

The Plymouth Rock Company
695 Atlantic Avenue
Boston, Massachusetts 02111

Chairman's Letter

February 24, 1994

To Our Shareholders:

This was the first year in which senior management devoted more than half its time to businesses other than Massachusetts personal lines, although Plymouth Rock Assurance Corporation, where those lines are written, produced more than 98 percent of the group's net income. The future may prove this a misallocation of effort, but it is not inadvertent. If, as I suspect, we are near the peak of a regulatory and economic cycle for Massachusetts auto insurance, it is the nurturing of our newer businesses that can permit a continuation of the Company's high rates of return in the second half of this decade. The year's fine results should not obscure the dangers ahead for Plymouth Rock Assurance Corporation, but, by the same token, the modest 1993 returns in our other operations should not mask their potential.

Net income in 1993 for The Plymouth Rock Company as a whole was \$11.9 million, up from \$9.8 million in the prior year. This represents a rate of return on prior yearend equity of 27 percent. Over the five year period since 1989, net income has grown at a compound annual rate of 31 percent, and return on equity has averaged 24 percent. We are proud of this record, since some of the gains came from good planning and hard work on the part of our management, staff and agents, but we thank good fortune as well. Plymouth Rock's consolidated equity, which was barely a million dollars ten years ago, is now \$55 million. Wherever permissible, moreover, we tend to be conservative in the statement of our results. This conservatism, along with a debt-free balance sheet, allows us a measure of comfort as we continue to incur a quite considerable measure of business risk.

The Plymouth Rock family now includes personal lines insurers in Massachusetts and New Hampshire, a reciprocal writing similar lines in New Jersey, a risk management and brokerage firm in Boston, and two service companies. Together these enterprises have created over 300 jobs. In addition, since last October, we have owned a minority interest in a Bermuda-based catastrophe reinsurer.

The New Jersey operation is the largest of the new enterprises. Palisades Safety and Insurance Association, a reciprocal insurer, was formed in 1992 as the replacement carrier

for a company exiting New Jersey automobile lines. The reciprocal, a membership organization owned by its policyholders, is managed by what is called in the statute an "attorney-in-fact", a curiosity of phrasing whose origins are lost to the living. The attorney-in-fact for Palisades is a stock company owned and controlled by our group. Reciprocals are an arcane form of organization, unique to insurance and unfamiliar to most people, so I am often asked why we did not go into business in New Jersey as a stockholder owned company or as a mutual.

A reciprocal is similar in some respects to a mutual company, but there is one critically important distinction. A mutual is operated by its own employees, whereas a reciprocal has no staff and is managed by the attorney-in-fact. The founders and managers of a mutual have no ownership stake in their company's success, while the creators of a reciprocal can at least have an ownership interest in the attorney-in-fact. We think the mutual form in general is a questionable arrangement for linking the interests of owners and managers or promoting efficiency. At the very least, it is unattractive to us. We have every desire to profit if we do a good job for the people of New Jersey, and the ownership of the attorney-in-fact should allow us to do just that.

The stock company format, while not lacking in incentives, was imperfect for other reasons. It might have been tougher to get approval for transferring capital to our own coffers than to the policyholders. It would certainly have been more difficult, in a stock company environment, to obtain the written assurance of the Insurance Department that the Plymouth Rock group in no way guaranteed the results of the new venture. And the reciprocal structure was beautifully congruent with our basic goal in New Jersey, having the policyholders feel a sense of belonging to a membership organization or club in which drivers who did all they could to make driving safer would enjoy the benefits of their choices.

New Jersey premium volume was minimal in 1992. By the close of 1993, it was about \$15 million. Most of the growth came from taking over the New Jersey auto business of American Reliance, a fine old company that was impaired by Hurricane Andrew and needed to divest itself of that line as part of its rescue plan. The growth allowed us to meet New Jersey's residual market depopulation quota, and launched us in the direction of sustainable scale. We still have a way to go, however, before we enjoy scale economies. I recall that, in our first discussion with the New Jersey Department, the Commissioner and I both picked \$40 million in volume as an estimate of what it would take to operate at full efficiency. So goal number one in New Jersey is to keep growing. Hal Belodoff has assembled a remarkable Agents Advisory Committee to help him expand his force of independent agents. If that works half as well in New Jersey as it did in Massachusetts, and if the competitors in New Jersey continue to demonstrate less and less appreciation for their agents, additional growth should be on its way.

With growth will come a reduction in the expense ratio. Measured to include both investment expenses and loss adjustment costs, Palisades' gross ratio of expenses to premiums was an unsatisfactory 65 percent in 1993. As in Massachusetts, the New Jersey goal is to move the expense ratio all the way down to 35 percent of premiums someday. This target, incidentally, is two points more ambitious than the one I set in the 1986 Annual Report and have frequently cited since that time. The whole industry is now on an expense reduction drive, and we will need to be even more frugal to stay ahead of the pack. Palisades has set 46 percent as an expense ratio objective for 1994. I hope good sales and careful cost management allow them to better this mark.

Excellent loss ratios, of course, do not come automatically with growth. Our target for the loss ratio in New Jersey is to be under 60 percent. Progress on this score is encouraging. The book of business acquired from American Reliance seems to have a loss ratio just a little higher than this, but the new business coming in from agents Palisades has recruited is better than the target. In addition, the 1993 loss ratio of 68 percent includes the impact of temporary state assessments to cover the deficits of a defunct residual market system and a private reinsurance charge specifically reflective of startup status. Both should move in our favor as time goes on.

The reciprocal inherited \$16 million in capital at its creation. At the time, I predicted half of that would be consumed in launching a successful enterprise. Whether we can keep to this forecast is still an open question. If the reciprocal has pre-tax losses totaling \$12 million before it turns profitable, and then gets back \$4 million of that sum in tax benefits, the goal will have been met. By the end of 1993, Palisades had accumulated pre-tax losses of \$6.6 million. Hal and Keith Rodney, who serves as Palisades' board chairman, think they can hold next year's loss on this basis to less than \$2.7 million, while actually operating at a profitable rate by the final quarter of 1994. They will deserve a cheer if they can accomplish this, since that would better my original prediction.

While making money in the reciprocal is not the same as having the Plymouth Rock group earn a profit from its ownership of the management company, the two are certainly linked. In 1993 the management company, which is the only part of the enterprise we reflect in the consolidated financial statements, lost \$118,000. We hope that someday it can contribute several million dollars to our annual net income, but that will occur only when the reciprocal and its members are prospering as well.

In New Hampshire, where Peter Jones was hoping to reach break-even in 1993, we are leaving the champagne on ice. Net losses for the year at Mt Washington Assurance Corporation decreased from \$516,000 in 1992 to about \$250,000. This is half the distance but not a touchdown. Bill Kelley, Mt Washington's chairman, and Peter now project the same course as Palisades: reduced operating losses in the first part of the year, an operating gain in the final months, followed by a full year gain in 1995. That would be

just fine. Premium volume in New Hampshire is now about \$7 million. While economies of scale there are probably available at a smaller volume than in New Jersey, Mt Washington will still need at least \$25 million in premiums to reach an acceptable expense ratio. The small population of New Hampshire and its relative regulatory calm make growth more of a challenge there than in Massachusetts or New Jersey.

There were no great surprises this year for the three businesses that comprise our Boston service cluster. SRB Corporation made a small profit on its sale of investment and data processing services. Pilgrim continued to earn its slim but steady profit providing first-rate service to other insurers. Boston Risk Management lost a little money as it continued to hunt for its path into the alternative markets world. Taken together these three companies contributed about half a million dollars to net income, a little more than the combined losses of Mt Washington and the Palisades management company.

The newest business involvement for our group is Centre Cat Limited, one of the Bermudian reinsurers formed last year to fill a widely acknowledged gap between the supply and demand for catastrophe coverage (hence "Cat") in the wake of Hurricane Andrew. Andrew, a storm that raised both rates and consciousness, came just as Lloyd's of London, for entirely independent reasons, was moving into a retrenchment mode. The market responded quickly, and more than half a dozen new carriers were born. Centre Cat, whose formation was led by Morgan Stanley with Zurich Re, Centre Re, Chubb, AT&T, General Motors and Chemical Bank as the other major owners, came into this world with an initial capital of \$312 million.

Plymouth Rock, the only small investor, owns less than one percent of the equity. I serve, however, on Centre Cat's board with enthusiasm. The distinguishing feature of the company is its uncompromising commitment to scientific underwriting. Unlike some of its competitors, who see risk selection as a business of hunches, instincts and keenly honed insights, Centre Cat believes that the underwriting of property catastrophe insurance can be analytical and mathematical. The management was selected with that view in mind. While there is always some degree of luck in the cat business, and thus I can not regard our investment as a guaranteed winner, I am confident that Centre Cat will hold its dependence on pure luck to as low a level as any participant in its industry.

Of the total net income for 1993, \$11.8 million was earned at Plymouth Rock Assurance Corporation. That company, in ten years, has become the tenth largest writer of Massachusetts personal lines. Our agents (and Insurance Division complaint statistics) suggest it ranks first in service; and its pure loss ratio, which has always been good, remained in the neighborhood of fifty points. These are our twin towers. The industry-wide deficit at Commonwealth Automobile Reinsurers, meanwhile, fell sharply as the residual market continued to contract. Readers may remember that in 1989 C.A.R. was insuring over two-thirds of the vehicles in the state; the current figure is more like one in

ten. Plymouth Rock and everyone else, therefore, paid less than expected for the residual market in 1993.

The company's gross expense ratio, including claim adjustment and investment expenses, came in below 38 percent for the first time in its history. While that is still three points north of my updated target, it represents gratifying progress. The claim department, with three excellent new managers, has now gotten into full swing in the hunt for efficiencies. I am guardedly optimistic that Plymouth Rock Assurance can squeeze out another expense point in 1994.

The expense ratio is on the right course as we look ahead, and it would be an unexpected setback if the residual market repopulates any time soon. The loss ratio, however, faces some jeopardy over the next few years. The causes are largely external to Plymouth Rock. The last five years in Massachusetts have all been blessed with mild winters, a favorable regulatory climate, and little or no growth in miles driven. The winter that began in December of 1993 has been fierce. The economic recovery, so welcome on all other grounds, will increase discretionary miles driven and, thus, claim frequency. The legal and regulatory climate poses a still greater concern.

Since the last set of legislative reforms in 1988, tort claims have continued to push bodily injury costs up by more than 20 percent per year, but the property damage statistics have improved each year, due largely to "direct pay" programs like our Crashbusters vans. The problem is that the bodily injury increases can go on forever, while the property damage results must eventually level out. If I am right about the economic recovery, this is probably the year that property damage costs will start upward again. To make matters worse, however, the legislature is seriously considering a complete repeal of no-fault. Although the Governor has put forward a sensible approach to redesigning no-fault, the trial bar has won the day already in the Senate. The option of continuing under the current regime is unappealing, but a pure tort environment would surely be worse. When things are working badly, not every change will make them better. I hope the legislature understands this.

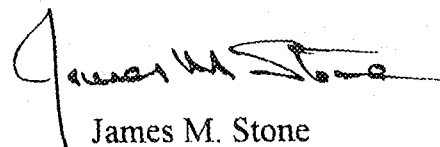
An issue of this magnitude in any prior year would have taken virtually all of my time. Fortunately, we now have Paula Gold, Plymouth Rock's newest vice president, to help us navigate the political thicket. She comes with more than fifteen years of government experience, including a distinguished tenure as Massachusetts Secretary of Consumer Affairs and Business Regulation. Paula and I will do the best we can, but it would be disingenuous to suggest undue confidence concerning near-term rate adequacy in Massachusetts auto insurance. At least, though, we can be sure of this. We are better positioned for stormy times than most, and, since the state's insurers are now overwhelmingly domestic with no deep pockets elsewhere, the government has far less freedom than it once did to jeopardize their condition for any substantial duration.

This year's letter ends with some reader response time. The three rules for equity investing presented in last year's Annual Report generated surprising feedback. The first two rules, calling for understandable product stories and for holding periods measured in decades, caused no problems, but the third ("we will consider only companies with whose chief executives we would all be willing to be photographed") elicited both confusion and criticism. One commentator asked if we ruled out companies with ugly CEOs, and another asked whether this meant we invested only in companies whose CEOs were pictured in their Annual Reports. No, no, no.

In addition to its Centre Cat position, Plymouth Rock now holds \$1.5 million of equity investments. Marketable equities represent a still conservative one percent of the total portfolio, and all were selected with careful adherence to the three rules. We never once judged a company by the CEO's appearance, though we take full account of the company's, and its managers', standard of ethics. If the relationship between shared ethics and a willingness to engage in joint photo-opportunities was too subtly stated in the last Annual Report, this should set the record straight.

That brings me to the criticism. One investment executive, who had no trouble comprehending the photograph rule, said it was the "most unprofessional" statement of investment philosophy she had ever heard. Ethics, she said, are not correlated with return. I have thought long and hard about her statement, and it is not easy to refute with rigor. One response would be that the universe of potential investments is so broad that no such correlation is required for us to confine our attention to a select subset without sacrifice of return. I prefer the stronger statement that there may, in fact, be a positive correlation between companies with managers we admire and those situations that the investment team at Plymouth Rock can identify as winners.

Just as our businesses outside Massachusetts personal lines will inevitably be of greater significance to the consolidated results, so it is inescapable that investments will also play an increasing role. We will stay with the three rules of equity selection; we will maintain our conservatism in asset allocation; and, most important, we will endeavor not to be distracted from the fundamentals of insurance. An insurance carrier that earns its customers' loyalty and knows how to select a profitable book has a valuable and durable franchise, even if its investments are uninspired. The most brilliant investing, in the absence of good service and underwriting, offers no comparable robustness.



James M. Stone