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A Broader View.  
A Sharper Focus.<sup>SM</sup>



***Board of Directors***

***Item 6 – March 17, 2011***

***California & Property Casualty  
Insurance Outlook***



Conning Asset Management  
One Financial Plaza  
Hartford, CT 06103  
860-299-2000  
[www.conning.com](http://www.conning.com)

# U.S. Economic Outlook

- ◆ U.S. GDP growth expected to average about 3.9% over the next two years
- ◆ Residential real estate appears to have bottomed, following government stimulus
- ◆ Federal Reserve likely on hold through 2011; may cease further asset purchases

| KEY ECONOMIC INDICATORS        | 2008    | Actual<br>2009 | 2010    | Forecast |          |
|--------------------------------|---------|----------------|---------|----------|----------|
|                                |         |                |         | 2011     | 2012     |
| Gross Domestic Product         | 0.0%    | -2.6%          | 2.8%    | 3.8%     | 4.0%     |
| Civilian Unemployment Rate     | 5.8%    | 9.3%           | 9.6%    | 9.1%     | 8.4%     |
| Capacity Utilization           | 77.9%   | 70.0%          | 74.3%   | 77.6%    | 79.5%    |
| Housing Permits (millions)     | 0.896   | 0.583          | 0.594   | 0.638    | 0.862    |
| New Home Sales (millions)      | 0.482   | 0.374          | 0.321   | 0.315    | 0.393    |
| Existing Home Sales (millions) | 4.894   | 5.149          | 4.918   | 5.222    | 5.528    |
| S&P Case-Shiller C-20 (Y/Y)    | -15.8%  | -11.5%         | 0.1%    | -2.0%    | -0.4%    |
| WTI Oil Price                  | \$99.57 | \$61.69        | \$79.43 | \$104.49 | \$130.55 |
| CPI (Y/Y)                      | 0.1%    | 2.7%           | 1.5%    | 2.7%     | 2.7%     |
| CPI Core (Y/Y)                 | 1.8%    | 1.8%           | 0.8%    | 0.8%     | 1.6%     |
| Fed Funds Rate                 | 1.88%   | 0.16%          | 0.16%   | 0.16%    | 1.35%    |
| 10-Year Note Yield             | 3.61%   | 3.29%          | 3.14%   | 3.80%    | 4.43%    |

Source of data and commentary: Action Economics

## *Impact of oil price spike; who gets hurt quickest?*

- ◆ Consumers
- ◆ Airlines
- ◆ Transportation
- ◆ Chemicals
- ◆ Financials

# Relative Value Decisions for March 2010

| Asset Class/Structure        | Bias               | Recommendation   |
|------------------------------|--------------------|--|
| Treasurys                    | <b>Underweight</b> | Corporate bonds offer better relative value. Use Treasurys to shorten duration.  |
| Agencies                     | <b>Underweight</b> | The U.S. Treasury white paper on housing reform strongly reiterated government support for FNMA and FHLMC, reducing volatility and tightening spreads. Valuations remain unattractive. |
| Corporates: Investment Grade | <b>Overweight</b>  | Spread tightening in recent months has moved the sector closer to fair value, yet fundamentals and technicals remain supportive.   |
| Corporates: High Yield       | Marketweight       | Improving economic data, solid earnings and supportive capital markets are tempered by current valuations and the overhang of geopolitical risks.                                      |
| Municipals                   | Marketweight       | On a one-year historical basis, municipal yield ratios are fair value across the majority of the curve.  |
| MBS                          | Marketweight       | Low supply and steady demand for AAA-rated spread product will keep valuations range-bound and coupon income the main return driver.   |
| CMBS                         | Marketweight       | Economic growth, spread contraction and renewed CMBS issuance have lowered future loss expectations and provided new opportunities within the sector.                                  |
| ABS                          | Marketweight       | ABS spreads remain at relatively tight levels and supply is well contained.  |
| Equities                     | <b>Overweight</b>  | Despite rising geopolitical risk in recent weeks, the market remains relatively inexpensive based on 13.8x next twelve months earnings.  |
| Duration                     | Short              | While flight-to-quality flows may moderate any increase in yields in the short term, strong global growth will lead to higher interest rates. Allow duration to shorten.               |
| Yield Curve                  | Bullet             | The Fed's extended low interest-rate policy leads us to recommend a bullet portfolio structure until the timing of a change in Fed policy becomes more certain.                        |

## California - Conning State of States Rank: #47

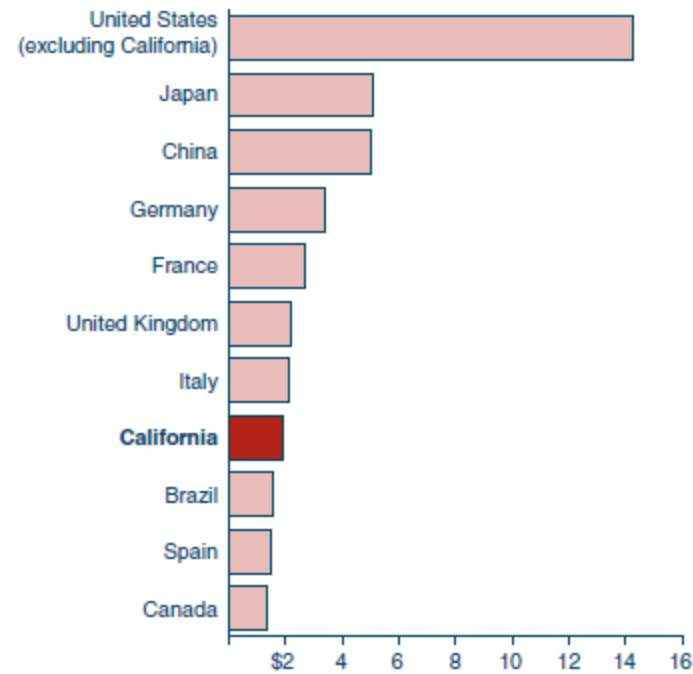


### Conning Ranking Factors

- ◆ High income level
- ◆ High per capita income
- ◆ Large budget gaps
- ◆ High unemployment rate
- ◆ Weak housing market

## California Ranks Among the World's Top Ten Economies

Gross Product in 2009 (In Trillions)



Source: Cal Facts January 2011

# California Economic Outlook

- ◆ Year-over-year percentage changes in real GDP and real exports are forecasted to accelerate
- ◆ Personal income will grow at a 3.5% rate in 2011 and at an accelerating rate through 2015
- ◆ Housing will remain a drag on growth as unemployment remains high
- ◆ Employment has dropped by 1.4 million jobs since 2007; only 100,000 new jobs are expected to be created in 2011

|                             | Actual<br>2009 | Estimated<br>2010 | Forecast |      |      |      |      |      |
|-----------------------------|----------------|-------------------|----------|------|------|------|------|------|
|                             |                |                   | 2011     | 2012 | 2013 | 2014 | 2015 | 2016 |
| <b>California</b>           |                |                   |          |      |      |      |      |      |
| Percent change in:          |                |                   |          |      |      |      |      |      |
| Personal Income             | -2.4           | 2.8               | 3.5      | 4.3  | 4.8  | 5.7  | 5.9  | 5.7  |
| Wage and Salary Employment  | -6.0           | -1.7              | 0.7      | 2.2  | 2.4  | 1.8  | 2.0  | 1.3  |
| Consumer Price Index        | -0.4           | 1.6               | 1.6      | 1.9  | 2.0  | 2.1  | 2.1  | 2.1  |
| Unemployment Rate (percent) | 11.4           | 12.5              | 11.9     | 10.5 | 9.1  | 8.2  | 7.1  | 6.6  |
| Housing Permits (thousands) | 34             | 42                | 67       | 79   | 99   | 113  | 121  | 121  |

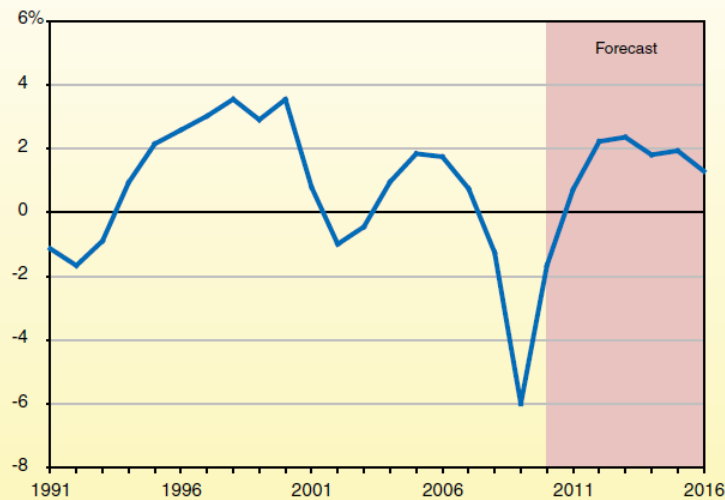
Source: California's Fiscal Outlook November 2010 Legislative Analyst's Office

# California Economic Outlook

- ◆ California's population base is expected to marginally increase over the next five years
- ◆ Inflation is expected to stay in the 1 to 2 percent range over the next 5 years
- ◆ California's unemployment rate is expected to hover around 12% throughout 2011 before gradually improving in 2012

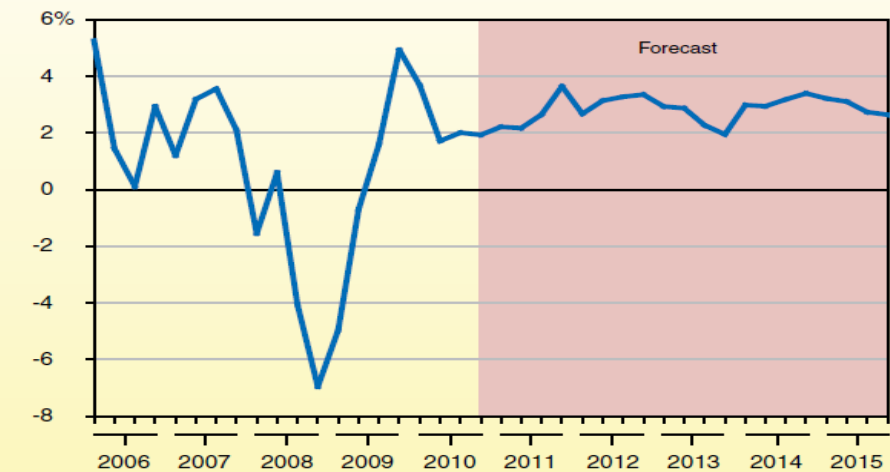
## Slow Employment Growth Expected

Percent Change in California Average Annual Employment



## Modest Growth Expected During Recovery

(Percent Change From Prior Quarter [Annual Rate]  
U.S. Real Gross Domestic Product)



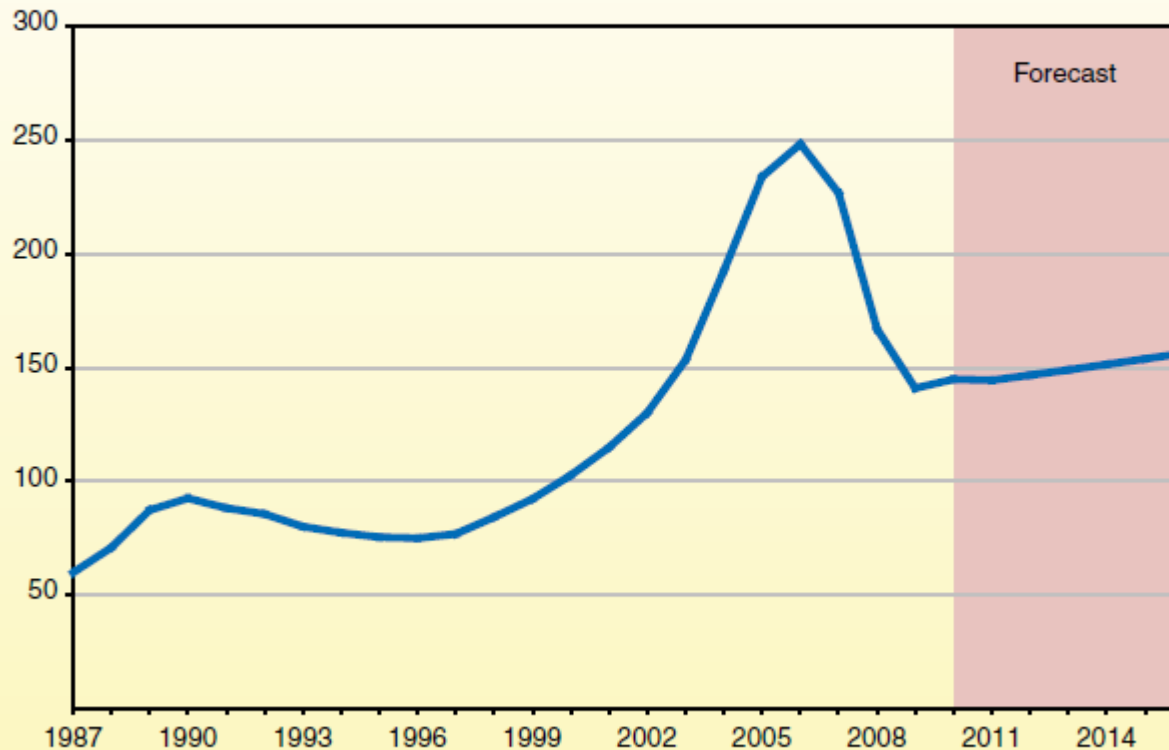
Source: California's Fiscal Outlook November 2010 Legislative Analyst's Office



# Home Prices – A Slow Recovery

## Minimal Growth in California Housing Prices Expected

(Blended Case-Shiller and Federal Housing Finance Agency Indices<sup>a</sup>)



<sup>a</sup>Uses Case-Shiller data for the California metropolitan areas it covers and Federal Housing Finance Agency data for the rest of the state. First quarter of 2000=100.

Source: California's Fiscal Outlook November 2010 Legislative Analyst's Office

# Revenue Outlook – Moderate Revenue Growth Expected

## LAO General Fund Revenue Forecast

(Dollars in Millions)

| Revenue Source                      | 2009-10         | 2010-11         | 2011-12         | 2012-13         | 2013-14         | 2014-15          | 2015-16          |
|-------------------------------------|-----------------|-----------------|-----------------|-----------------|-----------------|------------------|------------------|
| Personal income tax                 | \$44,575        | \$46,731        | \$44,252        | \$47,909        | \$50,868        | \$54,072         | \$57,507         |
| Sales and use tax                   | 26,741          | 27,310          | 25,370          | 27,725          | 29,137          | 30,397           | 31,622           |
| Corporation tax                     | 9,500           | 10,418          | 8,567           | 8,125           | 8,531           | 9,255            | 9,963            |
| Subtotal, "Big Three"               | (\$80,816)      | (\$84,460)      | (\$78,189)      | (\$83,760)      | (\$88,536)      | (\$93,724)       | (\$99,092)       |
| Percent change                      | 5.4%            | 4.5%            | -7.4%           | 7.1%            | 5.7%            | 5.9%             | 5.7%             |
| Insurance tax                       | \$2,020         | \$2,033         | \$2,060         | \$2,093         | \$2,129         | \$2,168          | \$2,223          |
| Vehicle license fee                 | 1,380           | 1,428           | 159             | 34              | —               | —                | —                |
| Estate tax                          | —               | 850             | 1,838           | 1,988           | 2,150           | 2,325            | 2,515            |
| Sales of fixed assets               | —               | 1,286           | 1               | 1               | 1               | 7                | 7                |
| Other revenues                      | 2,378           | 2,205           | 2,136           | 1,861           | 2,072           | 2,233            | 2,342            |
| Net transfers and loans             | 447             | 1,021           | -853            | -1,014          | -180            | 21               | 18               |
| <b>Total Revenues and Transfers</b> | <b>\$87,041</b> | <b>\$93,283</b> | <b>\$83,530</b> | <b>\$88,723</b> | <b>\$94,708</b> | <b>\$100,478</b> | <b>\$106,197</b> |
| Percent change                      | 5.2%            | 7.2%            | -10.5%          | 6.2%            | 6.7%            | 6.1%             | 5.7%             |

Source: California's Fiscal Outlook November 2010 Legislative Analyst's Office

# Workers' Compensation Update

## *CRC Industry Projections (Workers' Compensation)*

- ◆ Conning Research and Consulting (CRC) forecasts workers' compensation loss and combined ratios to climb in 2010 and 2011. GAAP return-on-equity is expected to remain in the 4%-5% range over the next three years.
- ◆ Conning predicts continued negative premium growth through 2010, but reversing in 2011.

| <b>Workers' Comp Projections (2010 Fourth Quarter)</b> |                       |                       |                      |                       |                         |
|--|-----------------------|-----------------------|----------------------|-----------------------|-------------------------|
| <b>Year</b>  | <b>Premium Growth</b> | <b>Statutory Data</b> |                      |                       | <b>GAAP</b>             |
|  |                       | <b>Loss Ratio</b>     | <b>Expense Ratio</b> | <b>Combined Ratio</b> | <b>Return on Equity</b> |
| <b>2009</b>  | -13.5%                | 83.6%                 | 26.7%                | 112.4%                | 3.0%                    |
| <b>2010</b>  | -3.0%                 | 85.0%                 | 27.0%                | 114.0%                | 5.0%                    |
| <b>2011</b>  | 5.5%                  | 90.0%                 | 26.0%                | 117.0%                | 4.5%                    |
| <b>2012</b>  | 10.0%                 | 91.0%                 | 25.0%                | 117.0%                | 4.3%                    |

Source: Conning Property-Casualty Forecast & Analysis By Line of Insurance 4Q10

# Workers' Compensation Update

## CRC Forecast Changes (Workers' Compensation)

| Premium Growth |       |       |        |
|----------------|-------|-------|--------|
|                | 3Q10  | 4Q10  | Change |
| 2010           | -4.0% | -3.0% | 1.0%   |
| 2011           | 5.5%  | 5.5%  | 0.0%   |
| 2012           | 10.0% | 10.0% | 0.0%   |

Source: Company statutory filings, CRC analysis

| Combined Ratio |        |        |        |
|----------------|--------|--------|--------|
|                | 3Q10   | 4Q10   | Change |
| 2010           | 114.5% | 114.0% | -0.5%  |
| 2011           | 117.0% | 117.0% | 0.0%   |
| 2012           | 117.0% | 117.0% | 0.0%   |

Source: Company statutory filings, CRC analysis

| GAAP Return on Equity |      |      |        |
|-----------------------|------|------|--------|
|                       | 3Q10 | 4Q10 | Change |
| 2010                  | 4.9% | 5.0% | 0.1%   |
| 2011                  | 4.6% | 4.5% | -0.1%  |
| 2012                  | 4.5% | 4.3% | -0.2%  |

Source: Company statutory filings, CRC analysis

- ◆ Conning's fourth quarter workers' comp forecast highlights:
  - Premium growth less negative in 2010
  - Combined ratio rising slightly through 2012
  - GAAP ROE declining in 2011-12