The Plymouth Rock Company

695 Atlantic Avenue
Boston, Massachusetts 02111

Chairman's Letter

February 12, 2009

To Our Shareholders:

History will record 2008 as the worst year for the financial services sector since the Great Depression. It is with considerable pride in our whole organization, and some measure of relief, that I can describe Plymouth Rock's performance in the same year as respectably decent. While our 13% return on equity may appear dull when compared with profitability in earlier years, there are lots of financial Goliaths out there who would love to have recorded double digit returns without parentheses. Our net income was $35.9 million, even after reflecting some unrealized losses on equity investments, and our budget projects a higher profit for 2009, a year already shaping up to be another harsh one for the economy as a whole. If the value of a business resides in its ability to generate long-term profits under expected conditions and its resilience in the face of adverse circumstances, Plymouth Rock's robustness in 2008 should send a comforting and positive message.

This is not to say that results were as we had hoped or that they were immune from the impact of the autumn market panic. Net income in 2008 for the group was 1.1% less than that of the prior year. Shareholders' equity rose by just under 2% after payment of our usual dividend to our shareholders in March and an extra dividend of roughly the same amount in December. Without these two dividends, equity would have risen by 7.6%. Book value is now $1,543 per common share, and the cumulative book value return over the full twenty-five years of Company operations is 18.4%, having fallen three-tenths of a point below last year's cumulative number. The year's top line was more encouraging than the bottom line. Where 2007 had seen our group's premiums underwritten and managed fall by nearly 4%, the total expanded by 4.6% in 2008 to $1.06 billion. Breaking the results into their largest sub-segments, I can report that our underwriting companies in New England taken together wrote $301 million in gross premiums during 2008, about $13 million less than in 2007, and our three insurance management companies handled $759 million in 2008 premiums, up by $60 million from the prior year. Since premiums in Massachusetts fell on average by 6% since the prior year, the New England dollar decline masks a small increase in policy count. The premium increase in New Jersey, where our reciprocal management companies are located, substantially understates the unit growth trends for the same reason. Both Palisades and High Point experienced net growth in insured exposure units.

I usually offer here a few key indicators to which I pay close attention but which are not readily discernable from our financials. The overall enterprise scale, stated above, of $1.06 billion combines premiums managed and underwritten, taken before reinsurance outlays. It is that number I prefer to use as a starting point for examining profitability. The ratio of net income to gross premiums written in the underwriting companies was 2.4%, significantly underperforming our 7.5% target for that measure. The return on gross premiums in the management companies was a much healthier 3.1%, against a target of 3.75%. In most years, these indices are more informative than traditional rate-of-return measures because our reciprocal management subsidiaries don't really need to keep capital on their balance sheets as an insurer would. These indices, moreover, are in some ways more interesting than ratios that can be computed from the GAAP financials, because the latter, by their nature, are designed to include only the reported numbers of those companies owned by the Plymouth Rock parent, and thus cannot reflect either the income or the equity of the reciprocal insurers that we manage but do not own.

This year the profitability comparisons raise a problem that we have not encountered before. Remember that the investment performance contributing to the results I talk about in this letter, whether measured by GAAP or estimated for economic impact, is only for our owned companies. Investment losses in 2008, or shortfalls against targets, thus are drags only on our underwriting companies' results. The New Jersey reciprocal family necessarily keeps its own balance sheets and income statements. The investment results for the reciprocals in 2008 were similar to those of our owned companies, since all of the companies in our family share the same investment manager, but these numbers are not included in the Plymouth Rock Company financials. Included instead in our numbers are only the results at the two New Jersey management companies, which were by and large unaffected by the stock market crash. The observed 2008 gap between actual performance and targets in the underwriting companies was shaped in part by falling equity prices that had no equivalent impact on our owned businesses in New Jersey. Had investment returns in 2008 mirrored our past track record, the underwriting companies would have earned 6.0% on gross premiums.

Investments this past year were, and remain now, at the front of virtually everyone's thoughts. For that reason, I would like to take the year's story out of its usual order and focus on the investments before turning to the analysis that underlies our underwriting and insurance management performance. The GAAP financials never tell the whole story, especially given our consistent focus on long-term total return. GAAP income statements quite properly reflect realized gains or losses from stocks sold in the current year even when the dominant price changes might have occurred in prior years. In our case, over $6 million of capital gains representing earlier year common stock appreciation was reflected in income for this past year. By the same token, income statements reflect only a portion of the year's changes in investment valuations for assets not sold. Diminutions in market values of publicly traded stocks are reflected only to the extent defined by OTTI (Other Than Temporarily Impaired) accounting rules, which are seldom triggered until a stock has been below cost for more than twelve months. Since most of the stock market declines in our portfolio, and in everyone else's, occurred in the final four months of 2008, the charges to 2008

net income are relatively small when compared to mark-to-market valuation changes. Reductions in the valuations of illiquid assets kept throughout the period, such as private equity and hedge fund interests, are reflected on the income statements under the equity method of accounting that we use only to the extent that fund managers estimate for us their net asset value changes. On Plymouth Rock's 2008 income statement, write-downs for private equity and hedge fund investments averaged 7%. Market value changes in our real estate holdings are not reflected in the GAAP income statement at all. The income statement shows investment income and capital gains of $16.1 million for 2008. Excluding premium finance income and interest on short-term loans, the reported number would have been $10.3 million. This implies that our investment portfolio produced about a 2% overall return. While this presents an accurate GAAP picture, it is not all you need to know. We didn't actually do anywhere near that well in economic terms.

Similarly, the balance sheet provides useful GAAP information, but it, too, tells only part of what an economic analysis of performance requires. The year-end balance sheet displays a reduction in Net Unrealized Gain on Investments in the amount of $15.4 million. Some of the decline represents the mark-to-market adjustments not shown on the income statement, but a portion of the change is simply a recognition of asset sales during the year and realization of the imbedded gains, which are then removed from this equity entry. There is no established audit standard for describing economic or total return results, but I will do my best.

Our bonds, representing just over half of the overall portfolio, returned 3.3% in 2008 on a total return basis. Our undiversified portfolio of half a dozen stocks, on the other hand, lost 31% of its value after the impact of dividends. While this performance beats the negative 37% total return of the Standard and Poor's index for the period, it drags our all-time internal rate of return on marketable common stock investments down to 16.3%. That is almost four points below the 20% cumulative mark we had previously been so proud of beating throughout our equity investment history. For internal measurement purposes, the investment team estimates that our hedge fund and private equity positions are down by 6%. While real estate is carried at cost on our financials, an educated estimate would be that the market values of our two office buildings (which we have neither a need nor a desire to sell) are down about 17% from what they were a year ago. On an economic basis, and in this case mirroring the statements, we estimate that we had a gain in the value of our Homesite holdings. Based on the year's results at Response Insurance, we made a downward adjustment to our valuation of that company as of year-end 2008. In the case of Response, of course, these estimates of value will be replaced by facts reflecting the actual transaction during the first quarter of 2009. Taking all of this together, my estimate is that The Plymouth Rock Company experienced about a $22 million pre-tax economic loss on investments in 2008, representing something like a negative 4.3% return on overall invested assets. That is nothing anyone would seek in the long run, but Jim Bailey and Rick Childs can join me in celebrating that we did no worse.

Those readers with good memories may be ready to take me to task for words I used in these pages last year. I described at that time with satisfaction that our portfolio was moving toward a higher concentration in equities and away from fixed income

instruments. Had we not moved in that direction, of course, our results for the year 2008 would be better. Since we make portfolio decisions for the long run and don't try to time markets, however, I'll stand by the thought. I hope in fact that we go farther in the equity direction as markets stabilize and bargains can be sought with a bit less risk of ruin. The lesson from the crash of 2008 is not that one should hold bonds, and surely not long-term bonds that hazard depletion by future inflation. The lesson is that investors should be wary of heavily leveraged businesses, of companies that wager on the continuation of upward trends in historically cyclical indices (such as housing prices), and of those that seek outsized gains trading complex derivatives in combinations with risk profiles and interdependencies even rocket scientists can't fully understand. Jim, Rick and I have always resisted the temptation to mimic the high fliers in our industry with respect to exotic investment strategies. No doubt, you have lost some available returns during the boom years as a consequence. In the winter of 2009, however, you should sleep better at night, as should our nearly 1700 employees, knowing that we are the rare financial company with a billion dollars in business that has no debt at all, never took on highly leveraged hedge fund positions, didn't trade credit default swaps or other complex instruments, and hasn't owned stock in any mortgage lender for twelve years.

Our two strategic investments in insurance companies went in divergent directions in 2008. Two years ago, I described to you a pending purchase of controlling interest in Response Insurance, a transaction that I thought would close in March of 2008, just after the completion of my 2007 letter. Much of what I said in that earlier letter has now turned out to be incorrect, and the transaction never occurred. Instead, Response was recently sold in its entirety to Unitrin, a Chicago-headquartered financial services company with an insurance subsidiary that directly competes with Response. I had long hoped that Unitrin Direct would become part of Response instead of the other way around, but the fates did not cooperate. Or, perhaps more precisely, none of us responsible for guiding Response ever found a path to business-building and brand-building that could work economically at Response's scale. Unitrin will have a better chance, given the greater scale of the combined entity, and it plans to continue use of the Response brand name, a decision I think wise. Although neither Plymouth Rock nor I will be an owner of the new Response, I wish it all possible luck and success.

Homesite Group continues to make progress as an independent company. One piece of good news is the addition of GEICO to the already lustrous list of partners who provide it homeowners insurance referrals. Progressive remains its fastest growing partner, and Homesite is thrilled to have good relationships with both of these direct response market giants. Total premium volume at Homesite Group has reached nearly $275 million on an annualized basis. I continue to predict that Homesite will someday reach the billion dollar premium mark. It may already be the industry's most impressive repository of homeowners insurance talent.

There seems to be a merry-go-round of attention-grabbing challenges in a business as large as ours. One horse at a time comes to front and center, carrying a trouble on its back, and, when it finally passes to the left and fades from view, there's another behind it. Regular readers of this letter will remember how unhappy it made Hal and me to learn that our flagship company, Plymouth Rock Assurance, was

underperforming its Massachusetts competitors in profitability. That's still the horse in the front of the carousel. This problem is not in the investment results, but in the loss and expense ratios. Hal and I have both devoted much of our energies in 2008 to remedying the situation. So did the underwriting team and much of the finance team. I can report some progress, but not enough. Plymouth Rock Assurance earned $5.6 million in 2008, but would have earned just over $15 million had this been a normal investment year. Its pure loss ratio was 62%, a few points better than budget, and its all-inclusive expense ratio was 41%, about the number it had budgeted. The combined ratio these numbers produce is not a tragedy but far from a triumph. Growth, on the other hand, was pleasing. In the first year of what is called "managed competition" in Massachusetts, Plymouth Rock Assurance was one of a very few agency companies to increase its market share. Our market share is now approaching 6%, a new historical high for Plymouth Rock.

With our Matrix systems project now complete, and CFO Bill Hartranft providing a new standard of oversight in spending, expenses have improved. Plymouth Rock is now near the middle of the expense pack for its Massachusetts agency peers, and the trend in the expense ratio is toward both absolute and relative improvement. Had it not been for four years in a row of premium reductions that shrunk the denominator, expense ratios would now be approaching long-term acceptable levels. This is not true for the loss ratio. Our low loss ratio used to be an object of envy, and, as recently as 2004, we still had the best loss ratio of the Massachusetts peer group. By 2007, however, our loss ratio had become worse than those of our most comparable peers. The loss ratio gap may have narrowed a little in 2008, due to a program of on-going improvements in our claims processes intended to reduce severities without disrupting fairness or service. It is too early to be confident about the extent of the loss ratio progress to date, but Hal and I can both see the necessary work being done. Plymouth Rock earned its stripes providing unusually good service, while simultaneously exercising disciplined and rigorous underwriting. We will need to concentrate, to push, to measure, to create, and to change until we are sure we are recognizably the best at these skills once again.

Connecticut and New Hampshire results continue to disappoint. The positive trend in Connecticut loss ratios we thought we spotted last year looks less clear now, and New Hampshire's loss ratio, while measurably better than Connecticut's, remains unsatisfactory. Premium declined slightly in Connecticut to just under $13 million, despite a new product offering and new agency appointments. That the Nutmeg State remains such a small part of our family may not be such a bad thing until we figure out how to run our business there more successfully. Our New Hampshire subsidiary, Mt. Washington, saw its business volume grow very slightly to $11 million, which is not enough to efficiently support the expenses of our Granite State operations. I described these states last year not just as beachheads for future expansion but also as laboratories for Plymouth Rock. That means they should be teaching our whole group lessons about underwriting, claims or marketing that we aren't learning in our major states. I'll repeat the assertion, but I am hard pressed to assure anyone that the knowledge gained in these states has been worth the costs of the ventures so far.

Our New England homeowners writer, Bunker Hill Insurance, improved by both top and bottom line measures in 2008. More sophisticated products, continued emphasis on account underwriting, and an expanding agency footprint contributed to modest growth in premiums. What would have been an excellent year was converted to a satisfactory year on the bottom line by an expensive mid-December ice storm in central Massachusetts. The resulting net income of $1.6 million on a base of $39.5 million in premium volume provided an unexciting 4.1% return on gross premiums. That is too little margin for any personal lines business but less attractive still in a business that carries with it catastrophe risk. Part of the problem is that we still over-buy reinsurance at the lower layers of risk and under-buy at the upper layers that protect us from unlikely but severe storms. A second part of the same problem lies in the way reinsurers price those upper layers. As I have often said before, I'd rather be a seller than a buyer of personal lines property catastrophe covers in New England. Expenses also remain a problem at Bunker Hill. Curt Troutman, a veteran executive at that subsidiary, is now the officer charged with making progress in expense reductions during 2009. Other than through Bunker Hill's share of the investment results, the crisis in the financial markets did not have an immediate impact on that company's business, but Bunker Hill plans some extra vigilance in 2009 with respect to homes that may have higher than normal foreclosure risk or declining maintenance.

This is a pleasing time for us in New Jersey. Gerry Wilson at High Point had his most impressive year with our companies, and Ed Fernandez at Palisades did as well. Their tandem success helps explain why our New Jersey operations came so close to meeting their near-term targets and enhanced their future prospects for years to come. In Gerry's case the successes were multiple, with repercussions beyond New Jersey. His number one challenge was to overcome the persistent falloff in volume from Prudential agents that has nibbled at our group's largest automobile writer each successive year for five years now. Prudential, of course, had never guaranteed that automobile insurance growth was to be a top future priority when that part of their business was sold to us. So Gerry came to High Point knowing that he would have to build additional sources of business to compensate for this trend. The optimal path, however, was less than clear. That is exactly why Hal and I asked Gerry to take on the assignment. He is creative, cooperative and driven: a nice combination.

We all agreed several years ago that Gerry should look for acquisitions to bring High Point growth in the short run, and innovative marketing and product design to bring it longer term expansion. At the close of 2007, High Point purchased a book of business from GMAC Insurance that brought us, after attrition, more than $15 million worth of new volume in 2008. That alone roughly compensated for the year's reduction in the volume provided by Prudential agents, so High Point had a little running room. Meanwhile, Gerry, Jim Tignanelli and their marketing wizard, Marc Buro, worked closely and effectively with Pru executives to redesign the growth incentives to cut the shrinkage from that source. We like the way that relationship is maturing. At the same time, they made great strides in building marketing channels independent of Pru and not reliant on purchases of other carriers' business. By the fourth quarter, new business by policy count was arriving from independent organic sources faster than it fell off from Pru, and 55% of all arriving business was from sources independent of

Pru or the purchased GMAC book. Taken all together, vehicles in force at High Point grew by nearly 2% for the year, a positive number for the first time since the High Point acquisition.

Growth by itself is never the whole story. Sometimes it takes extraordinary expenses to achieve expansion. High Point, however, managed in 2008 to accomplish it and still have the best all-inclusive expense ratio (a favorite measure of mine that, by combining underwriting expenses, claims adjustment costs and investment expenses into a single percentage of premiums, nullifies arguments about allocations) in our group of companies. Wearing his corporate hat, Gerry hit homeruns in the enterprise-wide ballpark as well. He led the group in the development of an innovative web marketing effort, which I firmly believe is an indispensible pre-condition to our success in the next decade. The consumer web interface will launch in 2009 at High Point and blaze a trail for our other companies to follow. Just as important, he is leading our whole enterprise's effort in the construction of a decision support database that will empower our talented people to support their insights with more powerful data usage than we have ever had before. Finally, and less noticeably to outsiders but much appreciated within our group, Gerry and his strong team have completed the integration of our largest acquisition into the Plymouth Rock family. High Point is a leader and not a follower in the teamwork culture of strong service, highly analytical thinking, and good citizenship that Plymouth Rock has tried to build through all of these years.

Ed Fernandez had an extraordinary year as well. Palisades had no shrinkage to reverse. It has been the only substantial independent agency company to increase its market share since rate competition was introduced in the New Jersey marketplace five years ago. Even in an environment of falling rates, Palisades was on a path to record growth by both unit count and premium in 2008. But the Palisades team didn't let it rest there. Ed and his officers led the successful purchase of a competitor and by year-end Palisades' personal lines auto insurance volume was more than 50% larger than it was at the close of 2007. In fact, Palisades is now the largest Independent Agency automobile insurance writer in New Jersey. Proformance Insurance had not thrived as fully as Palisades in recent years, and its publicly traded stock had fallen enough to discourage its owners. I admit to having been reluctant at first to engage in the purchase and privatization of a public company, but Ed was stalwart and found a way, working cooperatively with Proformance management, to meet every condition Hal and I imposed. It's a milestone for our group to have completed our first public company acquisition, and to have done so, apparently, without worrisome glitches. The Palisades officers will spend much of their energy in 2009 making sure that the integration goes smoothly, and it is well worth it. Proformance came to us at a price substantially less than its book value, even stated with an extra measure of conservatism on reserves. In this environment, the purchase may turn out to have been an important learning experience for our group. There are sure to be an increasing number of such bargains in a stock market so depressed.

As a consequence of the Proformance acquisition, on top of yet another solid year for loss ratio and expense ratio performance, Palisades contributed $7.2 million to our net income, more than twice the prior year's contribution. Once again, moreover, the

successes were earned with no diversion of attention from the quality of customer service. Palisades performed superbly in the New Jersey Insurance Department's ranking of companies by their ratios of valid complaints to vehicles insured. Palisades had no valid complaints and, as icing on the cake, once the acquisition was completed, Proformance had none either. Close behind Palisades' name on the list of meritorious company complaint records, by the way, was High Point's name. Among companies of significant size, our companies held two of the top handful of slots.

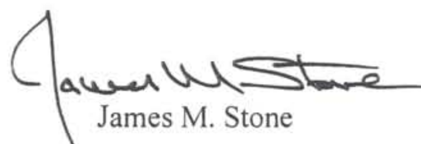
Pilgrim Insurance, which sells insurance management services to other insurers, had what is sometimes called a transitional year. It earned a smaller than targeted profit as it shifted its business model to accommodate the managed competition market in Massachusetts. Pilgrim was founded many years ago because Plymouth Rock had valuable expertise in dealing with the assigned exclusive agencies, called ERP's, that were central to Massachusetts' unique residual market mechanism. Servicing of out-of-state carriers' ERP assignments has remained a foundation of Pilgrim's business, although its president, Ellen Wilcox, has made steady progress in diversification. With Massachusetts now eyeing a national model and becoming an Assigned Risk state, ERP's will fade in numbers and importance. Ellen, therefore, has concentrated on new services, some of which are sold on a pure fee basis and do not involve the management of the whole premium dollar for the client company. Pilgrim signed up three new clients for services related to the new Assigned Risk Plan and several clients for claims and medical billing services in the Massachusetts voluntary markets. It is also exploring services for self-insurers of commercial auto. To thrive and secure its future, Pilgrim must replace its ERP focus with demonstrably superior expertise in another high-value-added field of insurance services.

In the shareholders' letter I wrote a year ago, I expounded a bit on the deficiencies in financial regulation over the last few decades and the systemic risks to which this laxity has exposed us. This year the evidence speaks for itself. The shame is that this current crisis, likely the worst since the Great Depression in human suffering and the most expensive ever in terms of cost passed on to our descendents for rescue and stimulus, never needed to occur. The economy could have weathered a turndown in the overheated mortgage and real estate markets without a catastrophe had there been a common sense rulebook in place for our essential institutions of finance. It is little short of amazing that some people today still want to preserve the "fruits of financial innovation" on Wall Street. Some temporarily inflated paychecks, and a crash to follow, are all the fruit that outsized leverage, unchecked scale and concentration, excessively complex instruments, and inadequate transparency can yield. I worry that the nation is now setting about to re-launch some of the damaged institutions, this time at taxpayer expense, without limiting the scope of activities we know beyond a reasonable doubt can endanger the financial institutions themselves, their counterparties, and millions of innocent bystanders.

Because I used to teach economics, I am frequently asked to predict what will happen next in the economy and the financial markets. My answers invariably disappoint. Here, by analogy, is the reason. Seventy-five years ago, in the 1930's, no one could explain hurricanes. By now, scientists have gotten pretty skilled at describing the physics of major storms. But it is still beyond the ability of the experts to predict

hurricanes much in advance, and no one can even begin to stop them. The abilities of economists in their field, where phenomena of mass psychology are paramount rather than temperature and pressure gradients, are similarly constrained, and for some of the same reasons. So many uncontrollable factors influence public and market moods in a crisis, and so many sensitive dependencies link the various drivers of outcomes, that prediction and cure are both elusive. Often the best prognostication one can do is to paint alternative scenarios. The nightmare scenario from here is one in which, at this time in 2010, people look back and say: The banks and brokers were bailed out, ditto the auto manufacturers; we had a stimulus package and a middle class tax cut; we ran huge Keynesian deficits; and interest rates were pushed toward zero -- but we are still in trouble. Confidence in that scenario could plummet well below where it is today. The best realistic scenario would seem to be that the passage of time, or those same tools, would gradually restore economic vigor, and paralyzing fears melt slowly into the past sometime during 2010. Any guess I offered about which picture better represents the future would be no better than that of any other interested citizen.

Last year I described it as disappointing that Plymouth Rock's net income was $36.3 million. This year, just twelve months later, I am gratified that the Company earned $35.9 million. The difference, of course, reflects the transformation of the broader economic climate. The Plymouth Rock Companies are not immune from external events but we are in an industry less vulnerable than most to recession. While our customers may slow down their buying of new cars when the economy is soft, they still insure most of the old ones. And they may drive less, especially during evening wining and dining hours, when a disproportionate share of the accidents occur. On the investment side, we will remain less vulnerable to market swings than some others as long as we stay sensible and conservative in our portfolio choices and eschew the temptation to copy those who pursue extra rewards by accepting unwise levels of risk. I have often told others, particularly advice seekers, that almost all successful business outcomes arise from some mix of ability, hard work and luck. I'd like to think your top executives have some talent and useful experience, and I am sure that the complement of men and women who back us up meet the highest standard of ability available in our industry. Hard work has, from day one, been an imperative for all of those who work here. We have never hesitated to make that clear before we hire someone. The third element of the mix, luck, you just hope for. Only a fool thinks that success perfectly tracks merit; only the vain believe it proves brilliance. In these troubled times in particular, let us be sure that Plymouth Rock never slips into complacency or takes any blessing for granted.



James M. Stone