# The Plymouth Rock Company

**695 Atlantic Avenue**
**Boston, Massachusetts 02111**

## Chairman's Letter

February 24, 1995

To Our Shareholders:

Three adverse developments, and one favorable trend, colored the year just ended. Last year's report to shareholders warned that we were nearing the peak of a cycle in the profitability of Massachusetts auto insurance. I must now report that we are past the peak. Although the 1994 results were unaffected by this change, future performance inevitably will be. Of more immediate impact in 1994 were a record harsh winter and bond market conditions that made the winter look mild. The good news, meanwhile, is that our course has been further established with respect to diversification. We are expanding our personal lines involvement in other states and growing our service businesses. Happy with the direction of these advances, and planning to step up the pace in the coming year, I am on balance optimistic. The cyclical determinants of our prosperity may be weaker for a time, but the permanent foundation of our enterprise is strengthening.

The Plymouth Rock Company's consolidated net income for 1994 was $12.8 million, up from $11.9 million the year before and representing a return on prior yearend equity of 23 percent. These numbers tell less of the story than one might wish. The impact of the fierce winter that besieged the Northeast is fully reflected in the net income. The bond market's damage, however, is not. New accounting rules applicable to our industry require losses suffered in the market value of bonds "available for sale" to go directly to the balance sheet without passing through the income statement. So, the published net income reflects only the realized portion of portfolio gains and losses. This year, unrealized losses predominated.

At the close of 1993, after an estimated provision for applicable taxes, there were $2.6 million of unrealized capital gains in the consolidated bond portfolio. Under that year's rules, unrealized gains and losses were shown only in footnotes. One year later we sat with $2.2 million in unrealized capital losses, which are now given their own line on the balance sheet. The net after-tax deterioration of $4.8 million in our bond portfolio is what the income statement obscures. To restate last year's numbers on a comparable basis is inconsistent with the accounting rules, but it is straightforward to determine that the increase in our group's equity was little more than half the net income.

How large an enterprise is Plymouth Rock and how much of the total is other than Massachusetts automobile insurance? This is a pertinent question when the Company faces a cyclical turndown in its largest line of business, though size is not uniformly defined for insurers. Our group's total assets are $250 million; we have about 330 employees; and our income statement shows revenues of $117 million (measured after payment for reinsurance protection). None of these indices corresponds to my preferred measure of size, which is the gross revenue stream from our customers. That number does not appear on the income statement. Two useful approximations are the sum of published revenue and the cost of ceded reinsurance, as shown in the footnotes, and the total of incoming items, other than reinsured claims, on the cash flow statement. The first sum comes to $158 million and would be higher by a few million if the published revenue were to be shown on a written basis; the second, on a cash basis, comes to $162 million. An estimate of $160 million is probably as reasonable a figure as needed of the Company's proprietary revenue stream.

So far, however, the estimate takes no account of the business under our management--but not our ownership--in New Jersey (about $19 million in written premium) or the premium flows we service at Pilgrim Insurance Company for customers outside our own group (about $10 million). If our size is appropriately defined by the stream of receipts implicated in either underwriting or management relationships, the total comes to nearly $190 million. This statistic provides a useful index of both our workload and our profit potential over time. Since the Massachusetts private passenger automobile share of this grand total is about $113 million, it might be fair to say that our receipts are 59 percent dependent on that single line and state combination. The fact that profits are more heavily weighted than revenues in the direction of Massachusetts auto is, I trust, a function of maturity. We have been in the auto insurance business now for eleven years, as opposed to just a few years for much of the rest.

Plymouth Rock Assurance Corporation is the Company's personal lines subsidiary responsible for the Massachusetts auto business and about $18 million in Massachusetts homeowners premium. I think of it as the tree in our garden, and the other businesses as saplings. With a market share between three and four percent in Massachusetts, it has become the tenth largest personal lines writer here. Its 1994 was a bit too exciting for my taste, but in the end satisfactory. The adventure was in the homeowners arena, where the brunt of the winter storms was taken. In ordinary years, homeowners tends to run a lower pure loss ratio than the larger auto insurance line, and that is because it is so much worse in the bad years. This was one of those. The ultimate threat is an unprecedented hurricane season, but a winter of record snowfalls and recurring freezes is no blessing.

Plymouth Rock Assurance expected, based on budgeting for a normal New England winter, to pay out $1.7 million in homeowners claims for the first quarter. It actually paid out two and a half times that, with most of the money going to cover damage from

ice dams on policyholders' roofs. More first quarter claims arrived belatedly as the year progressed. By yearend, the annual total of homeowners claims was still several million dollars above normal. Since net reinsurance costs in the homeowners line average several times those characterizing auto insurance, and all the usual commission and company expenses are at least as high, there is a thin margin for the payment of claims. This year's claims came to sixty-seven cents on the dollar, and the company lost money on homeowners coverage. Our overall loss ratio was spared by another successful year for auto insurance, an autumn season without a single hurricane, and a mild winter's start at yearend.

The expense ratio at Plymouth Rock Assurance continued its slow downward trajectory, improving almost half a point. Should we ever find Massachusetts transformed to a competitively rated state for auto insurance, every fraction of a point will make a potentially critical difference. Plymouth Rock Assurance treats it that way now. Having said that, I suspect we will have to give that company a year's grace in the long march next year. It is impossible to lower the overall expense ratio when the Insurance Commissioner has reduced rates and boosted agents commissions. The best one can hope for is a modest reduction in the company expense portion of the overall expense ratio, the total less commissions and premium taxes.

Plymouth Rock Assurance's goal for the foreseeable future is to maintain its moderate path of five to ten percent annual unit growth each year, while striving at all times to have the industry's best loss ratio and the market's best reputation for customer service. Let me stress that only the growth path is moderate; in our commitment to the two superlatives, moderation goes by the boards. A new executive, Alan Hines, has taken over the weighty responsibility for both the growth effort and the loss ratio. He joins Bill Kelley and Keith Rodney on the team primarily responsible for customer service.

The measurement of the growth objective in cars and houses rather than dollars accepts that, in years when the Commissioner raises the rates, premium growth will exceed unit growth. In years with rate decreases, the premium growth will lag the units. The coming year will see a rate decrease of about 6.1 percent, the first such cut in six years. The volume of business at Plymouth Rock Assurance, therefore, will be relatively flat throughout 1995. As other companies, especially those with dollar goals for annual growth, see how the new rates hurt their premiums, some may blindly bid for business just to meet quotas. That would make growth even more difficult in 1995. With our excellent reputation for service, we are well equipped to compete for the good business we are always seeking, but Plymouth Rock has no interest in meeting a top line goal at the expense of either quality or profits.

The Commissioner was probably not wrong to order a cut in rates. Premiums in the last few years have been ample, and the industry itself recommended a reduction for 1995.

Only the amount of the reduction was ever in question. If the Commissioner overshot the mark, as may have been the case, the industry will suffer a lean period. As I noted last year, though, the predominance of domestic companies places a practical limit on any potential inadequacy and its duration. There is simply no alternative to fair rates as a source of sufficient capital. I have always admired those who can make lemonade when life throws them lemons. The sudden shrinking of the premium stream is certainly a lemon, but a little lemonade is not beyond imagination. Markets that appear immune from cyclical correction are no good for rational competitors like Plymouth Rock Assurance. In the absence of a cycle, some folks can convince themselves that all business is forever profitable, and the starry-eyed fall over one another to acquire market share on uneconomic terms. We just saw a period like this come crashing to an end in real estate, and even more so in the real estate lending business. We prefer that bubbles are burst before they develop, and we accept the challenge ahead in Massachusetts personal lines with equanimity.

Last year, I reported that Peter Jones had reduced Mt Washington's 1992 losses by half and was hoping to reach breakeven in 1994. Despite the rough winter it appears that he accomplished exactly that, so I will uncork the bottle of champagne on ice for him. This is hardly a time to relax in Concord, however. Mt Washington is intended to be a clone of Plymouth Rock Assurance. It must someday match its larger sibling in both combined ratio and service reputation. The signs point in the right direction, but Mt Washington is struggling to achieve the necessary volume. The State of New Hampshire has less than one-sixth the personal lines premiums of Massachusetts. A drawn-to-scale copy of Plymouth Rock Assurance there would have about $20 million in premium, which is probably about what a company in that environment needs to realize expense efficiencies. Mt Washington's premium volume, about $7 million at last count, has not grown at all in the last twelve months. The task of getting the other $13 million, in a market where companies and agents are more content than they are in Massachusetts or New Jersey, will fall to someone other than Peter. He signed on to get the company up and running, and will return to Massachusetts sometime in April.

The SRB group of companies had another year of quiet strengthening. While the four companies had a combined net income of only about half a million dollars, we hope this represents the tip of an iceberg with respect to their worth. Palisades Management Company, for example, is only a $2 million company on our books, measured by revenues, and it lost $160,000 last year. Yet, it is unquestionably the most valuable of the SRB companies. Its worth lies in the fact that it manages a much larger business, Palisades Safety and Insurance Association, which in turn is owned by its policyholders. When the insurer makes money, the management company will also prosper. That day may not be far off, and the potential scale of a New Jersey personal lines insurer is at least as great as that we have already built in Massachusetts.

Palisades, the insurer, is now writing $19 million in premium, up from $16 million at the end of the prior year. The news is actually better than that, though, because most of the progress occurred toward yearend and seems to represent a new momentum. After six months in which that business failed to grow, president Hal Belodoff lit a fire under the marketing effort and overhauled its staffing. The results have been rewarding. For the last quarter of 1994, Palisades business grew at a monthly rate of $1 million in net new writings. This happens to be the same rate of growth averaged by Plymouth Rock Assurance over its eleven years. Hal believes he can maintain this rate in 1995, an essential prerequisite to cutting his expense ratio and reaching breakeven. While the quality of the business is looking good so far, the numbers are still a bit green for sophisticated analysis. I will have to save for next year a discussion of the all-important loss ratio.

Pilgrim Insurance, which provides services to other insurers and the residual market, had a good year. Vin Nieroda managed to add to both volume and profitability. I told him once that he would be considered a hero when he managed to earn a million dollars after taxes and did so within the context of an organization with which we would all be proud to be associated. He has taken that challenge to heart and swears that he will get us there within a few years. I would rather bet with that prediction than against it.

Boston Risk Management Corporation still operates at a small loss, but it has made progress nonetheless. BRMC now manages the workers compensation risks for a self-insured group of non-profit social service agencies. It has introduced an impressive program, called Comp 21, for intensive management of workers compensation costs more generally. I continue to believe that improved techniques of risk finance and loss management in workers compensation can save American business billions of dollars. While our entrance into that market has gone more slowly than contemplated, and the recent (almost certainly temporary) downward movement of traditional workers compensation premiums becalms for now the search for savings, there is no change in plans for BRMC. The opportunity is durable and the market is huge.

SRB Corporation itself is in the investment business, managing the portfolios of all the Plymouth Rock Companies. For the present, at least, it seeks no outside clients. The combined portfolios of the companies are now in excess of $200 million, of which $8.6 million is in common stocks and the remainder is held in fixed income instruments. The fixed income portfolio is conservatively invested, with an average credit quality of Aaa3 and an average duration of less than three years. Any unhedged portfolio of fixed income assets will be subject to a degree of interest rate risk. Although our exposure is far less than typical for the insurance industry, we saw the beast up close this year.

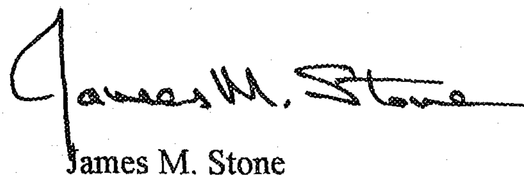
Avoidance of long-maturity instruments can be credited with having kept our total rate of return positive for the year. Negative total returns, I am told, abound for portfolio

managers and insurers in 1994. Wouldn't it be wonderful if we could have had a longer duration in the prior years, then shortened it or hedged it into a negative duration after the third quarter of last year? Yes, but that would have required a prognostication skill so powerful it would be wasted on mere financial enrichment. To one who believes no mortal is given that gift, our strategy still looks about right. We keep the bond portfolio quite conservative--but not radically so--and we take more risk for the prospect of greater returns on the equity side.

This posture is consistent with an underlying view that the interest rate market is relatively more efficient than the pricing of individual stocks and that free markets must invite equities to outperform bonds over long periods. It makes sense in such a world that whatever portion of an insurer's assets have to be protected from market fluctuation be invested without either equity risk or substantial interest rate risk. For us that means high quality, intermediate duration bonds. That part of the portfolio which can sustain market fluctuation is better directed toward equity positions than similarly risky long term debt, because the former are more susceptible to fundamental analysis and richer in the long run anyway. As we get larger, we will be placing an increasing share of our invested assets in selected equities.

Toward the close of 1994, we agreed to enter into a capital transaction which will give us two new shareholders and a new director. The amounts of money involved are not large, but the relationships are potentially important. Peter J. Wood is our new shareholder and director. He has built, in an astonishingly short period of time, the most successful personal lines insurer in the United Kingdom. Peter comes from a background in information technology and data processing. While our companies and their environments differ sharply, we look forward to having him question, challenge and compare the dichotomies. The other new shareholder will be an investment fund under the supervision of Morgan Stanley's merchant banking division. We already have a long-standing and productive relationship with Morgan Stanley, which this will only serve to deepen.

Next year may be the first in which Massachusetts personal auto insurance accounts for less than half of our managed, serviced and underwritten revenue stream. This will not be a minor event for Plymouth Rock. Making the best of increasing complexity and change requires good people: flexible, talented and prone to teamwork. I am aware of no insurer whose agency force, shareholders and staff are more amply endowed with these traits.



James M. Stone