			Total Net Paid			Net Asbestos Reserves		
	2010	2009	2008	2010	2009	2008	2010	2009	2008
Policyholders with settlement agreements	17	18	23	112	139	389	583	621	749
Home office and field office	1,705	1,697	1,651	209	176	217	1,778	1,956	1,983
Assumed reinsurance and other	0	0		29	26	52	187	181	182
Total	1,722	1,715	1,674	350	341	658	2,548	2,758	2,914

Source: Company reports

Table 70
The Travelers Companies, Inc.
Asbestos and Environmental Loss and LAE Unfavorable Prior-Year Development by Accident Year
(dollars in millions)

Asbestos	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Gross	5,953	5,680	2,020	1,995	1,547	713	516	517	447	262
Net	4,493	4,311	1,366	1,342	1,382	551	395	395	325	140

Environmental	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Gross	940	887	733	674	522	505	397	215	130	45
Net	893	851	701	642	525	495	375	190	105	35

Source: Company reports

Environmental exposure is much smaller than asbestos, with only \$350 million of reserves, and similar to asbestos claim activity, it has been receding in recent years. Table 70 shows the cumulative prior-year unfavorable development by accident year for asbestos and environmental reserves by accident year. This tables illustrates the danger that asbestos and environmental liabilities represent, as reserves have been deficient for every accident year.

Loss Deterioration

Although premiums are split 65% from commercial and 35% from personal lines, commercial lines account for 89% of reserves. The commercial segment has shown a significant deterioration in accident-year loss ratios in last three years, reflecting a six-year drop in pricing that has averaged more than 30% in most lines. Lines with particular declines include workers' compensation, directors' and officers' (D&O), and commercial multiple peril. Travelers' overall accident-year loss ratios have been similarly affected, with loss ratios excluding catastrophes increasing from 58.4% in 2007 to 61.6% in 2010. Including property catastrophe losses, the 2010 accident-year loss ratio is 66.8%.

We expect further deterioration. Pricing is more stable in 2011 than in 2010, but is still negative in most lines. International property treaty will likely be the exception. Claim activity, which was benign with the recession, appears to picking up. This means that 2009 and 2010 accident-year loss ratios could be understated on an industrywide basis. Overall, we forecast accident-year loss ratio excluding catastrophes will increase from 61.6% in 2010 to 63.6% in 2012 to reflect continued market underpricing and the potential for increased claim activity.

Table 71
The Travelers Companies, Inc.
Loss, Expense, and Combined Ratio Summary

	2005	2006	2007	2008	2009	2010	2011E	2012E
Loss and LAE Ratio	71.9%	57.5%	56.6%	59.4%	57.3%	61.0%	69.5%	65.5%
Underwriting Expense Ratio	29.4%	30.6%	30.8%	32.5%	31.9%	32.2%	32.5%	32.5%
GAAP Combined Ratio	101.3%	88.1%	87.4%	91.9%	89.2%	93.2%	102.0%	98.0%
Net Favorable Prior-Year Reserve Development	1.6%	-1.9%	-2.5%	-7.1%	-6.2%	-5.8%	-4.3%	-2.1%
Catastrophes Net of Reinsurance	10.7%	0.5%	0.7%	6.5%	2.1%	5.2%	11.0%	4.1%
Accident-Year Loss Ratio Excluding Catastrophe	59.6%	58.9%	58.4%	60.0%	61.4%	61.6%	62.9%	63.6%

Sources: Company reports

Financial Projections

Table 72
The Travelers Companies, Inc.
Financial Summary
(dollars in millions)

	2010A	2011E	2012E
Premiums	21,432	21,917	22,668
Net investment income	3,059	3,135	3,281
Total revenues	24,848	25,466	26,372
Operating income before income taxes	4,035	2,261	3,330
Income tax expense	999	443	811
% tax rate	24.8%	19.6%	24.3%
Operating income	3,036	1,818	2,520
Operating Income per share	6.26	4.25	6.10
% growth	-0.5%	-32.1%	43.6%
Diluted weighted average shares outstanding	482.5	427.9	413.0
Operating ROE	11.4%	7.3%	10.4%
Book value per share at period end	58.5	59.3	58.7
Loss and LAE ratio	61.0%	69.5%	65.5%
Underwriting expense ratio	32.2%	32.5%	32.5%
GAAP combined ratio	93.2%	102.0%	98.0%
Net favorable prior year reserve development	-5.8%	-4.3%	-2.1%
Catastrophes net of reinsurance	5.2%	11.0%	4.1%
Accident-year loss ratio excluding catastrophe	61.6%	62.9%	63.6%

Sources: Company reports and William Blair & Company, L.L.C. estimates

Summary

We forecast earnings per share to stay relatively flat over the next two years, with expected 2012 EPS of \$6.10 compared with \$6.26 in 2010. Share buybacks should help compensate for the expected deterioration in core earnings. Our forecast assumes that operating income declines from \$3.0 billion in 2010 to an expected \$2.5 billion in 2012. However, our estimates assume that diluted shares are reduced from 482 million to 413 million, as the lack of growth opportunities should translate into a high rate of share buybacks. We estimate return on equity to be between 9% and 10% and book value per to stay flat in the \$58-\$59 range over the next two years.

Upside/Downside Potential

A turn in the pricing cycle would be the biggest source of upside compared with our estimates. Our estimates assume continued pressure on pricing, as there have been no convincing signs of a turn, and we model 2013 to be a more likely time for the beginning of a hard cycle. From a downside perspective, the biggest risks to earnings are further increases in the loss ratio, particularly in the casualty segment, and an even more-exaggerated decline in reserve development during 2011 or 2012. Our current forecast assumes that reserve development will stay favorable through 2012 and be relatively flat in 2013. Each point of negative development would reduce earnings per share by roughly \$0.40.

Key Earnings Factors

Premium growth. We expect gross premiums written to increase by an average of 3% over the next three years. The personal lines and business insurance segment will likely experience moderate levels of growth, but should continue to be restrained by relatively soft markets. The financial, professional, and international lines will be helped in the near term by the recent JMalucelli acquisition, but are likely to remain slow as professional markets are relatively depressed.

Investment income. We forecast that investment income will grow slowly through 2012, as continued pressure on yields and a slow-to-recover economy continue to hurt growth in the portfolio. If interest rates begin to increase in 2012, there could be additional upside in investment income.

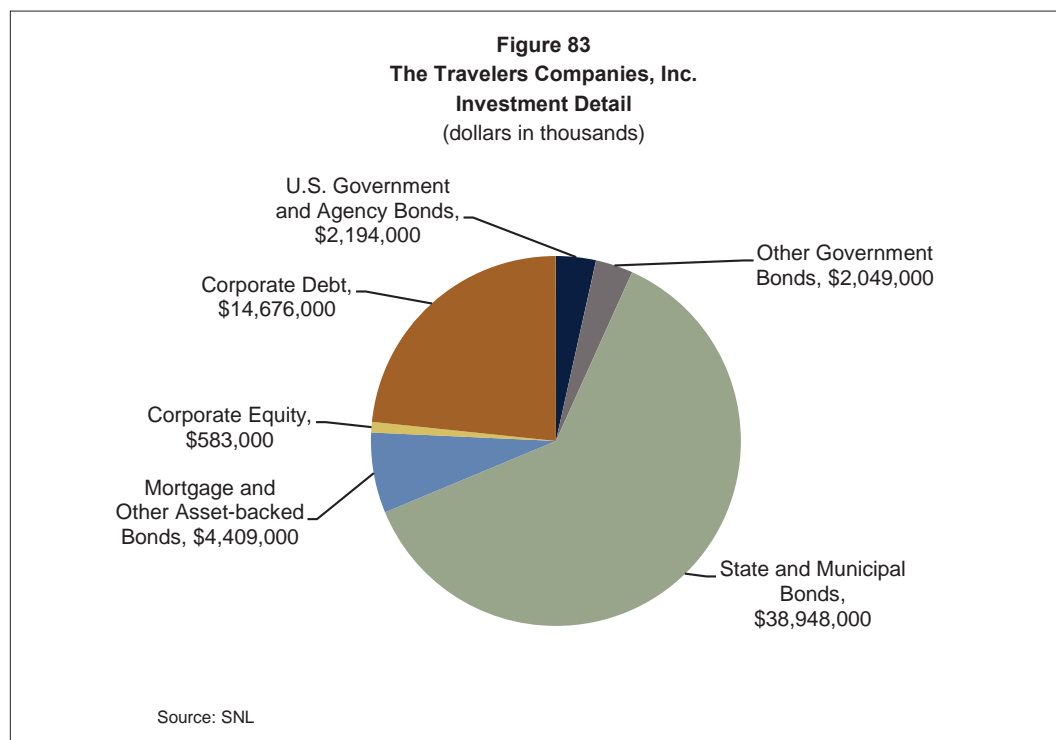
Loss ratio. We forecast that the accident-year loss ratios will continue to increase moderately as the soft market pressures underwriting margins. Our forecast has the accident-year loss ratio (excluding catastrophes) gradually increasing from 61.6% in 2010 to 63.6% in 2012. Calendar-year loss ratios are projected to grow even faster, due to declining levels of reserve development. We project reserve development to decline from 6 points favorable in 2010 to 2 points favorable in 2012, due to heavier losses in the underwriting accident years between 2007 and 2010.

Expense ratio. We believe the expense ratio may have some modest upward bias in the near term because of pressure to be competitive on agent/broker commissions and the potential for higher reinsurance costs. Our forecast has the expense ratio increasing by 30 basis points to 32.5% in 2012.

Balance Sheet

We expect Travelers to continue to underwrite on a well-capitalized basis. Net premiums written to GAAP equity should stay in the 0.85 to 0.91 times range over the next two years, which is very conservative, but admirable in the current market environment. The company is slightly more leveraged on gross basis, with an expected gross premium to GAAP equity of 0.91-0.95 times. We believe these are acceptable ranges given the current market environment, but expect them to pick up as we begin to see a turn in the cycle over the next few years.

Travelers' investment portfolio contains high-quality fixed-income securities, equity investments, and short-term investments, and is somewhat aggressively positioned compared with its peers. Based on the current market conditions and future expectations, we estimate the yield on investments to remain around 5% for the near term.

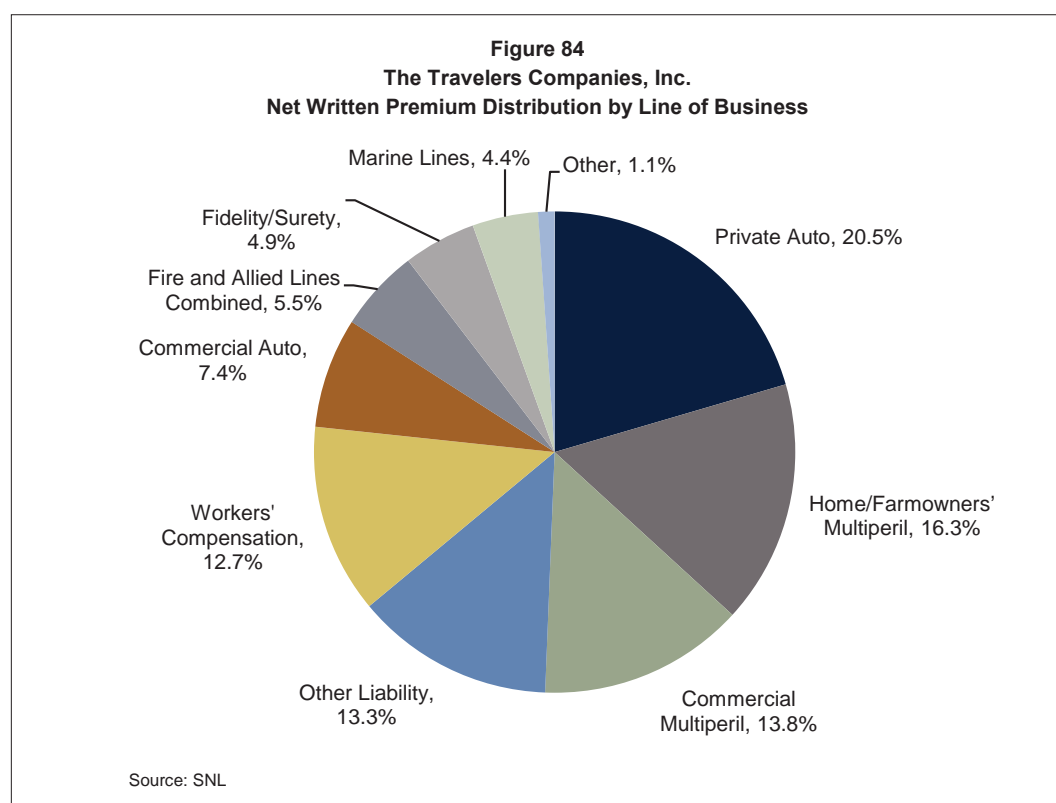


Corporate Profile

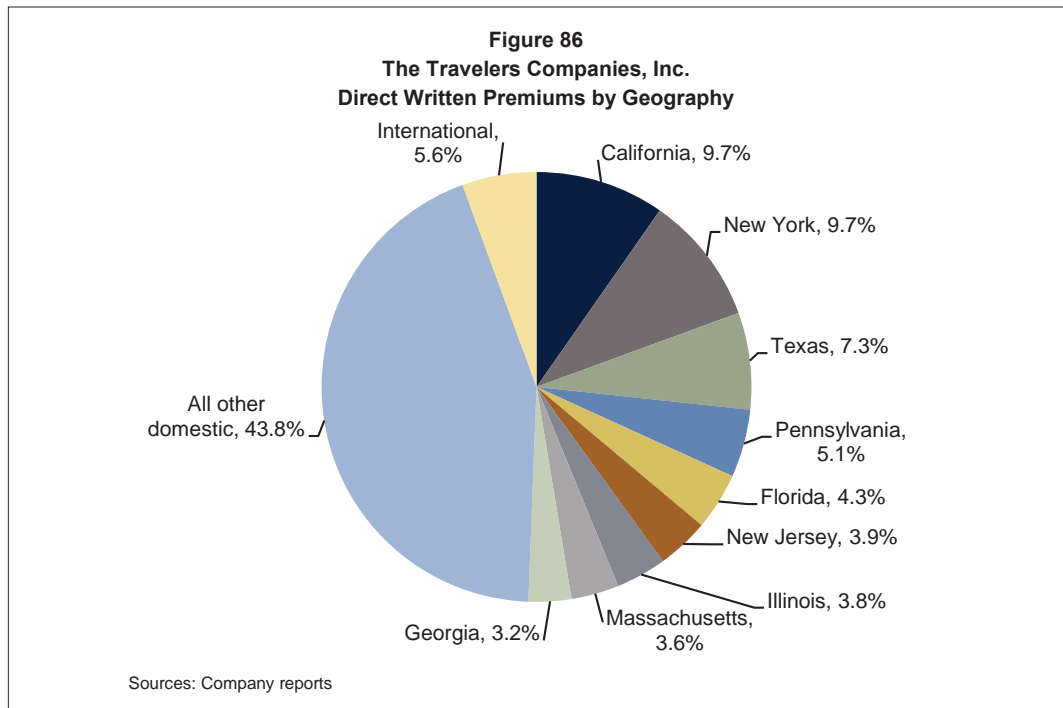
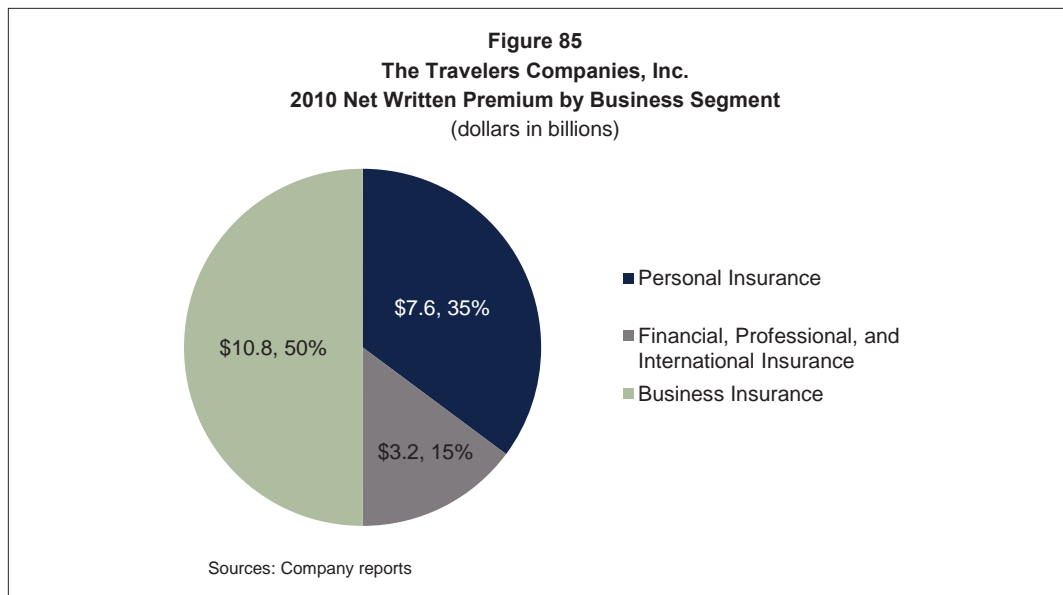
The Travelers Companies, Inc., founded in 1853, is an international property-and-casualty insurance holding company that underwrites and sells a diverse array of insurance products to businesses, government agencies, and consumers. The Travelers Companies became the entity it is today through the merger of St. Paul and Travelers Companies in 2004.

Travelers has offices in North America and Europe and is recognized as the sixth-largest U.S. P&C insurance group by A.M. Best. The company, with 2010 written premiums of \$23.3 billion and net income of \$3.2 billion, displays results across three underwriting business segments: business insurance; financial, professional, and international (FPI) insurance; and personal insurance. Travelers is one of the highest rated P&C firms in the United States, with an AA rating from S&P and an A+ rating from A.M. Best.

Travelers writes a multitude of different insurance products across many different insurance lines. The major types of insurance offered by statutory line are private auto (which accounts for 20% of total net written premiums), homeowners' (16%), commercial multiperil (14%), other liability (13%), workers' compensation (13%), commercial auto (7%), fire and allied lines (6%), fidelity/surety (5%), marine lines (4%), and all other lines (1%).



Travelers separates its operating results into three distinct segments. For 2010, the business insurance segment constituted 51% of total written premiums, the personal insurance segment was 34% of written premiums, and the FPI segment was 15% of total written premiums. Only 6% of net written premiums were written abroad; the remaining 94% were written domestically.



Structurally, Travelers writes insurance policies on a direct basis through multiple insurance companies and underwriting agencies across the United States and internationally.

Travelers also ceded roughly 5% of its business in 2010 to reinsurers to diversify risk and limit its maximum loss from catastrophic events.

Business Insurance

Table 73
The Travelers Companies, Inc.
Business Insurance LOB Net Written Premium Mix
(dollars in millions)

	2008	2009	2010
Commercial multiperil	2,938	2,933	2,995
% change	-4.2%	-0.2%	2.1%
Workers' compensation	2,452	2,486	2,586
% change	8.2%	1.4%	4.0%
Commercial automobile	1,952	1,927	1,910
% change	-2.9%	-1.3%	-0.9%
Property	1,860	1,727	1,641
% change	-6.5%	-7.2%	-5.0%
General liability	2,011	1,829	1,726
% change	3.5%	-9.1%	-5.6%
Other	7	0	-1
Total	11,220	10,902	10,857
% change	-0.9%	-2.8%	-0.4%

Sources: Company reports

Table 74
The Travelers Companies, Inc.
Business Insurance Net Written Premiums

	2010	% of total
Select Accounts	2,718	25.0%
Commercial Accounts	2,576	23.7%
National Accounts	806	7.4%
Industry-Focused Underwriting	2,299	21.2%
Target Risk Underwriting	1,573	14.5%
Specialized Distribution	872	8.0%
Business Insurance Other	13	0.1%
Total Business Insurance	10,857	100%

Sources: Company reports

The business insurance segment offers a broad array of P&C products and services to businesses of all sizes across the United States. Travelers splits its business insurance segment into five underwriting and marketing groups; three are organized around the size of the accounts, and the other two are focused on niche product lines or industries. The main lines of business the segment deals with are workers' compensation, commercial automobile, property, commercial liability, and commercial multi-peril. The products are distributed through a vast network of independent agencies and brokers, which typically sell Travelers' personal insurance products as well. The business insurance segment has developed its own proprietary pricing and underwriting system that has established a strong record of success.

The select accounts group generally sells packaged P&C coverage to small businesses (typically fewer than 50 employees) through an extensive broker and independent agent network. The business has recently expanded product offerings for brokers and agents, and relies on a technology platform for efficiently quoting and issuing business. Commercial accounts are geared toward more midsize accounts, but the platform has recently been expanded to be able to service these clients' insurance needs on a global basis. The division is focused on developing even more specialized tools and expertise for specific industries, as well as expanding into new lines of coverage to offer a more comprehensive product base. National accounts representatives go after large corporations with highly customizable offerings and

services. The business unit has been focused on adding capabilities to its platform, like metric tracking, alternative risk transfer offerings, and claims administration, to help clients manage and monitor their risk levels.

The target risk and industry-focused underwriting units are designed to deal with niche areas and provide more expertise with specific industries. The target risk group delivers specialized commercial coverage for large property, inland marine, ocean marine, equipment breakdown, and excess casualty. Industry-focused underwriting professionals cater to complex industries like energy, technology, agriculture, and construction, as well as public sector clients.

The business insurance segment generated total revenues for 2010 of \$13.2 billion compared with \$13.2 billion for 2009, which was an improvement following the 2% decline in 2009 and 7% decline in 2008. A 13% increase in investment income in 2010 offset a 2% decline in net earned premiums to get revenue to a flat result. The accident-year loss ratio excluding catastrophes has increased from 59.7% in 2007 to 63.4% in 2010. The overall combined ratio is also the highest in four years, at 91.3%, compared with a prior three-year average of 88%. This is the result of continued soft pricing in the commercial lines market, which is putting pressure on Travelers and its competitors. The 91.3% combined ratio is a good result taking the current environment into consideration, and is superior to many of its competitors.

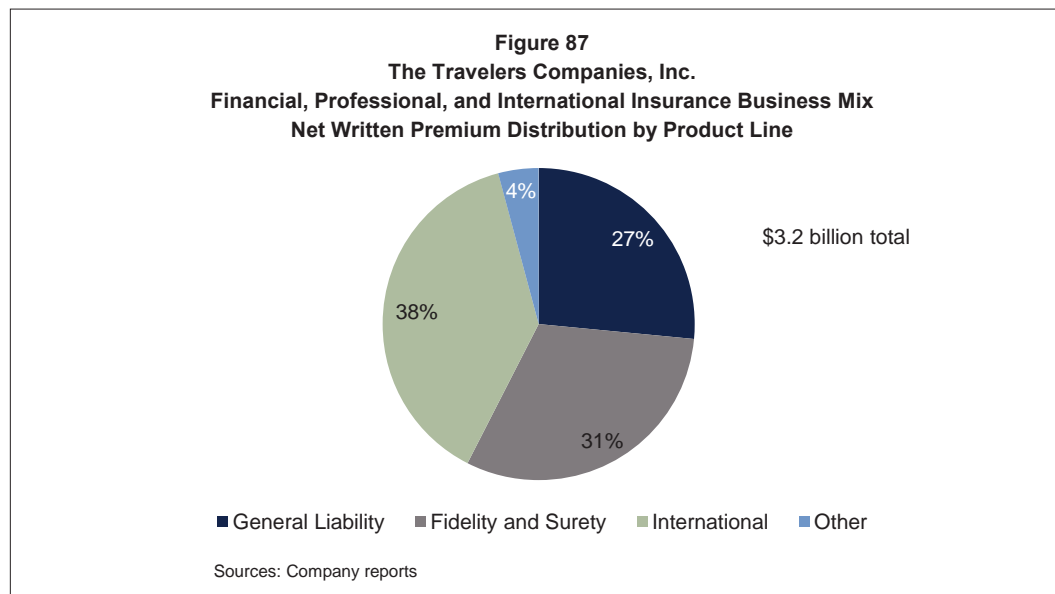
We project a net combined ratio of 98.9% for 2011, which is affected by 7.8 points of catastrophe losses and 5.5 points of favorable reserve development. We expect an accident-year loss ratio excluding catastrophes of 64.3% for 2011 compared with 63.4% for 2010. These projections result in an operating income before taxes of \$2.3 billion compared with \$3.1 billion for 2010. Excluding catastrophes from both years, the net combined ratio we project will be 3.9% higher in 2011 than 2010.

Table 75
The Travelers Companies, Inc.
Business Insurance Summary
(dollars in millions)

	2007	2008	2009	2010	2011E	2012E
Net written premiums	11,318	11,220	10,902	10,857	11,418	11,820
% change	2.5%	-0.9%	-2.8%	-0.4%	5.2%	3.5%
Net earned premiums	11,283	11,180	10,968	10,766	11,177	11,639
% change	3.7%	-0.9%	-1.9%	-1.8%	3.8%	4.1%
Net investment income	2,708	1,917	1,902	2,156	2,246	2,392
% change	6.7%	-29.2%	-0.8%	13.4%	4.2%	6.5%
Total revenues	14,523	13,517	13,218	13,235	13,732	14,343
% change	3.4%	-6.9%	-2.2%	0.1%	3.8%	4.5%
Claims and claim adjustment expenses	6,673	6,608	6,037	6,504	7,598	7,797
Amortization of deferred acquisition costs	1,742	1,818	1,775	1,749	1,827	1,905
General and administrative expenses	2,028	2,079	1,966	1,904	1,971	2,064
Total claims and expenses	10,444	10,506	9,778	10,157	11,396	11,767
Operating income before taxes	4,079	3,011	3,440	3,078	2,336	2,577
% change	15.2%	-26.2%	14.2%	-10.5%	-24.1%	10.3%
Loss and LAE	57.1%	57.7%	53.9%	59.1%	66.5%	65.6%
Underwriting expense ratio	30.7%	32.5%	32.2%	32.2%	32.4%	32.5%
Combined ratio	87.8%	90.2%	86.1%	91.3%	98.9%	98.1%
Impact of catastrophes	0.0%	6.3%	1.6%	4.1%	7.8%	3.0%
Impact of prior-year reserve development	-2.6%	-10.0%	-9.3%	-8.4%	-5.5%	-2.6%
Accident-year loss ratio excl. catastrophes	59.7%	61.3%	61.6%	63.4%	64.3%	65.3%

Sources: Company reports

Financial, Professional, and International Insurance



The FPI segment services three distinct client groups. The professional business unit offers management and professional liability for corporations and specific professions including lawyers, real estate agents, and architects. The financial group offers typical P&C products solely to financial institutions and houses the bond and surety business for construction and other general commercial enterprises. The international business offers P&C and liability coverage to companies in the United Kingdom, Canada, Ireland, and other countries around the globe through its operations at Lloyd's.

The FPI segment has seen net earned premiums decline by 0.5% in 2010 compared with a decrease of 2.8% for 2009 and a 1.3% increase for 2008. The accident-year loss ratio excluding catastrophes has remained steady the last three years, as has the overall combined ratio. The 2010 combined ratio was supported by 7.8 points of favorable prior-year development. Of the product lines, the general liability business shrunk the most (6%) in 2010, while the FPI segment excluding general liability shrunk 1%. The general liability lines of business have seen the greatest across-the-board price decreases, so this should be somewhat expected. For now, this has not affected the combined ratio, but it is possible that favorable prior-year development for new calendar years will be less than historical levels.

We expect this segment to deteriorate due to the rate softness in the professional liability market. Our projections have a combined ratio of 90.2% for 2011, 98.2% for 2012 and 104.8% for 2013. In the past 3 years this line has been supported by an average prior year favorable development of 7%. This should decline going forward and our projections incorporate a 6.7% favorable development for 2011, 1.4% favorable for 2012 and 3% adverse for 2013. Pretax operating income is projected to decline from \$865 million in 2010, to \$732 million in 2011, and to \$467 million in 2012.

Table 76
The Travelers Companies, Inc.
Financial, Professional, and International Insurance Segment Summary
(dollars in millions)

	2007	2008	2009	2010	2011E	2012E
Net written premiums	3,465	3,468	3,285	3,211	3,030	3,019
% change	2.1%	0.1%	-5.3%	-2.3%	-5.6%	-0.4%
Net earned premiums	3,384	3,429	3,333	3,317	3,080	3,007
% change	1.9%	1.3%	-2.8%	-0.5%	-7.2%	-2.4%
Net investment income	494	454	452	439	419	400
% change	15.2%	-8.1%	-0.4%	-2.9%	-4.5%	-4.5%
Total revenues	3,907	3,907	3,812	3,785	3,531	3,444
% change	3.5%	0.0%	-2.4%	-0.7%	-6.7%	-2.5%
Claims and claim adjustment expenses	1,737	1,769	1,747	1,700	1,636	1,845
Amortization of deferred acquisition costs	654	652	622	612	574	566
General and administrative expenses	590	581	579	608	587	566
Total claims and expenses	2,981	3,004	2,948	2,920	2,798	2,977
Operating income before federal income taxes	926	903	864	865	732	467
Loss and LAE	50.8%	51.2%	52.1%	50.9%	52.7%	61.0%
Underwriting expense ratio	36.8%	36.0%	36.0%	36.8%	37.4%	37.3%
Combined ratio	87.6%	87.2%	88.1%	87.7%	90.2%	98.2%
Impact of catastrophes on combined ratio	0.0%	2.5%	0.1%	2.5%	0.6%	0.6%
Impact of prior-year reserve development on combined ratio	-2.7%	-8.0%	-5.1%	-7.8%	-6.7%	-1.4%
Accident-year loss ratio excluding catastrophes	53.5%	56.7%	57.1%	56.3%	58.9%	61.8%

Sources: Company reports

Personal Insurance

Table 77
The Travelers Companies, Inc.
Personal Insurance Net Written Premium
(dollars in millions)

	2010	% of total
Automobile	3,772	49.8%
Homeowners' and Other	3,795	50.2%
Total Personal Insurance	7,567	100.0%

Source: Company reports

The personal insurance segment offers a broad array of products to consumers through multiple distribution channels. Insurance lines offered include automobile, homeowners', umbrella, tenant, flood, valuable items, boat and yacht, and many other specialty lines. Because of the variety of distribution channels, Travelers has devoted a lot of effort over the past several years to improving its efficiency in this area. It has developed a new quoting system to facilitate the quoting and issuing of new insurance policies for independent agencies, as well as building out its direct-to-consumer offerings to make them more user-friendly and simplify the insurance shopping process.

The two largest lines of insurance in the personal segment are automobile and homeowners'. Auto insurance tends to be driven by changes in claim frequency, which generally correlates with changes in overall economic conditions, and by inflation through costs like repairs, medical care, and litigation charges. The homeowners' business is driven by similar factors, but with the added factor of catastrophe damages associated with natural disasters, which makes assessing potential losses more difficult and makes claims far more concentrated in specific periods. Both of these coverages, particularly the rates charged, are subject to intense scrutiny at the state-regulatory level, which makes it more difficult to be responsive to changes in the environment that necessitate rate changes. Both of these lines also tend to be very competitive on price, due to the commoditized nature of many companies' offerings.

The personal insurance segment has seen its combined ratio rise in the last three years, with an average of 96.6%, compared with a 2005-2007 average of 86.3%. This is a result of increasing accident-year excluding catastrophe loss ratios coupled with declining favorable prior-year development. Catastrophe ratios on average have been 2.4 points worse than in the 2005-2007 period. Operating pretax income has dipped from \$1.65 billion in 2006 to \$574 million for 2010. The second quarter of 2011 will be a particularly tough quarter for the personal lines segment, due to an estimated \$1.15 billion in catastrophe losses. This pulls down our estimate for 2011 pretax operating earnings to -\$406 million, although we project a rebound in 2012, to \$671 million. We expect the accident-year loss ratio excluding catastrophes to increase to 62.4% in 2011, but then to stay relatively stable through 2013.

Table 78
The Travelers Companies, Inc.
Personal Insurance Summary
(dollars in millions)

	2007	2008	2009	2010	2011E	2012E
Net written premiums	6,835	6,995	7,149	7,567	7,857	8,211
% change	1.8%	2.3%	2.2%	5.8%	3.8%	4.5%
Net earned premiums	6,803	6,970	7,117	7,349	7,660	8,023
% change	3.7%	2.5%	2.1%	3.3%	4.2%	4.7%
Net investment income	559	421	422	464	470	489
% change	2.0%	-24.7%	0.2%	10.0%	1.4%	4.0%
Total revenues	7,452	7,465	7,623	7,888	8,204	8,585
% change	3.4%	0.2%	2.1%	3.5%	4.0%	4.7%
Claims and claim adjustment expenses	3,987	4,616	4,624	5,006	6,177	5,373
Amortization of deferred acquisition costs	1,310	1,410	1,416	1,441	1,461	1,525
General and administrative expenses	699	829	784	867	971	1,017
Total claims and expenses	5,996	6,855	6,824	7,314	8,610	7,914
Operating income before federal income taxes	1,456	611	799	574	-406	671
Loss and LAE	58.6%	66.2%	65.0%	68.1%	80.6%	67.0%
Underwriting expense ratio	28.2%	30.8%	29.6%	30.2%	30.7%	30.6%
Combined ratio	86.8%	97.0%	94.6%	98.3%	111.3%	97.6%
Impact of catastrophes on combined ratio	2.4%	8.9%	3.9%	8.1%	19.9%	6.9%
Impact of prior-year reserve development on combined ratio	-2.2%	-2.1%	-1.9%	-1.2%	-1.7%	-1.7%
Accident-year loss ratio excl. catastrophes	58.5%	59.4%	63.0%	61.2%	62.4%	61.8%

Sources: Company reports

Table 79
The Travelers Companies, Inc.
Personal Insurance Segment Split

Agency Automobile	2005	2006	2007	2008	2009	2010
Gross Written Premium	3,526	3,731	3,673	3,680	3,610	3,720
Net Written Premium	3,477	3,517	3,579	3,651	3,586	3,698
% change		1.2%	1.8%	2.0%	-1.8%	3.1%
Net Earned Premium	3,428	3,672	3,692	3,705	3,661	3,629
Loss and LAE Ratio	62.3%	64.2%	65.3%	70.5%	71.9%	70.3%
Underwriting Expense Ratio	23.8%	26.2%	26.1%	27.5%	26.8%	26.7%
Combined Ratio	86.1%	90.4%	91.4%	98.0%	98.7%	97.0%
Catastrophe Losses	0.5%	0.1%	0.1%	0.5%	0.7%	0.8%
Agency Homeowners' and Other	2005	2006	2007	2008	2009	2010
Gross Written Premium	2,948	3,280	3,471	3,680	3,610	4,060
Net Written Premium	2,751	3,007	3,207	3,651	3,586	3,772
% change		9.3%	6.7%	13.8%	-1.8%	5.2%
Net Earned Premium	2,600	2,891	3,111	3,705	3,661	3,639
Loss and LAE Ratio	62.1%	42.9%	50.7%	61.4%	57.3%	65.5%
Underwriting Expense Ratio	30.9%	31.0%	30.7%	33.3%	29.5%	29.6%
Combined Ratio	93.0%	73.9%	81.4%	94.7%	86.8%	95.1%
Catastrophe Losses	22.1%	3.5%	5.1%	18.4%	7.4%	15.5%

Sources: Company reports

Table 80
The Travelers Companies, Inc.
Earnings Model
(dollars in thousands except per share data)

	2005	2006	2007	2008	2009	2010	1Q'11	2Q'11E	3Q'11E	4Q'11E	2011E	2012E	2013E
Revenues													
Premiums	20,341	20,760	21,470	21,579	21,418	21,432	5,371	5,473	5,515	5,558	21,917	22,668	23,479
% change		2.1%	3.4%	0.5%	-0.7%	0.1%	2.7%	2.5%	1.7%	2.2%	2.3%	3.4%	3.6%
Net investment income	3,165	3,517	3,761	2,792	2,776	3,059	779	787	783	786	3,135	3,281	3,467
Fee income	664	591	508	390	306	287	74	71	60	62	267	250	234
Other revenues	178	211	124	131	163	70	34	37	41	35	147	173	210
Total revenues	24,348	25,079	25,863	24,892	24,663	24,848	6,258	6,368	6,399	6,440	25,466	26,372	27,391
% change		3.0%	3.1%	-3.8%	-0.9%	0.8%	2.7%	2.5%	2.3%	2.4%	2.5%	3.6%	3.9%
Claims and expenses													
Claims and claim adjustment expense	14,927	12,244	12,397	12,993	12,408	13,210	3,382	4,801	3,669	3,560	15,411	15,015	16,450
Loss and LAE ratio	71.9%	57.5%	56.6%	59.4%	57.3%	61.0%	62.1%	86.9%	65.7%	63.3%	69.5%	65.5%	69.3%
Underwriting expense ratio	29.4%	30.6%	30.8%	32.5%	31.9%	32.2%	32.6%	32.0%	32.6%	32.7%	32.5%	32.5%	32.0%
Combined ratio	101.3%	88.1%	87.4%	91.9%	89.2%	93.2%	94.7%	118.9%	98.3%	96.0%	102.0%	98.0%	101.3%
Amortization of deferred acquisition costs	3,252	3,339	3,706	3,880	3,813	3,802	948	951	975	989	3,863	3,996	4,080
General and administrative expenses	3,229	3,458	3,352	3,518	3,366	3,406	883	870	894	898	3,545	3,647	3,713
Interest expense	286	324	346	370	382	388	96	96	96	96	384	384	384
Total claims and expenses	21,694	19,372	19,808	20,768	19,976	20,813	5,311	6,718	5,633	5,543	23,203	23,042	24,627
Operating income before income taxes	2,654	5,714	6,062	4,124	4,687	4,035	947	-349	766	897	2,261	3,330	2,764
Income tax expense	628	1,514	1,562	936	1,094	999	123	-85	187	218	443	811	673
% tax rate	23.7%	26.5%	25.8%	22.7%	23.3%	24.8%	13.0%	24.3%	24.3%	24.3%	19.6%	24.3%	24.3%
Operating income	2,026	4,200	4,500	3,188	3,593	3,036	824	-264	580	679	1,818	2,520	2,091
% growth		107.3%	7.1%	-29.2%	12.7%	-15.5%	31.0%	-138.4%	-32.3%	-21.3%	-40.1%	38.6%	-17.0%
Operating income per share	2.90	5.90	6.71	5.26	6.29	6.26	1.89	-0.61	1.36	1.62	4.25	6.10	5.19
% growth		103.4%	13.7%	-21.6%	19.6%	-0.5%	54.9%	-144.0%	-25.0%	-14.1%	-32.1%	43.6%	-15.0%
Net realized investment gains after tax	35	8	101	-271	22	173	13	30	30	30	103	120	120
Discontinued operations	-439												
Net income	1,622	4,208	4,601	2,917	3,615	3,209	837	-234	610	709	1,921	2,640	2,211
Net income per share	2.33	5.91	6.86	4.81	6.33	6.62	1.92	-0.54	1.43	1.69	4.50	6.40	5.49
Basic weighted average shares outstanding (millions)	676.3	687.1	652.9	596.0	563.2	476.5	428.2	423.7	419.2	410.2	420.3	405.0	395.2
Diluted weighted average shares outstanding (millions)	712.8	716.7	672.0	604.4	568.6	482.5	434.4	431.7	427.2	418.2	427.9	413.0	403.2
Common shares outstanding at period end	693.4	678.3	627.8	585.1	520.3	434.6	420.3						
Operating ROE	9.1%	17.8%	17.5%	12.4%	13.4%	11.4%	13.0%	-4.2%	9.4%	11.0%	7.3%	10.4%	9.0%
Common stock dividends declared	621.8	696	738	712	690	670	155	174	172	168	669	664	648
Book value per share at period end	31.94	36.86	52.22	43.12	52.54	58.47	59.91	56.92	57.96	59.26	59.26	58.73	57.30
Loss and LAE ratio	71.9%	57.5%	56.6%	59.4%	57.3%	61.0%	62.1%	86.9%	65.7%	63.3%	69.5%	65.5%	69.3%
Underwriting expense ratio	29.4%	30.6%	30.8%	32.5%	31.9%	32.2%	32.6%	32.0%	32.6%	32.7%	32.5%	32.5%	32.0%
GAAP combined ratio	101.3%	88.1%	87.4%	91.9%	89.2%	93.2%	94.7%	118.9%	98.3%	96.0%	102.0%	98.0%	101.3%
Net favorable prior year reserve development	1.6%	-1.9%	-2.5%	-7.1%	-6.2%	-5.80%	-4.4%	-5.1%	-4.0%	-3.7%	-4.3%	-2.1%	0.5%
Catastrophes net of reinsurance	10.7%	0.5%	0.7%	6.5%	2.1%	5.20%	3.4%	29.7%	7.4%	3.4%	11.0%	4.1%	4.1%
Accident-year loss ratio excluding catastrophe	59.6%	58.9%	58.4%	60.0%	61.4%	61.6%	63.1%	62.4%	62.3%	63.7%	62.9%	63.6%	64.8%

Sources: Company reports and William Blair & Company, L.L.C.

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Jay S. Fishman, Chairman and Chief Executive Officer

Mr. Fishman has served as chairman since 2005, and served as CEO since joining St. Paul Company in 2001. Prior to that, Mr. Fishman worked in the Travelers Business for Citigroup, and as an executive for Primerica, which later became part of Citigroup.

Jay S. Benet, Vice Chairman and Chief Financial Officer

Mr. Benet has served as vice chairman and CFO since 2005, and has been CFO since 2002. Previously, Mr. Benet held various executive positions within Citigroup's Travelers division. Before joining Travelers, he was a partner at accounting firm Coopers & Lybrand.

Charles J. Clarke, Vice Chairman

Mr. Clarke has been vice chairman since 2004. Prior to the merger of St. Paul and Travelers, he served as president and vice chairman of Travelers.

Alan D. Schnitzer, Vice Chairman and Chief Legal Officer; Financial, Professional and International Insurance

Mr. Schnitzer has been vice chairman and chief legal officer since joining the firm in 2007. He was previously a partner at the law firm of Simpson Thacher & Bartlett LLP.

Brian W. MacLean, President and Chief Operating Officer

Mr. MacLean has been COO since 2005 and president since 2008. He joined the firm in 1988, and had several executive positions over the last 20 years, many in the claims services division.

Additional information is available upon request.

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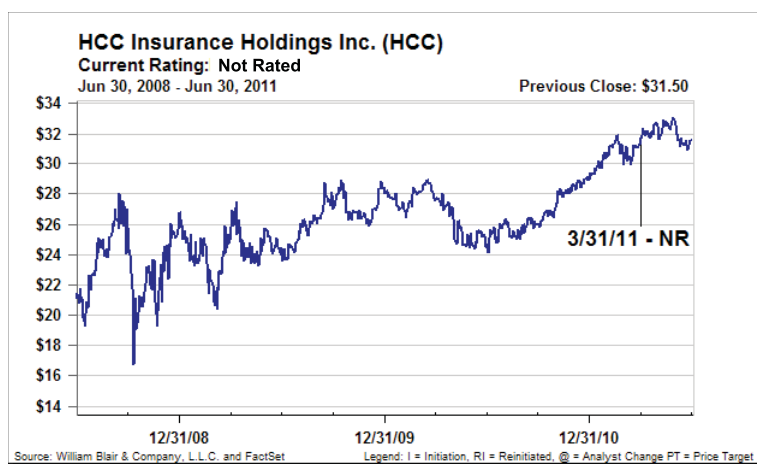
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DJIA:	12,414.34
S&P 500:	1,320.64
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The Progressive Corporation	\$21.38
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