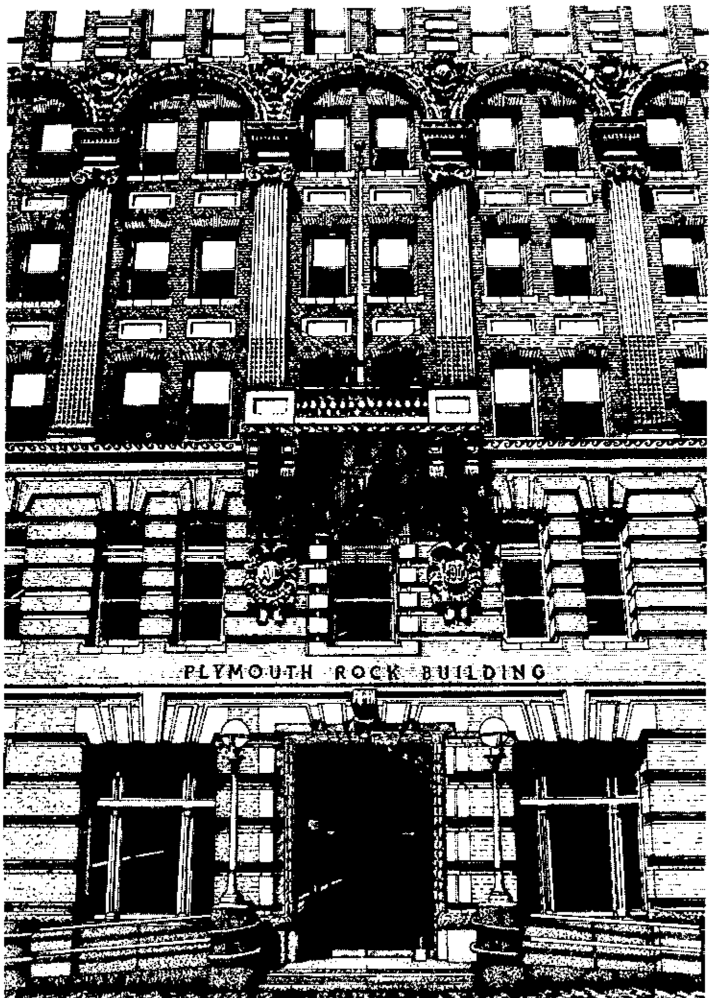
The Plymouth Rock Company



2003 Annual Report

The Plymouth Rock Company

695 Atlantic Avenue
Boston, Massachusetts 02111

Chairman's Letter

February 29, 2004

To Our Shareholders:

By virtually any standard, the year 2003 was the best our Company has ever experienced. Net income for the group in the year ended December 31 was $18.5 million, up more than 55% from the year prior. Internally generated growth in premiums underwritten or managed was a record $125 million. And, most important still, the Palisades reciprocal completed an acquisition that will more than double the whole group's scale in future years -- and with highly attractive risk-return characteristics. In calendar 2004, we should have total premiums, including those we manage, somewhat in excess of $1.1 billion. This last year was a fitting time to pass the billion dollar threshold, since the autumn of 2003 marked the twentieth anniversary of Plymouth Rock's first being licensed to write insurance.

Shareholders' equity at year-end, computed according to generally accepted accounting principles, stood at $130 million, which is $2 million below the equity at year-end 2002. The year-to-year change may appear inconsistent with the Company's profitability; the explanation lies in our payout of $25 million in the first quarter of 2003 to repurchase some of Progressive Corporation's shares in our Company. The per share numbers are not deflated in this manner. Stockholders' equity per share rose from $603 per share to $713 per share. Net income per share grew by 84%, from $53.65 to $98.84. The cumulative book value return on capitalization from inception in 1983 now stands at 17.6% per annum, no longer on the decline. Our GAAP numbers, as usual, tell only a portion of our story. Plymouth Rock's capital is obviously less than that appropriate for a billion dollar enterprise and our income statement, too, looks like that of a smaller company. The GAAP capital is less than one might expect because it omits entirely the quite substantial capital under the New Jersey reciprocal. GAAP also leaves out unrealized gains on our real estate portfolio and, with respect to our common stock investments in Homesite Group and Response Insurance, the value of our holdings in excess of their cost less a proportional share of operating losses to date. On the income side, we look smaller than a billion dollar enterprise mainly because the contribution of the New Jersey acquisition will take a full year to work its way into the numbers, and longer than that to shed its transition expenses. Even then its impact will be recorded on the top line at the scale of its management fees rather than the scale of the premiums earned. This understatement of your Company's true economic value is familiar to all of you by now, but as Palisades grows relative to the rest of the business, and success comes to Homesite and Response, the effects are increasing. I will do my best to provide a bit of the missing perspective.

Let me describe the acquisition straight away. A year ago last Fall, I received a call from an investment banker informing me that insurance and securities giant Prudential Financial was considering divestiture of its property and casualty insurance businesses. He said that he was confident of finding an interested buyer for everything except the New Jersey subsidiary, and he wondered if we would be interested in acquiring Prudential Property and Casualty of New Jersey, with annual premiums of about $520 million. When asked whether everyone understood that prices for companies in replacement carrier transactions were traditionally well below book in New Jersey, he responded affirmatively. Thus began nine months or so of intense negotiations, with Hal Belodoff leading our team superbly. Hal, Gerry Wilson and the others did a brilliant job of identifying and then surmounting the many obstacles along the course. In May, the deal was announced. The Palisades reciprocal was to acquire the PruPac of New Jersey group, and the three acquired stock companies, renamed the High Point Insurance Companies, would be managed for a fee by a subsidiary of the Palisades management company.

The purchase and many of the operating agreements required approval of the New Jersey Insurance Department, a department not known for lax scrutiny. The Department indeed applied a particularly high degree of rigor, befitting such a large transaction, and, while we occasionally found the level of scrutiny frustrating, I admit that this was more a reflection of our impatience than a justified criticism of the Department. The examination culminated in a public hearing held in Trenton in late September and, on Halloween evening of 2003, the Department issued its approval order; the closing with Prudential followed within minutes. Prudential has long employed its very effective slogan "Own a Piece of the Rock" in advertising its products. Well, after years of having been teased about how much smaller our rock was than theirs, Palisades actually owns a piece of their rock now, and we are thrilled. It came, moreover, with some highly competent people, including Jim Tignanelli, High Point's president. We heartily welcome Tig and his team to the Plymouth Rock family.

The shape of your Company is somewhat different since the New Jersey acquisition, and that calls for some thought about how its economics can be most clearly presented. The layers of data may be most transparent if one imagines the business not as its component corporations are organized, but as three conceptually different business elements. One is the underwriting of personal lines insurance business, the segment of the Plymouth Rock enterprise most completely reflected on the GAAP balance sheet and income statement. The second is the management for fee income of the same lines of business. In this segment, the fees are recorded as income when they are earned but neither premiums nor the bulk of the capital is permitted to be shown on the financials. The third is related to our investments. One of the ways I look at this element of profit is to compare our actual results with a hypothetical benchmark portfolio and consider the increment that the actual represents over the benchmark as the return on risk and skill. We could, for example, have met and exceeded industry standards of conservatism by keeping all of our investment assets in intermediate duration fixed income instruments of investment grade. A true believer in efficient markets, with no desire to diversify by asset class and no tolerance for additional risk, might think that a sound choice. Since we are believers in treating efficiency as no more (or less) than a rebutable presumption -- a starting point for investment thinking -- and we have a bit of tolerance for risk as well as a taste for diversification, our actual portfolio is more than a third invested in various types of equity assets rather than just fixed income investments. The gain we enjoy as a consequence of our deviation from the rigid fixed income standard is what I treat as our third business element.

The scale of each of the three components is as follows. Plymouth Rock Group's underwriting businesses include Plymouth Rock Assurance Corporation, Bunker Hill Insurance Company, and Mt. Washington Assurance Corporation. The gross premium volume in these three entities is about $275 million. This is more than $100 million greater than the premiums shown on the financials mainly because the income statement number is reduced by privately reinsured premiums, premiums ceded to the Massachusetts residual market mechanism (CAR), and the change in premiums written but not yet earned. The GAAP cash flow statement and Footnote 2F come considerably closer to tracking the full magnitudes of the underwriting businesses. The management businesses include Pilgrim Insurance and the Palisades Group, where High Point, Palisades Insurance Company, and Palisades Safety and Insurance Association reside. The total premium volume managed by our companies was $362 million in 2003, with High Point counted for only two months in that calendar year. Our estimate of the run rate for premiums managed, as we enter 2004, is close to $800 million. With the High Point acquisition, this has become the larger of our two insurance businesses by a substantial margin. Despite considerably lower potential per-unit returns on managed premiums than underwritten premiums, the managed business is likely to become your greater source of future profits.

Gains in the investment profit center are even harder to deduce from published numbers than those in the managed premium business segment. Since the contribution, as I define it, is equal to the difference between total return on the actual portfolio and the returns that would have been earned on a plain vanilla fixed income portfolio, and since neither the total return nor the plain vanilla benchmark is an element of GAAP accounting, one must do the work outside of the audited financials. The plain vanilla benchmark return on invested assets, which by this analysis belongs with the business results for the underwritten and managed business segments, has averaged 5¾% over the last twelve years. What we have made above that, whether reflected in the audited GAAP financials or not, represents the incremental profit. By Rick Childs' estimate, our actual total return is more like 8¼% for the same period. Don't look for too precise a number, though, because some of the assets in the calculation are evaluated at appraised values that may or may not prove accurate, and some are just educated guesswork. If the actual and benchmark numbers are close to the mark, the incremental 2½% or so per annum on our average portfolio balances over the period would have produced about a $60 million increment for the owners during the last decade. This is quite near Rick's asset-by-asset estimate, and I suspect it is about right. Even for those of us who live with compound interest calculations every day, the beauty of compounding can still inspire awe. The tax advantages of an equity portfolio, of course, make the true benefits of a portfolio like ours, as compared to a fixed income benchmark portfolio, even more substantial than the simple spread calculation reveals.

Plymouth Rock Assurance is the largest of the underwriting companies. While it did not quite meet its goal of keeping the combined operating ratio under 100% for the year (and thus ultimately paying out less in expenses and claims than it received in premiums), it had quite a satisfactory 2003. There is nothing magic, of course, about 100%. A combined ratio in the 90's is always better, and that is in fact what we aim for. A ratio of 102% -- the actual number for 2003 -- is a little worse than the target, but moderately elevated combined ratios can be tolerable when the costs have been well enough spent. In Plymouth Rock Assurance's case, much of the spending was related to its 2003 premium growth of over $40 million, more than in any year of the Company's history. The all-inclusive expense ratio, covering claim adjustment and investment costs as well as underwriting expenses, stood at 38%, which represents about a ¾ point improvement from the prior year's number. The bottom line was aided by a transfer of capital in the amount of $5.6 million from a company departing the state. Overall profit was $14.5 million, representing an 18.4% return on prior year-end capital. Premium in Connecticut approached $10 million this year, with an assist from our agency division (which is still quite profitably run by Don Southwick and now called Neighborhood Insurance). It may be a while before Connecticut premium catches any of the others, but I continue to see plenty of potential for us there. Connecticut independent agents used to be coddled by their carriers. Now they have to look harder to find a company -- like ours -- that values them so much.

Perhaps the greatest unknowable for Plymouth Rock Assurance is the future regulatory landscape in Massachusetts. Both the Governor and the Attorney General have pledged to make reform of the auto insurance regulatory framework a priority. It is not entirely clear why they have, given the explosive sensitivity of automobile insurance as a public policy issue and the fact that its politics have been so quiet for decades in this state. Auto insurance is always a volatile topic because it looks to many people like a large regressive tax: regressive in that the urban poor pay more than anyone else for the product; comparable to a tax because insurance is required before one can drive a car -- even when the ability to work depends on driving; and large because premium payments can require one of the largest annual checks that many households write. The political leaders may run some risk of waking a sleeping dragon -- but the political wisdom is for them to judge. We share their view that reforms can help make the system more competitive, and we feel well positioned to thrive in a competitive environment. At the same time, we have tried to emphasize to all who will listen that the bottom line tests of a good reform will not be met by press conferences announcing the entry of a few high profile insurers into the marketplace. The real tests of any reform are: whether it moderates price increases over time relative to the national averages, whether it keeps the residual market from growing, and whether it maintains a workable degree of fairness in relative rates, including those of urban drivers.

Reform will likely backfire and destabilize the markets if the price tag for luring new entrants into the state includes worsening the outcomes on these three tests. National statistics show that, since 1996, insurance premiums for the average Massachusetts driver have risen only 50% as fast as the U.S. averages. Our residual market covers about 7% of the vehicles insured, which is a good, safe number by national standards. In addition, Massachusetts has a successful and tested mechanism for tempering extreme geographic differences in good driver rates. The state's residual market credits prevent the emergence of a relative rate distribution that would be less fair, less affordable in the cities, probably unsustainable ... and could turn our customers against us. If reforms create more freedoms to innovate and compete, we will be happy with them. If they create political chaos, we ought to be able to weather that as well as anyone but uncertainties would abound. Stay tuned for news on this subject.

Mt. Washington Assurance, under Eric Neely's direction, had an improved year. The New Hampshire insurer operated close to break-even on a stand-alone basis, i.e. separated out of its quota share arrangement with Plymouth Rock Assurance, and it grew in annual volume by 23% to $19 million. Bunker Hill Insurance Company, our homeowners specialty carrier, had a less successful year. Under John Tierney's leadership, the premium volume has gone up and the Probable Maximum Loss, a measure of portfolio risk, has gone down. The expense ratio is 1.2 points better than last year's, a nice accomplishment given that processing and service measures are improving rather than suffering. Unfortunately, two terribly cold winters bracketed the 2003 calendar year and the loss ratio reflected the chill. Unusually high fire and frozen pipe losses contributed to Bunker Hill's showing a net loss of about two-thirds of a million dollars. I said last year that a homeowners writer should be earning 20% on its capital, after purchasing enough reinsurance to withstand the worst weather in a 250 year period. Bunker Hill is now a much sounder company by those metrics than it was a few years ago, but it has more work to do if it is to reach those targets.

In our insurance management segment, you already know the blockbuster news about High Point. The just plain big news is that the Palisades reciprocal is outdoing itself, too. Premiums written at Palisades Safety and Insurance Association and its subsidiary Palisades Insurance Company rose from $90 million to $160 million. The net after-tax income generated for the Plymouth Rock group by managing this business rose from $1.6 million to nearly $3.7 million. The business was run more efficiently as well. Palisades' all inclusive expense ratio was a full five points lower than the prior year's, and for the first time, below that of Plymouth Rock Assurance Corporation. If that doesn't impress you enough, try this. While the Palisades senior team was absorbed with pushing along the High Point acquisition process and handling their unprecedented internal growth, you might expect that service would have suffered a bit. Instead, we just learned from the New Jersey Insurance Department that Palisades had the lowest (best) ratio of valid complaints to insured vehicles among the thirty-two carriers writing more than 10,000 New Jersey cars in 2003. New Jersey Manufacturers, Chubb and USAA were second, third, and fourth, respectively, so the competition was not exactly made up of slouches. Next year, Gerry and Tig hope to elevate High Point, whose ranking as a Prudential subsidiary was a quite respectable ninth, to the top of that list as well. I said last year that

Gerry Wilson was determined to make New Jersey our largest and most profitable market. With his newly expanded New Jersey portfolio, he is assured of meeting the top line goal in 2004 and may soon be able to meet the bottom line goal.

As in Massachusetts, there is regulatory reform afoot in New Jersey. There, however, the dragon has not been asleep, and the problems of the old system were evident. The legislature and the McGreevey Administration have taken the dragon by its horn, and in 2004 there will be a long list of changes. Palisades is an active member of the Commissioner's Urban Insurance Task Force, and a representative of our group has been asked to chair a new Territorial Rating Commission. The underlying issues and standards for success are similar to those in Massachusetts, but the reform plans are further along in New Jersey and we are guardedly optimistic about where things are going. The state has expanded the leeway for expedited rate increases from 3% to 7% overall in any one year, begun permitting the use of credit as an underwriting criteria, and relaxed the rules that govern its excess profits tax calculation. More dramatically, the state says it plans to phase out the take-all-comers rules that make it very hard to turn down an applicant for insurance on grounds other than fraud. A note of caution is required concerning this phase-out. The whole value of the reforms can be undermined if ending take-all-comers causes a residual market explosion. Serious work on the part of the regulators and the Urban Insurance Task Force will be needed for this and other reasons if the state is to guarantee reasonable availability and affordability to all of its citizens. That having been said, Palisades and High Point will do all they can to help make the changes work -- as long as the playing field is level. Companies with our scale, talent, and service traditions can thrive on any level field and may in fact do better on the new one than the old one, which had accumulated too many ad-hoc repairs over the years.

Pilgrim Insurance is the smallest carrier in the insurance management segment of our business. Its new president, Ellen Wilcox, has left last year's issues behind her and she has nicely moved on to enlarge the business. Total premiums managed at Pilgrim are now just under $60 million, up 20% from a year ago. Net income was $1.6 million, the highest profit that company has ever reported. Ellen is hard at work now on broadening Pilgrim's offerings and expanding its footprint and revenue base.

That brings me finally to the investment segment of our business. SRB Corporation now manages well more than a billion dollars in assets, including our own and those of the New Jersey reciprocal and its subs, as well as Homesite's and Response's portfolios. Jim Bailey and Rick Childs continue to run a tight operation. Equity investment decisions are made internally, by Jim and Rick and me. Bond management responsibility is shared with Standish Mellon, a firm that has long provided investment services to us. The portfolio of fixed income securities, whose performance I consider at least as much an aspect of our insurance businesses as a test of the investment operation, had a total return just short of 3% in 2003, the lackluster number being a direct consequence of the low interest rate environment in which we find ourselves. We have little present desire to run a race against the markets in this portfolio. The risks at our scale of stretching for a lofty bond return are not justified by the potential rewards in this, the most efficient of the securities markets.

Strategic investments suffer from no such problem of efficiency. It is no trouble at all to perform in these investments very differently from the broad market indices, though doubtlessly far easier to underperform than to outperform. This has in fact been a promising year for Plymouth Rock's positions in Response Insurance and Homesite Group, our major strategic investment commitments. The headline at Response is that, after eight long start-up years in the red, 2003 was the direct response auto insurer's first year in black ink. The loss ratio, not long ago in the 90's, is now comfortably in the 60's, a level we would be happy to see it hold indefinitely. With help from acquisitions and some skillful belt-tightening on Mory Katz's part, the general expense ratio (not to be compared directly with Plymouth Rock's "all-inclusive expense ratio", which is a much broader measure of insurer costs) improved substantially, falling to about 25% from over 50% just a year or so earlier. The expense ratio has ten points to go before full efficiency can be claimed, but the current percentage costs should now be a ceiling, and profitability at moderate rates of growth should thus be attainable for years to come. One more sound acquisition could complete the drive to economic scale, so Mory and his team are still in the hunt. Response began the year 2004 as a $140 million company, counting the premium from its year-end purchase of National Merit Insurance Company of Seattle. Net income for 2003 broke through the break-even line to $1.4 million, and the trend looks as though it will continue into the year ahead. Response is now one of the hundred largest auto insurers in the country -- and *the* largest stockholder-owned national direct response insurer not part of a larger corporate entity. Its next tasks are to grow the renewal book to where its profits can pay for immodest growth, and to show that it can use those profits to gain high quality new exposures at suitable acquisition cost metrics. No one underestimates the rigor of the remaining course, but I am hopeful that the hardest stretch is now in the rearview mirror.

Homesite Group did not make a profit in 2003, but it had an impressive year nonetheless. The national homeowners carrier started the year with less than $40 million in premiums in force and ended it with around $100 million of premiums. This coming year, the rapid pace of growth should continue and Homesite expects to have at least $130 million in business on the books by year-end. CEO Fabian Fondriest strengthened his top operating team this year as well, with the addition of Doug Batting as Chief Operating Officer. Doug counts among his many accomplishments having been a highly successful CEO of Chubb-Canada -- and having been Fabian's boss at Chubb some years ago. Doug adds to Homesite's strength in many dimensions. As you know, Homesite gets its business through partnerships with companies which can acquire the business readily but have less desire than Homesite does to be a part of the homeowners insurance industry. Homesite's largest partners today include GMAC Insurance, Prudential Financial, Nationwide, Wells Fargo and our own High Point Insurance Companies. Watch for a new name next year; Homesite has a contract very close to signing. The net operating loss for 2003 will be about $11 million, down from $16 million the prior year. The number would have been better had we not paid our share of the California wildfire claims this summer -- but, then again, Homesite is in business precisely because such things are possibilities. If all goes as Fabian forecasts, progress in 2004 will bring that company much closer to break-even despite its extremely aggressive growth. Cash flow from operations is already positive, and Fabian's forecasts haven't been far from right yet.

The year gone by was a strong recovery year for the stock market, so it should not be too surprising that our marketable equity portfolio did well. The gain was over 30%, beating the Dow and the S&P indices by about two hundred basis points. While we are not confident that bargains abound in this market, we did do some selective buying of stocks already on our short list of approved equity investments. All of us would feel better about the markets without the specter of massive deficits ahead, and without the domestic and foreign uncertainties related to the menace of terrorism. The internal rate of return on all of our marketable equities since we started investing is a satisfying 23.5%. Owner-occupied real estate continued to fall during 2003 in appraised value, and we continue not to be concerned about it. The high cash-on-cash returns and the benefits of controlling our own space have made our office investments winners. We might even expand that portfolio if building prices in our areas of interest fall far enough.

One of our traditional strong points has been the hiring and retention of talented people. Good folks seem to like it here. We have, in fact, never had a better team of executives than we have now -- but, ironically, this is also the area of the Company where we need the most improvement. Part of the task arises simply from recently increased scale and complexity. A formidable team for a moderate sized company can often be lacking in some of the tools needed to do the job in a large enterprise. In addition, there is a greater requirement now for backup and for collegiality at the senior level. We are well staffed at the top echelon. In February of 2004, the Company entered into a new, long-term compensation arrangement with Hal, one which should reward him fittingly over its term for hands-on management at Plymouth Rock Assurance and partnering with me in running the group. Hal is, of course, a huge asset to us as well as a good friend. His having shown up in my office for career advice thirteen years ago was one of the Company's luckiest breaks ever, and I look forward to working with him for the rest of my career. Gerry and Tig, who run the largest of the other companies in the family, both tell us they have never been happier, and the affection is mutual. We are fortunate in our smaller companies' presidents as well. What we do not have is a roster of second-in-commands who can share the load with their presidents, brainstorm decisions that Hal or I would have discussed with them just a few years ago, or fill in for them if they were to be unavailable for any reason.

All of our major companies should have a number two that can play those roles, for the sakes of the presidents and for our sakes as well. None of the Plymouth Rock Companies presently have that job filled. Adding at least one senior executive at each of the major companies in the group is, therefore, a major assignment for 2004. One might argue that adding a person at this level is a bit too expensive and not really necessary, given the bench strength already in place. I strongly disagree. Over the years, I have seen companies hurt by many varieties of overspending. I have never seen a company damaged by adding one more smart and hard-working executive. We are looking for people with native intelligence, a good training in insurance, a high level of energy and ambition, a positive attitude toward work and colleagues, and, of course, unassailable character. We can offer them competitive compensation, an unusually nice corporate culture and working environment, and an exciting future in our still-entrepreneurial, still-young (but not so small) company.

James M. Stone