

RLI CORP  
Form 10-Q  
July 28, 2006

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

**Quarterly Report Pursuant to Section 13 or 15(d) of the  
Securities Exchange Act of 1934**

For the quarterly period ended **June 30, 2006**

or

**Transition Report Pursuant to Section 13 or 15(d) of the  
Securities Exchange Act of 1934**

For the transition period from      to

Commission File Number: 0-6612

**RLI Corp.**

(Exact name of registrant as specified in its charter)

**ILLINOIS**

(State or other jurisdiction of  
incorporation or organization)

**9025 North Lindbergh Drive, Peoria, IL**  
(Address of principal executive offices)

**37-0889946**

(I.R.S. Employer  
Identification Number)

**61615**  
(Zip Code)

**(309) 692-1000**

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(Registrant's telephone number, including area code)

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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

**APPLICABLE ONLY TO CORPORATE ISSUERS:**

As of July 20, 2006 the number of shares outstanding of the registrant's Common Stock was 24,723,637.

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## PART I FINANCIAL INFORMATION

## Item 1. Financial Statements

**RLI Corp. and Subsidiaries**  
**Condensed Consolidated Statements of Earnings and Comprehensive Earnings**  
**(Unaudited)**

	For the Three-Month Period Ended June 30,	
	2006	2005
	(in thousands, except per share data)	
Net premiums earned	\$ 125,867	\$ 123,674
Net investment income	17,556	14,666
Net realized investment gains	1,489	4,389
	144,912	142,729
Losses and settlement expenses	74,966	49,323
Policy acquisition costs	34,207	35,572
Insurance operating expenses	9,736	9,176
Interest expense on debt	1,710	1,854
General corporate expenses	1,654	1,710
	122,273	97,635
Equity in earnings of uncons. investees	4,867	4,515
Earnings before income taxes	27,506	49,609
Income tax expense	4,584	15,214
Net earnings	\$ 22,922	\$ 34,395
Other comprehensive earnings (loss),net of tax	(8,199 )	13,659
Comprehensive earnings	\$ 14,723	\$ 48,054
Earnings per share:		
Basic:		
Basic net earnings per share	\$ 0.91	\$ 1.35
Basic comprehensive earnings per share	\$ 0.59	\$ 1.89
Diluted:		
Diluted net earnings per share	\$ 0.89	\$ 1.31
Diluted comprehensive earnings per share	\$ 0.57	\$ 1.83
Weighted average number of common shares outstanding		
Basic	25,157	25,439
Diluted	25,762	26,275
Cash dividends declared per common share	\$ 0.19	\$ 0.16

The accompanying notes are an integral part of the financial statements.

**RLI Corp. and Subsidiaries**  
**Condensed Consolidated Statements of Earnings and Comprehensive Earnings**  
**(Unaudited)**

	<b>For the Six-Month Period</b>	
	<b>Ended June 30,</b>	
	<b>2006</b>	<b>2005</b>
	<b>(in thousands, except per share data)</b>	
Net premiums earned	\$ 253,254	\$ 247,714
Net investment income	34,264	29,278
Net realized investment gains	5,931	7,373
	293,449	284,365
Losses and settlement expenses	141,643	105,842
Policy acquisition costs	69,806	67,436
Insurance operating expenses	18,937	18,434
Interest expense on debt	3,392	3,664
General corporate expenses	3,509	3,614
	237,287	198,990
Equity in earnings of uncon. investees	7,607	5,774
Earnings before income taxes	63,769	91,149
Income tax expense	15,191	27,447
Net earnings	\$ 48,578	\$ 63,702
Other comprehensive earnings (loss),net of tax	(11,794 )	(3,858 )
Comprehensive earnings	\$ 36,784	\$ 59,844
<b>Earnings per share:</b>		
<b>Basic:</b>		
Basic net earnings per share	\$ 1.92	\$ 2.51
Basic comprehensive earnings per share	\$ 1.45	\$ 2.35
<b>Diluted:</b>		
Diluted net earnings per share	\$ 1.86	\$ 2.43
Diluted comprehensive earnings per share	\$ 1.41	\$ 2.28
<b>Weighted average number of common shares outstanding</b>		
Basic	25,357	25,412
Diluted	26,050	26,244
Cash dividends declared per common share	\$ 0.36	\$ 0.30

The accompanying notes are an integral part of the financial statements.

**RLI Corp. and Subsidiaries**  
**Condensed Consolidated Balance Sheets**

	June 30, 2006 (Unaudited)	December 31, 2005
(in thousands, except share data)		
<b>ASSETS</b>		
Investments		
Fixed maturities		
Available-for-sale, at fair value	\$ 1,150,436	\$ 1,181,636
Held-to-maturity, at amortized cost	121,805	134,451
Trading, at fair value	14,897	15,312
Equity securities, at fair value	334,918	321,096
Short-term investments, at cost	61,027	45,296
Total investments	1,683,083	1,697,791
Accrued investment income	17,315	16,974
Premiums and reinsurance balances receivable	140,489	126,894
Ceded unearned premium	103,018	114,668
Reinsurance balances recoverable on unpaid losses	548,673	593,209
Deferred policy acquisition costs	74,002	69,477
Property and equipment	21,245	20,859
Investment in unconsolidated investees	45,432	54,340
Goodwill and indefinite-lived intangibles	26,214	26,214
Other assets	21,799	15,444
<b>TOTAL ASSETS</b>	<b>\$ 2,681,270</b>	<b>\$ 2,735,870</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Liabilities:		
Unpaid losses and settlement expenses	\$ 1,329,247	\$ 1,331,866
Unearned premiums	400,621	383,683
Reinsurance balances payable	81,821	97,526
Notes payable, short-term debt	15,309	15,541
Income taxes-deferred	14,954	22,717
Bonds payable, long-term debt	100,000	100,000
Other liabilities	66,974	91,596
<b>TOTAL LIABILITIES</b>	<b>2,008,926</b>	<b>2,042,929</b>
Shareholders' Equity		
Common stock (\$1 par value)		
(31,590,360 shares issued at 6/30/06)		
(31,344,058 shares issued at 12/31/05)	31,590	31,344
Paid-in Capital	186,366	181,794
Accumulated other comprehensive earnings	70,990	82,785
Retained Earnings	517,585	478,043
Deferred compensation	7,351	7,735
Less: Treasury shares at cost		
(6,866,723 shares at 6/30/06)		
(5,792,753 shares at 12/31/05)	(141,538)	(88,760)
<b>TOTAL SHAREHOLDERS' EQUITY</b>	<b>672,344</b>	<b>692,941</b>
<b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>	<b>\$ 2,681,270</b>	<b>\$ 2,735,870</b>

The accompanying notes are an integral part of the financial statements.



**RLI Corp. and Subsidiaries**  
**Condensed Consolidated Statements of Cash Flows**  
**(Unaudited)**

	<b>For the Six Month Period</b>	
	<b>Ended June 30,</b>	
	<b>2006</b>	<b>2005</b>
	<b>(in thousands)</b>	
Net cash provided by operating activities	\$ 68,496	\$ 78,346
<b>Cash Flows from Investing Activities</b>		
Investments purchased	(338,875 )	(210,126 )
Investments sold	302,670	140,653
Investments called or matured	51,256	40,956
Net change in short term investments	(24,132 )	(25,136 )
Changes in notes receivable	0	(5,500 )
Net property and equipment purchased	(2,162 )	(2,972 )
Net cash used in investing activities	(11,243 )	(62,125 )
<b>Cash Flows from Financing Activities</b>		
Cash dividends paid	(8,678 )	(7,104 )
Payments on debt	(267 )	(10,228 )
Proceeds from issuance of debt	35	214
Stock option plan share issuance	3,710	897
Excess tax benefit from exercise of stock options	1,109	0
Treasury shares purchased	(53,162 )	0
Net cash used in financing activities	(57,253 )	(16,221 )
Net increase in cash	0	0
Cash at the beginning of the year	0	0
Cash at June 30	\$ 0	\$ 0

The accompanying notes are an integral part of the financial statements.

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** - The financial information is prepared in conformity with accounting principles generally accepted in the United States of America (GAAP), and such principles are applied on a basis consistent with those reflected in our 2005 annual report filed with the Securities and Exchange Commission. Management has prepared the financial information included herein without audit by independent registered public accountants. The condensed consolidated balance sheet as of December 31, 2005 has been derived from, but does not include all the disclosures contained in, the audited consolidated financial statements for the year ended December 31, 2005.

The information furnished includes all adjustments and normal recurring accrual adjustments that are, in the opinion of management, necessary for a fair statement of results for the interim periods. Results of operations for the three and six month periods ended June 30, 2006 and 2005 are not necessarily indicative of the results of a full year.

The accompanying financial data should be read in conjunction with the notes to the financial statements contained in our 2005 Annual Report on Form 10-K.

**Earnings Per Share:** Basic earnings per share (EPS) excludes dilution and is computed by dividing income available to common shareholders by the weighted-average number of common shares outstanding for the period. Diluted EPS reflects the dilution that could occur if securities or other contracts to issue common stock or common stock equivalents were exercised or converted into common stock. When inclusion of common stock equivalents increases the earnings per share or reduces the loss per share, the effect on earnings is antidilutive. Under these circumstances, the diluted net earnings or net loss per share is computed excluding the common stock equivalents.

Pursuant to disclosure requirements contained in Statement of Financial Accounting Standards (SFAS) 128, Earnings Per Share, the following represents a reconciliation of the numerator and denominator of the basic and diluted EPS computations contained in the condensed financial statements.

	<b>For the Six-Month Period Ended June 30, 2006</b>		
	<b>Income</b>	<b>Shares</b>	<b>Per Share</b>
	<b>(Numerator)</b>	<b>(Denominator)</b>	<b>Amount</b>
	<b>(in thousands, except per share data)</b>		
<b>Basic EPS</b>			
Income available to common Shareholders	\$ 48,578	25,357	\$ 1.92
<b>Effect of Dilutive Securities</b>			
Incentive Stock Options		693	
<b>Diluted EPS</b>			
Income available to common Shareholders	\$ 48,578	26,050	\$ 1.86



	For the Six-Month Period Ended June 30, 2005		
	Income (Numerator) (in thousands, except per share data)	Shares (Denominator)	Per Share Amount
<b>Basic EPS</b>			
Income available to common stockholders	\$ 63,702	25,412	\$ 2.51
<b>Effect of Dilutive Securities</b>			
Incentive Stock Options		832	
<b>Diluted EPS</b>			
Income available to common stockholders	\$ 63,702	26,244	\$ 2.43

**Other Accounting Standards:** In December 2004, the Financial Accounting Standards Board (FASB) revised Statement of Financial Accounting Standards (SFAS) No. 123, Share-Based Payment, (SFAS 123R) which required companies to expense the estimated fair value of employee stock options and similar awards, for all options vesting, granted, or modified after the effective date of this revised statement. The accounting provisions of SFAS 123R were to become effective for interim periods beginning after June 15, 2005. In April 2005, the Securities and Exchange Commission (SEC) adopted a final rule amending Rule 4-01(a) of Regulation S-X regarding the compliance date for SFAS 123R. The effect of this ruling was to delay the effective date of SFAS 123R to the first interim or annual reporting period of the registrant's first fiscal year beginning on or after June 15, 2005. As a result, the accounting provisions of SFAS 123R became effective for our financial statements beginning January 1, 2006.

SFAS 123R is a revision of SFAS No. 123, Accounting for Stock-Based Compensation (SFAS 123), and supersedes Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25), and its related implementation guidance. On January 1, 2006, we adopted the provisions of SFAS 123R using the modified prospective method. SFAS 123R requires entities to recognize compensation expense for awards of equity instruments to employees based on the grant-date fair value of those awards (with limited exceptions). Prior to the adoption of SFAS 123R, we followed the intrinsic value method in accordance with APB 25 to account for our employee stock options and recognized no compensation expense for the stock option grants.

**Stock based compensation:** During 2005, our shareholders approved the RLI Corp. Omnibus Stock Plan (omnibus plan). In conjunction with the adoption of this plan, effective May 5, 2005, options will no longer be granted under the two other option plans previously in existence. The purpose of the omnibus plan is to promote our interests and those of our shareholders by providing our key personnel an opportunity to acquire a proprietary interest in the company and reward them for achieving a high level of corporate performance and to encourage our continued success and growth. Awards under the omnibus plan may be in the form of restricted stock, stock options (both incentive and nonqualified), stock appreciation rights, performance units, as well as other stock based awards. Eligibility under the omnibus plan is limited to our employees or employees of any affiliate and to individuals or entities who are not employees but who provide services to us or an affiliate, including services provided in the capacity of consultant, advisor or director. The granting of awards is solely at the discretion of the executive resources committee and the nominating/corporate governance committee of our board of directors. The total number of shares of common stock available for distribution under the omnibus plan may not exceed 1,500,000 shares (subject to adjustment for changes in our capitalization). In 2005, we granted 233,500 stock options under this plan. In 2006, we have granted 176,900 stock options under this plan.

Under the omnibus plan, we grant to officers, directors and other employees stock options for shares with an exercise price equal to the fair market value of the shares at the date of grant. Options generally vest and become exercisable ratably over a five-year period and have a ten-year life. The related compensation expense is recognized over the requisite service period. In most instances the requisite service period and vesting period will be the same. For participants who are retirement eligible, defined by the plan as those individuals whose age and years of service equals seventy-five, the requisite service period is deemed to be met and options are immediately expensed on the date of grant. For participants who will become retirement eligible during the vesting period, the requisite service period over which expense is recognized is the period between the grant date and the attainment of retirement eligibility. Shares issued upon option exercise are newly issued shares.

During 2005, our board of directors adopted resolutions authorizing the accelerated vesting of existing unvested stock options, including directors' stock options. These resolutions were effective May 5, 2005, for all options issued prior to this date and December 30, 2005, for options issued in 2005 subsequent to May 5, 2005. Acceleration was applicable to substantially all unvested options and contains certain share transfer restrictions. These modifications, which occurred prior to the effective date of SFAS 123R, effectively removed these options from expense consideration under SFAS 123R. Under APB 25, compensation expense recorded for accelerated vesting was measured by applying two criteria: (1) the difference between the market price and the option exercise price on the date of acceleration, and (2) the number of options that would have been forfeited as unexercisable (unvested) had acceleration not occurred. Using the guidance set forth in APB 25 and related interpretations, our historical forfeiture rate of less than 10 percent, and certain other assumptions for anticipated retirements, we recorded \$0.8 million of pre-tax compensation expense during 2005. This expense represented our best estimate of the total expense associated with acceleration.

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The following table summarizes option activity in 2006:

	Number of Options Outstanding	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value (in 000 s)
Outstanding options at January 1, 2006	1,931,627	\$ 26.53		
Options granted	176,900	\$ 50.21		
Options exercised	(289,690 )	\$ 20.20		\$ 9,627
Options canceled/forfeited	(2,900 )	\$ 34.64		
Outstanding options at June 30, 2006	1,815,937	\$ 29.83	5.79	\$ 33,316
Exercisable options at June 30, 2006	1,639,037	\$ 27.63	5.35	\$ 33,676

The majority of our options are granted annually at the board meeting in May. Thus far in 2006, 176,900 options have been granted with an average exercise price of \$50.21 and an average fair value of \$13.99. Of these grants, 171,900 were granted at the board meeting in May with a calculated fair value of \$13.97. We recognized \$0.3 million of expense during the first six months of 2006 related to this grant. Since options granted in 2006 have been non-qualified, we recorded a tax benefit of \$0.1 million related to this compensation expense. Total unrecognized compensation expense relating to these grants was \$2.0 million, which will be recognized over the remainder of the five-year vesting period. There were no options that vested during the first six months of 2006.

The fair value of share-based payment awards was estimated using a Black-Scholes based option pricing model with the following grant-date assumptions and weighted average fair values:

	2006	2005
Weighted average fair value of grants	\$ 13.99	\$ 13.08
Risk-free interest rates	5.03	% 3.97
Dividend yield	1.51	% 1.50
Expected volatility	22.44	% 22.90
Expected option life	6.31 years	8.0 years

The risk-free rate is determined based on U.S. treasury yields that most closely approximate each options expected life. The dividend yield is calculated based on the average annualized dividends paid during the most recent five-year period. The expected volatility is an implied volatility. For 2006, this volatility is calculated by computing the weighted average of the most recent 1-year volatility, the most recent 6.31-year (equal to the expected life) volatility and the median of the 6.31-year rolling volatilities of RLI stock. For 2006, the expected option life is determined based on historical exercise behavior and the assumption that all outstanding options will be exercised at the midpoint of the current date and remaining contractual term, adjusted for the demographics of the current year's grant. In prior years, the expected life was determined using historical exercise patterns.

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As discussed previously, prior to the adoption of SFAS 123R, we followed the intrinsic value method in accordance with APB 25 to account for employee stock options and accordingly recognized no compensation expense for the stock option grants. In accordance with SFAS 123R, we adopted the provisions of the statement on January 1, 2006 using the modified prospective approach. Under this method, prior periods are not restated. Had compensation cost for share-based plans been determined consistent with SFAS 123R, our net earnings and earnings per share for the six and three-month periods ended June 30, 2005 would have been reduced to the following pro forma amounts:

	Six-Month period Ended June 30, 2005 (in thousands, except per share data)	Three-Month period Ended June 30, 2005
Net earnings, as reported	\$ 63,702	\$ 34,395
Add: Stock-based employee compensation expense included in reported earnings, net of related tax effects	487	487
Deduct: Total stock-based employee compensation expense determined under fair-value-based methods for all awards, net of related tax effects	(2,442 )	(1,820 )
Pro forma net earnings	\$ 61,747	\$ 33,062
Earnings per share:		
Basic as reported	\$ 2.51	\$ 1.35
Basic pro forma	\$ 2.43	\$ 1.30
Diluted as reported		
Diluted pro forma	\$ 2.43	\$ 1.31
	\$ 2.35	\$ 1.26

Pro forma disclosures for 2006 are not presented because the amounts are recognized in the Statement of Earnings.

**Pension Plan:** On December 31, 2003, our pension plan was amended to freeze benefit accruals as of March 1, 2004. Additionally, the plan was also closed to new participants after December 31, 2003. Participants' benefits would increase in the future based on changes in their final average earnings. Future pay increases were indexed to a maximum of 5% annually. Increases in excess of 5% would not be reflected in the determination of participants' final average earnings. Effective December 31, 2005, the plan was further amended such that all participants' benefits were frozen and future pay will not alter a participant's accrued benefit. In 2005, we also shortened the amortization period of the plan's unrecognized gain/loss, to fully amortize it over the next two years because we intend to terminate the plan in 2006. Given the necessary regulatory approval process, we expect the entire plan termination process, including final asset distribution, to be completed by the end of 2007.

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The table below represents the various components of pension expense for the three month periods ended June 30, 2006 and 2005.

Pension Expense	2006	2005
	(in thousands)	
Service Cost	\$	\$
Interest Cost	294	379
Expected Return on Assets	(242 )	(387 )
Prior Service Cost		
Recognition of Transition Asset		
Recognition of (Gains)/Losses	648	440
Net Periodic Cost	\$ 700	\$ 432
Settlement Expense	213	
Total Pension Cost	\$ 913	\$ 432

During the second quarter of 2006, we had pension payouts that resulted in our year-to-date distributions exceeding the interest cost of the plan. As a result, we incurred settlement expense of \$213,000, relating to these distributions.

While the ERISA required minimum contribution for the fiscal year ending December 31, 2006 is \$0, we will likely contribute the amount necessary to terminate the plan in late 2006 and distribute benefits in 2007.

**Intangible assets:** In accordance with SFAS 142, *Goodwill and Other Intangible Assets*, the amortization of goodwill and indefinite-lived intangible assets is not permitted. Goodwill and indefinite-lived intangible assets remain on the balance sheet and are tested for impairment on an annual basis, or earlier if there is reason to suspect that their values may have been diminished or impaired. Goodwill and indefinite-lived intangible assets, which relate to our surety segment, are listed separately on the balance sheet and totaled \$26.2 million at June 30, 2006 and December 31, 2005. Impairment testing was performed during the second quarter of 2006, pursuant to the requirements of SFAS 142. Based upon this review, these assets do not appear to be impaired.

Intangible assets with definite lives continue to be amortized over their estimated useful lives. Definite-lived intangible assets that continue to be amortized under SFAS 142 relate to our purchase of customer-related and marketing-related intangibles. These intangibles have useful lives ranging from five to 10 years. Amortization of intangible assets was \$0.2 million for the first six months of 2006 and 2005. At June 30, 2006, net intangible assets totaled \$0.3 million, net of \$5.4 million of accumulated amortization, and are included in other assets.

2. OPERATING SEGMENT INFORMATION - Selected information by operating segment is presented in the table below. Additionally, the table reconciles segment totals to total earnings and total revenues.

SEGMENT DATA	For the Six-Month Periods Ended June 30,			
	EARNINGS		REVENUES	
	2006	2005	2006	2005
	(in thousands)			
Property	\$ 3,304	\$ 13,451	\$ 50,992	\$ 42,046
Casualty	15,521	41,055	173,081	180,831
Surety	4,043	1,496	29,181	24,837
Operating segment totals before income taxes	\$ 22,868	\$ 56,002	\$ 253,254	\$ 247,714
Net investment income	34,264	29,278	34,264	29,278
Realized gains	5,931	7,373	5,931	7,373
General corporate expense and interest on debt	(6,901)	(7,278)		
Equity in earnings of unconsolidated investee	7,607	5,774		
Total earnings before income taxes	\$ 63,769	\$ 91,149		
Income tax expense	15,191	27,447		
Total	\$ 48,578	\$ 63,702	\$ 293,449	\$ 284,365

The following table further summarizes revenues (net premiums earned) by major product type within each operating segment:

	For the Six-Month Period Ended June 30,	
	2006	2005
	(in thousands)	
<b>Property</b>		
Commercial property	\$ 39,362	\$ 32,106
Construction	1,044	6,092
Other property	10,586	3,848
Total	\$ 50,992	\$ 42,046
<b>Casualty</b>		
General liability	\$ 89,347	\$ 88,716
Commercial and personal umbrella	31,765	29,310
Commercial transportation	24,475	27,007
Specialty program business	12,786	20,796
Executive products	6,183	4,739
Other	8,525	10,263
Total	\$ 173,081	\$ 180,831
<b>Surety</b>	\$ 29,181	\$ 24,837
<b>Grand Total</b>	\$ 253,254	\$ 247,714

A detailed discussion of earnings and results by segment is contained in management's discussion and analysis of financial condition and results of operations.

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.**

**SAFE HARBOR STATEMENT UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995:** This discussion and analysis may contain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 that are not historical facts, and involve risks and uncertainties that could cause actual results to differ materially from those expected and projected. Various risk factors that could affect future results are listed in our filings with the Securities and Exchange Commission, including the Annual Report on Form 10-K for the year ended December 31, 2005.

**OVERVIEW**

We are a holding company that underwrites selected property and casualty insurance and surety coverage through insurance company subsidiaries collectively known as RLI Insurance Group, or the Group. The Group provides insurance coverages primarily for commercial risks representing 86% of our consolidated revenue for the first six months of 2006 compared to 87% for the same period last year.

As a niche company, we offer specialty insurance products designed to meet specific insurance needs of targeted insured groups and underwrite particular types of coverage for certain markets that are underserved by the insurance industry, such as our commercial earthquake coverage and oil and gas surety bonds. As a niche company, we also provide types of insurance products not generally offered by other companies, such as our stand-alone personal umbrella policy. The excess and surplus insurance market, which unlike the standard admitted market is less regulated and more flexible in terms of policy forms and premium rates, provides an alternative market for customers with hard-to-place risks and risks that admitted insurers specifically refuse to write. When we underwrite within the surplus lines market, we are selective in the line of business and type of risks we choose to write. Using our non-admitted status in this market allows us to tailor terms and conditions to manage these exposures more effectively than our admitted counterparts. Often the development of these specialty insurance products is generated through proposals brought to us by an agent or broker seeking coverage for a specific group of clients. Once a proposal is submitted, underwriters determine whether a proposal would be a viable product in keeping with our business objectives.

Management measures the results of our insurance operations by monitoring certain measures of growth and profitability across three distinct business segments: property, casualty and surety. Growth is measured in terms of gross premiums written, while profitability is analyzed through GAAP (accounting principles generally accepted in the United States of America) combined ratios, which are further subdivided into their respective loss and expense components. The GAAP combined ratios represent the profit generated from our insurance operations.

The foundation of our overall business strategy is to underwrite for profit. This drives our ability to provide shareholder returns in three different ways: the underwriting profit itself, investment income from fixed-income portfolios, and long-term growth in our equity portfolio. Our investment strategy is based on preservation of capital as the first priority, with a secondary focus on generating total return.

The property and casualty insurance business is cyclical and influenced by many factors, including price competition, economic conditions, natural or man-made disasters (for example, earthquakes, hurricanes, and terrorism), interest rates, state regulations, court decisions and changes in the law. One of the unique and challenging features of the property and casualty insurance business is that products must be priced before costs have fully developed, because premiums are charged before claims are incurred. This requires that liabilities be estimated and recorded in recognition of future loss and settlement obligations. Due to the inherent uncertainty in estimating these liabilities, there can be no assurance that actual liabilities will not be more or less than recorded amounts; if actual liabilities differ from recorded amounts, there will be an adverse or favorable effect on net earnings. In evaluating the objective performance measures previously mentioned, it is important to consider the following individual characteristics of each major insurance segment.

Our property segment primarily underwrites commercial fire, earthquake, difference in conditions, marine, and in the state of Hawaii, select personal lines policies. Property insurance results are subject to the variability introduced by perils such as earthquakes, fires and hurricanes. Our major catastrophe exposure is to losses caused by earthquakes, primarily in the state of California. Our second largest catastrophe exposure is to losses caused by hurricanes to commercial properties throughout the Gulf and East Coasts, as well as to homes we insure in Hawaii. We attempt to limit our net aggregate exposure to a catastrophic event by purchasing reinsurance and through extensive use of computer-assisted modeling techniques. These techniques provide estimates of the concentration of risks exposed to catastrophic events.

The casualty portion of our business consists largely of general liability, transportation, multi-peril program business, commercial umbrella, personal umbrella, executive products and other specialty coverages. In addition, we provide employers indemnity and in-home business owners coverage. The casualty book of business is subject to the risk of accurately estimating losses and related loss reserves because the ultimate settlement of a casualty claim may take several years to fully develop. The casualty line may also be affected by evolving legislation and court decisions that define the extent of coverage and the amount of compensation due for injuries or losses.

The surety segment specializes in writing small to large commercial and small contract surety products, as well as those for the energy (plugging and abandonment), petrochemical and refining industries. Our surety products usually involve a statutory requirement for bonds, and these bonds have maintained a relatively low loss ratio. Losses may fluctuate, however, due to adverse economic conditions that may affect the financial viability of an insured. Contract surety products typically guarantee the construction work of a commercial contractor for a specific project. Generally, losses occur due to adverse economic conditions, inclement weather conditions or the deterioration of a contractor's financial condition. As such, this line has historically produced marginally higher loss ratios than other surety lines.



The insurance marketplace has softened over the last two years, meaning that the marketplace became more competitive and prices were generally flat to falling, even as coverage terms became less restrictive. Recently, pricing in the property segment has hardened, meaning that prices are increasing, and terms have become more restrictive, particularly in hurricane and earthquake-prone areas. We believe that our business model is geared to create underwriting profits by focusing on sound underwriting discipline. Our primary focus will continue to be on underwriting profitability as opposed to premium growth or market share measurements.

***GAAP and non-GAAP Financial Performance Metrics***

Throughout this quarterly report, we present our operations in the way we believe will be most meaningful, useful and transparent to anyone using this financial information to evaluate our performance. In addition to the GAAP presentation of net earnings and certain statutory reporting information, we show certain non-GAAP financial measures that we believe are valuable in managing our business, evaluating our performance, and drawing comparisons to our peers. These measures include gross revenues, gross premiums written, net premiums written, combined ratios, and net unpaid loss and settlement expenses.

Following is a list of non-GAAP measures found throughout this report with their definitions, relationships to GAAP measures, and explanations of their importance to our operations.

*Gross revenues*

This is an RLI-defined metric equaling the sum of gross premiums written, net investment income and net realized gains (losses). It is used by our management as an overall barometer of gross business volume across all operating segments.

*Gross premiums written*

While net premiums earned is the related GAAP measure used in the statements of earnings, gross premiums written is the component of net premiums earned that measures insurance business produced before the impact of ceding reinsurance premiums, but without respect to when those premiums will be recognized as actual revenue. We use this measure as an overall gauge of gross business volume in our insurance underwriting operations with some indication of profit potential subject to the levels of our retentions, expenses and loss costs.

*Net premiums written*

While net premiums earned is the related GAAP measure used in the statements of earnings, net premiums written is the component of net premiums earned that measures gross premiums written less the cost of ceding reinsurance premiums, but without respect to when those premiums will be recognized as actual revenue. We use this measure as an indication of retained or net business volume in our insurance underwriting operations. It is an indicator of future earnings potential subject to our expenses and loss costs.

*Combined ratios*

This ratio is a common insurance industry measure of profitability for any underwriting operation, and is calculated in two components. First, the expense ratio reflects the sum of policy acquisition costs and insurance operating expenses, divided by net premiums earned. The second component, the loss ratio, is losses and settlement expenses divided by net premiums earned. The sum of the loss and expense ratios is the combined ratio. The difference between the combined ratio and 100 reflects the per-dollar rate of underwriting profit or loss. For example, a combined ratio of 95 implies that for every \$100 of premium we earn, we record \$5 of underwriting profit.

*Net Unpaid Loss and Settlement Expenses*

Unpaid losses and settlement expenses, as shown in the liabilities section of our balance sheets, represents the total obligations to claimants for both estimates of known claims and estimates for incurred but not reported (IBNR) claims. The related asset item, reinsurance balances recoverable on unpaid losses and settlement expense, is the estimate of known claims and estimates of IBNR that we expect to recover from reinsurers. The net of these two items is generally referred to as net unpaid loss and settlement expenses and is commonly referred to in our disclosures regarding the process of establishing these various estimated amounts.

**Critical Accounting Policies**

In preparing the condensed consolidated financial statements, our management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosures of contingent assets and liabilities as of the date of the condensed consolidated financial statements and the reported amounts of revenues and expenses for the reporting period. Actual results could differ significantly from those estimates.

The most critical accounting policies involve significant estimates and include those used in determining the liability for unpaid losses and settlement expenses, investment valuation, recoverability of reinsurance balances and deferred policy acquisition costs.

*Unpaid Losses and Settlement Expenses*

We accrue liabilities intended to represent the ultimate settlement cost of losses and loss expenses incurred but not yet settled as of the accounting date. This includes both claims whose loss circumstances have been reported to us and for which our claims personnel have established estimates of ultimate cost (case reserves), and claims which have occurred, but which have not yet been reported to us (incurred but not reported or IBNR reserves). The ultimate cost of both of these categories, and therefore the liability booked to represent their ultimate cost, involve estimates.

The estimates underlying the accrued liabilities are derived from generally accepted actuarial techniques, applied to our actual experience, and take into account insurance industry data to the extent judged relevant to our operations. These estimates all have a level of uncertainty attached to them that can be measured using generally accepted actuarial techniques. Once uncertainty has been determined, a range of outcomes can be calculated. To that end, we have separated our settlement cost liabilities into three categories: latent liability loss and allocated losses and settlement expenses (LAE), remaining loss and allocated LAE, and unallocated LAE. For each of these categories we use a separate generally accepted actuarial method to measure the uncertainty of the estimates within that category. These methods were selected based on the loss development characteristics of each of the categories.

Our loss experience in a given accounting period is affected by all those factors that influence the quality of the business written in competitive coverage marketplaces: the premiums for which the coverage can be sold, the frequency and severity of claims ultimately produced on that business, the terms at which we purchase reinsurance coverage, and our expense structure. In the estimation of ultimate loss and loss expense liabilities, the factors that most significantly affect the ultimate results are:

- changes in claim frequency and severity, or, more generally, the underwriting quality of the business written;
- changes in the coverage sold (limits of coverage, deductibles, exclusions and extensions of coverage, reinsurance terms); and
- changes in the overall profitability of the competitive coverage marketplace.

One of the unique and challenging features of the property and casualty insurance business is that products must be priced before costs have fully developed, because premiums are charged before claims are incurred. This requires that liabilities be estimated and recorded in recognition of incurred losses and settlement obligations that have not been reported. Due to the inherent uncertainty in estimating these liabilities, there can be no assurance that actual liabilities will not exceed recorded amounts; if actual liabilities do exceed recorded amounts, there will be an adverse effect. Furthermore, we may determine that recorded reserves are more than adequate to cover expected losses as happened during 2005 and, to a lesser degree, so far in 2006, when favorable experience on casualty business led us to reduce our reserves. Further information on these reserve releases is contained in the discussion of results below.

#### *Underwriting Quality of the Business Written*

In general, competitive insurance marketplaces change over time. This is particularly true of the excess and surplus lines marketplace. The principal measure of those changes is the average profitability of business in a given segment, which is principally determined by the premium charged as well as the frequency and severity of claims produced. Because the quality of business changes continuously, the ultimate profitability of the business being written in the current accounting period must be estimated. As the quality of the business changes, the reliability of recent experience as a guide to the results of current business weakens.

We therefore monitor changes in the quality of business written by the number of claims per unit of exposure, the cost per claim, and the shifts in the distribution of business by geographic region and product segment. We incorporate our understanding of those changes into our estimates of the ultimate cost of current claims for which reserves have been established.

*Changes in the Coverage Sold*

The excess and surplus lines marketplace is characterized by somewhat greater regulatory latitude in coverage terms and pricing. As competitive marketplace conditions change, our underwriters respond by modifying our coverage terms and pricing. While this is an appropriate response to a changing competitive environment, it also weakens the reliability of past experience as a predictor of the ultimate cost of claims arising from current business. The admitted marketplaces in which we operate provide for more stable terms and pricing because of their regulated nature. However, this regulation limits our ability to quickly adapt terms and pricing in light of changing marketplace dynamics.

Reinsurance is also important to our operations. Reinsurance is purchased in a related, but distinct competitive marketplace which also changes over time. The changes in the relative cost of reinsurance affect the ultimate cost of net loss liabilities for which we accrue reserves. In general, as we grow and increase our financial capacity to absorb fluctuations in results, our need for, and purchase of, reinsurance may decrease incrementally.

*Changes in Overall Profitability*

During and immediately after the period in which coverage is provided and the corresponding premiums are earned, there may be little actual claim experience from which to estimate the ultimate cost of those claims. In particular, for longer-tailed liability lines such as excess coverage, the reporting, case reserving, and settlement of those claims may take considerable time.

We therefore use generally accepted actuarial techniques that use the premiums charged for coverage as a basis for estimating the ultimate cost of losses and loss expenses for relatively immature accident periods. While this is technically appropriate, it does introduce another variable into the reserve estimate: the changing profitability of premiums for a given coverage over time. Since the ultimate profitability of the business written in a given period depends upon all the factors mentioned above, highly accurate profitability estimates of the longer-tailed lines are difficult to achieve.

We have insignificant exposure to asbestos and environmental policy liabilities. We entered affected liability lines after the industry had already recognized them as a problem, and we therefore adopted appropriate coverage exclusions. What exposure does exist is through our commercial umbrella, general liability, and discontinued assumed reinsurance lines of business. The majority of that exposure is in the excess layers of our commercial umbrella and assumed reinsurance books of business. Although our asbestos and environmental exposure is limited, management cannot determine our ultimate liability with any reasonable degree of certainty. This ultimate liability is difficult to assess due to evolving legislation on such issues as joint and several liability, retroactive liability, and standards of cleanup and that our participation exists in the excess layers of coverage on these risks.

***Investment Valuation***

Throughout each year, our internal and external investment managers buy and sell securities to maximize overall investment returns in accordance with investment policies established and monitored by our officers and board of directors. This includes selling individual securities that have unrealized losses when the investment manager believes future performance can be improved by buying other securities deemed to offer superior long-term return potential.

We classify our investments in debt and equity securities with readily determinable fair values into one of three categories. Held-to-maturity securities are carried at amortized cost. Available-for-sale securities are carried at fair value with unrealized gains/losses recorded as a component of comprehensive earnings and shareholders' equity, net of deferred income taxes. Trading securities are carried at fair value with unrealized gains/losses included in earnings.

Management regularly evaluates our fixed maturity and equity securities portfolio to determine impairment losses for other-than-temporary declines in the fair value of the investments. Criteria considered during this process include, but are not limited to: the current fair value as compared to the cost (amortized, in certain cases) of the security, degree and duration of the security's fair value being below cost, credit ratings, current economic conditions, the anticipated speed of cost recovery, and our decisions to hold or divest a security. Impairment losses result in a reduction of the underlying investment's cost basis. Significant changes in these factors could result in a considerable charge for impairment losses as reported in the condensed consolidated financial statements.

Part of our evaluation of whether particular securities are other-than-temporarily impaired involves assessing whether we have both the intent and ability to continue to hold securities in an unrealized loss position until their recovery. We have not sold any securities for the purpose of generating cash over the last several years to pay claims, dividends or any other expense or obligation. Accordingly, we believe that our sale activity does not undermine our ability to continue to hold securities in an unrealized loss position until our cost may be recovered.

***Recoverability of Reinsurance Balances***

Ceded unearned premiums and reinsurance balances recoverable on paid and unpaid losses and settlement expenses are reported separately as assets, rather than being netted with the related liabilities, since reinsurance does not relieve us of our liability to policyholders. Such balances are subject to the credit risk associated with the individual reinsurer. Additionally, the same uncertainties associated with estimating unpaid losses and settlement expenses impact the estimates for the ceded portion of such liabilities. We continually monitor the financial condition of our reinsurers. Our policy is to periodically charge to earnings an estimate of unrecoverable amounts from troubled or insolvent reinsurers. Further discussion of our reinsurers and relating reinsurance balances recoverable can be found in note 5 to the financial statements included in our 2005 Annual Report on Form 10-K.

*Deferred Policy Acquisition Costs*

We defer commissions, premium taxes and certain other costs related to the acquisition of insurance contracts. These costs are capitalized and charged to expense in proportion to premium revenue recognized. The method followed in computing deferred policy acquisition costs limits the amount of such deferred costs to their estimated realizable value. This would also give effect to the premiums to be earned and anticipated losses and settlement expenses, as well as certain other costs expected to be incurred as the premiums are earned. Judgments as to ultimate recoverability of such deferred costs are highly dependent upon estimates of future loss costs associated with the premiums written.

**SIX MONTHS ENDED JUNE 30, 2006, COMPARED TO SIX MONTHS ENDED JUNE 30 2005**

Consolidated gross revenues, as displayed in the table that follows, totaled \$444.0 million for the first six months of 2006 compared to \$402.2 million for the same period in 2005.

Gross revenues	For the Six-Month Period Ended June 30,	
	2006	2005
	(in thousands)	
Gross premiums written	\$ 403,843	\$ 365,545
Net investment income	34,264	29,278
Net realized investment gains	5,931	7,373
Total gross revenues	\$ 444,038	\$ 402,196

Gross premiums written for the Group increased 10% from 2005 levels, as both property and surety posted strong growth. Net investment income improved 17% to \$34.3 million. This growth is attributable to continued positive operating cash flow, coupled with a higher interest rate environment. Additionally, the sale of certain securities during the first six months of 2006 resulted in the recognition of \$5.9 million in net realized gains.

Consolidated net revenue for the first six months of 2006 increased \$9.1 million, or 3%, from the same period in 2005. Net premium earned was up 2%, while net investment income advanced 17%.

Net after-tax earnings for the first six months of 2006 totaled \$48.6 million, \$1.86 per diluted share, compared to \$63.7 million, \$2.43 per diluted share, for the same period in 2005. While both periods reflect favorable development on prior year's loss reserves, the magnitude of this favorable development was considerably larger in 2005. During the first six months of 2005, positive development on prior accident year's hurricane and casualty loss reserves resulted in additional pretax earnings of \$29.0 million (\$0.73 per diluted share). In 2006, positive development on prior accident year's hurricane and casualty loss reserves resulted in additional pretax earnings of only \$5.0 million (\$0.12 per diluted share). Offsetting this positive development were losses and reinstatement premiums associated with the run-off of previously exited construction coverages adversely impacting results for 2006 by \$7.0 million (\$0.18 per share).

The amounts disclosed for favorable loss development are net of performance-related bonus impacts, which affected other insurance and general corporate expenses. Bonuses earned by executives, managers and associates are predominately influenced by corporate performance (operating earnings and return on capital).

During the first six months of 2006, equity in earnings of unconsolidated investees of \$7.6 million included \$5.6 million related to Maui Jim, Inc. and \$2.0 million from Taylor Bean & Whitaker Mortgage Corp. Results for 2005 showed \$5.8 million in income, which included \$4.9 million related to Maui Jim and \$0.9 million from Taylor Bean & Whitaker. Continued strong operating performance from both companies drove the growth in 2006.

Results for the first six months of 2006 include pre-tax realized gains of \$5.9 million, \$0.14 per diluted share, compared to pre-tax gains of \$7.4 million, \$0.18 per diluted share, for the same period last year. Additionally, results for 2006 reflect the favorable resolution of a recent tax examination. As a result of the conclusion of this examination we recorded a tax benefit of \$3.2 million (\$0.12 per share), resulting from a change in tax estimate related to the sale of assets.

Comprehensive earnings, which include net earnings plus unrealized gains/losses net of tax, totaled \$36.8 million, \$1.41 per diluted share, for the first six months of 2006, compared to comprehensive earnings of \$59.8 million, \$2.28 per diluted share, for the same period in 2005. Unrealized losses, net of tax, for the first six months of 2006 were \$11.8 million, \$0.45 per diluted share, compared to unrealized losses of \$3.9 million, \$0.15 per diluted share, for the same period in 2005. Both periods were negatively impacted, to varying degrees, by volatility experienced in the bond and equity markets.

#### **RLI INSURANCE GROUP**

As indicated earlier, gross premiums written for the Group advanced to \$403.8 million for the first six months of 2006, as property and surety posted strong growth. Underwriting income for the Group declined \$33.1 million to a pre-tax profit of \$22.9 million for the first six months of 2006. Results for 2005 of \$56.0 million include \$29.0 million in favorable development on prior accident years casualty and hurricane reserves. On a comparative basis, results for 2006 include \$5.0 million in favorable development on prior accident years casualty and hurricane reserves and were negatively impacted by a \$7.0 million underwriting loss on construction coverages. The GAAP combined ratio totaled 90.9 for the first six months of 2006, compared to 77.4 for the same period in 2005. The Group's loss ratio increased to 55.9 for 2006, compared to 42.7 for 2005, reflective of the reduction in prior accident years reserve releases and losses on construction coverages.

	For the Six-Month Period Ended June 30,	
	2006	2005
<b>Gross premiums written (in thousands)</b>		
Property	\$ 120,095	\$ 80,648
Casualty	250,094	254,292
Surety	33,654	30,605
Total	\$ 403,843	\$ 365,545
<b>Underwriting income (in thousands)</b>		
Property	\$ 3,304	\$ 13,451
Casualty	15,521	41,055
Surety	4,043	1,496
Total	\$ 22,868	\$ 56,002
<b>Combined ratio</b>		
Property	93.5	68.0
Casualty	91.0	77.3
Surety	86.2	94.0
Total	90.9	77.4

**Property**

Gross premiums written for the Group's property segment improved \$39.4 million, or (49%) from the same period last year. For the first six months of 2006, property's gross premiums totaled \$120.1 million. Our domestic fire book posted a \$27.7 million (72%) increase in written premium, as rates for hurricane-prone areas have increased in excess of 50%. Additionally, California earthquake premium advanced \$6.5 million (23%) as rates in earthquake-prone areas have advanced 50%, as well. Growth in fire and California earthquake was achieved primarily on the basis of increased rates, as our overall exposure to hurricanes and earthquakes remained relatively constant. In addition, our marine division, which was launched during the second quarter of last year reported over \$11.0 million in written premium during 2006. Offsetting these improvements, construction premium declined \$4.2 million (66%) due to the fourth quarter 2005 decision to discontinue our participation in this line.

For the segment, net premiums written advanced at a faster pace than gross production. Net premiums for the segment were up 73%. This change is driven by a shift in mix of business, a slight increase in retention, and the structure of our catastrophe reinsurance. Catastrophe reinsurance is ceded on a gross premiums earned basis. Given the acceleration in growth of catastrophe-exposed business in 2006, gross premiums earned lagged premiums written, resulting in a lower amount of premiums ceded on catastrophe-exposed business during this period of rapid growth in writings. This trend will reverse as the gross premium is earned, which will result in increased premiums ceded in future periods, and conversely, lower net premiums written. We would expect this gap to narrow during the second half of the year.

Underwriting income for the segment was \$3.3 million for the first six months of 2006, compared to \$13.5 million for the same period in 2005. In 2006, we experienced over \$2.0 million in increased weather-related claims (wind, hail, tornados) compared to the same period in 2005. Additionally in 2006, losses and reinstatement premiums associated with the run-off of previously exited construction coverages adversely impacted results for 2006 by \$7.0 million. These construction coverages often insured large projects covering multiple



years and relied heavily on reinsurance. Certain multiple-year projects remain ongoing, during this period of run-off. While overall exposure and policy counts are down 50% since the fourth quarter decision to exit this business, several losses developed adversely in 2006. This triggered both increased losses incurred of \$3.8 million and additional reinsurance premium of \$3.2 million to reinstate reinsurance coverage exhausted by the increase in developed losses. Overall exposure and policy count will continue to decline during the last half of 2006. We would expect exposure and policy count to be down by 75% by year end.

Segment results for 2006 translate into a combined ratio of 93.5, compared to 68.0 for the same period last year. The segment's loss ratio advanced to 51.9 from 31.0 in 2005, due to the aforementioned construction and weather-related losses.

From an expense standpoint, the segment's expense ratio increased to 41.6 from 37.0 in 2005. The expense ratio for the first six months of 2005 was lower due to \$2.9 million in increased reinsurance profit commission recognition. The expense ratio in 2006 is more indicative of the trend for this segment.

### *Casualty*

The casualty segment posted gross premiums written of \$250.1 million for the first six months of 2006, down 2% from the same period last year. Rates have continued to soften at a modest pace in the casualty segment. Despite this softening, margins remain good and we continue to find opportunities for profitable growth. Gross premium for executive products advanced \$6.2 million (27%) and umbrella was up \$3.4 million (7%). Despite a slight erosion in rates, general liability, our largest growth contributor over the past several years, posted writings off only 1% from last year and continues to produce profitable results. Our specialty program business declined \$9.6 million (40%) due to increased competition and exiting certain unprofitable accounts. As the casualty market continues to soften, we will remain focused on growing areas that provide the best return, while maintaining strict adherence to underwriting discipline.

In total, the casualty segment posted underwriting income of \$15.5 million, compared to income of \$41.1 million for the same period last year. Results for 2005 include favorable experience on prior accident years (2002 through 2004) for general liability, transportation and specialty programs. Due to this positive emergence, during the first and second quarters of 2005, we released reserves. These reserve releases improved the segment's underwriting results by \$26.1 million, net of related bonuses. Moreover during 2005, a re-evaluation of last year's hurricanes resulted in the release of reserves, adding \$2.8 million of underwriting income, net of related bonuses. Hurricane reserves on specialty program business (package policies on service stations and hotels) developed favorably and expected demand surge did not materialize, resulting in this first quarter 2005 reserve release. From a comparative standpoint, results for 2006 include only \$2.3 million of favorable experience on prior accident years (2000 and 2003), primarily from executive products and \$0.3 million in hurricane reserve releases. Overall, the combined ratio for the casualty segment was 91.0 for 2006 compared to 77.3 in 2005. The segment's loss ratio was 62.6 in 2006 compared to 46.9 in 2005, primarily driven by the reduction in prior accident years' reserve releases.

**Surety**

The surety segment posted gross premiums written of \$33.7 million for the first six months of 2006, up 10% from the same period last year. Premium growth was experienced across all lines: miscellaneous, commercial, energy and contract. The segment posted underwriting income of \$4.0 million, compared to an income of \$1.5 million for the same period last year. The combined ratio for the surety segment totaled 86.2 in 2006, versus 94.0 for the same period in 2005. The segment's loss ratio was 23.3 for 2006, compared to 32.1 for 2005, as results for both contract and commercial improved considerably. The expense ratio increased to 62.9 but was in line with expectations.

We are in litigation regarding certain commercial surety bond claims arising out of a specific bond program. A detailed discussion of this litigation can be found in Item 3 – Legal Proceedings and note 10 of our 2005 Annual Report on Form 10-K. There have been no significant changes to this litigation since the filing of the Annual Report.

**INVESTMENT INCOME AND REALIZED CAPITAL GAINS**

During the first six months of 2006, net investment income increased by 17.0% over that reported for the same period in 2005. This improvement was due to an increased asset base and a higher interest rate environment. On an after-tax basis, investment income increased by 15%. The average annual yields on our investments for the first six months of 2006 and 2005 were as follows.

	2006	2005
<b>Pretax Yield</b>		
Taxable	5.16 %	4.91 %
Tax-Exempt	3.97 %	3.99 %
<b>After-tax yield</b>		
Taxable	3.35 %	3.19 %
Tax-Exempt	3.76 %	3.78 %

During the first six months of 2006, the yield increased on the taxable bonds but decreased slightly on tax-exempt bonds.

The fixed-income portfolio decreased by \$44.3 million during the first six months of 2006. This portfolio had a tax-adjusted total return on a mark-to-market basis of 0.4%. Our equity portfolio increased by \$13.8 million during the first six months of 2006, to \$334.9 million. The equity portfolio had a total return of 6.9% during the first six months of 2006.

We realized a total of \$5.9 million in capital gains in the first six months of 2006, compared to capital gains of \$7.4 million in the first six months of 2005. The decrease in net realized gains is due in part to the timing of the sale of individual securities.

We regularly evaluate the quality of our investment portfolio. When we believe that a specific security has suffered an other-than-temporary decline in value, the investment's value is adjusted by reclassifying the decline from unrealized to realized losses. This has no impact on shareholders' equity. During the first six months of 2006 and 2005, there were no losses associated with the other-than-temporary impairment of securities.

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The following table is used as part of our impairment analysis and illustrates certain industry-level measurements relative to our equity portfolio as of June 30, 2006, including fair value, cost basis, and unrealized gains and losses.

	<b>Cost Basis</b>	<b>6/30/06 Fair Value</b>	<b>Gross Unrealized Gains</b>	<b>Losses</b>	<b>Net</b>	<b>Unrealized Gain/Loss % (1)</b>
	<b>(dollars in thousands)</b>					
Consumer Discretionary	\$ 12,757	\$ 15,132	\$ 2,455	\$ (80 )	\$ 2,375	18.6 %
Consumer Staples	15,627	31,913	16,314	(28 )	16,286	104.2 %
Energy	10,622	28,991	18,371	(2 )	18,369	172.9 %
Financials	31,572	63,083	32,007	(496 )	31,511	99.8 %
Healthcare	11,158	25,579	14,422	(1 )	14,421	129.2 %
Industrials	18,474	39,919	21,596	(151 )	21,445	116.1 %
Materials	6,965	9,651	2,732	(46 )	2,686	38.6 %
Information Technology	13,001	16,450	4,446	(997 )	3,449	26.5 %
Telecommunications	9,497	15,997	6,525	(25 )	6,500	68.4 %
Utilities	46,604	67,919	21,334	(19 )	21,315	45.7 %
Other	20,320	20,284		(36 )	(36 )	-0.2 %
	\$ 196,597	\$ 334,918	\$ 140,202	\$ (1,881 )	\$ 138,321	70.4 %

(1) Calculated as the percentage of net unrealized gain (loss) to cost basis.

The following table is also used as part of our impairment analysis and illustrates the total value of securities that were in an unrealized loss position as of June 30, 2006. It segregates the securities based on type, noting the fair value, cost (or amortized cost), and unrealized loss on each category of investment as well as in total. The table further classifies the securities based on the length of time they have been in an unrealized loss position.



**Investment Positions with Unrealized Losses  
Segmented by Type and Period of Continuous  
Unrealized Loss at June 30, 2006**

(dollars in thousands)

0-12 Mos.