

MERCURY GENERAL CORP
Form 10-Q
October 30, 2018
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934
For the Quarter Ended September 30, 2018
Commission File No. 001-12257

MERCURY GENERAL CORPORATION
(Exact name of registrant as specified in its charter)

California	95-2211612
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

4484 Wilshire Boulevard, Los Angeles, California	90010
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: (323) 937-1060

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer
Non-accelerated filer Smaller reporting company
Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant is a shell company (as defined in the Rule 12b-2 of the Exchange Act). Yes No

At October 25, 2018, the registrant had issued and outstanding an aggregate of 55,339,577 shares of its Common Stock.

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

MERCURY GENERAL CORPORATION AND SUBSIDIARIES
 CONSOLIDATED BALANCE SHEETS
 (in thousands)

	September 30, 2018	December 31, 2017
	(unaudited)	
ASSETS		
Investments, at fair value:		
Fixed maturity securities (amortized cost \$2,951,571; \$2,823,230)	\$ 2,952,871	\$ 2,892,777
Equity securities (cost \$619,444; \$474,197)	688,387	537,240
Short-term investments (cost \$263,037; \$302,693)	262,806	302,711
Total investments	3,904,064	3,732,728
Cash	261,680	291,413
Receivables:		
Premium	558,004	474,060
Accrued investment income	48,021	39,368
Other	6,077	6,658
Total receivables	612,102	520,086
Reinsurance recoverables	53,419	56,349
Deferred policy acquisition costs	216,480	198,151
Fixed assets (net of accumulated depreciation \$354,967; \$340,523)	149,719	145,223
Current income taxes	27,012	61,257
Goodwill	42,796	42,796
Other intangible assets, net	16,901	20,728
Other assets	28,864	32,592
Total assets	\$ 5,313,037	\$ 5,101,323
LIABILITIES AND SHAREHOLDERS' EQUITY		
Loss and loss adjustment expense reserves	\$ 1,580,054	\$ 1,510,613
Unearned premiums	1,240,776	1,101,927
Notes payable	371,635	371,335
Accounts payable and accrued expenses	138,643	108,252
Deferred income taxes	7,146	22,932
Other liabilities	240,553	224,877
Total liabilities	3,578,807	3,339,936
Commitments and contingencies		
Shareholders' equity:		
Common stock without par value or stated value:		
Authorized 70,000 shares; issued and outstanding 55,340; 55,332	97,967	97,523
Retained earnings	1,636,263	1,663,864
Total shareholders' equity	1,734,230	1,761,387
Total liabilities and shareholders' equity	\$ 5,313,037	\$ 5,101,323

See accompanying Notes to Consolidated Financial Statements.

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CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

(unaudited)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2018	2017	2018	2017
Revenues:				
Net premiums earned	\$858,135	\$801,205	\$2,500,178	\$2,388,641
Net investment income	38,159	30,988	104,455	94,058
Net realized investment (losses) gains	(3,910)	20,718	(48,355)	66,334
Other	2,427	5,446	7,108	9,675
Total revenues	894,811	858,357	2,563,386	2,558,708
Expenses:				
Losses and loss adjustment expenses	614,069	595,290	1,851,850	1,790,550
Policy acquisition costs	142,295	136,290	424,799	416,728
Other operating expenses	63,904	64,339	190,125	182,959
Interest	4,257	4,191	12,779	10,873
Total expenses	824,525	800,110	2,479,553	2,401,110
Income before income taxes	70,286	58,247	83,833	157,598
Income tax expense	11,708	11,762	7,682	32,500
Net income	\$58,578	\$46,485	\$76,151	\$125,098
Net income per share:				
Basic	\$1.06	\$0.84	\$1.38	\$2.26
Diluted	\$1.06	\$0.84	\$1.38	\$2.26
Weighted average shares outstanding:				
Basic	55,337	55,324	55,334	55,311
Diluted	55,341	55,334	55,337	55,323
Dividends paid per share	\$0.6250	\$0.6225	\$1.8750	\$1.8675

See accompanying Notes to Consolidated Financial Statements.

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CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

	Nine Months Ended September 30,	
	2018	2017
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$76,151	\$ 125,098
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	43,730	41,617
Net realized investment losses (gains)	48,355	(66,334)
Increase in premiums receivable	(83,944)	(26,716)
Gain on sale of fixed assets	—	(3,307)
Decrease in reinsurance recoverables	2,930	2,548
Changes in current and deferred income taxes	18,459	18,149
Increase in deferred policy acquisition costs	(18,328)	(1,093)
Increase in loss and loss adjustment expense reserves	69,441	81,916
Increase in unearned premiums	138,849	45,536
Increase in accounts payable and accrued expenses	31,628	19,260
Share-based compensation	104	60
Other, net	(2,180)	39,731
Net cash provided by operating activities	325,195	276,465
CASH FLOWS FROM INVESTING ACTIVITIES		
Fixed maturity securities available for sale in nature:		
Purchases	(547,385)	(527,418)
Sales	148,421	86,970
Calls or maturities	243,982	436,479
Equity securities available for sale in nature:		
Purchases	(778,405)	(626,097)
Sales	641,159	480,293
Calls	—	7,100
Changes in securities payable and receivable	13,647	(22,474)
Change in short-term investments and purchased options	39,650	9,186
Purchase of fixed assets	(20,649)	(14,275)
Sale of fixed assets	—	6,239
Other, net	8,064	1,983
Net cash used in investing activities	(251,516)	(162,014)
CASH FLOWS FROM FINANCING ACTIVITIES		
Dividends paid to shareholders	(103,752)	(103,303)
Proceeds from stock options exercised	340	2,162
Net proceeds from issuance of senior notes	—	371,011
Payoff of principal on loan and credit facilities	—	(320,000)
Net cash used in financing activities	(103,412)	(50,130)
Net (decrease) increase in cash	(29,733)	64,321
Cash:		
Beginning of the year	291,413	220,318

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End of period	\$261,680	\$284,639
SUPPLEMENTAL CASH FLOW DISCLOSURE		
Interest paid	\$16,500	\$9,863
Income taxes (refunded) paid, net	\$(10,778)	\$14,350

See accompanying Notes to Consolidated Financial Statements.

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MERCURY GENERAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

1. General

Consolidation and Basis of Presentation

The interim consolidated financial statements include the accounts of Mercury General Corporation and its subsidiaries (referred to herein collectively as the “Company”). For the list of the Company’s subsidiaries, see Note 1. Summary of Significant Accounting Policies of the Notes to Consolidated Financial Statements in the Company’s Annual Report on Form 10-K for the year ended December 31, 2017. These interim financial statements have been prepared in conformity with U.S. generally accepted accounting principles (“GAAP”), which differ in some respects from those filed in reports to insurance regulatory authorities. The financial data of the Company included herein are unaudited. In the opinion of management, all material adjustments of a normal recurring nature have been made to present fairly the Company’s financial position at September 30, 2018 and the results of operations and cash flows for the periods presented. All intercompany transactions and balances have been eliminated.

Certain financial information that is normally included in annual financial statements prepared in accordance with GAAP, but that is not required for interim reporting purposes, has been omitted from the accompanying interim consolidated financial statements and related notes. Readers are urged to review the Company’s Annual Report on Form 10-K for the year ended December 31, 2017 for more complete descriptions and discussions. Operating results and cash flows for the nine months ended September 30, 2018 are not necessarily indicative of the results that may be expected for the year ending December 31, 2018.

Certain prior period amounts have been reclassified to conform to the current period presentation.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosures of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. These estimates require the Company to apply complex assumptions and judgments, and often the Company must make estimates about the effects of matters that are inherently uncertain and will likely change in subsequent periods. The most significant assumptions in the preparation of these consolidated financial statements relate to reserves for losses and loss adjustment expenses. Actual results could differ from those estimates. See Note 1. Summary of Significant Accounting Policies of the Notes to Consolidated Financial Statements in the Company’s Annual Report on Form 10-K for the year ended December 31, 2017.

Earnings per Share

Potentially dilutive securities representing approximately 82,000 and 73,000 shares of common stock were excluded from the computation of diluted earnings per common share for the three and nine months ended September 30, 2018, respectively, because their effect would have been anti-dilutive. There were no potentially dilutive securities with anti-dilutive effect for the three and nine months ended September 30, 2017.

Deferred Policy Acquisition Costs

Deferred policy acquisition costs consist of commissions paid to outside agents, premium taxes, salaries, and certain other underwriting costs that are incremental or directly related to the successful acquisition of new and renewal insurance contracts and are amortized over the life of the related policy in proportion to premiums earned. Deferred

policy acquisition costs are limited to the amount that will remain after deducting from unearned premiums and anticipated investment income, the estimated losses and loss adjustment expenses, and the servicing costs that will be incurred as premiums are earned. The Company's deferred policy acquisition costs are further limited by excluding those costs not directly related to the successful acquisition of insurance contracts. Deferred policy acquisition cost amortization was \$142.3 million and \$136.3 million for the three months ended September 30, 2018 and 2017, respectively, and \$424.8 million and \$416.7 million for the nine months ended September 30, 2018 and 2017, respectively. The Company does not defer advertising expenditures but expenses them as incurred. The Company recorded net advertising expense of approximately \$34 million and \$32 million for the nine months ended September 30, 2018 and 2017, respectively.

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Revenue from Contracts with Customers

On January 1, 2018, the Company adopted Topic 606, Revenue from Contracts with Customers, using the modified retrospective transition method. The Company had no cumulative-effect adjustment and its consolidated financial statement line items were not impacted as a result of the adoption, mostly because the accounting for insurance contracts was outside of the scope of Topic 606 and the application of the key aspects of revenue recognition of Topic 606 to the Company's in-scope transactions, such as the timing of recognition of revenue (at a point in time vs. over time) and the estimation of refund liability, resulted in recognition of revenues and related expenses consistent with that under the legacy accounting guide, Topic 605.

The Company's total revenue from contracts with customers that are in scope of Topic 606 amounted to approximately \$15.2 million with related expenses of \$10.2 million for the year ended December 31, 2017. This revenue represents the commission income that the Company's 100% owned insurance agencies, Auto Insurance Specialists LLC ("AIS") and PoliSeek AIS Insurance Solutions, Inc. ("Poliseek"), earned from third-party insurers, and accounted for approximately 0.4% of the total consolidated revenue in 2017. The Company's commission income from third-party insurers was approximately \$12.3 million and \$11.6 million representing approximately 0.5% and 0.5% of the consolidated total revenue, with related expenses of \$7.6 million and \$7.8 million, for the nine months ended September 30, 2018 and 2017, respectively. Due to the immateriality of the Company's commission income and its related expenses to the overall consolidated financial statements, the commission income, net of related expenses, is included in other revenues in the Company's consolidated statements of operations, and in other income of the Property and Casualty business segment in the Company's segment reporting in accordance with Topic 280, Segment Reporting (see Note 13. Segment Information).

AIS and PoliSeek are primarily engaged in the marketing and sales of insurance policies in private passenger automobile, commercial automobile and homeowners lines of business. Their revenues primarily consist of commission income received from property and casualty insurers. Approximately 80% of their total revenue is generated from sales of policies issued by the Company's insurance subsidiaries, which are eliminated as intercompany transactions in consolidation, with the remaining from sales of policies issued by third-party property and casualty insurers. The primary performance obligation of AIS and Poliseek in return for the commission income from the insurers is to complete the sale of the policy and deliver the control of the policy to the insurer prior to the policy effective date. In addition, AIS and PoliSeek provide administrative services to the insurer or the policyholder subsequent to the sale of the policy as needed, including processing of endorsements, collection of premiums, and answering general questions concerning the policyholder's account. The administrative services and the costs to perform such services are deemed immaterial in the context of the contract and to the Company's consolidated financial statements, and hence, such services are not identified as a separate performance obligation and the costs to perform such services are not accrued at the time of the sale of the policy but are expensed as incurred as part of the overall operating expenses.

The total revenue from the sale of a policy is recognized when the sale is complete and the policy is effective as all the material aspects of the performance obligation are satisfied and the insurer is deemed to obtain control of the insurance policy at that time. The commission income is constrained such that the revenue is recognized only to the extent that the commission income received is not likely to be returned to the insurers due to policy cancellations. Any commission income not received when the sale is complete is recognized as commission income receivable, which is included in other receivables in the Company's consolidated balance sheets. The commission income receivable at September 30, 2018 and December 31, 2017 was \$1.1 million and \$1.2 million, respectively.

A refund liability is recorded for the expected amount of the commission income that has to be returned to the insurers based on estimated policy cancellations. The refund liability is computed for the entire portfolio of contracts as a practical expedient, rather than for each contract or performance obligation. The estimated policy cancellations and

the resulting refund liability are computed using the expected value method based on all relevant information, including historical data. The refund liability at September 30, 2018 and December 31, 2017 was \$0.7 million, which was included in other liabilities in the Company's consolidated balance sheets.

As of September 30, 2018 and December 31, 2017, the Company had no contract assets, contract liabilities, or capitalized costs to obtain or fulfill a contract, associated with revenues from contracts with customers.

2. Recently Issued Accounting Standards

In August 2018, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2018-15, "Intangibles - Goodwill and Other - Internal-Use Software (Subtopic 350-40), Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract." ASU 2018-15 aligns the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software under Subtopic 350-40. This ASU also requires an entity

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to expense the capitalized implementation costs of a hosting arrangement that is a service contract over the term of the hosting arrangement and present such expense in the same line item in the statement of income as the fees associated with the hosting element (service) of the arrangement and classify payments for capitalized implementation costs in the statement of cash flows in the same manner as payments made for fees associated with the hosting element. The entity is also required to present the capitalized implementation costs in the statement of financial position in the same line item that a prepayment for the fees of the associated hosting arrangement would be presented. ASU 2018-15 will be effective for the Company beginning January 1, 2020 with early adoption permitted. The Company is in the process of evaluating the impact of ASU 2018-15 on its consolidated financial statements and related disclosures.

In August 2018, the FASB issued ASU 2018-13, "Fair Value Measurement (Topic 820), Disclosure Framework - Changes to the Disclosure Requirements for Fair Value Measurement." The amendments in this ASU require certain existing disclosure requirements in Topic 820 to be modified or removed, and certain new disclosure requirements to be added to the Topic. In addition, this ASU allows entities to exercise more discretion when considering fair value measurement disclosures. ASU 2018-13 will be effective for the Company beginning January 1, 2020 with early adoption permitted. The Company is in the process of evaluating the impact of ASU 2018-13 on its consolidated financial statements and related disclosures.

In January 2017, the FASB issued ASU 2017-04, "Intangibles - Goodwill and Other (Topic 350), Simplifying the Test for Goodwill Impairment." ASU 2017-04 removes the requirement to compare the implied fair value of goodwill with its carrying amount as part of Step 2 of the goodwill impairment test and requires an entity to recognize an impairment charge for the amount by which the carrying amount of a reporting unit exceeds its fair value. An entity still has the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary. ASU 2017-04 will be effective for the Company beginning January 1, 2020 with early adoption permitted. The Company does not anticipate that ASU 2017-04 will have a material impact on its consolidated financial statements and related disclosures.

In June 2016, the FASB issued ASU 2016-13, "Financial Instruments - Credit Losses (Topic 326)." The amendments in this ASU replace the "incurred loss" methodology for recognizing credit losses with a methodology that reflects expected credit losses and requires consideration of a broader range of information including past events, current conditions and reasonable and supportable forecasts that affect the collectibility of reported amounts of financial assets that are not accounted for at fair value through net income, such as loans, certain debt securities, trade receivables, net investment in leases, off-balance sheet credit exposures and reinsurance receivables. Under the current GAAP incurred loss methodology, recognition of the full amount of credit losses is generally delayed until the loss is probable of occurring. Current GAAP restricts the ability to record credit losses that are expected, but do not yet meet the probability threshold. ASU 2016-13 will be effective for the Company beginning January 1, 2020. While the Company is in the process of evaluating the impact of ASU 2016-13, it does not expect this ASU to have a material impact on its consolidated financial statements and related disclosures as most of its financial instruments with potential exposure to material credit losses are accounted for at fair value through net income.

In February 2016, the FASB issued ASU 2016-02, "Leases (Topic 842)," which supersedes the guidance in Accounting Standards Codification ("ASC") 840, "Leases." Subsequently, the FASB has issued additional ASUs on Topic 842 that do not change the core principle of the guidance in ASU 2016-02. ASU 2016-02 requires a lessee to recognize lease assets and lease liabilities resulting from all leases. ASU 2016-02 retains the distinction between a finance lease and an operating lease. Lessor accounting is largely unchanged from ASC 840. ASU 2016-02 along with the additional ASUs will be effective for the Company beginning January 1, 2019. While the Company is in the process of evaluating the impact of ASU 2016-02, it does not expect this ASU to have a material impact on its consolidated financial statements, except for recognizing right-of-use assets and lease liabilities for its operating leases and adding additional required disclosures. The Company's lease obligations under various non-cancellable operating lease agreements amounted to approximately \$31.9 million at December 31, 2017.

3. Financial Instruments

Financial instruments recorded in the consolidated balance sheets include investments, note receivable, other receivables, options sold, total return swap, accounts payable, and unsecured notes payable. Due to their short-term maturities, the carrying values of other receivables and accounts payable approximate their fair values. All investments are carried at fair value in the consolidated balance sheets.

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The following table presents the fair values of financial instruments:

	September 30, 2018	December 31, 2017
(Amounts in thousands)		
Assets		
Investments	\$3,904,064	\$ 3,732,728
Note receivable	5,514	5,565
Liabilities		
Total return swap	\$961	\$ 1,200
Options sold	589	123
Unsecured notes	361,118	385,583
Investments		

The Company applies the fair value option to all fixed maturity and equity securities and short-term investments at the time an eligible item is first recognized. The cost of investments sold is determined on a first-in and first-out method and realized gains and losses are included in net realized investment gains (losses) in the Company's consolidated statements of operations. See Note 4. Fair Value Option for additional information.

In the normal course of investing activities, the Company either forms or enters into relationships with variable interest entities ("VIEs"). A VIE is an entity that either has investors that lack certain essential characteristics of a controlling financial interest, such as simple majority kick-out rights, or lacks sufficient funds to finance its own activities without financial support provided by other entities. The Company performs ongoing qualitative assessments of the VIEs to determine whether the Company has a controlling financial interest in the VIE and therefore is the primary beneficiary. The Company is deemed to have a controlling financial interest when it has both the ability to direct the activities that most significantly impact the economic performance of the VIE and the obligation to absorb losses or right to receive benefits from the VIE that could potentially be significant to the VIE. Based on the Company's assessment, if it determines it is the primary beneficiary, the Company consolidates the VIE in its consolidated financial statements.

The Company forms special purpose investment vehicles to facilitate its investment activities involving derivative instruments such as total return swaps, or limited partnerships such as private equity funds. These special purpose investment vehicles are consolidated VIEs as the Company has determined it is the primary beneficiary of such VIEs. Creditors have no recourse against the Company in the event of default by these VIEs. The Company had no implied or unfunded commitments to these VIEs at September 30, 2018 and December 31, 2017. The Company's financial or other support provided to these VIEs and its loss exposure are limited to its collateral and original investment.

The Company also invests directly in limited partnerships such as private equity funds. These investments are non-consolidated VIEs as the Company has determined it is not the primary beneficiary. The Company's maximum exposure to loss is limited to the total carrying value that is included in equity securities in the Company's consolidated balance sheets. At September 30, 2018 and December 31, 2017, the Company had no outstanding unfunded commitments to these VIEs whereby the Company may be called by the partnerships during the commitment period to fund the purchase of new investments and the expenses of the partnerships.

Note Receivable

In August 2017, the Company completed the sale of approximately six acres of land located in Brea, California (the "Property"), for a total sale price of approximately \$12.2 million. Approximately \$5.7 million of the total sale price was received in the form of a promissory note (the "Note") and the remainder in cash. The Note is secured by a first trust deed and an assignment of rents on the Property, and bears interest at an annual rate of 3.5%, payable in monthly installments. The Note matures in August 2020. The Company recognized a gain of approximately \$3.3 million on the

sale transaction, which is included in other revenues in the Company's consolidated statements of operations. Only the cash portion of the total sale price of the Property, excluding the Note, is reported in the Company's consolidated statements of cash flows. Interest earned on the Note is recognized in other revenues in the Company's consolidated statements of operations. The Company elected to apply the fair value option to the Note at the time it was first recognized. The fair value of note receivable is included in other assets in the Company's consolidated balance sheets, while the changes in fair value of note receivable are included in net realized investment gains or losses in the Company's consolidated statements of operations.

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Options Sold

The Company writes covered call options through listed and over-the-counter exchanges. When the Company writes an option, an amount equal to the premium received by the Company is recorded as a liability and is subsequently adjusted to the current fair value of the option written. Premiums received from writing options that expire unexercised are treated by the Company as realized gains from investments on the expiration date. If a call option is exercised, the premium is added to the proceeds from the sale of the underlying security or currency in determining whether the Company has realized a gain or loss. The Company, as writer of an option, bears the market risk of an unfavorable change in the price of the security underlying the written option. Liabilities for covered call options are included in other liabilities in the Company's consolidated balance sheets.

Total Return Swap

The fair value of the total return swap reflects the estimated amount that, upon termination of the contract, would be received for selling an asset or paid to transfer a liability in an orderly transaction.

Unsecured Notes

The fair value of the Company's publicly traded \$375 million unsecured notes at September 30, 2018 and December 31, 2017 was obtained from a third party pricing service.

For additional disclosures regarding methods and assumptions used in estimating fair values, see Note 5. Fair Value Measurements.

4. Fair Value Option

The Company applies the fair value option to all fixed maturity and equity investment securities and short-term investments at the time an eligible item is first recognized. In addition, the Company elected to apply the fair value option to the note receivable recognized as part of the sale of land in August 2017. The primary reasons for electing the fair value option were simplification and cost-benefit considerations as well as the expansion of the use of fair value measurement by the Company consistent with the long-term measurement objectives of the FASB for accounting for financial instruments.

Gains or losses due to changes in fair value of financial instruments measured at fair value pursuant to application of the fair value option are included in net realized investment gains or losses in the Company's consolidated statements of operations. Interest and dividend income on investment holdings are recognized on an accrual basis at each measurement date and are included in net investment income in the Company's consolidated statements of operations, while interest earned on the note receivable is included in other revenues in the Company's consolidated statements of operations.

The following table presents gains (losses) due to changes in fair value of investments and the note receivable that are measured at fair value pursuant to the application of the fair value option:

	Three Months Ended September 30, 2018		Nine Months Ended September 30, 2017	
	2018	2017	2018	2017
	(Amounts in thousands)			
Fixed maturity securities	\$(22,257)	\$9,796	\$(68,246)	\$45,705
Equity securities	9,253	7,765	5,900	14,227
Short-term investments	99	150	(249)	(89)
Total investments	\$(12,905)	\$17,711	\$(62,595)	\$59,843
Note receivable	(2)	(103)	(51)	(103)

Total (losses) gains \$(12,907) \$17,608 \$(62,646) \$59,740

5. Fair Value Measurements

The Company employs a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The fair value of a financial instrument is the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date using the exit price.

Accordingly, when market observable data are not readily available, the Company's own assumptions are used to reflect those that market participants would be presumed to use in pricing the asset or liability at the measurement date. Assets and liabilities recorded at fair value on the consolidated balance sheets are categorized based on the level of judgment associated with inputs used to measure their fair values and the level

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of market price observability, as follows:

- Level 1 Unadjusted quoted prices are available in active markets for identical assets or liabilities as of the reporting date.
- Pricing inputs are other than quoted prices in active markets, which are based on the following:
- Quoted prices for similar assets or liabilities in active markets;
- Level 2
- Quoted prices for identical or similar assets or liabilities in non-active markets; or
 - Either directly or indirectly observable inputs as of the reporting date.
- Level 3 Pricing inputs are unobservable and significant to the overall fair value measurement, and the determination of fair value requires significant management judgment or estimation.

In certain cases, inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, the level in the fair value hierarchy within which the fair value measurement in its entirety falls has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. Thus, a Level 3 fair value measurement may include inputs that are observable (Level 1 or Level 2) and unobservable (Level 3). The Company's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment and consideration of factors specific to the asset or liability.

The Company uses prices and inputs that are current as of the measurement date, including during periods of market disruption. In periods of market disruption, the ability to observe prices and inputs may be reduced for many instruments. This condition could cause an instrument to be reclassified from Level 1 to Level 2, or from Level 2 to Level 3. The Company recognizes transfers between levels at either the actual date of the event or a change in circumstances that caused the transfer.

Summary of Significant Valuation Techniques for Financial Assets and Financial Liabilities

The Company's fair value measurements are based on the market approach, which utilizes market transaction data for the same or similar instruments.

The Company obtained unadjusted fair values on 98.2% of its investment portfolio from an independent pricing service. For a private equity fund that was classified as Level 3 and included in equity securities at September 30, 2018 and December 31, 2017, the Company obtained specific unadjusted broker quotes based on net fund value and, to a lesser extent, unobservable inputs from at least one knowledgeable outside security broker to determine the fair value. The fair value of the private equity fund was \$1.4 million and \$1.5 million at September 30, 2018 and December 31, 2017, respectively.

Level 1 measurements - Fair values of financial assets and financial liabilities are obtained from an independent pricing service, and are based on unadjusted quoted prices for identical assets or liabilities in active markets. Additional pricing services and closing exchange values are used as a comparison to ensure that reasonable fair values are used in pricing the investment portfolio.

U.S. government bonds /Short-term bonds: Valued using unadjusted quoted market prices for identical assets in active markets.

Common stock: Comprised of actively traded, exchange listed U.S. and international equity securities and valued based on unadjusted quoted prices for identical assets in active markets.

Money market instruments: Valued based on unadjusted quoted prices for identical assets in active markets.

Options sold: Comprised of free-standing exchange listed derivatives that are actively traded and valued based on unadjusted quoted prices for identical instruments in active markets.

Level 2 measurements - Fair values of financial assets and financial liabilities are obtained from an independent pricing service or outside brokers, and are based on prices for similar assets or liabilities in active markets or valuation models whose inputs are observable, directly or indirectly, for substantially the full term of the asset or liability.

Additional pricing services are used as a comparison to ensure reliable fair values are used in pricing the investment portfolio.

Municipal securities: Valued based on models or matrices using inputs such as quoted prices for identical or similar assets in active markets.

Mortgage-backed securities: Comprised of securities that are collateralized by residential and commercial mortgage loans valued based on models or matrices using multiple observable inputs, such as benchmark yields, reported trades and broker/dealer quotes, for identical or similar assets in active markets. The Company had holdings of \$25.0 million and \$19.3 million in commercial mortgage-backed securities at September 30, 2018 and December 31, 2017, respectively.

Corporate securities/Short-term bonds: Valued based on a multi-dimensional model using multiple observable inputs, such as

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benchmark yields, reported trades, broker/dealer quotes and issue spreads, for identical or similar assets in active markets.

Non-redeemable preferred stock: Valued based on observable inputs, such as underlying and common stock of same issuer and appropriate spread over a comparable U.S. Treasury security, for identical or similar assets in active markets.

Total return swap: Valued based on multi-dimensional models using inputs such as interest rate yield curves, underlying debt/credit instruments and the appropriate benchmark spread for similar assets in active markets, observable for substantially the full term of the contract.

Collateralized loan obligations ("CLOs"): Valued based on underlying debt instruments and the appropriate benchmark spread for similar assets in active markets.

Other asset-backed securities: Comprised of securities that are collateralized by non-mortgage assets, such as automobile loans, valued based on models or matrices using multiple observable inputs, such as benchmark yields, reported trades and broker/dealer quotes, for identical or similar assets in active markets.

Note receivable: Valued based on observable inputs, such as benchmark yields, and considering any premium or discount for the differential between the stated interest rate and market interest rates, based on quoted market prices of similar instruments.

Level 3 measurements - Fair values of financial assets are based on inputs that are both unobservable and significant to the overall fair value measurement, including any items in which the evaluated prices obtained elsewhere were deemed to be of a distressed trading level.

Private equity fund: Private equity fund, excluding a private equity fund measured at net asset value ("NAV"), is valued based on underlying investments of the fund or assets similar to such investments in active markets, taking into consideration specific unadjusted broker quotes based on net fund value and unobservable inputs from at least one knowledgeable outside security broker related to liquidity assumptions.

Fair value measurement using NAV practical expedient - The fair value of the Company's investment in private equity fund measured at net asset value is determined using NAV as advised by the external fund manager and the third party administrator. The NAV of the Company's limited partnership interest in this fund is based on the manager's and the administrator's valuation of the underlying holdings in accordance with the fund's governing documents and GAAP. In accordance with applicable accounting guidance, this investment, measured at fair value using the NAV practical expedient, is not classified in the fair value hierarchy. The strategy of the fund is to provide current income to investors by investing mainly in equity tranches and sub-investment grade rated debt tranches of CLO issuers in the new and secondary markets, and equity interests in vehicles established to purchase and warehouse loans in anticipation of a CLO closing or to satisfy regulatory risk retention requirements associated with certain CLOs. The Company has made all of its capital contributions in the fund and had no outstanding unfunded commitments at September 30, 2018 with respect to this fund. The underlying assets of the fund are expected to be liquidated over the period of approximately one to five years from September 30, 2018. The Company does not have the contractual option to redeem but will receive distributions based on the liquidation of the underlying assets and the interest proceeds from the underlying assets. In addition, the Company does not have the ability to withdraw from the fund, or to sell, assign, pledge or transfer its investment, without the consent from the general partner of the fund.

The Company's financial instruments at fair value are reflected in the consolidated balance sheets on a trade-date basis. Related unrealized gains or losses are recognized in net realized investment gains or losses in the consolidated statements of operations. Fair value measurements are not adjusted for transaction costs.

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The following tables present information about the Company's assets and liabilities measured at fair value on a recurring basis, and indicate the fair value hierarchy of the valuation techniques utilized by the Company to determine such fair values:

	September 30, 2018			
	Level 1	Level 2	Level 3	Total
	(Amounts in thousands)			
Assets				
Fixed maturity securities:				
U.S. government bonds	\$ 14,105	\$—	\$—	\$ 14,105
Municipal securities	—	2,590,847	—	2,590,847
Mortgage-backed securities	—	31,513	—	31,513
Corporate securities	—	119,292	—	119,292
Collateralized loan obligations	—	155,796	—	155,796
Other asset-backed securities	—	41,318	—	41,318
Total fixed maturity securities	14,105	2,938,766	—	2,952,871
Equity securities:				
Common stock	583,851	—	—	583,851
Non-redeemable preferred stock	—	33,626	—	33,626
Private equity fund	—	—	1,446	1,446
Private equity fund measured at net asset value ⁽¹⁾	—	—	—	69,464
Total equity securities	583,851	33,626	1,446	688,387
Short-term investments:				
Short-term bonds	31,448	24,048	—	55,496
Money market instruments	207,310	—	—	207,310
Total short-term investments	238,758	24,048	—	262,806
Other assets:				
Note receivable	—	5,514	—	5,514
Total assets at fair value	\$ 836,714	\$ 3,001,954	\$ 1,446	\$ 3,909,578
Liabilities				
Other liabilities:				
Total return swap	\$—	\$ 961	\$—	\$ 961
Options sold	589	—	—	589
Total liabilities at fair value	\$ 589	\$ 961	\$—	\$ 1,550

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	December 31, 2017			
	Level 1	Level 2	Level 3	Total
	(Amounts in thousands)			
Assets				
Fixed maturity securities:				
U.S. government bonds	\$13,236	\$—	\$—	\$13,236
Municipal securities	—	2,556,532	—	2,556,532
Mortgage-backed securities	—	27,165	—	27,165
Corporate securities	—	137,542	—	137,542
Collateralized loan obligations	—	105,202	—	105,202
Other asset-backed securities	—	53,100	—	53,100
Total fixed maturity securities	13,236	2,879,541	—	2,892,777
Equity securities:				
Common stock	429,367	—	—	429,367
Non-redeemable preferred stock	—	34,869	—	34,869
Private equity fund	—	—	1,481	1,481
Private equity fund measured at net asset value ⁽¹⁾				71,523
Total equity securities	429,367	34,869	1,481	537,240
Short-term investments:				
Short-term bonds	29,998	2,020	—	32,018
Money market instruments	270,693	—	—	270,693
Total short-term investments	300,691	2,020	—	302,711
Other assets:				
Note receivable	—	5,565	—	5,565
Total assets at fair value	\$743,294	\$2,921,995	\$1,481	\$3,738,293
Liabilities				
Other liabilities:				
Total return swap	\$—	\$1,200	\$—	\$1,200
Options sold	123	—	—	123
Total liabilities at fair value	\$123	\$1,200	\$—	\$1,323

⁽¹⁾ The fair value is measured using the NAV practical expedient; therefore, it is not categorized within the fair value hierarchy. The fair value amount is presented in this table to permit reconciliation of the fair value hierarchy to the amounts presented in the Company's consolidated balance sheets.

The following table presents a summary of changes in fair value of Level 3 financial assets and financial liabilities:

	Private Equity Funds			
	Three Months		Nine Months	
	Ended	Ended	Ended	Ended
	September 30,	September 30,	September 30,	September 30,
	2018	2017	2018	2017
	(Amounts in thousands)			
Beginning balance	\$1,450	\$8,764	\$1,481	\$9,068
Realized losses included in earnings	(4)	(80)	(35)	(384)
Ending balance	\$1,446	\$8,684	\$1,446	\$8,684
	\$(4)	\$(80)	\$(35)	\$(384)

The amount of total losses for the period included in earnings attributable to assets still held at September 30

There were no transfers between Levels 1, 2, and 3 of the fair value hierarchy during the nine months ended September 30, 2018 and 2017.

At September 30, 2018, the Company did not have any nonrecurring fair value measurements of nonfinancial assets or nonfinancial liabilities.

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Financial Instruments Disclosed, But Not Carried, at Fair Value

The following tables present the carrying value and fair value of the Company's financial instruments disclosed, but not carried, at fair value, and the level within the fair value hierarchy at which such instruments are categorized:

September 30, 2018

Carrying Value	Fair Value	Level 1	Level 2	Level 3
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(Amounts in thousands)

Liabilities

Notes payable:

Unsecured notes	\$371,635	\$361,118	\$ —	\$ —
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December 31, 2017

Carrying Value	Fair Value	Level 1	Level 2	Level 3
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(Amounts in thousands)

Liabilities

Notes payable:

Unsecured notes	\$371,335	\$385,583	\$ —	\$ —
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Unsecured Notes

The fair value of the Company's publicly traded \$375 million unsecured notes at September 30, 2018 and December 31, 2017 was based on the spreads above the risk-free yield curve. These spreads are generally obtained from the new issue market, secondary trading and broker-dealer quotes.

See Note 11. Notes Payable for additional information on unsecured notes.

6. Derivative Financial Instruments

The Company is exposed to certain risks relating to its ongoing business operations. The primary risk managed by using derivative instruments is equity price risk. Equity contracts (options sold) on various equity securities are intended to manage the price risk associated with forecasted purchases or sales of such securities.

The Company also enters into derivative contracts to enhance returns on its investment portfolio.

On February 13, 2014, Fannette Funding LLC ("FFL"), a special purpose investment vehicle formed by and consolidated into the Company, entered into a total return swap agreement with Citibank. Under the agreement, FFL receives the income equivalent on underlying obligations due to Citibank and pays to Citibank interest on the outstanding notional amount of the underlying obligations. The total return swap is secured by approximately \$31 million of U.S. Treasuries as collateral, which are included in short-term investments on the consolidated balance sheets. The Company paid interest, which was equal to LIBOR plus 128 basis points prior to the renewal of the agreement in January 2018 and LIBOR plus 120 basis points subsequent to the January 2018 renewal through July 2018, on approximately \$112 million and \$108 million of underlying obligations as of September 30, 2018 and December 31, 2017, respectively. The agreement had an initial term of one year, subject to periodic renewal. In July 2018, the agreement was renewed through January 24, 2020, and the interest rate was changed to LIBOR plus 105 basis points.

On August 9, 2013, Animas Funding LLC ("AFL"), a special purpose investment vehicle formed and consolidated by the Company, entered into a three-year total return swap agreement with Citibank, which was renewed for an additional one-year term through February 17, 2018. The total portfolio of underlying obligations was liquidated during June 2017, and the total return swap agreement between AFL and Citibank was terminated on July 7, 2017. Under the agreement, AFL received the income equivalent on underlying obligations due to Citibank and paid to

Citibank interest on the outstanding notional amount of the underlying obligations. The total return swap was secured by approximately \$40 million of U.S. Treasuries as collateral, which were included in short-term investments on the consolidated balance sheets. The Company paid interest, which was equal to LIBOR plus 135 basis points prior to the amendment of the agreement in January 2017 and LIBOR plus 128 basis points subsequent to the amendment until June 2017, on approximately \$152 million of underlying obligations as of December 31, 2016.

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The following tables present the location and amounts of derivative fair values in the consolidated balance sheets and derivative gains or losses in the consolidated statements of operations:

	Derivative Fair Values		Gains (Losses) Recognized in Income			
	September 30, 2018	December 31, 2017	Three Months Ended September 30, 2018		Nine Months Ended September 30, 2017	
	(Amount in thousands)					
Options sold - Other liabilities	\$589	\$ 123				
Total return swap - Other liabilities	961	1,200				
Total derivatives	\$1,550	\$ 1,323				

	(Amounts in thousands)			
Total return swap - Net realized investment (losses) gains	\$393	\$118	\$674	\$(2,535)
Options sold - Net realized investment (losses) gains	2,141	557	7,872	1,857
Total	\$2,534	\$675	\$8,546	\$(678)

Most options sold consist of covered calls. The Company writes covered calls on underlying equity positions held as an enhanced income strategy that is permitted for the Company's insurance subsidiaries under statutory regulations. The Company manages the risk associated with covered calls through strict capital limitations and asset diversification throughout various industries. See Note 5. Fair Value Measurements for additional disclosures regarding options sold.

7. Goodwill and Other Intangible Assets

Goodwill

There were no changes in the carrying amount of goodwill during the three and nine months ended September 30, 2018 and 2017. Goodwill is reviewed annually for impairment and more frequently if potential impairment indicators exist. No impairment indicators were identified during the three and nine months ended September 30, 2018 and 2017. All of the Company's goodwill is associated with the Property and Casualty business segment (See Note 13. Segment Information for additional information on the reportable business segment).

Other Intangible Assets

The following table presents the components of other intangible assets:

	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Useful Lives
	(Amounts in thousands)			(in years)
As of September 30, 2018:				
Customer relationships	\$53,048	\$(46,798)	\$ 6,250	11
Trade names	15,400	(6,256)	9,144	24
Technology	4,300	(4,193)	107	10
Insurance license	1,400	—	1,400	Indefinite
Total other intangible assets, net	\$74,148	\$(57,247)	\$ 16,901	

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As of December 31, 2017:

Customer relationships	\$52,890	\$ (43,617)	\$ 9,273	11
Trade names	15,400	(5,775)	9,625	24
Technology	4,300	(3,870)	430	10
Insurance license	1,400	—	1,400	Indefinite
Total other intangible assets, net	\$73,990	\$ (53,262)	\$ 20,728	

Other intangible assets are reviewed annually for impairment and more frequently if potential impairment indicators exist. No impairment indicators were identified during the three and nine months ended September 30, 2018 and 2017.

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Other intangible assets with definite useful lives are amortized on a straight-line basis over their useful lives. Other intangible assets amortization expense was \$1.4 million and \$1.3 million for the three months ended September 30, 2018 and 2017, respectively, and \$4.1 million and \$4.0 million for the nine months ended September 30, 2018 and 2017, respectively.

The following table presents the estimated future amortization expense related to other intangible assets as of September 30, 2018:

Year	Amortization Expense (Amounts in thousands)
Remainder of 2018	\$ 1,367
2019	5,036
2020	889
2021	869
2022	845
Thereafter	6,495
Total	\$ 15,501

8. Share-Based Compensation

Share-based compensation expenses for all stock options granted or modified are based on their estimated grant-date fair values. These compensation costs are recognized on a straight-line basis over the requisite service period of the award. The Company estimates forfeitures expected to occur in determining the amount of compensation cost to be recognized in each period. As of September 30, 2018, all outstanding stock options have a term of ten years from the date of grant and become exercisable in four equal installments on the first through fourth anniversaries of the grant date. The fair value of stock option awards is estimated using the Black-Scholes option pricing model with the grant-date assumptions and weighted-average fair values.

The fair value of each restricted stock unit ("RSU") grant is determined based on the market price of the Company's common stock on the grant date for awards classified as equity and on each reporting date for awards classified as liability. The RSUs vest at the end of a three-year performance period beginning with the year of the grant, and then only if, and to the extent that, the Company's performance during the performance period achieves the threshold established by the Compensation Committee of the Company's Board of Directors. Performance thresholds are based on the Company's cumulative underwriting income, annual underwriting income, and net earned premium growth. Compensation cost is recognized based on management's best estimate of the performance goals that will be achieved at the end of the performance period, taking into account expected forfeitures. If the minimum performance goals are not expected to be met, no compensation cost will be recognized and any recognized compensation cost will be reversed.

In February 2015, the Company's Board of Directors adopted the 2015 Incentive Award Plan (the "2015 Plan"), replacing the 2005 Equity Incentive Plan which expired in January 2015. The 2015 Plan was approved at the Company's Annual Meeting of Shareholders in May 2015. A maximum of 4,900,000 shares of common stock are authorized for issuance under the 2015 Plan upon exercise of stock options, stock appreciation rights and other awards, or upon vesting of RSU or deferred stock awards. As of September 30, 2018, the Company had 77,250 RSUs and 80,000 stock options granted and outstanding and 4,742,750 shares of common stock available for future grant under the 2015 Plan.

In February 2018, the Compensation Committee of the Company's Board of Directors awarded a total of 80,000 stock options to four senior executives under the 2015 Plan which will vest over the four-year requisite service period. The fair values of these stock options were estimated on the date of grant using a closed-form option valuation model (Black-Scholes).

The following table provides the assumptions used in the calculation of grant-date fair values of these stock options based on the Black-Scholes option pricing model:

Weighted-average grant-date fair value	\$8.09
Expected volatility	33.18 %
Risk-free interest rate	2.62 %
Expected dividend yield	5.40 %
Expected term in months	72

Expected volatilities are based on historical volatility of the Company's stock over the term of the stock options. The Company

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estimated the expected term of stock options, which represents the period of time that stock options granted are expected to be outstanding, by using historical exercise patterns and post-vesting termination behavior. The risk-free interest rate is determined based on U.S. Treasury yields with equivalent remaining terms in effect at the time of the grant.

As of September 30, 2018, the Company had \$0.5 million of unrecognized compensation expense related to stock options awarded under the 2015 Plan, which will be recognized ratably over the remaining vesting period of approximately 3.4 years.

As of September 30, 2018, the Company had the following RSU awards outstanding. These awards were granted to the Company's senior management and key employees and will vest based upon the Company's performance during the three-year performance period:

Grant year	2016
Three-year performance period ending December 31, 2018	
Vesting shares, target (net of forfeited)	77,250
Vesting shares, maximum (net of forfeited)	144,844

In March 2018, based on certification by the Compensation Committee of the Company's Board of Directors of the results of the three-year performance period ended December 31, 2017, all of the outstanding RSUs granted in 2015 expired unvested because the Company did not meet the minimum three-year performance threshold.

In March 2017, a total of approximately \$3.6 million was paid upon vesting of 61,445 RSUs awarded in 2014 resulting from the attainment of performance goals above the target threshold during the three-year performance period ended December 31, 2016.

As of September 30, 2018, 18,500 target RSUs granted in 2016 have been forfeited because the recipients were no longer employed by the Company.

No RSUs were awarded during the nine months ended September 30, 2018.

9. Income Taxes

For financial statement purposes, the Company recognizes tax benefits related to positions taken, or expected to be taken, on a tax return only if, the positions are "more-likely-than-not" sustainable. Once this threshold has been met, the Company's measurement of its expected tax benefits is recognized in its consolidated financial statements.

There was a \$759,000 increase to the total amount of unrecognized tax benefits related to tax uncertainties during the nine months ended September 30, 2018. The increase was the result of tax positions taken regarding California state tax issues based on management's best judgment given the facts, circumstances, and information available at the reporting date.

The Company and its subsidiaries file income tax returns with the Internal Revenue Service and the taxing authorities of various states. Tax years that remain subject to examination by major taxing jurisdictions are 2014 through 2016 for federal taxes and 2011 through 2016 for California state taxes. For tax years 2003 through 2010, the Company achieved a resolution with the Franchise Tax Board ("FTB") in December 2017 and paid a \$4.6 million negotiated settlement amount in accordance with the settlement agreement provided by the FTB and signed by the Company. The Company believes that the resolution of tax years 2003 through 2010 has the potential to establish guidance for future audit assessments proposed by the FTB for future tax years.

The Company is currently under examination for tax years 2011 through 2016. For tax years 2011 through 2013, the FTB issued Notices of Proposed Assessments ("NPAs") to the Company, which the Company formally protested. If a reasonable settlement is not reached, the Company intends to pursue other options, including a formal hearing with the FTB, an appeal with the California Office of Tax Appeals, or litigation in Superior Court. For tax years 2014 through 2016, the FTB commenced its audit in December 2017.

The Company believes that the resolution of these examinations and assessments will not have a material impact on the consolidated financial statements.

Deferred tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the financial reporting basis and the respective tax basis of the Company's assets and liabilities, and expected benefits of utilizing net operating loss, capital loss, and tax-credit carryforwards. The Company assesses the likelihood that its deferred tax assets will be realized and, to the extent management does not believe these assets are more likely than not to be realized, a valuation allowance

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is established. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates or laws is recognized in earnings in the period that includes the enactment date.

At September 30, 2018, the Company's deferred income taxes were in a net liability position, which included a combination of ordinary and capital deferred tax expenses or benefits. In assessing the Company's ability to realize deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon generating sufficient taxable income of the appropriate character within the carryback and carryforward periods available under the tax law. Management considers the reversal of deferred tax liabilities, projected future taxable income of an appropriate nature, and tax planning strategies in making this assessment. The Company believes that through the use of prudent tax planning strategies and the generation of capital gains, sufficient income will be realized in order to maximize the full benefits of its deferred tax assets. Although realization is not assured, management believes that it is more likely than not that the Company's deferred tax assets will be realized.

As a result of the Tax Cuts and Jobs Act of 2017 (the "Act"), the Company's deferred tax assets and liabilities were remeasured as of December 31, 2017 using the new corporate tax rate of 21% that is effective for tax years beginning January 1, 2018, rather than the pre-enactment corporate tax rate of 35%. Additionally, the Company's alternative minimum tax credit ("AMT") carryforward balance of \$57.9 million at December 31, 2017 was reclassified to current income taxes receivable as a refundable credit. The Company believes it will realize the full benefit of the AMT credit no later than the tax year ending December 31, 2021.

In computing taxable income, property and casualty insurers reduce underwriting income by losses and loss adjustment expenses incurred. The amount of the deduction for losses incurred associated with unpaid losses is discounted at the interest rates and for the loss payment patterns prescribed by the U.S. Treasury. The changes included in the Act related to discounting of unpaid losses are broad and complex. The Act changes the prescribed interest rates to rates based on corporate bond yield curves and extends the applicable time periods for the loss payment pattern. These changes are effective for tax years beginning after 2017 and are subject to a transition rule that spreads the additional tax payments resulting from applying these changes over the subsequent eight years beginning in 2018.

The amounts of income tax adjustments resulting from the Act related to AMT credits and loss reserve discounting are provisional amounts based on reasonable estimates of the Company's tax obligations using the latest information available and are subject to changes as additional information becomes available. The Securities Exchange Commission issued Staff Accounting Bulletin No. 118 ("SAB 118") that expresses views of the staff regarding application of Topic 740, Income Taxes. SAB 118 allows for a measurement period of up to one year after the enactment date of the Act to finalize the recording of the related tax impacts. The transitional impact of the Act will be finalized and recorded by the end of the measurement period.

During the nine months ended September 30, 2018, the Company conducted further analysis of the provisional amounts recorded at December 31, 2017 and did not recognize any adjustments to those amounts. The Company will continue to monitor any additional guidance released by the U.S. Treasury on AMT credits and loss reserve discounting during the measurement period, which may impact the provisional amounts.

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10. Loss and Loss Adjustment Expense Reserves

The following table presents the activity in loss and loss adjustment expense reserves:

	Nine Months Ended September 30,	
	2018	2017
	(Amounts in thousands)	
Gross reserves at January 1	\$ 1,510,613	\$ 1,290,248
Less reinsurance recoverables on unpaid losses	(64,001)	(13,161)
Net reserves at January 1	1,446,612	1,277,087
Incurred losses and loss adjustment expenses related to:		
Current year	1,781,452	1,772,203
Prior years	70,399	18,347
Total incurred losses and loss adjustment expenses	1,851,851	1,790,550
Loss and loss adjustment expense payments related to:		
Current year	1,072,758	1,099,656
Prior years	695,678	606,615
Total payments	1,768,436	1,706,271
Net reserves at September 30	1,530,027	1,361,366
Reinsurance recoverables on unpaid losses	50,027	10,798
Gross reserves at September 30	\$ 1,580,054	\$ 1,372,164

The increase in the provision for insured events of prior years in 2018 of approximately \$70.4 million was primarily attributable to higher than estimated California automobile losses resulting from severity in excess of expectations for bodily injury claims as well as higher than estimated defense and cost containment expenses in the California automobile line of insurance business.

The increase in the provision for insured events of prior years in 2017 of approximately \$18.3 million was primarily attributable to higher than estimated California automobile and property losses.

For the nine months ended September 30, 2018 and 2017, the Company recorded catastrophe losses of approximately \$34 million (\$24 million of net losses after reinsurance benefits) and \$59 million, respectively. There were no reinsurance benefits used for catastrophe losses for the nine months ended September 30, 2017. The majority of the 2018 catastrophe losses were caused by the Carr Wildfire in Northern California, which resulted in \$21 million of gross losses (\$10 million of net losses after reinsurance benefits). Weather-related catastrophes across several states made up the remainder of the 2018 catastrophe losses. The 2017 catastrophe losses were primarily due to severe rainstorms in California, the impact of Hurricane Harvey in Texas and Hurricane Irma in Florida and Georgia, and storms and tornadoes in Oklahoma and Texas.

11. Notes Payable

The following table presents information about the Company's notes payable:

	Lender	Interest Rate	Maturity Date	September 30, 2018	December 31, 2017
				(Amounts in thousands)	
Senior unsecured notes ⁽¹⁾	Publicly traded	4.40%	March 15, 2027	\$ 375,000	\$ 375,000

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Unsecured credit facility ⁽²⁾	Bank of America and Wells Fargo Bank	LIBOR plus 112.5-162.5 basis points	March 29, 2022	—	—
Total principal amount				375,000	375,000
Less unamortized discount and debt issuance costs ⁽³⁾				3,365	3,665
Total debt				\$371,635	\$ 371,335

On March 8, 2017, the Company completed a public debt offering issuing \$375 million of senior notes. The notes
⁽¹⁾ are unsecured, senior obligations of the Company with a 4.4% annual coupon payable on March 15 and September
15 of each year commencing September 15, 2017. These notes mature on March 15, 2027. The Company used the
proceeds from the

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notes to pay off amounts outstanding under the existing loan and credit facilities and for general corporate purposes. The Company incurred debt issuance costs of approximately \$3.4 million, inclusive of underwriters' fees. The notes were issued at a slight discount of 99.847% of par, resulting in the effective annualized interest rate including debt issuance costs of approximately 4.45%.

On March 29, 2017, the Company entered into an unsecured credit agreement that provides for revolving loans of up to \$50 million and matures on March 29, 2022. The interest rates on borrowings under the credit facility are based on the Company's debt to total capital ratio and range from LIBOR plus 112.5 basis points when the ratio is under 15% to LIBOR plus 162.5 basis points when the ratio is greater than or equal to 25%. Commitment fees for (2) the undrawn portions of the credit facility range from 12.5 basis points when the ratio is under 15% to 22.5 basis points when the ratio is greater than or equal to 25%. The debt to total capital ratio is expressed as a percentage of (a) consolidated debt to (b) consolidated shareholders' equity plus consolidated debt. The Company's debt to total capital ratio was 17.8% at September 30, 2018, resulting in a 15 basis point commitment fee on the \$50 million undrawn portion of the credit facility. As of October 25, 2018, there have been no borrowings under this facility. The unamortized discount and debt issuance costs are associated with the publicly traded \$375 million senior unsecured notes. These are amortized to interest expense over the life of the notes, and the unamortized balance is (3) presented in the Company's consolidated balance sheets as a direct deduction from the carrying amount of the debt. The unamortized debt issuance cost of approximately \$0.2 million associated with the \$50 million five-year unsecured revolving credit facility maturing on March 29, 2022 is included in other assets in the Company's consolidated balance sheets and amortized to interest expense over the term of the credit facility.

12. Contingencies

The Company is, from time to time, named as a defendant in various lawsuits or regulatory actions incidental to its insurance business. The majority of lawsuits brought against the Company relate to insurance claims that arise in the normal course of business and are reserved for through the reserving process. For a discussion of the Company's reserving methods, see the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

In March 2006, the California DOI issued an Amended Notice of Non-Compliance to a Notice of Non-Compliance originally issued in February 2004 (as amended, "2004 NNC") alleging that the Company charged rates in violation of the California Insurance Code, willfully permitted its agents to charge broker fees in violation of California law, and willfully misrepresented the actual price insurance consumers could expect to pay for insurance by the amount of a fee charged by the consumer's insurance broker. The California DOI sought to impose a fine for each policy on which the Company allegedly permitted an agent to charge a broker fee, to impose a penalty for each policy on which the Company allegedly used a misleading advertisement, and to suspend certificates of authority for a period of one year. In January 2012, the administrative law judge bifurcated the 2004 NNC between (a) the California DOI's order to show cause (the "OSC"), in which the California DOI asserts the false advertising allegations and accusation, and (b) the California DOI's notice of noncompliance (the "NNC"), in which the California DOI asserts the unlawful rate allegations. In February 2012, the administrative law judge ("ALJ") submitted a proposed decision dismissing the NNC, but the Commissioner rejected the ALJ's proposed decision. The Company challenged the rejection in Los Angeles Superior Court in April 2012, and the Commissioner responded with a demurrer. Following a hearing, the Superior Court sustained the Commissioner's demurrer, based on the Company's failure to exhaust its administrative remedies, and the Company appealed. The Court of Appeal affirmed the Superior Court's ruling that the Company was required to exhaust its administrative remedies, but expressly preserved for later appeal the legal basis for the ALJ's dismissal: violation of the Company's due process rights. Following an evidentiary hearing in April 2013, post-hearing briefs, and an unsuccessful mediation, the ALJ closed the evidentiary record on April 30, 2014. Although a proposed decision was to be submitted to the Commissioner on or before June 30, 2014, after which the Commissioner would have 100 days to accept, reject or modify the proposed decision, the proposed decision was not submitted until December 8, 2014. On January 7, 2015, the Commissioner adopted the ALJ's proposed decision, which became the Commissioner's adopted order (the "Order"). The decision and Order found that from the period July 1, 1996, through 2006, the Company's "brokers" were actually operating as "de facto agents" and that the charging of "broker fees" by these

producers constituted the charging of "premium" in excess of the Company's approved rates, and assessed a civil penalty in the amount of \$27.6 million against the Company. On February 9, 2015, the Company filed a Writ of Administrative Mandamus and Complaint for Declaratory Relief (the "Writ") in the Orange County Superior Court seeking, among other things, to require the Commissioner to vacate the Order, to stay the Order while the Superior Court action is pending, and to judicially declare as invalid the Commissioner's interpretation of certain provisions of the California Insurance Code. Subsequent to the filing of the Writ, a consumer group petitioned and was granted the right to intervene in the Superior Court action. The Court did not order a stay, and the \$27.6 million assessed penalty was paid in March 2015. The Company filed an amended Writ on September 11, 2015, adding an explicit request for a refund of the penalty, with interest.

On August 12, 2016, the Superior Court issued its ruling on the Writ, for the most part granting the relief sought by the

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Company. The Superior Court found that the Commissioner and the California DOI did commit due process violations, but declined to dismiss the case on those grounds. The Superior Court also agreed with the Company that the broker fees at issue were not premium, and that the penalties imposed by the Commissioner were improper, and therefore vacated the Order imposing the penalty. The Superior Court entered final judgment on November 17, 2016, issuing a writ requiring the Commissioner to refund the entire penalty amount within 120 days, plus prejudgment interest at the statutory rate of 7%. On January 12, 2017, the California DOI filed a notice of appeal of the Superior Court's judgment entered on November 17, 2016. While the appeal is still pending, the California DOI returned the entire penalty amount plus accrued interest, a total of \$30.9 million, to the Company in June 2017 in order to avoid accruing further interest. Because the matter has been appealed, the Company has not yet recognized the \$30.9 million as a gain in the consolidated statements of operations; instead, the Company recorded the \$30.9 million plus interest earned, a total of approximately \$31.4 million at September 30, 2018, in other liabilities in the consolidated balance sheets. The Company had filed a motion to dismiss the false advertising portion of the case based on the Superior Court's findings, but the ALJ denied that motion after the appeal was filed. The ALJ did, however, grant the Company's alternative request to stay further proceedings pending the final determination of the appeal. The Company has accrued a liability for the estimated cost to continue to defend itself in the false advertising OSC. Based upon its understanding of the facts and the California Insurance Code, the Company does not expect that the ultimate resolution of the false advertising OSC will be material to its financial position.

The Company establishes reserves for non-insurance claims related lawsuits, regulatory actions, and other contingencies when the Company believes a loss is probable and is able to estimate its potential exposure. For loss contingencies believed to be reasonably possible, the Company also discloses the nature of the loss contingency and an estimate of the possible loss, range of loss, or a statement that such an estimate cannot be made. While actual losses may differ from the amounts recorded and the ultimate outcome of the Company's pending actions is generally not yet determinable, the Company does not believe that the ultimate resolution of currently pending legal or regulatory proceedings, either individually or in the aggregate, will have a material adverse effect on its financial condition or cash flows.

In all cases, the Company vigorously defends itself unless a reasonable settlement appears appropriate. For a discussion of legal matters, see the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

13. Segment Information

The Company is primarily engaged in writing personal automobile insurance and provides related property and casualty insurance products to its customers through 14 subsidiaries in 11 states, principally in California. The Company has one reportable business segment - the Property and Casualty business segment. The Company's Chief Operating Decision Maker evaluates operating results based on pre-tax underwriting results which is calculated as net premiums earned less (a) losses and loss adjustment expenses and (b) underwriting expenses (policy acquisition costs and other operating expenses). Expenses are allocated based on certain assumptions that are primarily related to premiums and losses. The Company's net investment income, net realized investment gains or losses, other income, and interest expense are excluded in evaluating pretax underwriting profit. The Company does not allocate its assets, including investments, or income taxes in evaluating pre-tax underwriting profit.

Property and Casualty Lines

The Property and Casualty business segment offers several insurance products to the Company's individual customers and small business customers. These insurance products are: private passenger automobile which is the Company's primary business, and related insurance products such as homeowners, commercial automobile and commercial property. These related insurance products are primarily sold to the Company's individual customers and small business customers, which increases retention of the Company's private passenger automobile client base. The insurance products comprising the Property and Casualty business segment are sold through the same distribution

channels, mainly through independent and 100% owned insurance agents, and go through a similar underwriting process.

Other Lines

The Other business segment represents net premiums written and earned from an operating segment that does not meet the quantitative thresholds required to be considered a reportable segment. This operating segment offers automobile mechanical protection warranties which are primarily sold through automobile dealerships and credit unions.

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The following tables present the Company's operating results by reportable segment:

	Three Months Ended September 30,					
	2018			2017		
	Property	Other	Total	Property	Other	Total
	&			&		
	Casualty			Casualty		
	(Amounts in millions)					
Net premiums earned	\$850.5	\$ 7.6	\$858.1	\$792.7	\$ 8.5	\$801.2
Less:						
Losses and loss adjustment expenses	610.2	3.9	614.1	591.1	4.2	595.3
Underwriting expenses	202.8	3.3	206.1	196.7	3.9	200.6
Underwriting gain	37.5	0.4	37.9	4.9	0.4	5.3
Investment income			38.2			31.0
Net realized investment (losses) gains			(3.9)			20.7
Other income			2.4			5.4
Interest expense			(4.3)			(4.2)
Pre-tax income			\$70.3			\$58.2
Net income			\$58.6			\$46.5

	Nine Months Ended September 30,					
	2018			2017		
	Property	Other	Total	Property	Other	Total
	&			&		
	Casualty			Casualty		
	(Amounts in millions)					
Net premiums earned	\$2,476.9	\$23.3	\$2,500.2	\$2,362.4	\$26.2	\$2,388.6
Less:						
Losses and loss adjustment expenses	1,840.1	11.8	1,851.9	1,777.1	13.5	1,790.6
Underwriting expenses	604.0	10.9	614.9	587.7	11.9	599.6
Underwriting gain (loss)	32.8	0.6	33.4	(2.4)	0.8	(1.6)
Investment income			104.5			94.1
Net realized investment (losses) gains			(48.4)			66.3
Other income			7.1			9.7
Interest expense			(12.8)			(10.9)
Pre-tax income			\$83.8			\$157.6
Net income			\$76.2			\$125.1

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The following tables present the Company's net premiums earned and direct premiums written by line of insurance business:

	Three Months Ended September 30,					
	2018			2017		
	Property & Other Casualty	Total	Property & Other Casualty	Total	Property & Other Casualty	Total
	(Amounts in millions)					
Private passenger automobile	\$659.6	\$ —	\$659.6	\$619.8	\$ —	\$619.8
Homeowners	120.0	—	120.0	108.3	—	108.3
Commercial automobile	48.7	—	48.7	43.6	—	43.6
Other	22.2	7.6	29.8	21.0	8.5	29.5
Net premiums earned	\$850.5	\$ 7.6	\$858.1	\$792.7	\$ 8.5	\$801.2
Private passenger automobile	\$695.1	\$ —	\$695.1	\$633.7	\$ —	\$633.7
Homeowners	140.7	—	140.7	125.8	—	125.8
Commercial automobile	50.3	—	50.3	45.6	—	45.6
Other	24.5	6.9	31.4	22.9	7.1	30.0
Direct premiums written	\$910.6	\$ 6.9	\$917.5	\$828.0	\$ 7.1	\$835.1
	Nine Months Ended September 30,					
	2018			2017		
	Property & Other Casualty	Total	Property & Other Casualty	Total	Property & Other Casualty	Total
	(Amounts in millions)					
Private passenger automobile	\$1,932.1	\$—	\$1,932.1	\$1,850.3	\$—	\$1,850.3
Homeowners	340.5	—	340.5	322.3	—	322.3
Commercial automobile	140.3	—	140.3	127.3	—	127.3
Other	64.0	23.3	87.3	62.5	26.2	88.7
Net premiums earned	\$2,476.9	\$23.3	\$2,500.2	\$2,362.4	\$26.2	\$2,388.6
Private passenger automobile	\$2,035.1	\$—	\$2,035.1	\$1,872.8	\$—	\$1,872.8
Homeowners	394.0	—	394.0	352.3	—	352.3
Commercial automobile	149.9	—	149.9	133.7	—	133.7
Other	73.6	20.5	94.1	69.9	21.3	91.2
Direct premiums written	\$2,652.6	\$20.5	\$2,673.1	\$2,428.7	\$21.3	\$2,450.0

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations
Forward-Looking Statements

The Private Securities Litigation Reform Act of 1995 provides a "safe harbor" for certain forward-looking statements. Certain statements contained in this report are forward-looking statements based on the Company's current expectations and beliefs concerning future developments and their potential effects on the Company. There can be no assurance that future developments affecting the Company will be those anticipated by the Company. Actual results may differ from those projected in the forward-looking statements. These forward-looking statements involve significant risks and uncertainties (some of which are beyond the control of the Company) and are subject to change based upon various factors, including but not limited to the following risks and uncertainties: changes in the demand for the Company's insurance products, inflation and general economic conditions, including general market risks associated with the Company's investment portfolio; the accuracy and adequacy of the Company's pricing methodologies; catastrophes in the markets served by the Company; uncertainties related to estimates, assumptions and projections generally; the possibility that actual loss experience may vary adversely from the actuarial estimates made to determine the Company's loss reserves in general; the Company's ability to obtain and the timing of the approval of premium rate changes for insurance policies issued in states where the Company operates; legislation adverse to the automobile insurance industry or business generally that may be enacted in the states where the Company operates; the Company's success in managing its business in non-California states; the presence of competitors with greater financial resources and the impact of competitive pricing and marketing efforts; the ability of the Company to successfully manage its claims organization outside of California; the Company's ability to successfully allocate the resources used in the states with reduced or exited operations to its operations in other states; changes in driving patterns and loss trends; acts of war and terrorist activities; court decisions and trends in litigation and health care and auto repair costs; and legal, cybersecurity, regulatory and litigation risks. The Company undertakes no obligation to publicly update or revise any forward-looking statements, whether as the result of new information, future events or otherwise. For a more detailed discussion of some of the foregoing risks and uncertainties, see the Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission on February 8, 2018.

OVERVIEW

A. General

The operating results of property and casualty insurance companies are subject to significant quarter-to-quarter and year-to-year fluctuations due to the effect of competition on pricing, the frequency and severity of losses, the effect of weather and natural disasters on losses, general economic conditions, the general regulatory environment in states in which an insurer operates, state regulation of insurance including premium rates, changes in fair value of investments, and other factors such as changes in tax laws. The property and casualty insurance industry has been highly cyclical, with periods of high premium rates and shortages of underwriting capacity followed by periods of severe price competition and excess capacity. These cycles can have a significant impact on the Company's ability to grow and retain business.

This section discusses some of the relevant factors that management considers in evaluating the Company's performance, prospects, and risks. It is not all-inclusive and is meant to be read in conjunction with the entirety of management's discussion and analysis, the Company's consolidated financial statements and notes thereto, and all other items contained within this Quarterly Report on Form 10-Q.

B. Business

The Company is primarily engaged in writing personal automobile insurance through 14 insurance subsidiaries ("Insurance Companies") in 11 states, principally California. The Company also writes homeowners, commercial automobile, commercial property, mechanical protection, and umbrella insurance. The Company's insurance policies are mostly sold through independent agents who receive a commission for selling policies. The Company believes that it has thorough underwriting and claims handling processes that, together with its agent relationships, provide the

Company with competitive advantages.

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The following tables present direct premiums written, by state and line of insurance business, for the nine months ended September 30, 2018 and 2017:

Nine Months Ended September 30, 2018
(Dollars in thousands)

	Private Passenger Automobile	Homeowners	Commercial Automobile	Other Lines	Total	
California	\$ 1,764,061	\$ 343,285	\$ 89,281	\$ 87,208	\$ 2,283,835	85.4 %
Florida ⁽¹⁾	98,162	6	11,465	129	109,762	4.1 %
Other states ⁽²⁾	172,877	50,701	49,120	6,776	279,474	10.5 %
Total	\$ 2,035,100	\$ 393,992	\$ 149,866	\$ 94,113	\$ 2,673,071	100.0 %
	76.2	% 14.7	% 5.6	% 3.5	% 100.0	%

Nine Months Ended September 30, 2017
(Dollars in thousands)

	Private Passenger Automobile	Homeowners	Commercial Automobile	Other Lines	Total	
California	\$ 1,592,750	\$ 301,810	\$ 75,194	\$ 82,867	\$ 2,052,621	83.8 %
Florida ⁽¹⁾	110,134	8	13,736	655	124,533	5.1 %
Other states ⁽²⁾	169,914	50,526	44,753	7,695	272,888	11.1 %
Total	\$ 1,872,798	\$ 352,344	\$ 133,683	\$ 91,217	\$ 2,450,042	100.0 %
	76.4	% 14.4	% 5.5	% 3.7	% 100.0	%

⁽¹⁾ The Company is writing and expects to continue writing nominal premiums in the Florida homeowners market.

⁽²⁾ No individual state accounted for more than 4% of total direct premiums written.

C. Regulatory and Legal Matters

The Department of Insurance (“DOI”) in each state in which the Company operates is responsible for conducting periodic financial, market conduct, and rating and underwriting examinations of the Insurance Companies in their states. Market conduct examinations typically review compliance with insurance statutes and regulations with respect to rating, underwriting, claims handling, billing, and other practices.

The following table presents a summary of recent examinations:

State	Exam Type	Period Under Review	Status
CA,FL,GA,IL,OK,TX	Coordinated Multi-state Financial	2014 to 2017	Fieldwork began in the second quarter of 2018.
CA	Market Conduct Claims	2015	Received final report.
CA	Rating and Underwriting	2014	Fieldwork is completed. Awaiting draft report.
VA	Market Conduct	2014 to 2015	Received final report.
TX	Market Conduct	2016	Received final report.

During the course of and at the conclusion of these examinations, the examining DOI generally reports findings to the Company. None of the findings reported to date are expected to be material to the Company's financial position.

In January 2018, the California DOI approved a 5.0% rate increase on Mercury Insurance Company's private passenger automobile line of insurance business, which represented approximately 53% of the Company's total net premiums earned for the nine months ended September 30, 2018. This rate increase became effective in March 2018.

The Company is, from time to time, named as a defendant in various lawsuits or regulatory actions incidental to its insurance business. The majority of lawsuits brought against the Company relate to insurance claims that arise in the normal course of business and are reserved for through the reserving process. For a discussion of the Company's reserving methods, see the

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Company's Annual Report on Form 10-K for the year ended December 31, 2017.

The Company establishes reserves for non-insurance claims related lawsuits, regulatory actions, and other contingencies when the Company believes a loss is probable and is able to estimate its potential exposure. For loss contingencies believed to be reasonably possible, the Company also discloses the nature of the loss contingency and an estimate of the possible loss, range of loss, or a statement that such an estimate cannot be made. While actual losses may differ from the amounts recorded and the ultimate outcome of the Company's pending actions is generally not yet determinable, the Company does not believe that the ultimate resolution of currently pending legal or regulatory proceedings, either individually or in the aggregate, will have a material adverse effect on its financial condition or cash flows.

In all cases, the Company vigorously defends itself unless a reasonable settlement appears appropriate. For a discussion of legal matters, see the Company's Annual Report on Form 10-K for the year ended December 31, 2017, and Note 12. Contingencies of the Notes to Consolidated Financial Statements of this Quarterly Report.

D. Critical Accounting Policies and Estimates

Loss and Loss Adjustment Expense Reserves ("Loss Reserves")

Preparation of the Company's consolidated financial statements requires management's judgment and estimates. The most significant is the estimate of loss reserves. Estimating loss reserves is a difficult process as many factors can ultimately affect the final settlement of a claim and, therefore, the loss reserve that is required. A key assumption in estimating loss reserves is the degree to which the historical data used to analyze reserves will be predictive of ultimate claim costs on incurred claims. Changes in the regulatory and legal environments, results of litigation, medical costs, the cost of repair materials, and labor rates, among other factors, can impact this assumption. In addition, time can be a critical part of reserving determinations since the longer the span between the incidence of a loss and the payment or settlement of a claim, the more variable the ultimate settlement amount could be. Accordingly, short-tail claims, such as property damage claims, tend to be more reasonably predictable than long-tail liability claims.

The Company calculates a loss reserve point estimate rather than a range. There is inherent uncertainty with estimates and this is particularly true with loss reserve estimates. This uncertainty comes from many factors which may include changes in claims reporting and settlement patterns, changes in the regulatory and legal environments, uncertainty over inflation rates, and uncertainty for unknown items. The Company does not make specific provisions for these uncertainties, rather it considers them in establishing its loss reserve by reviewing historical patterns and trends and projecting these out to current loss reserves. The underlying factors and assumptions that serve as the basis for preparing the loss reserve estimate include paid and incurred loss development factors, expected average costs per claim, inflation trends, expected loss ratios, industry data, and other relevant information.

The Company also engages independent actuarial consultants to review the Company's loss reserves and to provide the annual actuarial opinions under statutory accounting principles as required by state regulation. The Company analyzes loss reserves quarterly primarily using the incurred loss, paid loss, average severity coupled with the claim count development methods, and the generalized linear model ("GLM") described below. When deciding among methods to use, the Company evaluates the credibility of each method based on the maturity of the data available and the claims settlement practices for each particular line of insurance business or coverage within a line of insurance business. The Company may also evaluate qualitative factors such as known changes in laws or legal rulings that could affect claims handling or other external environmental factors or internal factors that could affect the settlement of claims. When establishing the loss reserve, the Company will generally analyze the results from all of the methods used rather than relying on a single method. While these methods are designed to determine the ultimate losses on claims under the Company's policies, there is inherent uncertainty in all actuarial models since they use historical data to project

outcomes. The Company believes that the techniques it uses provide a reasonable basis in estimating loss reserves.

The incurred loss method analyzes historical incurred case loss (case reserves plus paid losses) development to estimate ultimate losses. The Company applies development factors against current case incurred losses by accident period to calculate ultimate expected losses. The Company believes that the incurred loss method provides a reasonable basis for evaluating ultimate losses, particularly in the Company's larger, more established lines of insurance business which have a long operating history.

The paid loss method analyzes historical payment patterns to estimate the amount of losses yet to be paid.

The average severity method analyzes historical loss payments and/or incurred losses divided by closed claims and/or total claims to calculate an estimated average cost per claim. From this, the expected ultimate average cost per claim can be estimated. The average severity method coupled with the claim count development method provide meaningful

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information regarding inflation and frequency trends that the Company believes is useful in establishing loss reserves. The claim count development method analyzes historical claim count development to estimate future incurred claim count development for current claims. The Company applies these development factors against current claim counts by accident period to calculate ultimate expected claim counts.

The GLM determines an average severity for each percentile of claims that have been closed as a percentage of estimated ultimate claims. The average severities are applied to open claims to estimate the amount of losses yet to be paid. The GLM utilizes operational time, determined as a percentile of claims closed rather than a finite calendar period, which neutralizes the effect of changes in the timing of claims handling.

The Company analyzes catastrophe losses separately from non-catastrophe losses. For catastrophe losses, the Company generally determines claim counts based on claims reported and development expectations from previous catastrophes and applies an average expected loss per claim based on loss reserves established by adjusters and average losses on previous similar catastrophes. For catastrophe losses on individual properties that are expected to be total losses, the Company typically establishes reserves at the policy limits.

At September 30, 2018 and December 31, 2017, the Company recorded its point estimate of approximately \$1.58 billion and \$1.51 billion (\$1.53 billion and \$1.45 billion, net of reinsurance), respectively, in loss reserves, which included approximately \$684.6 million and \$668.4 million (\$672.2 million and \$626.7 million, net of reinsurance), respectively, of incurred but not reported loss reserves (“IBNR”). IBNR includes estimates, based upon past experience, of ultimate developed costs, which may differ from case estimates, unreported claims that occurred on or prior to September 30, 2018 and December 31, 2017, and estimated future payments for reopened claims. Management believes that the liability for loss reserves is adequate to cover the ultimate net cost of losses and loss adjustment expenses incurred to date; however, since the provisions are necessarily based upon estimates, the ultimate liability may be more or less than such provisions.

The Company evaluates its loss reserves quarterly. When management determines that the estimated ultimate claim cost requires a decrease for previously reported accident years, favorable development occurs and a reduction in losses and loss adjustment expenses is reported in the current period. If the estimated ultimate claim cost requires an increase for previously reported accident years, unfavorable development occurs and an increase in losses and loss adjustment expenses is reported in the current period. For the nine months ended September 30, 2018, the Company reported unfavorable development of approximately \$70 million on the 2017 and prior accident years’ loss reserves. The majority of the unfavorable development in 2018 was attributable to higher than estimated California automobile losses resulting from severity in excess of expectations for bodily injury claims as well as higher than estimated defense and cost containment expenses in the California automobile line of insurance business. The Company has recently experienced an increase in the number of claims settled for high dollar amounts (over \$25,000). The Company believes increased utilization of medical services, including epidural injections and surgical procedures, rising medical costs, an increase in alleged traumatic brain injuries and an aggressive plaintiff’s bar have increased the cost to settle claims.

Industry-wide data showed a 10.1% quarterly increase in bodily injury severity in the California personal automobile line of insurance business for the fourth quarter of 2017, compared to a quarterly increase of between 2.0% and 7.1% for the preceding six quarters. Furthermore, the annual increase as of the second quarter of 2018 was 6.3%. The industry severity trend suggests that the drivers of the increasing bodily injury claims costs affecting the Company are also impacting its competitors.

For the nine months ended September 30, 2018, the Company recorded catastrophe losses of approximately \$34 million (\$24 million of net losses after reinsurance benefits). The majority of the 2018 catastrophe losses were caused by the Carr Wildfire in Northern California, which resulted in \$21 million of gross losses (\$10 million of net losses after reinsurance benefits). Weather-related catastrophes across several states made up the remainder of the 2018 catastrophe losses.

For a further discussion of the Company’s reserving methods, see the Company’s Annual Report on Form 10-K for the year ended December 31, 2017.

Investments

The Company's fixed maturity and equity securities are classified as "trading" and carried at fair value as required when applying the fair value option, with changes in fair value reflected in net realized investment gains or losses in the consolidated statements of operations. The majority of equity holdings, including non-redeemable preferred stocks, are actively traded on national exchanges or trading markets, and are valued at the last transaction price on the balance sheet date.

Fair Value of Financial Instruments

Financial instruments recorded in the consolidated balance sheets include investments, note receivable, other receivables,

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total return swap, accounts payable, options sold, and unsecured notes payable. The fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Due to their short-term maturity, the carrying values of other receivables and accounts payable approximate their fair values. All investments are carried on the consolidated balance sheets at fair value, as described in Note 3. Financial Instruments of the Notes to Consolidated Financial Statements.

The Company's financial instruments include securities issued by the U.S. government and its agencies, securities issued by states and municipal governments and agencies, certain corporate and other debt securities, equity securities, and exchange traded funds. At September 30, 2018, 98.2% of the fair value of these financial instruments is based on observable market prices, observable market parameters, or is derived from such prices or parameters. The availability of observable market prices and pricing parameters can vary by financial instrument. Observable market prices and pricing parameters of a financial instrument, or a related financial instrument, are used to derive a price without requiring significant judgment.

The Company may hold or acquire financial instruments that lack observable market prices or market parameters because they are less actively traded currently or in future periods. The fair value of such instruments is determined using techniques appropriate for each particular financial instrument. These techniques may involve some degree of judgment. The price transparency of the particular financial instrument will determine the degree of judgment involved in determining the fair value of the Company's financial instruments. Price transparency is affected by a wide variety of factors, including the type of financial instrument, whether it is a new financial instrument and not yet established in the marketplace, and the characteristics particular to the transaction. Financial instruments for which actively quoted prices or pricing parameters are available or for which fair value is derived from actively quoted prices or pricing parameters will generally have a higher degree of price transparency. By contrast, financial instruments that are thinly traded or not quoted will generally have diminished price transparency. Even in normally active markets, the price transparency for actively quoted instruments may be reduced during periods of market dislocation.

Alternatively, in thinly quoted markets, the participation of market makers willing to purchase and sell a financial instrument provides a source of transparency for products that otherwise are not actively quoted.

Income Taxes

At September 30, 2018, the Company's deferred income taxes were in a net liability position mainly due to deferred tax liabilities generated by unrealized gains on securities held and deferred acquisition costs. These deferred tax liabilities were substantially offset by deferred tax assets resulting from unearned premiums, loss reserve discounting, and expense accruals. The Company assesses the likelihood that its deferred tax assets will be realized and, to the extent management does not believe these assets are more likely than not to be realized, a valuation allowance is established. Management's recoverability assessment of the Company's deferred tax assets which are ordinary in character takes into consideration the Company's strong history of generating ordinary taxable income and a reasonable expectation that it will continue to generate ordinary taxable income in the future. Further, the Company has the capacity to recoup its ordinary deferred tax assets through tax loss carryback claims for taxes paid in prior years. Finally, the Company has various deferred tax liabilities that represent sources of future ordinary taxable income.

Management's recoverability assessment with regard to its capital deferred tax assets is based on estimates of anticipated capital gains, tax-planning strategies available to generate future taxable capital gains, and the Company's capacity to absorb capital losses carried back to prior years, each of which would contribute to the realization of deferred tax benefits. The Company has significant unrealized gains in its investment portfolio that could be realized through asset dispositions, at management's discretion. In addition, the Company expects to hold certain debt securities, which are currently in loss positions, to recovery or maturity. Management believes unrealized losses related to these debt securities, which represent a portion of the unrealized loss positions at period-end, are fully realizable at maturity. Management believes its long-term time horizon for holding these securities allows it to avoid any forced sales prior to maturity. Further, the Company has the capability to generate additional realized capital gains by entering into sale-leaseback transactions using one or more of its appreciated real estate holdings. Finally, the Company has the capacity to recoup capital deferred tax assets through tax capital loss carryback claims for taxes paid

within permitted carryback periods.

The Company has the capability to implement tax planning strategies as it has a steady history of generating positive cash flows from operations and believes that its liquidity needs can be met in future periods without the forced sale of its investments. This capability assists management in controlling the timing and amount of realized losses generated during future periods. By prudent utilization of some or all of these strategies, management has the intent and believes that it has the ability to generate capital gains and minimize tax losses in a manner sufficient to avoid losing the benefits of its deferred tax assets. Management will continue to assess the need for a valuation allowance on a quarterly basis. Although realization is not assured, management believes it is more likely than not that the Company's deferred tax assets will be realized.

As a result of enactment of the Tax Cuts and Jobs Act of 2017 (the "Act") on December 22, 2017 that is effective for tax

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years beginning January 1, 2018, the Company made certain tax adjustments for the twelve months ended December 31, 2017. Adjustments were made to reflect the Company's deferred tax balances at December 31, 2017 that were computed at the new corporate rate of 21%, rather than the pre-enactment rate of 35%. Additional adjustments were made to account for the impact of the Act on the realizability of the Company's tax credit carryforwards and tax balances at December 31, 2017. These adjustments resulted in a net tax benefit of approximately \$7.4 million, which was reflected in net income for the twelve months ended December 31, 2017.

The Company is currently evaluating other impacts that the Act may have on business and investment strategies as well as financial results in future years, and has not yet determined the extent of such impacts. There are complex factors at play, including the effect of insurance regulation and competition, which will likely require the tax benefits to be passed on to consumers, and changing dynamics in the capital markets, which may result in a shift in the Company's allocation between taxable and tax-exempt investments.

The Company's effective income tax rate can be affected by several factors. These generally include tax-exempt investment income, other non-deductible expenses, and periodically, non-routine tax items such as changes in the statutory tax rates and adjustment to unrecognized tax benefits related to tax uncertainties. The effective tax rate for the nine months ended September 30, 2018 was 9.2%, compared to 20.6% for the same period in 2017. The decrease in the effective tax rate was principally due to a lower proportion of fully taxable income versus tax-exempt investment income for the nine months ended September 30, 2018, compared to the same period in 2017, combined with the lower statutory federal income tax rate effective January 1, 2018. The Company's effective tax rate for the nine months ended September 30, 2018 was lower than the statutory tax rate primarily as a result of tax-exempt investment income earned.

Contingent Liabilities

The Company has known, and may have unknown, potential liabilities which include claims, assessments, lawsuits, or regulatory fines and penalties relating to the Company's business. The Company continually evaluates these potential liabilities and accrues for them and/or discloses them in the notes to the consolidated financial statements where required. The Company does not believe that the ultimate resolution of currently pending legal or regulatory proceedings, either individually or in the aggregate, will have a material adverse effect on its financial condition, results of operations, or cash flows. See "Regulatory and Legal Matters" above and Note 12. Contingencies of the Notes to Consolidated Financial Statements.

Premiums

The Company's insurance premiums are recognized as income ratably over the term of the policies and in proportion to the amount of insurance protection provided. Unearned premiums are carried as a liability on the consolidated balance sheets and are computed monthly on a pro-rata basis. The Company evaluates its unearned premiums periodically for premium deficiencies by comparing the sum of expected claim costs, unamortized acquisition costs, and maintenance costs partially offset by investment income to related unearned premiums. To the extent that any of the Company's lines of insurance business become unprofitable, a premium deficiency reserve may be required.

RESULTS OF OPERATIONS

Three Months Ended September 30, 2018 Compared to Three Months Ended September 30, 2017

Revenues

Net premiums earned and net premiums written for the three months ended September 30, 2018 increased 7.1% and 9.4%, respectively, from the corresponding period in 2017. The increase in net premiums earned and net premiums written was primarily due to higher average premiums per policy arising from rate increases in the California private passenger automobile and homeowners lines of insurance business and growth in the number of private passenger automobile and homeowners policies written in California.

The Company, which predominantly offers six-month personal automobile insurance policies, reintroduced twelve-month personal automobile policies for new business in its largest insurance subsidiary, Mercury Insurance Company (“MIC”), in March 2018. Twelve-month policies are generally sold for twice the price of six-month policies. The Company estimates that the total net premiums written for the three months ended September 30, 2018 increased by approximately \$20 million due to the reintroduction of twelve-month policies in MIC, compared to what the total would have been without the reintroduction. There was no material impact to net premiums earned for the three months ended September 30, 2018 resulting from the reintroduction of twelve-month policies.

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Net premiums earned included ceded premiums earned of \$9.5 million and \$7.8 million for the three months ended September 30, 2018 and 2017, respectively. Net premiums written included ceded premiums written of \$12.3 million and \$8.0 million for the three months ended September 30, 2018 and 2017, respectively. The increase in ceded premiums earned and ceded premiums written for the three months ended September 30, 2018 compared to the same period in 2017 resulted mostly from an increase in reinsurance rates, growth in the covered book of business and reinstatement premiums on the catastrophe reinsurance treaty effective July 1, 2018.

Net premiums earned, a GAAP measure, represents the portion of net premiums written that is recognized as revenue in the financial statements for the periods presented and earned on a pro-rata basis over the term of the policies. Net premiums written is a non-GAAP financial measure which represents the premiums charged on policies issued during a fiscal period less any applicable reinsurance. Net premiums written is a statutory measure designed to determine production levels.

The following is a reconciliation of net premiums earned to net premiums written:

	Three Months Ended September 30, 2018 2017	
	(Amounts in thousands)	
Net premiums earned	\$858,135	\$801,205
Change in net unearned premium	47,204	26,214
Net premiums written	\$905,339	\$827,419
Expenses		

Loss and expense ratios are used to interpret the underwriting experience of property and casualty insurance companies. The following table presents the Insurance Companies' loss, expense, and combined ratios determined in accordance with GAAP:

	Three Months Ended September 30, 2018 2017	
Loss ratio	71.6%	74.3%
Expense ratio	24.0%	25.0%
Combined ratio	95.6%	99.3%

Loss ratio is calculated by dividing losses and loss adjustment expenses by net premiums earned. The Company's loss ratio was affected by unfavorable development of approximately \$6 million and \$4 million on prior accident years' loss reserves during the third quarter of 2018 and 2017, respectively. The majority of the unfavorable development in the third quarter of 2018 was attributable to higher than estimated California automobile losses resulting from severity in excess of expectations for bodily injury claims as well as higher than estimated defense and cost containment expenses in the California automobile line of insurance business. The majority of the unfavorable development in the third quarter of 2017 was attributable to higher than estimated California automobile losses. In addition, the third quarter 2018 loss ratio was negatively impacted by approximately \$13 million of catastrophe losses, net of reinsurance benefits, primarily due to the Carr Wildfire in Northern California. The third quarter 2017 loss ratio was also negatively impacted by approximately \$19 million of catastrophe losses, primarily due to the impact of Hurricane Harvey in Texas and Hurricane Irma in Florida and Georgia.

Expense ratio is calculated by dividing the sum of policy acquisition costs and other operating expenses by net premiums earned. The expense ratio for the three months ended September 30, 2018 decreased compared to the same period in 2017, largely due to a decrease in other operating expenses coupled with an increase in net premiums earned and a slight reduction in average policy acquisition costs.

Combined ratio is equal to loss ratio plus expense ratio and is the key measure of underwriting performance traditionally used in the property and casualty insurance industry. A combined ratio under 100% generally reflects profitable underwriting results, and a combined ratio over 100% generally reflects unprofitable underwriting results. Income tax expense was \$11.7 million and \$11.8 million for the three months ended September 30, 2018 and 2017, respectively. The \$0.1 million decrease in income tax expense was primarily due to a decrease in the federal corporate tax rate from 35% to 21%, partially offset by an increase in fully taxable income. Tax-exempt investment income, a component of total pre-tax income, remained relatively unchanged compared to the same period in 2017.

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Investments

The following table presents the investment results of the Company:

	Three Months Ended September 30, 2018			2017
	(Dollars in thousands)			
Average invested assets at cost ⁽¹⁾	\$3,809,689			\$3,630,223
Net investment income ⁽²⁾				
Before income taxes	\$38,159			\$30,988
After income taxes	\$33,522			\$27,071
Average annual yield on investments ⁽²⁾				
Before income taxes	4.0	%	3.4	%
After income taxes	3.5	%	3.0	%
Net realized investment (losses) gains	\$(3,910)		\$20,718

(1) Fixed maturities and short-term bonds at amortized cost; equities and other short-term investments at cost. Average invested assets at cost are based on the monthly amortized cost of the invested assets for each period.

Net investment income before and after income taxes increased largely due to higher average invested assets combined with rising market interest rates. Average annual yield on investments before and after income taxes

(2) increased primarily due to yield increases in short-term and floating-rate securities resulting from rising market interest rates. Net investment income and average annual yield on investments after income taxes also benefited modestly from the lower tax rate effective January 1, 2018 applied to taxable investment income.

The following tables present the components of net realized investment gains (losses) included in net income:

	Three Months Ended September 30, 2018		
	Gains (Losses) Recognized in Net Income		
	Changes		
	Sales	in fair value	Total
	(Amounts in thousands)		
Net realized investment gains (losses)			
Fixed maturity securities ⁽¹⁾⁽²⁾	\$(888)	\$(22,257)	\$(23,145)
Equity securities ⁽¹⁾⁽³⁾	7,346	9,253	16,599
Short-term investments ⁽¹⁾	5	99	104
Note receivable ⁽¹⁾	—	(2)	(2)
Total return swap	(39)	432	393
Options sold	1,904	237	2,141
Total	\$8,328	\$(12,238)	\$(3,910)

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Three Months Ended
September 30, 2017
Gains (Losses) Recognized
in Net Income
Changes
Sales in fair Total
value

(Amounts in thousands)

Net realized investment gains (losses)			
Fixed maturity securities ⁽¹⁾⁽²⁾	\$(476)	\$9,796	\$9,320
Equity securities ⁽¹⁾⁽³⁾	2,919	7,765	10,684
Short-term investments ⁽¹⁾	(8)	150	142
Note receivable ⁽¹⁾	—	(103)	(103)
Total return swaps	(18)	136	118
Options sold	580	(23)	557
Total	\$2,997	\$17,721	\$20,718

(1) The changes in fair value of the investment portfolio and note receivable resulted from the application of the fair value option.

The decrease in fair value of fixed maturity securities for the third quarter of 2018 was primarily due to increases

(2) in market interest rates. The increase in fair value of fixed maturity securities for the third quarter of 2017 was primarily due to overall improvement in market conditions affecting fixed maturity securities.

(3) The increase in fair value of equity securities for the third quarter of 2018 and 2017 was primarily due to overall improvement in equity markets.

Net Income

Three Months Ended
September 30,
2018 2017

(Amounts in thousands,
except per share data)

Net income	\$ 58,578	\$ 46,485
Basic average shares outstanding	55,337	55,324
Diluted average shares outstanding	55,341	55,334
Basic Per Share Data:		
Net income	\$ 1.06	\$ 0.84
Net realized investment (losses) gains, net of tax	\$ (0.05)	\$ 0.24
Diluted Per Share Data:		
Net income	\$ 1.06	\$ 0.84
Net realized investment (losses) gains, net of tax	\$ (0.05)	\$ 0.24

Nine Months Ended September 30, 2018 Compared to Nine Months Ended September 30, 2017

Revenues

Net premiums earned and net premiums written for the nine months ended September 30, 2018 increased 4.7% and 8.6%, respectively, from the corresponding period in 2017. The increase in net premiums earned and net premiums written was primarily due to higher average premiums per policy arising from rate increases in the California private passenger automobile and homeowners lines of insurance business and growth in the number of private passenger

automobile and homeowners policies written in California.

In addition, as a result of reintroducing twelve-month personal automobile insurance policies for new business in MIC in March 2018, as discussed above, the Company estimates that the total net premiums written for the nine months ended September 30, 2018 increased by approximately \$43 million, compared to what the total would have been without the reintroduction. There was no material impact to net premiums earned for the nine months ended September 30, 2018 resulting from the reintroduction of twelve-month policies.

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Net premiums earned included ceded premiums earned of \$34.5 million and \$16.4 million for the nine months ended September 30, 2018 and 2017, respectively. Net premiums written included ceded premiums written of \$28.5 million and \$13.9 million for the nine months ended September 30, 2018 and 2017, respectively. The increase in ceded premiums earned and ceded premiums written for the nine months ended September 30, 2018 compared to the same period in 2017 resulted mostly from increased coverage and reinstatement premiums on the catastrophe reinsurance treaty effective July 1, 2017 and 2018.

The following is a reconciliation of net premiums earned to net premiums written:

	Nine Months Ended September 30,	
	2018	2017
	(Amounts in thousands)	
Net premiums earned	\$2,500,178	\$2,388,641
Change in net unearned premiums	144,846	48,022
Net premiums written	\$2,645,024	\$2,436,663

Expenses

The following table presents the Insurance Companies' loss, expense, and combined ratios determined in accordance with GAAP:

	Nine Months Ended September 30,	
	2018	2017
Loss ratio	74.1 %	75.0 %
Expense ratio	24.6 %	25.1 %
Combined ratio	98.7 %	100.1 %

The Company's loss ratio was affected by unfavorable development of approximately \$70 million and unfavorable development of approximately \$18 million on prior accident years' loss reserves for the nine months ended September 30, 2018 and 2017, respectively. The majority of the unfavorable development for the nine months ended September 30, 2018 was attributable to higher than estimated California automobile losses resulting from severity in excess of expectations for bodily injury claims as well as higher than estimated defense and cost containment expenses in the California automobile line of insurance business, while the majority of the unfavorable development for the nine months ended September 30, 2017 resulted from higher than estimated California automobile and property losses. The 2018 loss ratio was also negatively impacted by a total of \$24 million of catastrophe losses, net of reinsurance benefits, primarily due to the Carr Wildfire in Northern California and weather-related catastrophes across several states. The 2017 loss ratio was also negatively impacted by a total of \$59 million of catastrophe losses, primarily due to severe rainstorms in California, the impact of Hurricane Harvey in Texas and Hurricane Irma in Florida and Georgia, and storms and tornadoes in Oklahoma and Texas. Excluding the effect of estimated prior accident years' loss development and catastrophe losses, the loss ratio was 70.3% and 71.7% for the nine months ended September 30, 2018 and 2017, respectively. The decrease in the loss ratio resulted primarily from premium rate increases on automobile and homeowners insurance policies.

The expense ratio for the nine months ended September 30, 2018 decreased slightly compared to the same period in 2017. The reduction in the expense ratio was primarily due to net premiums earned growing at a higher rate than policy acquisition costs and other operating expenses.

Income tax expense was \$7.7 million and \$32.5 million for the nine months ended September 30, 2018 and 2017, respectively. The \$24.8 million decrease in income tax expense was primarily due to a \$73.8 million decrease in total pre-tax income. Tax-exempt investment income, a component of total pre-tax income, remained relatively unchanged

compared to the same period in 2017. Also contributing to the decrease in income tax expense was a decrease in the federal corporate tax rate from 35% to 21%.

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Investments

The following table presents the investment results of the Company:

	Nine Months Ended September 30, 2018		2017	
	(Dollars in thousands)			
Average invested assets at cost ⁽¹⁾	\$3,722,365		\$3,563,855	
Net investment income ⁽²⁾				
Before income taxes	\$104,455		\$94,058	
After income taxes	\$92,867		\$82,381	
Average annual yield on investments ⁽²⁾				
Before income taxes	3.7	%	3.5	%
After income taxes	3.3	%	3.1	%
Net realized investment (losses) gains	\$(48,355))	\$66,334	

⁽¹⁾ Fixed maturities and short-term bonds at amortized cost; equities and other short-term investments at cost. Average invested assets at cost are based on the monthly amortized cost of the invested assets for each period.

Net investment income before and after income taxes increased largely due to higher average invested assets combined with rising market interest rates. Average annual yield on investments before and after income taxes

⁽²⁾ increased primarily due to yield increases in short-term and floating-rate securities resulting from rising market interest rates. Net investment income and average annual yield on investments after income taxes also benefited modestly from the lower tax rate effective January 1, 2018 applied to taxable investment income.

The following tables present the components of net realized investment gains (losses) included in net income:

	Nine Months Ended September 30, 2018		
	Gains (Losses) Recognized in Net Income		
	Sales	Changes in fair value	Total
	(Amounts in thousands)		
Net realized investment gains (losses)			
Fixed maturity securities ⁽¹⁾⁽²⁾	\$(2,288)	\$(68,246)	\$(70,534)
Equity securities ⁽¹⁾⁽³⁾	8,001	5,900	13,901
Short-term investments ⁽¹⁾	32	(249)	(217)
Note receivable ⁽¹⁾	—	(51)	(51)
Total return swap	435	239	674
Options sold	7,657	215	7,872
Total	\$13,837	\$(62,192)	\$(48,355)

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Nine Months Ended
September 30, 2017
Gains (Losses) Recognized in
Net Income

Sales Changes
 in fair Total
 value

(Amounts in thousands)

Net realized investment gains (losses)			
Fixed maturity securities ⁽¹⁾⁽²⁾	\$(1,666)	\$45,705	\$44,039
Equity securities ⁽¹⁾⁽³⁾	8,937	14,227	23,164
Short-term investments ⁽¹⁾	1	(89)	(88)
Note receivable ⁽¹⁾	—	(103)	(103)
Total return swaps	(1,044)	(1,491)	(2,535)
Options sold	1,843	14	1,857
Total	\$8,071	\$58,263	\$66,334

(1) The changes in fair value of the investment portfolio and note receivable resulted from the application of the fair value option.

The decrease in fair value of fixed maturity securities for the nine months ended September 30, 2018 was primarily due to increases in market interest rates. The increase in fair value of fixed maturity securities for the nine months ended September 30, 2017 was primarily due to overall improvement in market conditions affecting fixed maturity securities, combined with decreases in market interest rates.

(2) The increase in fair value of equity securities for the nine months ended September 30, 2018 and 2017 was primarily due to overall improvement in equity markets.

Net Income

Nine Months Ended
September 30,
2018 2017

(Amounts in thousands,
except per share data)

Net income	\$ 76,151	\$ 125,098
Basic average shares outstanding	55,334	55,311
Diluted average shares outstanding	55,337	55,323
Basic Per Share Data:		
Net income	\$ 1.38	\$ 2.26
Net realized investment (losses) gains, net of tax	\$ (0.69)	\$ 0.78
Diluted Per Share Data:		
Net income	\$ 1.38	\$ 2.26
Net realized investment (losses) gains, net of tax	\$ (0.69)	\$ 0.78

LIQUIDITY AND CAPITAL RESOURCES

A. Cash Flows

The Company has generated positive cash flow from operations since the public offering of its common stock in November 1985. The Company does not attempt to match the duration and timing of asset maturities with those of liabilities; rather, it manages its portfolio with a view towards maximizing total return with an emphasis on after-tax income. With combined cash and short-term investments of \$524.5 million at September 30, 2018 as well as \$50 million of credit available on a \$50 million revolving credit facility, the Company believes its cash flow from operations is adequate to satisfy its liquidity requirements without the forced sale of investments. Investment maturities are also available to meet the Company's liquidity needs. However, the Company operates in a rapidly evolving and often unpredictable business environment that may change the timing or amount of expected future cash receipts and expenditures. Accordingly, there can be no assurance that the Company's sources of funds will be sufficient to meet its liquidity needs or that the Company will not be required to raise additional funds to meet those needs or for future

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business expansion, through the sale of equity or debt securities or from credit facilities with lending institutions.

Net cash provided by operating activities for the nine months ended September 30, 2018 was \$325.2 million, an increase of \$48.7 million compared to the corresponding period in 2017. The increase was primarily due to an increase in premium collections and a decrease in income tax payments, partially offset by higher paid losses and loss adjustment expenses and operating expenses. The Company utilized the cash provided by operating activities during the nine months ended September 30, 2018 primarily for the payment of dividends to its shareholders and net purchases of investment securities.

The following table presents the estimated fair value of fixed maturity securities at September 30, 2018 by contractual maturity in the next five years:

	Fixed Maturity Securities (Amounts in thousands)
Due in one year or less	\$ 191,644
Due after one year through two years	76,676
Due after two years through three years	130,200
Due after three years through four years	123,466
Due after four years through five years	65,312
Total due within five years	\$ 587,298

B. Reinsurance

For California homeowners policies, the Company has reduced its catastrophe exposure from earthquakes by placing earthquake risks directly with the California Earthquake Authority ("CEA"). However, the Company continues to have catastrophe exposure to fires following an earthquake.

The Company is party to a Catastrophe Reinsurance Treaty ("Treaty") covering a wide range of perils that is effective through June 30, 2019. For the 12 months ending June 30, 2019 and 2018, the Treaty provides \$205 million of coverage on a per occurrence basis after covered catastrophe losses exceed the \$10 million Company retention limit. The first \$190 million of losses above the Company's \$10 million retention are covered 100% by the reinsurers. Losses above \$200 million are shared pro-rata with 5% coverage by the reinsurers and 95% retention by the Company, up to \$15 million total coverage provided by the reinsurers. The Treaty specifically excludes coverage for any Florida business and for California earthquake losses on fixed property policies, such as homeowners, but does cover losses from fires following an earthquake. The annual premium for the Treaty is approximately \$22 million for the 12 months ending June 30, 2019, as compared to \$19 million for the 12 months ended June 30, 2018. The increase in the annual premium is primarily due to an increase in reinsurance rates and growth in the Company's homeowners insurance book of business covered by the Treaty. In addition to the annual premium, the Treaty is subject to reinstatement premiums based on the amount of reinsurance benefits paid to the Company, up to the maximum reinstatement premium of approximately \$22 million and \$19 million if the full amount of benefit is used for the 12 months ending June 30, 2019 and 2018, respectively. The total amount of reinstatement premiums is recorded as ceded reinstatement premiums written at the time of the catastrophe event based on the total amount of reinsurance benefits expected to be used for the event, and such reinstatement premiums are recognized ratably over the remaining term of the Treaty as ceded reinstatement premiums earned.

In October 2018, Hurricane Michael caused substantial damage in Florida, Georgia and Virginia. Based on the information currently available, the Company estimates that its total losses from this catastrophe will range from \$4 million to \$8 million, which will be recorded as losses in the fourth quarter of 2018. Further, the Company anticipates that should the amount of losses exceed its \$10 million reinsurance retention limit, they would be fully reimbursed under the Treaty effective July 1, 2018.

The Company has incurred a total of approximately \$21 million in losses, before reinsurance benefits, resulting from a destructive wildfire, known as the Carr Fire, that occurred in Shasta County of Northern California in the third quarter of 2018. The loss to the Company, net of reinsurance benefits, was \$10 million, which is the Company's retention on the catastrophe event. The Company recorded approximately \$3 million in ceded reinstatement premiums written and \$1 million in ceded reinstatement premiums earned in the third quarter of 2018 for reinstatement of the reinsurance benefits used under the Treaty related to this catastrophe event.

In addition, the Company has incurred a total of approximately \$109 million in losses, before reinsurance benefits, resulting from two catastrophe events that took place in the fourth quarter of 2017, consisting of the Northern California wildfires with approximately \$83 million in losses and the Southern California wildfires with approximately \$26 million in losses. The combined loss from these wildfires, net of reinsurance benefits, totaled \$20 million, which is the Company's total retention on the two

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catastrophe events, \$10 million each. The Company recorded a total of approximately \$12 million in ceded reinstatement premiums written in the fourth quarter of 2017 for reinsurance benefits used up under the Treaty related to these two catastrophe events, of which \$3 million and \$9 million were recognized as ceded reinstatement premiums earned in the fourth quarter of 2017 and in the first half of 2018, respectively.

The Company carries a commercial umbrella reinsurance treaty and seeks facultative arrangements for large property risks. In addition, the Company has other reinsurance in force that is not material to the consolidated financial statements. If any reinsurers are unable to perform their obligations under a reinsurance treaty, the Company will be required, as primary insurer, to discharge all obligations to its policyholders in their entirety.

C. Invested Assets

Portfolio Composition

An important component of the Company's financial results is the return on its investment portfolio. The Company's investment strategy emphasizes safety of principal and consistent income generation, within a total return framework. The investment strategy has historically focused on maximizing after-tax yield with a primary emphasis on maintaining a well-diversified, investment grade, fixed income portfolio to support the underlying liabilities and achieve return on capital and profitable growth. The Company believes that investment yield is maximized by selecting assets that perform favorably on a long-term basis and by disposing of certain assets to enhance after-tax yield and minimize the potential effect of downgrades and defaults. The Company believes that this strategy enables the optimal investment performance necessary to sustain investment income over time. The Company's portfolio management approach utilizes a market risk and consistent asset allocation strategy as the primary basis for the allocation of interest sensitive, liquid and credit assets as well as for determining overall below investment grade exposure and diversification requirements. Within the ranges set by the asset allocation strategy, tactical investment decisions are made in consideration of prevailing market conditions.

The following table presents the composition of the total investment portfolio of the Company at September 30, 2018:

	Cost ⁽¹⁾	Fair Value
	(Amounts in thousands)	
Fixed maturity securities:		
U.S. government bonds	\$ 14,343	\$ 14,105
Municipal securities	2,588,926	2,590,847
Mortgage-backed securities	31,251	31,513
Corporate securities	119,650	119,292
Collateralized loan obligations	156,126	155,796
Other asset-backed securities	41,275	41,318
	2,951,571	2,952,871
Equity securities:		
Common stock	513,865	583,851
Non-redeemable preferred stock	34,429	33,626
Private equity fund	1,481	1,446
Private equity fund measured at net asset value ⁽²⁾	69,669	69,464
	619,444	688,387
Short-term investments	263,037	262,806
Total investments	\$ 3,834,052	\$ 3,904,064

⁽¹⁾ Fixed maturities and short-term bonds at amortized cost; equities and other short-term investments at cost.

⁽²⁾ The fair value is measured using the NAV practical expedient. See Note 5. Fair Value Measurements of the Notes to Consolidated Financial Statements for additional information.

At September 30, 2018, 65.1% of the Company's total investment portfolio at fair value and 86.1% of its total fixed maturity securities at fair value were invested in tax-exempt state and municipal bonds. Equity holdings consist of non-redeemable preferred stocks, dividend-bearing common stocks on which dividend income is partially tax-sheltered by the 50% corporate dividend received deduction, and private equity funds including a fund measured at net asset value. At September 30, 2018, 78.9% of short-term investments consisted of highly rated short-duration securities redeemable on a daily or weekly basis.

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Fixed Maturity Securities and Short-Term Investments

Fixed maturity securities include debt securities, which are mostly long-term bonds and other debt with maturities of at least one year from purchase, and which may have fixed or variable principal payment schedules, may be held for indefinite periods of time, and may be used as a part of the Company's asset/liability strategy or sold in response to changes in interest rates, anticipated prepayments, risk/reward characteristics, liquidity needs, tax planning considerations, or other economic factors. Short-term instruments include money market accounts, options, and short-term bonds that are highly rated short duration securities and redeemable within one year.

A primary exposure for the fixed maturity securities is interest rate risk. The longer the duration, the more sensitive the asset is to market interest rate fluctuations. As assets with longer maturity dates tend to produce higher current yields, the Company's historical investment philosophy has resulted in a portfolio with a moderate duration. The Company's portfolio is heavily weighted in investment grade tax-exempt municipal bonds. Fixed maturity securities purchased by the Company typically have call options attached, which further reduce the duration of the asset as interest rates decline. The holdings that are heavily weighted with high coupon issues, are expected to be called prior to maturity. Modified duration measures the length of time it takes, on average, to receive the present value of all the cash flows produced by a bond, including reinvestment of interest. As it measures four factors (maturity, coupon rate, yield and call terms) which determine sensitivity to changes in interest rates, modified duration is considered a better indicator of price volatility than simple maturity alone.

The following table presents the maturities and durations of the Company's fixed maturity securities and short-term investments:

	September 30, 2018	December 31, 2017
	(in years)	
Fixed Maturity Securities		
Nominal average maturity:		
excluding short-term investments	13.8	12.9
including short-term investments	12.7	11.6
Call-adjusted average maturity:		
excluding short-term investments	5.1	5.3
including short-term investments	4.7	4.8
Modified duration reflecting anticipated early calls:		
excluding short-term investments	4.4	4.4
including short-term investments	4.1	4.0
Short-Term Investments	—	—

Another exposure related to the fixed maturity securities is credit risk, which is managed by maintaining a weighted-average portfolio credit quality rating of A+, at fair value, at September 30, 2018, consistent with the average rating at December 31, 2017. The Company's municipal bond holdings of which 98.2% were tax exempt, represented 86.1% of its fixed maturity securities portfolio at September 30, 2018, at fair value, and are broadly diversified geographically. See Part I-Item 3. Quantitative and Qualitative Disclosures About Market Risks for a breakdown of municipal bond holdings by state.

To calculate the weighted-average credit quality ratings disclosed throughout this Quarterly Report on Form 10-Q, individual securities were weighted based on fair value and credit quality ratings assigned by nationally recognized securities rating organizations.

Taxable holdings consist principally of investment grade issues. At September 30, 2018, fixed maturity securities holdings rated below investment grade and non-rated bonds totaled \$41.2 million and \$68.7 million, respectively, at fair value, and represented 1.4% and 2.3%, respectively, of total fixed maturity securities. The majority of non-rated issues are a result of municipalities pre-funding and collateralizing those issues with U.S. government securities with an implicit AAA equivalent credit risk. At December 31, 2017, fixed maturity securities holdings rated below investment grade and non-rated bonds totaled \$48.3 million and 78.6 million, respectively, at fair value, and

represented 1.7% and 2.7%, respectively, of total fixed maturity securities.

Credit ratings for the Company's fixed maturity securities portfolio were stable during the nine months ended September 30, 2018, with 93.4% of fixed maturity securities at fair value experiencing no change in their overall rating. 4.0% and 2.6% of fixed maturity securities at fair value experienced upgrades and downgrades, respectively, during the nine months ended September 30, 2018; the downgrades were slight and still within the investment grade portfolio.

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The following table presents the credit quality ratings of the Company's fixed maturity securities by security type at fair value:

Security Type	September 30, 2018 (Dollars in thousands)					Total Fair Value ⁽¹⁾
	AAA ⁽¹⁾	AA ⁽¹⁾	A ⁽¹⁾	BBB ⁽¹⁾	Non-Rated/Other ⁽¹⁾	
U.S. government bonds:						
Treasuries	\$ 14,105	\$ —	\$ —	\$ —	\$ —	\$ 14,105
Total	14,105	—	—	—	—	14,105
	100.0	% —	% —	% —	% —	100.0 %
Municipal securities:						
Insured	23,257	152,568	151,275	70,195	15,149	412,444
Uninsured	59,689	705,143	1,133,345	216,967	63,259	2,178,403
Total	82,946	857,711	1,284,620	287,162	78,408	2,590,847
	3.2	% 33.1%	49.6%	11.1%		