The Plymouth Rock Company

695 Atlantic Avenue
Boston, Massachusetts 02111

Chairman's Letter

February 15, 2013

To Our Shareholders:

After a few disappointing years, all signs were pointing toward a healthy turnaround in 2012. Then along came Sandy. The Frankenstorm, as some meteorologists called it, hit New Jersey brutally, changing many lives and our results for the worse. In a period of no more than twelve hours, wind and water caused as much as $50 billion worth of damage in New York and New Jersey. We don't insure in New York, but our share of the Garden State claims and associated expenses reached a whopping $108 million on a gross basis. We can thank goodness for strong capitalization, wonderful staff, and solid reinsurance protection, but those blessings couldn't prevent our consolidated group's suffering its first losing year since 1984, the year when we wrote our very first policies. Consolidated pretax income and comprehensive income were both positive for the year. But net income on a fully consolidated basis, including the managed reciprocals, was in the red -- a loss of about $3.9 million.

Due to our unusual structure, the earnings of the reciprocal group we manage in New Jersey do not directly or immediately affect the profits of the shareholder-owned company. The Plymouth Rock Company earns investment income, a management fee in New Jersey, and any underwriting profits thrown off by our New England operations. None of these three income sources were hurt by Sandy's aggravated assault. In fact, we had quite a solid year with respect to both investments and our New England underwriting businesses. The Plymouth Rock Company's earnings, as a consequence, rebounded from $28.7 million to $48.0 million, representing a 12.8% income statement return on December 31, 2011 equity. Book value, had we paid no shareholder dividends in 2012, would have grown by over $52 million, among the largest increases in our company's history. That increment corresponds to an effective return on equity of 14%. Plymouth Rock's accumulated book value, even after dividend payouts, rose by 8.3% and now stands at $2,215 per common share. The cumulative book value rate of return over the twenty-nine years of the Company's history, taking account of both shareholder dividends and accumulated equity, is 18.1%, down one-tenth of a point from the last reported cumulative number.

As you can plainly see, this past year brought mixed news. The group loss is surely bad news. Worse news is that the volume of business written by the New Jersey reciprocal shrank considerably. The number of automobiles our group insured in 2012 in that state is 10% below its level a year ago; this translates after rate increases to an 8% fall in premiums written. The vehicle count is down 24% from just two years ago, resulting in a two-year premium drop of 15%. Reductions of volume at this magnitude, if allowed

to continue, would inevitably diminish the value of our whole enterprise. The good news begins with the shareholder gain, but also encompasses the New England results. Our insurers in the north are doing better than they have done in quite a few years, with every prospect of continuing that success into 2013 despite a winter blizzard.

The bad news stories deserve first placement. Sandy was plainly the most dramatic event of the year. The weather in the northeastern United States had been favorably mild for just shy of ten months in 2012, but in one long night, on Monday, October 29th, the whole year's place in history changed. A disturbance that began as a relatively typical Atlantic hurricane in the Caribbean joined with a wintry storm coming down from Canada, the low pressure of the latter pulling the hurricane towards land and increasing its power when it would otherwise have dissipated over the cold waters of the North Atlantic Ocean. Sandy made a left turn just where the graveyard for most coastal hurricanes beckoned from the right. The storm hit the shoreline, moreover, during a period of full moon tides, which greatly increased flooding. One top academic expert has described this triple confluence as a 1-in-800 year event. Damage in New Jersey was immediate. Houses were bombarded by direct winds and flying tree branches; cars were salt-water flooded; and electricity failed at power stations and along transmission lines serving millions of residents. As the fates would have it, though, just hours before Sandy slammed into the shores of New Jersey, the National Weather Service reclassified it to Post-Tropical Storm status. The causes of the downgrade had no discernible mitigating impact on damage, but a huge impact on homeowners claims costs. Most of our New Jersey policies carry deductibles for the first dollars of wind losses from a hurricane, but these could not be applied because Sandy was no longer officially a hurricane as it struck New Jersey. The gross losses our companies paid as a result of Sandy would have been at least $40 million less had the deductibles been applied. The consolidated profit for the Plymouth Rock Companies would presumably have been written in black ink had the storm not been downgraded.

The damage from Sandy was also persistent. Nearly two weeks went by before most everyone had power again, while completed repairs to homes and replacement of flooded cars often took a month or more. For the first week or so, our own employees, even those with undamaged residences, had limited access to their offices, and the gasoline required for their commutes was hard to come by. These were the conditions that inspired Plymouth Rock of New Jersey's finest hour. The company provided free hot food for all staffers, a bed for those in need of one, and, for their out-of-school children, day care overseen by simultaneously out-of-school teachers. Gerry Wilson and his team even arranged for a gasoline tanker truck to drive to Red Bank and create an improvised filling station of sorts for employees who had vital services to perform for the community. For our customers, our team organized a massive social media effort to reach out to affected policyholders, initiated on-site rapid response appraisals in hard hit towns, sponsored a one-stop "Resource Recovery Day" with representatives of numerous relevant agencies and types of service providers, and even gave out holiday turkeys to the longest-suffering storm victims. We are very proud that the men and women of Plymouth Rock, including those who pitched in from New England, rose to insurance greatness in this crisis. I sincerely doubt that any of our competitors matched our speed of claim settlement or level of teamwork and service.

The issues related specifically to Sandy, we hope, are in the past now. We will revisit our reinsurance protection, though I doubt I would change much given the costs and benefits in covering such unlikely events. We can tweak our disaster recovery protocols at the margin, although Hal and I found many more pleasant surprises than unpleasant ones as we watched the recovery procedures implemented under circumstances that mercilessly tested their robustness. The more chronic New Jersey issues are not yet in the past, and these issues matter more than the 2012 financials can display. As I have so often said, there is only short-run immunization for the shareholders when the reciprocals underperform. Our managed enterprise in New Jersey was already hurting on the top line, and just recovering on the bottom line, when 2012 began. The problems on the bottom line were traceable in part to reserving inadequacies of our own making against a background of unusually escalating statewide no-fault coverage costs. It is in single state disequilibrium situations like the New Jersey no-fault eruption that we feel the pinch from being such a geographically concentrated company, a feature that has always served us well along the service dimension. A fifty-state carrier can ride out a cost crisis in any one state more comfortably than a tightly focused insurer. We felt an absolute need to raise our automobile premium rates decisively. Knowing that there would be a trade-off between profitability and volume, we judged profit restoration to be more essential than volume maintenance. A company can, within limits, grow and shrink in response to fluctuations in its environment and still thrive over the long run. Without profits, it puts its reason for being in jeopardy. Prices were raised and, absent Sandy, Gerry and his team would have been able to boast gains once again this past year. Volume fell, which was directionally as expected, the only problem being that it fell more than any of us liked and more than for our peer competitors.

The impact of insurance price changes on customers is always difficult to calibrate in advance. Overshooting and undershooting are endemic risks in such a complex system. One never knows precisely how much of any rate filing request will translate into actual average premium increase because customers, by their actions, have as much say in that as companies do. Nor can one be sure how much change will cause a customer to leave loyalty behind, overcome inertia, and shop. Gerry, Hal, and I have no regrets about having leaned toward profits and thus risked volume, even if we might have turned the dials differently to avoid some of the sticker shock given perfect hindsight. We could (with bold mendacity) claim to have been geniuses and suppressed the volume intentionally because we somehow foreordained that 2012 would be a losing year for the New Jersey insurers. The direct loss ratio for Plymouth Rock in that state overall was 76% this past year. Without the Superstorm, it would have been a healthy 60%. Given Sandy, it was fortuitous that our writings were downsized, not only because the losses would have been proportionally greater at larger scale, but also because the reductions in volume turned out to match the storm-related losses in capital and thus kept our statutory ratios of premium to surplus at healthy levels. We were in that sense lucky to have shrunk, but enough is enough. The underwritten and managed gross premium volume for our entire group was dragged down by the New Jersey shrinkage, to the effect that total premium volume at yearend 2012 was $1.04 billion, down by $22 million from the equivalent count at last year's close. With rate shock finally behind us, we trust, we would now like to restore the New Jersey volume.

The headwind that operates against volume growth in New Jersey remains the success of

the competitive direct response writers there. Direct response insurers, who had avoided that state until recently, have recently snatched up more than half the vehicles previously written by independent agency carriers, pushing New Jersey to the far corner among the fifty states in terms of low agency market share. If national logic holds, the shift should be largely over by now, but New Jersey is already an outlier so no one can be certain. Sandy, ironically, may provide the tailwinds we are seeking. Our companies already have a reputation for fine service, as illustrated by our continuing excellence in the New Jersey Insurance Department's published complaint ratio data and amplified by standout performance in the aftermath of the storm. Now, we have to hope that the competition over-learns the lessons of Sandy and reactively puts the screws to the property insurance markets in the extended neighborhood of the Hudson River. Plymouth Rock Assurance will remain open as a source of homeowners coverage for our New Jersey automobile insurance customers, regardless of the proclivities of the competition. Give us both the auto and the homeowners policies, and we've got you covered. Gerry foresees a profitable 2013, with those bleak volume charts flattening out by the time the year ends.

The report on our New England business stands in welcome contrast to the New Jersey story of recent years. After a decade of inadequate performance in our home state, the Massachusetts carrier is now prosperous, ambitious, and primed to set new marks. Chris Olie presided over a profitable year in auto insurance, with a combined ratio of about 98%. This was also a year of growth, with the company's Massachusetts market share in our oldest line of business having risen from 5.6% to 5.8%. More than that, the Bay State carrier has built out a good part of its underwriting analytical staff. Years ago, we were able to boast that our sophistication in underwriting mathematics gave us a durable comparative advantage over our local peers. We inadvertently permitted that lead to dissipate as we concentrated elsewhere, but we are recreating it now and I expect it to pay handsome dividends. At the same time, we are constructing an Internet expertise that can also provide a competitive advantage. I have made no secret of my view that Internet skill will eventually be required for the very survival of an insurer, but for now the youthful state of the web provides more opportunity than danger. Chris has overseen growth in our Massachusetts eSales premium into the seven digits and the launching of an Agent Quote Marketplace that should allow us and our agents to monetize Internet quotes that do not convert immediately to Plymouth Rock policies. It is a source of no small pride that a number of our agents have described us as the clear leader among Massachusetts agency carriers on the path to effective Internet commerce.

Our New England homeowners writer, Bunker Hill, came off a bad weather year in 2011 with an almost unbelievable bounce. The unusually gentle Massachusetts weather of 2012 allowed that company to replace its 127% prior year loss and loss adjustment expense ratio with an equivalent number 82 points lower. One good year, though, does not a good business make. I still have concerns about the homeowners business in the long run. Climate change is an uncertainty, while low decadal risk-adjusted returns on capital, after provision for fully prudent reinsurance levels, have been a certainty. On the other hand, homeowners insurance is important to our agents in completing the personal lines menu. Homeowners premiums, moreover, have been rising more sharply in recent years than in the past, while they have been relatively flat for a decade in automobile insurance. Account-writing, where companies within our family sell both products to a customer also increases persistency and seems to reduce automobile loss

ratios. Worries notwithstanding, therefore, Hal, Chris, and I are comfortable to see Bunker Hill expand its homeowners appetite -- but only where our group also has the customer for automobile insurance. Bunker Hill shed some stand-alone homes in 2012, and thus ended the year about 5% smaller than in 2011. The trimming will continue in 2013 but it will be largely balanced by new homeowners volume, matched with insured auto writings. We would be unrealistic to expect a repeat of the 2012 loss ratio.

Pilgrim Insurance, our Massachusetts insurance services provider, is shrinking as the residual market for automobile insurance in Massachusetts continues to contract. This downsizing of the market of last resort is a sign of overall industry health, but Pilgrim is a caregiver of sorts and does best when the other carriers need external assistance. Its revenue is down by 17% from a year ago. Profits under Bill Hartranft's able leadership continue to be strong, at just over $3 million, but if Pilgrim's service business is to grow it must find new sources of client revenue. New Jersey, where Pilgrim is licensed but inactive, is a possibility. Encharter, our subsidiary that invests in and operates insurance agencies, has ambitions to be the model for an agency of the future, fully utilizing all the tools of the Internet age. It has yet to translate its pioneering into large scale, but this task is noticeably rising on agendas here. Mt. Washington Assurance, headquartered in New Hampshire, recovered from a poor year in 2011 to achieve a pure loss ratio in the fifties, but its writings remained flat. Its profit levels are acceptable at the margin but are scarcely noticeable in our group results. I promised you that we would try again to rev up Connecticut. The results so far look promising, with volume on the rise and an accident year loss ratio under 70 points, but it will take a few more years on this track to see if Plymouth Rock's Connecticut writings can become a meaningful factor in that state's insurance industry or in our own enterprise's results. It would be a profoundly satisfying victory if that came to pass.

This was a better year for investment results than the prior two. Considering all classes of investments together, the economic return on the entire portfolio was in excess of 6%. The marketable equity segment of the portfolio, which has generally outperformed the indices in most years, did not keep up with the 16% Standard & Poor's gain this year, in part because we nearly doubled that portfolio's size near year-end (at the expense of our parent company's bond holdings), and thus suffered from the case of Fiscal Cliff Fever the market caught during the last days of December. It was not, moreover, a stellar year for blue chips in general -- and blue-chip chip makers in particular. Our worst performing jumbo-cap stock was Intel. Still, we are quite happy with our undiversified stock portfolio, whose component securities one can still number with a single digit. While the internal rate of return in the new millennium on our stocks is lower than it was during the long boom period of the 1990's, a twenty-year internal rate of return on marketable equities of 15.4% is snappy enough to be a source of satisfaction. The S&P return, which generally approximates the dart board return and slightly exceeds the mutual fund industrywide return, was by contrast under 11% for the same period.

Bond returns were once again expectedly skimpy, which is all that is possible for a fixed income portfolio on which we refuse to take significant credit or interest rate risk. In the prior year, our bonds gave us a tax-equivalent return, with both coupon and price changes considered, of about 4%. This year, as bonds of older vintages matured and were replaced with even lower yielding equivalents of more recent issuance, our yield

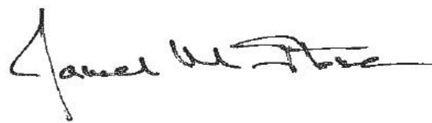
predictably fell, and the equivalent total return is today more like 3.7%. As you are very well aware, I have never been a fan of holding bonds, which have slightly poorer risk-return characteristics than stocks in many periods -- and grossly worse characteristics in a period of petite yields and hefty inflation risk. We sold the bulk of the Plymouth Rock parent company's fixed-income holdings during the year and, with an eye to available dividends as well as capital gains potential, have replaced those bonds with various equity holdings. Encouraged by Federal Reserve policies, the low-yield environment for short and intermediate bonds seems likely to endure. We will examine carefully, within what rating agencies and regulators find prudent, whether our insurance company bond concentrations can be reduced, at least to some degree, in 2013.

Plymouth Rock's relatively illiquid investments with equity characteristics, including hedge funds, private equity, and real estate holdings, had an especially strong year. Our economic gains in this category averaged somewhere north of 15%. This includes increases in real estate appraisals, which are reflected in neither reported income nor equity. Homesite Insurance Group, in which Plymouth Rock and some of its officers are investors, had a trying year once again. Its premium levels, like those of its competitors in the national homeowners line, are rising faster than at any time in recent memory but have not fully kept pace with historically abnormal weather-related events. Though Homesite finished the year barely above a pretax breakeven, we continue to believe that the company will succeed. Homesite has gathered by now the most skilled collection of homeowners executives in the nation, passed half a billion dollars in revenue, and created a track record of valuable service to its corporate partners, many of whom write automobile insurance but have less (or no) appetite for the accompanying homeowners. Homesite is concentrating these days on raising its rates to match the weather-driven claims results. It has a wonderful opportunity, but it almost goes without saying that it must resume full profitability soon if our investment's value is to grow.

I was asked recently by a reader of this letter whether I was planning to write again about excesses in the derivatives positions of the largest financial institutions. Without endorsing her characterization of my comments on this topic as rants, I admit to having devoted considerable space to derivatives. I could surely do so once again, since neither the boards of directors of the banks nor their government overseers seem yet to be fully cognizant of the individual and systemic hazard inherent in oversized positions or willing to mitigate them. On the other hand, I have little to add on that matter right now, and there is at this time another, more hotly debated, policy subject that deserves some thought. It has been recognized by both major political parties that the burden of the national debt being passed to the young and the unborn is an increasing threat to the country's future. At the same time, the economy, while improving, is still far short of operating at full potential. My party, against this backdrop, has so far been loath to limit entitlement programs that are plainly imbalanced over the long haul, while the other major party has shied from stimulus measures that could revitalize the economy now. Our top leaders are able, and they surely appreciate that there is a logical path back to prosperity and a sensible deficit posture, but they apparently lack the legislative support to lead us there. If this nation wishes to reduce its debt load, it should trim defense spending, temper Medicare costs (perhaps through means-tested copayments), and postpone or reduce retirement obligations (a necessity when lifespans and birth demographics vary so greatly from their patterns in prior decades). Those items, and

only those, carry large enough costs to make the requisite difference in the debt. Yes, this should be done with a close eye to national security and humane considerations as well as frugality, but that too is within our grasp if a little imagination and flexibility can be brought to bear. An assurance that the debt has been set on a pronounced downward course over the long horizon could then permit what would be, by comparison, a small increment to short-term stimulus expenditure, aimed principally at upgrades to our stressed and under-maintained infrastructure. I am no pessimist about the future for the United States in this century. Our country's lead in economic creativity is robust, and its competitive outlook still looks rosy to me, even accepting that we cannot forever maintain a nearly 20% share of world GNP for less than 5% of the world's people. It is embarrassing, though, that the road forward has lately become impeded by problems of factional politics that exceed historical norms.

There are a few topics from last year's letter that call for updates this year. The largest is the question of whether climate change represents a serious and continuing threat to the insurance business. The past year was apparently the warmest ever recorded in the United States. The unsettling, costly uptick in hailstorms throughout the central U.S. of recent years persisted. Nothing, however, brought clarity to the picture. It is impossible to tell if these patterns are temporary spikes, new norms, or the inception of some still-to-worsen trend. Although some may disagree, I see Sandy's occurrence as adding no useful evidence about planetary climate. What I do see, however, is enough of a concern to encourage that Plymouth Rock move further toward the cautious end of product offerings and prices for property coverages. The last annual letter also discussed an enterprise-wide systems alignment project under Hal's direction. Among its goals is to ensure that our now disparate automobile insurance offerings in the various states migrate to a common platform. The increase in product uniformity will allow the whole enterprise to share the benefits of analytical research wherever located, to cut the costs of product maintenance, and to expedite updates for pricing and tiering changes. That project continues apace, with implementation expected in this calendar year. Finally, in last year's message, I invited data wizards and modelers to apply for Plymouth Rock jobs. The analytical underwriting staff is being built out nicely, but there are still positions open. You can contact me directly (jstone@prac.com) if you know someone who would be a good fit. The right person could have an opportunity to help establish the most innovative analytical shop in the insurance industry.



James M. Stone