The Plymouth Rock Company

695 Atlantic Avenue
Boston, Massachusetts 02111

Chairman's Letter

February 29, 1996

To Our Shareholders:

Plymouth Rock will recall 1995 as a year in which preparation for change took precedence over all matters immediate. Some of the change was forced upon us, and some was at our own initiative. Fierce competition and the adverse phase of the regulatory cycle came to Massachusetts automobile insurance. And, while our financial results were still dominated by that line of business, much of my own effort in 1995 was devoted to developments elsewhere. Your senior management has, for some time, been anticipating the unfavorable turn in its home state's automobile insurance market. The cyclical nature of that business would be reason enough to seek complementary sources of strength. Just as important, moreover, Keith Rodney and I both feel ourselves drawn, perhaps irresistibly drawn, to the challenge inherent in a broader geographic arena. The transition now being explored would require changes in both scale and structure. We will be consulting with you on these matters as 1996 takes shape.

The results for the year were a little behind those of the prior year. Consolidated net income was $12.3 million, versus $12.8 million for the twelve months of 1994. Even this result, a bit better than budget, reflected an element of good luck in that the winter of 1994-5 was unusually mild and the financial markets allowed us to realize about four million dollars in capital gains. We would have earned something nearer ten million dollars after taxes had the winter and the capital gains been more in line with long term norms. The essential force in the depression of profitability was declining premium rates for Massachusetts automobile insurance coverages. The situation in that line as we look forward is neither alluring nor improving. While what occurred is straightforward enough to explain, explanation falls woefully short of cure.

Automobile insurance rates in Massachusetts have been heavily regulated since 1925. The Insurance Commissioner fixes, after public hearings, a statewide matrix of premium rates, and each company must either use these as promulgated or apply for a downward "deviation", either for all of its business or for some nondiscriminatory subdivision of the book. A company can also apply for approval of any number of group marketing plans, with discounted rates for eligible risks. Neither mechanism allows a carrier to charge

more than the Commissioner's rate for any driver in the system. This is a one way ratchet, and thus the privilege to deviate or discount, over most of Massachusetts' regulatory history, has been largely theoretical. Companies have usually just griped and accepted the Commissioner's rates as their own.

This regime is far more restrictive than the rate regulatory environment typical for the fifty states, but over many decades Massachusetts has been neither consistently above nor below the national norms in profitability. For the last several years, Massachusetts rate regulation has tended to encourage price competition, with Massachusetts having been among the top dozen states in profitability every year since 1992. Had anyone suggested in the eighties that Massachusetts auto insurance carriers would soon be using rates below those fixed by the Commissioner, seasoned observers might have laughed derisively. More recently, however, the laughter would seem inappropriate. Competition's first stirrings came in the form of group discounting for payroll deduction plans of selected employer units. Then selectivity went by the board as some companies began to discount open enrollment groups of policyholders, such as automobile clubs, allowing any driver in the state to enjoy the discount simply by joining the sponsoring organization. Next, a number of carriers announced that they would waive the customary finance charges for policyholders who paid their premiums in monthly installments. Finally, at the end of 1995, companies began filing for downward deviations and extending discounts to non-group policyholders across the state.

The impact of these discounts must be regarded as significant by any standard, especially since the Commissioner reduced the base premium rate by about 6.1% for 1995 and another 4.5% for 1996. Premium income for insurers in 1996 will be less by hundreds of millions of dollars than would have been the case had rates simply been flat for the last two years. An individual example may be most illustrative of the cumulative downward pressures. Imagine that typical policyholder Smith paid a $1000 premium in 1994 and has the right characteristics for a 10% downward deviation in 1996. Smith's 1995 premium, assuming an average benefit of the rate decrease that year, would have dropped to $939, reflecting the Commissioner's average statewide decrease. Then in 1996, Smith would have enjoyed both a rate decrease and a deviation, taking the premium down to $807. If Smith joined an open group with an additional 10% discount, the premium would be $726. This is an overall reduction of 27% from the 1994 premium in constant dollars, before any benefit Smith may have received from waiver of finance charges, and an even greater reduction if account of inflation is taken. Profits have indeed been good in recent years, but not that good.

The situation in Massachusetts automobile insurance can, almost certainly, be characterized as an unsustainable price war. Correction is inevitable, but it is hard to say when. Largely because of the prospects for this still dominant segment of our business, the group net income will almost certainly be down in the near future.

Plymouth Rock is not a leader in the price war, but we cannot afford to be a victim either. In our business it is valuable to maintain policyholder relationships over long periods of time. It often costs something extra, whether on the agent's part or the company's, to attract a new customer, and it hurts a company's expense ratio to lose volume after fixed costs have anticipated more. Regular customers, moreover, learn to feel appreciated by Plymouth Rock, and we think most will return that sentiment by engaging in responsible claims behavior. As long as the market imbalance is thought to be short-lived, it does not make sense to passively accept the loss of long term market share, especially among our excellent drivers. We will aim to increase new business selectivity as margins fall, while keeping the defenses around our existing book as formidable as possible.

Accordingly, we have sought and received permission from the Commissioner to offer an 11% downward deviation for good drivers, and we are searching for select group business that properly deserves a discount over all phases of the cycle. Even at this, the lack of a widely available open group plan may cause us to lose a little market share. This is the cost of hewing to selectivity during a competitive feeding frenzy. If we have to accept this outcome, it will be preferable to losing money or discarding the comparative advantage we have gained over the years by offering the best service to the best drivers.

Plymouth Rock Assurance Corporation would be more comfortable in a competitive arena if it could provide its excellent service at an especially low cost. The lowest cost producer always has an edge in competition. That goal, however, remains elusive. With mandated commissions up and premiums down, the gross expense ratio actually rose just over a point in 1995--to 38.8%, including both loss adjustment expenses and investment expenses, a figure which approximates the average expense ratio for our agency company peer group. The pending premium cuts in 1996 will render it fruitless to seek an expense ratio reduction in the coming year. Progress is made in the years when premiums rise and discipline keeps expenses from rising at an equal pace. Over time, years of increasing premiums predominate, so the long struggle is not as hopeless as it may look in this period. The benefit of tough periods is that they redouble the commitment of our department heads to keeping tight reins on staff size and seeking new ways to be efficient.

Last year, I reported to you deep misgivings about homeowners profitability. Given current rate levels in that line, it is by no means clear that any company, at least in our part of the United States, can purchase adequate reinsurance and still have enough left over to earn a worthwhile return on the homeowners business. The profits look great in years without severe winters or tropical storms in the autumn, but the long term record is nothing to brag about and the uninsured catastrophe risk is horrendous. GEICO, one of the most thoughtful carriers in the personal lines business, announced in 1995 that it would leave the homeowners line entirely. Some of our competitors in Massachusetts are cutting back. It should not come as a surprise, therefore, that we talked about beating a

similar retreat at Plymouth Rock Assurance Corporation. Instead, we decided to stick with homeowners insurance. A weakening of competitive resolve always creates opportunities, and prices inadequate to pay for the reinsurance are not necessarily inherent to the business. Our choice was to spin our homeowners risks off into a separate corporation, the newly licensed Bunker Hill Insurance Company, where we will specialize in underwriting by precise analysis and mapping of our catastrophe concentration risk. This process will allow the company to write broadly throughout its jurisdiction, while maintaining the spread of risk essential to survival when catastrophe strikes. Assuming Bunker Hill's reinsurers will allow us to pay a rational price for coverage preselected to minimize concentration risk, we are optimistic we can make homeowners a larger rather than smaller business for our family of companies.

The last report prematurely celebrated Mt Washington's first tiny profit. I should probably have described that year's results as breakeven, and the ink went red again in 1995. Mt Washington lost between three and four hundred thousand dollars on gross premiums of $7.1 million. A swing of a few percentage points is normal for personal lines, and the trend reveals little. The challenge for Mt Washington is to add customers until premiums are twice or three times their present level, and thus lower the expense ratio. A company of Mt Washington's small scale cannot be a reliable moneymaker and still pay for a high quality management team. This is the case despite our good luck in having Gene Meyung as that company's chief executive. Gene is a proven industry star who came out of retirement to guide the company for a year or two and insists on being paid less for his time than he could command. Gene, and his eventual successor, will just have to keep plugging to achieve the necessary growth in New Hampshire's highly competitive environment. They will be aided by Ray Moore, the vice president for accounting, data processing and administration at Plymouth Rock Assurance Corporation, who has now added the chairmanship of Mt Washington to his duties. Like its Massachusetts counterpart, Mt Washington has concentrated on building a reputation for unusually good service to both its agents and its customers. I remain confident that, if top service can be combined with efficiency, the strategy is a winner.

Having just confessed to premature celebration with respect to Mt Washington, I should measure my words with respect to Palisades. Hal Belodoff had set as goals for the reciprocal insurer he manages in New Jersey that 1995 premiums written would pass $30 million and that the last quarter of the year would be the company's first quarter of profitability. Both goals were achieved. Palisades now has the scale it needs for reasonable expense ratio control, and it has both the reputation and vigor required to attract new business. Entering its fifth year, Palisades can also begin to answer meaningful questions now about the quality of the business it has secured. New carriers are everywhere assumed to suffer from initial adverse selection, and New Jersey is known as an especially tough state with respect to rate approvals. Palisades' loss ratio, despite

both of these handicaps, has averaged very close to sixty points for all years tak together, while Palisades' rate levels are slightly below the statewide average. These tv facts together suggest that the book is considerably better than a typical unseasoned bo and probably as good as it ever needs to be.

Since complacency ranks as just about the deadliest sin around here, it is wo emphasizing that Palisades' loss ratio is not sustainable without the constant applicati of effort and skill. It is possible, for starters, that appearances are deceiving and that ev now the experience is worse than the books suggest. Some of the liability claims f years past are still outstanding and may develop upward as the cases are finally closed. may be that good business, which was available for the asking when other carriers we furious at New Jersey's depopulation plan, will dry up as the market tightens. In tl case, Palisades may find itself bidding for its future growth, a process not hospitable loss ratio refinement. Rate needs, moreover, change. It is not enough to have called t cost and market trends skillfully in past rate filings; one has to keep calling them rig time and time again. The goal is not to be perfect, a standard incompatible with hum enterprises. It is to be better than one's competitors, always and forever. Palisad appears to be doing all the right things to make that possible.

Vin Nieroda, who runs our service company--Pilgrim Insurance, is also a bearer of go news. Pilgrim, under Vin's leadership since inception, has been profitable for sev years in a row. Because Pilgrim's income is fee-based and of lower risk than tl generated in our underwriting entities, a dollar of net income there is worth a bit extra terms of shareholder value. Its 1995 net income was about seven hundred thousa dollars, approaching double the prior year's profit. It appears that Pilgrim's growth w continue into 1996, led by an expansion of its residual market services for taxis a limousines. Vin still has his eyes fixed on a longstanding two-clause challenge Pilgrim: to earn over a million dollars in an environment where everyone involved proud to be associated with the company. See this space next year for an update on Pilgrim's progress.

Boston Risk Management Corporation has a new chief executive, Bob Barrese, wh unambiguous mission is to speed up its growth. While BRMC has a fine reputation professionalism and a nice little business in the management of self-insured work compensation programs, its revenues have been a disappointment. With so much to done in the workers compensation field, this seems ironic. Before I eat too much cro however, I want to give Bob his chance to improve the record. Bob comes to us wit highly successful track record in marketing and product development at Liberty Mut He is probably the most skilled and experienced sales professional ever hired for any our companies. BRMC continues to appear an attractive adjunct to our personal li businesses; it is now Bob's work that will shape its role in our corporate family.

This was a good year for investors in stocks and bonds, and SRB Corporation did better than most. Under the executive supervision of Jim Bailey and Rick Childs, SRB's performance was close by its benchmarks on fixed income securities and decisively beat the equities benchmarks. The market value of the group's fixed income portfolio was more than four million dollars below its cost at the close of 1994; a year later market value was nearly two million dollars above cost. Since we keep duration passively short and are loathe to wager anything on interest rate predictions, we must thank general economic conditions for most of the gain in bonds. On the equity side, though, thanks are due Jim and Rick. Our marketable equities portfolio rose in value by nearly seventy percent in a year, about thirty points better than the performance of the Standard and Poor's average--and not because we chose risky or volatile stocks. Our strategy continues to emphasize extensive fundamental analysis of share value, corporate culture and product quality, with the assumption that holding periods will be measured in decades.

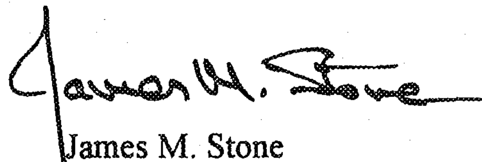
The bull market broke records day after day in 1995. The surest conclusion from this fact is that it has gotten progressively tougher to find undervalued stocks. So, late in the year, we turned to real estate, which we think is still quite undervalued in New England and where we have, as a user of space, some degree of downside protection. Many of the newer, large-floorplate properties in this area have recovered somewhat in price since the real estate collapse a few years ago. The prices of older or smaller buildings have not shown equivalent gains. Since we prefer the latter anyway, we purchased an office building in New Hampshire for Mt Washington and an office building in Boston suitable as a future home for Plymouth Rock Assurance or the SRB Companies. We consider that we are now hedged in both places should real estate prices rise in the future. The investment risk from these purchases is tempered by our ability to occupy and our ability to forgo liquidity for long time periods.

At the December board meeting, Ray Moore was added to our short list of holding company officers. Paula Gold, who has played a key role in shaping Plymouth Rock Assurance Corporation's competitive strategy, was promoted at the same time to general counsel of the Massachusetts insurer. After eight years of service on the board, Benno Schmidt will soon retire as a Plymouth Rock Company director. Benno, at 83, remains the wisest person I can call a friend, so I tried in vain to talk him into staying. His best counteroffer, which I have accepted, was to continue our regular lunches and visits. He will be missed and, so far as I can tell, he is irreplaceable.

If the reference to contemplated expansion at the beginning of this letter sounded a bit cryptic, it is because discussions of future projects must be dealt with gingerly. It can be harmful to disclose details of negotiations in progress, deceptive to imply that whatever is cooking is sure to reach the dinner table, and unwise for a business to share its next

moves with a large audience. At the same time, this has been a substantial consumer of top management attention. And, given that some of the story has appeared in the press already, it makes little sense to pretend the matter is more secret than it is.

When I predicted last year that Plymouth Rock's next phase of growth would come from outside Massachusetts, I pictured a gradual shift of momentum toward other jurisdictions. We are now contemplating something less gradual. Our newest director, Peter Wood, and I have devoted nearly a week out of every month to discussing the future of personal lines insurance in the United States, and the conversation has never lagged. Peter is the entrepreneur who founded Direct Line Insurance and built it into the largest automobile insurance writer in the United Kingdom. Peter and I, in conjunction with Plymouth Rock, are now thinking of creating a new enterprise in those parts of this country where Plymouth Rock does not write. The business under consideration, which would be modeled upon the best of both Direct Line and Plymouth Rock, will require substantial financing from investors outside the current Plymouth Rock family. The prospects for Plymouth Rock's participation are exciting, and Peter is a world-class talent, but all else is uncertain. To count on launching an ambitious venture would be foolish, and to count on succeeding all the more so, but you can be certain that all involved are giving this their best shot. It is hard to imagine that anyone could assemble a team more ready for the challenge.



James M. Stone