The Plymouth Rock Company

INCORPORATED

177 Milk Street
Boston, Massachusetts 02109

Chairman's Letter

March 31, 1987

To Our Shareholders:

The year 1986 was characterized at Plymouth Rock by rapid growth and a pleasing enhancement of retained earnings. Gross Premiums Written expanded from $11.7 million to $21.3 million, an increase of about 80%. This is the best measure of how big a company we are and how much we've grown. Although financial statements focus, and rightly so, on the much smaller number that measures Net Premiums Earned, the gross written figure determines our scale and our staffing. We closed 1986 a twenty million dollar enterprise. We will soon have to begin thinking of Plymouth Rock as a middle-sized company rather than a start-up. We expect another year of rapid expansion in 1987, which is sure to reinforce this feeling.

Our net income, just over $1.3 million, was boosted by two non-recurring items (a tax loss carry-forward benefit of $100,000 and net capital gains of $436,000) as well as substantial operating progress. The tax carry-forward from 1983 and 1984 is now entirely used up; and the investment profits — as nice as they are — largely reflect our benefits, as fixed income investors, from the falling interest rate environment of the last two years. We will have no tax loss advantage in 1987, and it is virtually inconceivable that capital gains will have a similar impact on our 1987 results. Consequently, I would call attention to the item labelled ''Income from Insurance Operations'', about half way down our income statement, as a more meaningful index of our business progress than the larger bottom line amount.

The 1986 Income from Insurance Operations of $1,087,284 compares with a 1985 profit on a similar basis of $169,723. This year's number is 6.0% of gross premiums earned versus last year's 1.9% of gross premiums earned. A six percent profit on gross premiums is something we did not expect to see so early in Plymouth Rock's corporate life.

Our management budget for 1986 had underestimated volume for the year by about two and a half million dollars. This is the second year in a row that volume has been above expectations. As we ask ourselves why, our attention is drawn to a pair of

marketplace phenomena that literally dominate our Massachusetts personal lines environment. One factor is the chronic and continuing deterioration of competition for Massachusetts automobile insurance business. The other, related only in part, is the low and worsening quality of service the industry offers to its agents and customers in personal lines.

Massachusetts automobile insurance has been described for years by the insurance industry as a disaster area. During most of the decade of the 1970's, the numbers told a different story. Regulation was always weighty but Massachusetts profitability compared favorably to countrywide statistics. In the 1980's, however, profits have increasingly fallen below the predictions inherent in the Insurance Commissioner's annual rate decisions. In both 1985 and 1986 premiums were reduced from existing levels, yet neither frequency of claims nor average claim cost for these years appears to have fallen. For 1987, the industry requested an increase of nearly 40%. A full quarter into the new year, the decision had not been issued. The automobile rate setting process has become so contentious and tedious that a highly capable Commissioner with an excellent staff has not, as of this date, been able to produce a rate decision due in the fall of 1986.

The perception of rates so inadequate as to defy any near-term correction, combined with the fact of an encumbered rate-making process, has had its undeniable impact on the marketplace. National companies, never comfortable with Massachusetts, are being moved to actions once considered unthinkable. A few have gotten out. Numerous others are threatening to do so. And all too few, sadly, have made the commitment to hunker down and work toward a constructive, long-term solution which suits the needs of the public as well as the industry. In the meanwhile, volume is amply available to any company that seeks it.

The service problem is partially a corollary to this condition and partially the consequence of unrelated trends. Those companies who view themselves as remaining in Massachusetts only at great financial sacrifice have tended to cut back both staffing and service levels in an effort to trim the expense component of their net losses and, simultaneously, to discourage new customers. This aggravates a pre-existing tendency toward lower service that has been visible for years now. The national competition between agency companies and direct writers has put great pressure on company expense ratios. In states like Massachusetts, with a high agency market share and some unique processing costs, this has led to unrealistically tight operating budgets at some carriers, and, in some cases, a loss of regard for the all-important customer. The worsening service drives business quickly in the direction of those few companies that have managed to keep service levels high. It is easy to draw new business when your competitors don't want it and can't service it properly. We expect our growth to continue in 1987.

Our highly favorable 1986 loss ratio (62% as opposed to 69% in 1985) reflects the continued success of our sophisticated underwriting models, and it was both directly and indirectly aided by the market environment. With so few of our competitors seeking new business, Plymouth Rock was able to maintain its selectivity with no adverse volume consequences. At the same time, our loss results were aided by a lower deficit

payment to the residual market mechanism, Commonwealth Automobile Reinsurers (or C.A.R.). Since 1984, C.A.R. has responded to the tight market situation by operating a system of rewards and penalties for market performance. Movement in participation shares is tightly capped. Companies that grow are thus rewarded with participation shares in the C.A.R. deficit that can lag substantially behind current voluntary market shares. A company withdrawing coverage is required to accept a share of the deficit that exceeds current market share. Since C.A.R.'s deficit for fiscal 1986 was a staggering $550 million, the effects of differential participation shares can be as important a determinant of a carrier's overall loss ratio as cautious underwriting.

The legality of using the residual market mechanism as a source of incentives for the provision of coverage has been challenged by a number of insurers. The Commissioner of Insurance recently issued a long and scholarly decision upholding C.A.R.'s approach, and the matter will now go to the courts. Pending any court action, the rules stand. To achieve a low loss ratio against this backdrop of tight rates and powerful market share incentives, a company must choose its voluntary risks skillfully and simultaneously grow its way into a reduced residual market participation. Both pieces are essential, and Plymouth Rock has paid attention to both. The peril, however, is obvious. At some point, we will use up all the available growth opportunities that meet our underwriting standards. We may lose even sooner the rewards from C.A.R. Under a new rule proposal before the Commissioner of Insurance, C.A.R. would phase out most of the growth rewards beginning in 1989. This would be adverse to Plymouth Rock and other rapidly growing companies but, frankly, I think the proposal is fair. Rate adequacy is, in the end, an irresistable force and there can be no immovable objects.

Plymouth Rock's expense ratio for 1986 was within a point of our budget goal. Although I would always prefer to hit the budgetary target dead on, the 1986 result is consistent with the pressures of rapid growth. Our greatest stresses were on occupancy costs, policy processing, personnel administration and accounting. Both the rent and policy processing overages reflect decisions made in 1986 to prepare for another volume surge in 1987. We could perhaps have argued to defer some of these costs, but we don't like to do so when the money is gone and the contingency for which it was spent remains too uncertain.

The additional cost in accounting was due not only to the heavy premium volume but also to an upgrading of systems and procedures that worked well for a ten million dollar business but won't serve a company twice or three times that size. We also decided, a year earlier than planned, to set up a full-time personnel office. This was one of the most fortunate decisions we made all year. I don't see how our managers would have gotten through 1986 without the help this gave them in their recruiting and supervisory tasks.

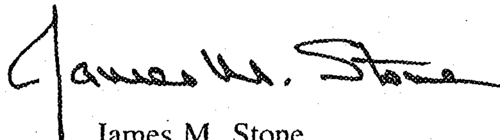
Our budget focuses on the ratio of gross expenses, including claim department expenses and investment expenses, to gross premiums earned. By this measure, we moved from a 54% cost in 1985 to a 44% cost in 1986. Our financial statements focus on net expenses, which exclude claim and investment costs and deduct out reinsurance commissions and reimbursements. The ratio to premiums on that basis was 37% in

1986, down from 46% last year and 56% in 1984. Our goal is to bring the expense ratio down to 37% on the budgetary scale and below 30% on the accounting scale. The battle to achieve this while keeping service standards high continues unabated.

Our investment portfolio at year end included about $16 million of cash and marketable securities. We remain loathe to accept unnecessary investment risk. There is risk enough on the insurance side of our business. Plymouth Rock's securities portfolio is now held entirely in fixed-income government securities. We sold all of our convertible corporates during the year and purchased municipal bonds to replace them. The share of our portfolio devoted to municipals has grown as we have begun paying taxes. We think the spreads between taxable and tax-exempt securities remain favorable for the latter.

Our portfolio duration, always shorter than is typical for an insurance company, is now even shorter than it was in previous years. We want very little exposure to interest rate risk at this juncture. At the end of 1985, we had an unrealized capital gain of $536,000. This grew in 1986, and we harvested most of it into capital. The market value of our portfolio as of the end of 1986 exceeded the carrying value by $284,000.

Looking ahead is always difficult, and the turmoil in Massachusetts automobile insurance makes it all the more difficult today. We will doubtlessly be buffeted by forces beyond our control. Our best consolation is that we are a relatively agile company. Because we are smaller than the giants, and because all of our talent can be mustered to analyze and react to change in Massachusetts, Plymouth Rock will look for opportunities where others find dangers and channels where others find rocks. Our company enters its next year with a solid underwriting track record, a hard-earned reputation for service, a healthy respect for budgeting, and a group of agents and employees that should give any insurance company a warm feeling. These assets don't make us feel smug, or even secure, but they do keep us ready for the next challenge and fundamentally optimistic.



James M. Stone