

The Plymouth Rock Company
695 Atlantic Avenue
Boston, Massachusetts 02111

Chairman's Letter

February 20, 2001

To Our Shareholders:

The Millennial year has been a good one for us. I am hoping that sets a precedent for the next nine hundred and ninety-nine. Net income for the group in year 2000 was \$13.9 million, the largest number in the Company's history. While record profits are welcome, of course, the better news is about your Company's positioning for the future. Readers of this letter have commented that its tone, especially for the last five years or so, has not been as bullish as one normally expects from a corporate annual report. If that is true, part of the cause is my preference for using this letter more as an informational record than a sales brochure. The other factor, though, has been my effort to communicate that Plymouth Rock has faced a difficult environment during these years. This year's letter is of a more upbeat cast because the situation is showing signs of improvement, and not, I certainly hope, because I have been seduced by the allure of spin.

One contributor to bullishness is my feeling about the Company's operating management. I have always liked Hal Belodoff. His first assignment, to help with the creation of Palisades, convinced me we should work together for many years to come. Now, he is the president of Plymouth Rock Assurance Corporation and my partner in all of our agency-distribution insurance businesses. Hal is a counter-example with respect to the famous Peter Principle: that incompetence is rife in business because each executive is repeatedly promoted until he reaches a job he can't handle, where he then sits indefinitely. At each ascending step, Hal has done better than at the last. One of Hal's key assignments for the year was to make sure we had two people at the next level with the potential to be as strong as he is. This year, we recruited Gerry Wilson to become Palisades' president, and Hal is hard at work finding another executive to serve at about the same level. The other operating officers, who run your companies department by department, are now more seasoned and stronger than at any time since our founding. And, last but far from least, Jim Bailey and Rick Childs work with me on the ever-expanding investment side of the business. The distinguished track record there speaks for itself.

The overall financial picture for the group remains as difficult as ever to discern from the audited numbers. As I am prone to point out regularly, much of Plymouth Rock's value lies in assets not recognized by generally accepted accounting standards. There is nothing wrong with this state of affairs, but it means that readers have to look at more than the first two pages of numbers to stay informed. The footnotes help. We try in that section to go beyond requirements in providing some of the less obvious facts, and this text is intended for a similar purpose. The balance sheet shows that shareholders' equity rose by \$12.9 million in 2000. With an equity

base of \$100.0 million last year, the return on prior year equity is simpler to compute than it is ever likely to be again. On a per-share basis, the increase in book value was from \$457 to \$516. Book values always ignore the going-concern momentum of a business. In our case they also exclude somewhat more tangible assets, such as our indefinite contract to manage the Palisades reciprocal, considerable unrealized gains in our real estate holdings, and the progress of our investments in Homesite Group and Response Insurance (where we are, in each, the largest common stockholder). The value of these three excluded assets, at least according to recent appraisals, may be of the same order of magnitude as all the Company's included net assets.

The income statement tells less than you will want to know as well. Since GAAP requires a net presentation of revenues, the income statement is not really intended to reveal how large a business we operate. The top lines on the financials show \$120 million in premiums and service revenues. Netted out of the premium number before it gets there, however, is the more than 30% of our gross premium income that goes to pay for reinsurance from GenRe and Commonwealth Automobile Reinsurers. Also excluded, for good reason, are the \$54 million in gross premium written by the New Jersey reciprocal insurer and all of the business Pilgrim writes as a consequence of its servicing business. If the total revenue were on a written basis and grossed up by the excluded amounts to something like \$235 million, the numbers would, in one sense, no longer reflect revenue that is "ours", but it might be a more useful indicator of size. I find that number particularly meaningful, because it moves with our task load and the size of the work force for which we are responsible. The latter number, about 375 people, is a source of pride, since Plymouth Rock created those jobs and filled them with an unusual degree of selectivity. Both the gross and the net revenue numbers are larger this year than at any prior year in our history, and we expect both to grow again in 2001.

Plymouth Rock Assurance Corporation, the largest of our companies, wrote \$121 million in premiums, all from Massachusetts automobile insurance. This represents a growth in volume of 22% over 1999's equivalent number. It has been half a dozen years since that company has grown so rapidly in percentage terms. That Plymouth Rock Assurance grew so much this year was far from coincidence. On the supply side, the demise of Trust Insurance, a once-aggressive competitor placed in receivership last February, gave us a source of new agents looking for appointments with a stable partner. Relations with our own superlative agency force, moreover, have been fully restored after a bump in the road a few years back. On the demand side, we increased our appetite for new business, as Hal and I became more convinced that this highly cyclical industry was turning in the right direction.

In the 1994 Annual Report, I predicted that we would soon find ourselves on the downward slope of the regulatory cycle. Results were excellent then, but signs were plain enough that the peak was past. Excellent profits and accumulating reserves convinced the Commissioner to begin that year a series of rate reductions, the cumulative effects of which have taken more than 18% out of our year 2000 volume before considering the impact of inflation. Put another way, if the state-set rates were the same in 2000 as they were in 1994, Plymouth Rock Assurance's year 2000 premium would have been closer to \$150 million than \$120 million. A new form of competition among carriers, sharply discounting rates for group business and select drivers, added to the downward price pressure. Plymouth Rock Assurance joined the pack, and the resulting discounts reduced its revenues by another \$6.7 million in 2000. Just last December, the

Commissioner ordered a much larger rate cut than the industry had expected for 2001, which will result in a further premium decrease of about 8.3%. Yet, despite this bad news in the short-run, I am guessing that the cycle is ready to turn up again. This is largely based on two clues. First, the discounts for groups and select drivers have been cut back for the fourth year in a row by almost every company. And, second, Plymouth Rock's internal analysis of its peers' reserves indicates that the inevitable rainy day funds built up during the good years are pretty well expended by now. Although I expect 2001 to bring lackluster industry performance, that is probably needed to reverse the cycle. Remember, however, that I used the word "guessing" a few sentences ago. While insurance regulatory and competitive cycles are by no means pure random walks, they are too complex to be predicted with confidence.

Events influencing Plymouth Rock Assurance's competition at this time will be helpful, even if the cycle has not yet hit bottom. Whereas five years ago it seemed as though some of our peers were ready to reach for market share at any price, competitive zeal is finally waning. A number of the largest home-grown companies are now establishing, as we did, diversification beachheads in other jurisdictions. That is a road they may find slower and more consuming than they anticipate. Trust, which was larger than Plymouth Rock, is gone. A second of our larger competitors is currently for sale. A third, CGU Corporation (formed by a 1990's merger of Commercial Union and General Accident) was recently sold by its U.K. parent. The buyer was a group headed by Jack Byrne, who is legendary not only for his insurance genius but for decisively exiting heavily regulated states in prior assignments. No one should doubt that Jack will do something bold with his new acquisition, but, since he is as full of surprises as talent, I'd be out of my depth to predict what it is.

Loss ratio performance for 2000 verifies the thesis of Geoff Arnold, our Vice President for Underwriting, that Plymouth Rock Assurance maintains a small advantage in that important metric. That company's pure loss ratio, before loss adjustment expenses and residual market charges, remains in the 50's. This is just where it ought to be for success in Massachusetts. When Hal and I were concerned about the loss ratio numbers back in 1998, Geoff assured us that an apparent decline in our advantage was due primarily to differences between Plymouth Rock and its peers in the degree of conservatism used in reserving. Since then Plymouth Rock's calendar year results have gotten better relative to the peer group, so it looks as though the reassurances were valid. Managing the expense ratio at Plymouth Rock Assurance has been one of the hallmarks of the Belodoff Administration. Measured all-inclusively, which means combining underwriting expenses with claim department expenses and investment expenses, the expense ratio remains around 41%. This is not the improvement Hal had sought, but there are a number of one time charges this year, especially in connection with the rapid growth of revenues. Hal promises that, even with a drop in rate level, the ratio will go below forty next year for the first time since 1995.

This year for the first time, Mt Washington Assurance Corporation's results are reported as a part of the Plymouth Rock Assurance numbers, due to a 100% quota share agreement. This is largely a reflection of our difficulties in growing Mt Washington to a truly independent scale. With only about ten million in premiums, the New Hampshire subsidiary could not reach an efficient size for expense management. And, even if its loss and expense ratios had been what we hoped at that size, it would have earned only enough to justify a capital base too small to be treated well

by the rating agencies. The quota share treaty allows Mt Washington to share more of Plymouth Rock's operating resources and efficiencies, and it immediately boosts that company's A. M. Best rating from a B- to an A-. This should make the task of Mt Washington's new president, John Condon, at least a little easier. John comes to us with twenty years of experience in the New Hampshire insurance marketplace, and he has been quick to accept responsibility for taking Mt Washington from a net loss position to a dependable profit. He knows our standard, that a valuable member of the Plymouth Rock corporate family must be able to aim realistically for a 15% to 20% return on its capital, contribute a million dollars or more to net income, and be a source of pride for all associated with it. Mt Washington, which has given superior service to its Granite State constituents for a decade now, already meets the last standard. It has been slower than hoped to meet the profit tests, but there is every reason to keep at it. The new arrangement should give Mt Washington a boost in its tenth anniversary year.

The biggest news at Palisades is its change in leadership. Hal had run Palisades from the day it was created. He was there when we negotiated our license, having virtually lived on a couch in the reception area outside the New Jersey Commissioner's office for weeks to gain the final state approvals. He signed up the first agents and hired the first staffers. He selected the company's first offices, in Hoboken. Now Palisades has grown up. It is a \$54 million company group with an agency and two insurance carriers, Palisades Safety and Insurance Association and Palisades Insurance Company. The latter company is owned by the former, and the former, a reciprocal, is owned by its policyholders. The whole enterprise is managed by our subsidiary, Palisades Management Company. Just last month, Palisades' headquarters moved from Hoboken to Summit, New Jersey. Hal doesn't even have an office there, and he's shopping for a house in suburban Boston. His successor, Gerry Wilson, came to us from Progressive, where he had managed a successful and growing auto insurance business in Michigan. He is an unusually talented executive, so we feel quite lucky to have him. Gerry has set an ambitious 20% growth goal for next year, which will give him plenty of opportunity to put that talent to work. If he conquers New Jersey, where we ought to be as large someday as we are in Massachusetts, perhaps his next target will be to open a company for us in Pennsylvania.

This past year Palisades contributed \$700,000 to our group net income via the management contract. Profits for all Palisades entities combined, including the reciprocal, were just over \$2.5 million. This is about as anticipated in the year 2000 budget. As in Massachusetts, a New Jersey auto insurance carrier has to have a voluntary loss ratio in the 50's to prosper after payment of the various residual market costs. Palisades' automobile loss ratio for 2000 met that mark comfortably, putting it a few points ahead of its budget, an accomplishment that reflects cautious underwriting and superior agent selection. If the loss ratio there never changed, I would be very happy. Expenses, especially for salaries and related items, swallowed up much of the potential gain, so no one would be happy to see the 2000 expense ratio cast in concrete. Some of the expense points were consequences of a legislatively mandated 15% premium reduction and the move to Summit, which increased employee turnover as well as one time direct costs. Next year, with more agents, more strategic relationships, and fewer moving vans, Palisades should have its best year to date.

Bunker Hill and Pilgrim, under Vin Nieroda's leadership, both had solid years. Bunker Hill, the Massachusetts homeowners carrier, earned just over \$1 million on revenues of \$23 million. The

year gone by had no powerful hurricanes and a mild winter in this region, which helped its loss ratio come in under target. Its expense ratio, which was temporarily out of whack because of the volume decline in 1998 and 1999, is now in sight of normalcy again as the volume picks up. By next year, absent hostility on nature's part and assuming the strong growth management plans for, Bunker Hill should be fully up to its capacity in writings and close to its target return on equity. Pilgrim is the dominant provider in Massachusetts of policy issuance, underwriting and claims services to other automobile insurance carriers. It now services auto insurance business for ten well-known carriers, including USAA and Fireman's Fund. Its volume is growing and its capital base can be small, since its services do not include assumption of the actual insurance risk. As a consequence, Pilgrim can return 20% on equity in a good year. The year 2000 met that standard. Pilgrim's revenue exceeded \$12 million, and profits were about \$1.25 million. Vin expects a similarly good year in 2001.

Outside of the immediate Plymouth Rock family, but still important to us, are the two direct response insurers we helped to create. The Plymouth Rock Company is an investor and the largest common shareholder in both Response Insurance and the Homesite Group. Both of these enterprises have national ambitions, planning to write almost everywhere in the United States except Massachusetts, Rhode Island and northern New England. Both are extremely well funded by preferred shareholders associated with Morgan Stanley Capital Partners. The two companies share a chairman, yours truly; a vice chairman, Peter Wood; and a Treasurer, Jim Bailey. They are otherwise entirely separate businesses, selling different products, and each has its own CEO and senior management team.

Response, which is in the direct automobile insurance business, continues to sail against the wind. It was started with a belief that the basic economics of direct response automobile insurance were favorable, that the direct response share of the auto insurance market (still only about 10%) will inevitably grow, that the telecommunications revolution will place increasing emphasis on low prices and good service, and that scientific underwriting and twenty-first century systems should produce a sustainable combined ratio advantage. A one percent market share and a superior combined ratio in automobile insurance would create a billion dollar company with excellent value metrics. All of these original beliefs are still intact, but Response's performance is significantly behind plan. What we did not see coming was the longest period of downward general-market premium movement in the history of the automobile. Response's target audience consists of good drivers who are upset that, despite clean records, they keep receiving premium increases. For the last four years, however, most good drivers have instead enjoyed decreases from the large agency carriers who dominate the market. A competitor can sell into this kind of market only at a greatly increased marketing cost per unit of business acquired. Worse than that, though, the business that arrives has different risk characteristics than it would have in a normal situation of annual premium increases. The good drivers are content with their decreases and tend to be unresponsive, but the poorer drivers, who are still faced with increases, continue to shop. Since no one has an underwriting screen powerful enough to sort applicants with a particularly high explanation of variance, the worse the responding population, the worse the new book will be. The surprise to most industry observers is not how much more expensive direct business has become to acquire but how much higher than just a few years ago is its new business loss ratio.

Response has done as well as can be expected in this environment. Its loss ratio is above target and its scale is below, but its accomplishments are noteworthy. It has built a \$50 million book of business, representing faster expansion than any Plymouth Rock company ever achieved. It has developed an enviable infrastructure, including first-rate systems, and a national footprint of licenses and approved rates. It has excellent people and a \$200 million capital base. So, I am convinced that Response will ultimately be an industry leader, albeit not as soon as all involved had hoped. Given that its direct mail and advertising campaigns will be cost-effective again only when the giants start to raise their rates, Response has altered its expansion emphasis to focus on acquisitions and select affinity relationships. Never passive, it expects growth this year of at least 30% from those channels. One particularly promising initiative arises from Response's purchase last year of the Teachers' Insurance Plan, a leading affinity marketer of auto insurance for the elementary and high school teacher market. In the meanwhile, its direct response competitors are dropping like flies. We know of half a dozen attempts, both entrepreneurial and within established industry giants, that have been abandoned or are on the block. If the loss ratios are not too forbidding, Response may be interested.

A change in Response's management will soon occur. Steve Carlsen, who has been that company's number two for several years, and done a fine job, has asked for a reassignment to internal consultant status. He has earned the right to call his shot. Mory Katz, Peter Wood and I have all decided that we will draw the strongest possible replacement candidates for Steve if we fill his slot by offering co-CEO status with Mory. Consider this an advertisement. Your help is solicited.

The reception has been far warmer for our other direct investment, Homesite Group, Inc. Homeowners prices are not falling, and that market is not especially competitive, so there was never a threat from the same problems Response has faced. More important, though, Homesite selected a strategy that makes brand-building and the direct sale itself less central to its future. Homesite's opportunity is to become the partner-of-choice for leading businesses who have customers in need of homeowners coverage, the credibility to make an endorsement count, and a healthy wariness about offering their own homeowners product. Last year's letter hinted that Homesite was close to an arrangement with a universally known first partner. Since then, it has made good and signed a long-term contract to be the homeowners provider for GMAC, the financial arm of General Motors. More recently it entered into a pilot program with a General Electric insurance subsidiary. Due diligence is in progress with another giant and, someday, Homesite will crack the bank-owned mortgage origination market in a significant way. Morgan Stanley Capital Partners added \$38 million to its investment in Homesite early this year. Last year at this time, Homesite had less than \$3 million in premium on the books. Its gross written and assumed business under contract for 2001 is nearly \$30 million. Charlie Kline, Fabian Fondriest and Russ Fletcher, the senior team there, are preparing for a rapid takeoff.

This was no ordinary year for investment professionals. The last eighteen months saw the largest sudden expansion of paper wealth in the history of the world, followed promptly by history's fastest ever evaporation of paper gains. Most of the action centered on technology issues, especially Internet-related companies, traded on the NASDAQ stock market. The NASDAQ market used to be called the "over-the-counter" market because no exchange floor is required for its trades, and as recently as half a dozen years ago it was considered the poor cousin

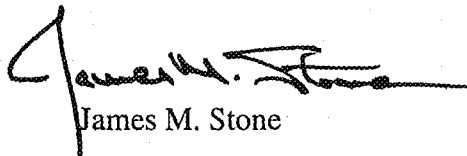
of the exchange markets. It is poor no more. After tripling in index value from June of 1996 to November of 1999, the NASDAQ rose by another 70% during the next four months. This took the aggregate market value of NASDAQ stocks traded to over \$6.2 trillion, more than half the value of all New York Stock Exchange stocks. In last year's report, I wrote that a bubble mentality was beginning to threaten the rational valuation of all types of stocks. After March, the bubble broke. The NASDAQ index fell from 5132 at its peak to around half that at year end, erasing \$3 trillion in wealth that entrepreneurs and their employees, venture investors and speculators thought they had. This is more than the Gross National Product of any nation in the world except the United States and Japan. The NASDAQ is still a wealthy market and there are many enduring fortunes built on the telecommunications revolution, but the bubble is no longer. The big slide restored a reasonable pricing environment, bargains and all, in the technology sector. It's a good thing, too, at least for those of us who are fundamental value investors with no intention of changing. A bubble, said one wise friend, can be depressingly de-professionalizing.

Jim, Rick and I came to a unanimous conclusion during the Spring that this was that rarest of situations, one in which a little market timing was justified. We had never bought any of the hot technology issues, largely because we did not have sufficient confidence that we could analyze a stock whose metrics defied the only valuation discipline we knew. We missed out on some juicy gains, of course, but that doesn't bother me any more than that I didn't win the last Powerball jackpot. You, as shareholders, may take comfort of sorts from the fact that, even if we had purchased stock in some of the super-performers, we would doubtlessly have sold them too early to maximize the gains anyway. The penumbra of the tech boom, though, did cover a couple of equity holdings we had bought for other reasons. So, when these stocks rose to heights we could not understand, we sold them, producing the \$10 million capital gain that dominates our net income for the year.

The stock portfolio, under generally accepted accounting principles, is reflected at market value in our balance sheet, with only the realized gains flowing through the income statement. As a consequence, this year's results added to net income, while in most years our marketable equity gains have been unrealized and have gone straight to the balance sheet. The year 2000 return was 34%, and the internal rate of return since we began equity investing in 1992 is over 30%, outpacing the S&P by a nice margin for both periods. We like the fact that this was accomplished in relatively safe, liquid stocks of first-rate companies, rather than speculation. As we measure it, the risk-adjusted return on marketable equities has been all we could have hoped for. We would, of course, all be much wealthier if only we had been sufficiently over-capitalized to have invested entirely in equities for this period. But "just-enough" capitalization requires us to keep most of our reserves in bonds, where our performance has been more ordinary. This is true for both the current year and the from-inception numbers. The total return during 2000 of 8.1% on the bond side was a bit higher than normal, but within the range of customary fluctuation for a portfolio of its conservative character. We believe that neither we nor our outside fixed income managers can outperform, except at the margin, the relatively efficient market in highly liquid investment-grade debt securities, at least on a properly risk-adjusted basis. It is only in ownership assets that we try to outperform the rest of the market by any amount that will be significant to the Company's value.

Asset prices in most of these sectors remain high, and that is still a cause for some concern. We are not inclined, at least for now, to liquidate our major real estate holdings, even though they may look expensive by historical standards. We own two office buildings in downtown Boston. Plymouth Rock occupies nearly half of one of them, and the other's largest tenant is Homesite. Our investments in the two buildings embody at least \$15 million in unrecognized capital gains, none of this amount reflected in our financials. We still like our real estate, even if the economy is slowing, because both buildings will be enhanced by completion of the gargantuan Central Artery and Tunnel construction project going on around us every day. Both buildings, moreover, abut sites where top quality developers are putting up new office towers that may raise the prestige and practicality of the locations. Some of the common stocks we own also look expensive by historical standards, especially when judged by their price-earnings ratios. We would not have bought them all at these prices and, in fact, we only add to our positions when they come back to our comfort zone. Nonetheless, we are, at least as of this date, inclined to hold them. Prospective equity market returns, after a boom period like the 1990's, are probably not as inviting as they would be in normal times, but our stocks were chosen for relative attractiveness and with long horizons in mind. Selling would force us to do something else with the money, and I am not aware of any place Jim, Rick and I would be equally comfortable.

With a return on capital in the past year of about 13.5%, the book value return from inception moves a little farther short of our goal – which has always been a 20% compound annual return. The seventeen-year cumulative return on book value now stands at 18.7%. On the other hand, if we were to liquidate our real estate, our ownership of Palisades, or our stock in the direct writers, the Company's book value would have to be adjusted to reflect these potentially substantial gains. So, I would be surprised if the compounding in economic value falls short of the mark. Whether there are twenty percent return years in our future, depends in large measure on the future automobile insurance environment, on asset markets more generally, and on our ability to create new entrepreneurial projects. My confidence in the first and third of these is a bit higher than my confidence in the second. Of this, though, I am extremely convinced. The Plymouth Rock team is readier than ever.


James M. Stone