

**The Plymouth Rock Company**  
**695 Atlantic Avenue**  
**Boston, Massachusetts 02111**

**Chairman's Letter**

February 21, 2002

To Our Shareholders:

When I wrote two years ago that Plymouth Rock had been through "a year of consolidation and building for the future", you had every reason to wonder whether that was just wishful thinking or euphemistic phrasing. We had experienced both a drop in revenues and a tightening of operating margins. Now, with 2001 complete, the description looks more convincing. Net income for the group in year 2001 was a respectable \$10.3 million, but, just as important, there has been a sharp upturn in growth and an improvement in operating efficiency. The bump in the road during the late '90s is history now; we have made up all the lost volume and more. Top line growth was strong, and it appears to be continuing into 2002. The bottom line was aided by expense ratio progress, even after the costs associated with adding new volume, and that trend too seems to be continuing. You have to spend something to put business on the books, and new business is not as profitable as seasoned books of business. So, the fact that volume grew in our family of companies, without diminution of quality, means that the year's economic gain was greater than the net income. I'd be happy for more years like 2001.

The financials, as always, tell part of the story. The balance sheet shows that shareholders' equity rose by \$7.8 million in 2001. This is less than the amount of net income. The difference is explained by a decrease in our unrealized gains on investments and the payment of our customary dividend. On a per share basis, the increase in book value was from \$516 to \$551. By my estimates, this book value represents roughly half of your true shareholder equity, even before applying a valuation multiple to the base. Among the assets not recognized for balance sheet purposes by generally accepted accounting principles are the contract we hold to manage the Palisades reciprocal in New Jersey, a considerable unrealized gain on our real estate portfolio, and any gain over basis from our minority investments in Homesite Group and Response Insurance. Certain contingent liabilities, less than a million dollars worth, are not carried on the balance sheet but are disclosed in the footnotes. Writing this in a season when the financial news is dominated by the failure of Enron and its off-balance-sheet partnerships, I feel the need to assure you that these off-balance-sheet items are very different indeed. First, we would be more than happy to put all of the non-included items on the balance sheet if we could. The accounting rules simply don't permit it. Second, there are no such items that you are unaware of and none of substance that aren't mentioned in this report. Third, there are no Plymouth Rock guarantees connected with the assets and

the liabilities are strictly limited to the amount disclosed. The only issue we should have to concern ourselves with is how much more than book value these items taken together make our shares worth. Finally, our officers' holdings in Homesite and Response are known to you in detail, and there are no such holdings in the real estate gains or in the Palisades management company. I would support, by the way, a change in generally accepted accounting principles that explicitly required disclosure, at least in footnotes, of most of the things that Enron failed to disclose as well as all the items I have just listed for you. It would not make much difference at Plymouth Rock, but it would make our investment analysts' task quite a bit easier when we looked at other companies.

It is hard to resist a note about derivatives trading, which was at the center of the Enron partnerships' activities. This is a field I had the opportunity to see up close when I was chairing the Commodity Futures Trading Commission. Derivatives markets can be unquestionably useful in hedging risk, but they are to be approached with caution. Foremost among the reasons is that, given their typically high margin leverage, it is very easy for a small imperfection in a supposed hedge to turn it into a hazardous speculation. Anyone who doubts this should read about the fall of Long Term Capital, where even Nobel laureate economists couldn't see the exposure until it was too late. Long Term Capital was a company that at least made a serious attempt to limit the degree of speculative risk. Many ventures into this arena are not that, but pure speculations inaccurately described as hedges simply because among their holdings are positions that gain in value if some relevant market rises and others that fall in response to the same market movement. That makes for a true hedge *only* if the two opposite exposures are precisely balanced and there are no possible world events that can disturb that balance. As soon as there is a deviation from this standard, creating a net exposure in some imaginable future state of the world, there is speculation involved. When there is great leverage as well, that speculation can easily exceed its anticipated level. Remember, too, that derivatives markets are not regulated under the same rules as stock markets. If they are regulated at all, it is largely without restrictions on the use of valuable and private market information or disclosure of large positions. As a consequence, the uninformed speculators as a whole have more than taxes and transactions costs as a handicap in that they must also fund any gains to the holders of the valuable information.

None of this means that Plymouth Rock places derivatives off limits for hedging risk. At present, we make no use of derivatives markets directly, but certain of our portfolio investments do. You should feel very free to ascertain that we have asked ourselves all of the requisite questions. The lack of such questioning and lack of disclosure in the Enron situation with respect to its trading activities was plainly a part of the problem. Business bankruptcies are intrinsic to our system, providing a much needed form of market discipline, and we should not decry them too quickly; but the Enron case left too many innocent victims. In this citizen's view, it would have been far less painful if there had been better pension rules, better derivatives markets regulation, and a better political campaign financing system. No market disciplines need be eroded to improve in all three areas.

The top line in Plymouth Rock's financials shows a net premiums earned number of \$128 million. To turn this into the measure I use each year to describe our effective scale, one would add to this about \$8 million in premiums written but not yet earned, about \$48 million of business that is ours but which we ceded as reinsurance to Commonwealth Automobile Reinsurers and General Re, the \$66 million in New Jersey personal lines premiums we manage for Palisades, and \$45 million in automobile insurance premiums we manage for others at Pilgrim Insurance. From this is netted \$21 million in items that would otherwise be double counted and business which is not ours but is assumed from CAR. The grand total is \$274 million, an increase of about 16% since last year. This total reflects a change in how Plymouth Rock Assurance records its residual market load. In the past, the top line on the financials had not reflected business at CAR, where all carriers are forced to share in the losses of high risk drivers. We simply took our share of those losses on the claim and claim adjustment expenses line as though they were a single large claim. Beginning with the 2001 statements, in order to increase consistency with new statutory accounting rules, that company will treat its proportional share of the CAR results as though it had voluntarily assumed reinsurance in that premium amount. It will include a part of CAR premium in its top line and add in its proportional share of the claims and expenses in a corresponding manner. This "grosses up" the company's premiums to a level about \$16 million higher than under the old treatment. The 2000 year in the consolidated statement is restated to the new treatment for comparability. None of this, of course, had any impact at all on the bottom line. The \$274 million number is, in my view, the best measure of your Company's scale. I expect we will pass \$300 million in 2002. It was just ten years ago that we passed the \$100 million milestone. Tripling again in the next ten years looks inviting from here.

Once again return on capital in the past year was below our 20% target, and the cumulative return on book value from inception now stands at 18%. On the other hand, this was a much better year than that statement alone implies. The value of the growth is not reflected in those numbers. The year began with a Massachusetts auto insurance rate decrease of more than 8%. And group operating income, before capital gains or losses, is up considerably over last year, even though the net income is not. I continue to think a 20% annual rate of return on equity is a realistic target, as well as a reasonable estimate of the true economic story from inception to date.

Plymouth Rock Assurance, under Hal Belodoff's excellent stewardship, had a solid enough year in its Massachusetts automobile insurance business. Premiums grew as competitors became fewer and less aggressive. Trust Insurance has been liquidated; Berkshire Mutual and Horace Mann stopped writing Massachusetts automobile insurance. Safety Insurance, one of our most direct competitors, changed ownership hands just prior to the death of its founder. Dick Simches was a man of talent and honor, and the whole industry is poorer without him. It remains to be seen whether the new majority owners, a New York private equity firm, will bring about any changes in how Safety operates in the marketplace. Travelers is being spun off from Citigroup, and one might also ask whether changes will occur in its Massachusetts subsidiary, Premier Insurance. Some observers believe that the new public company will have a higher market value if the Massachusetts subsidiary is not part of the package. We are told that other companies, too, are reassessing their

Massachusetts profiles. If so, it will be positive for Plymouth Rock, which goes steadily onward and represents a stable partnership choice for the state's independent agents. Hal, incidentally, has now completed moving his family back to Massachusetts from New Jersey, which will help him in his duties throughout our group of companies as well as in his duties as CEO of Plymouth Rock Assurance.

The rate decision of the Commissioner for 2002 was no Christmas surprise this year. The outcome, very close to no change, was negotiated with the industry in the fall. I continue to believe that this Commissioner has called the rates about right. If there is any shortfall between needs and revenues, it results from voluntary discounting on the part of the carriers. Discounts this coming year have been continued for groups, but most companies, including Plymouth Rock, have stopped offering discounts in excess of those built into the rates for drivers with good records. The Plymouth Rock loss ratio remains attractive, and Hal has recently launched a project to improve it further in 2002. Paula Gold's appointment to a seat on the Governing Committee of CAR, where I served for twelve years in the Company's early years, will help keep us focused on understanding the maze of rules that affect Massachusetts loss ratios. Expense ratio reduction is the more pressing task if we are to meet our return on equity goals. Plymouth Rock's all-inclusive expense ratio was down a point in 2001 to the best level it has seen in five years, just as Hal promised it would be. To move this ratio southward the additional point and a half he has targeted for 2002 requires both discipline and IT systems improvements. The Board has approved a significant upgrade of the Plymouth Rock Assurance IT systems, which Hal assures us will make them cheaper as well as more effective. The first phase of that upgrade, involving imaging of the claims records, is already a success. The next step will be the introduction of a whole new claims processing system, beginning this year.

Perhaps the most important initiative planned for 2002 at Plymouth Rock Assurance is its entry into Connecticut. If your company is to become the true regional carrier we have long envisioned, it must grow its footprint. Connecticut is the next expansion. We are licensed there, and Eric Neely has joined us to lead the effort. Eric was previously a General Manager with Progressive, like Gerry Wilson at Palisades. He is confident he can get us at least \$5 million in Connecticut volume during our maiden year. This will represent our first move into a new state in nine years.

Don Southwick, whose BCS Holdings has been a successful partner of ours for several years now, will help Eric get started with Connecticut agents. As in Massachusetts, Don will specialize in providing solutions for the perpetuation puzzles and liquidity needs that so many first-rate agencies encounter. Don can do that better than any of the rest of us at Plymouth Rock because he is among the statesmen of the agency community in New England. Since he took on his role for us, he has successfully managed the purchase of three agencies for BCS, which now has almost \$25 million in premiums, \$4 million in revenues, and a nice annual profit.

The two companies with the least satisfactory results in our group are the two smallest: Bunker Hill and Mt. Washington. Bunker Hill Insurance, the homeowners carrier in



Massachusetts, had a sub-par year. It earned only \$700,000 for the group as opposed to a budgeted net income of twice that. Neither its loss ratio nor its expense ratio was where it ought to be. Since this past year was hurricane-free, the results should have been much better. In the short run, some of the shortfall can be ascribed to unexpected severity in fire claims that may just be random bad luck, but there is a larger issue. The real problem at Bunker Hill is intrinsic to the homeowners business, and well known to us, because it provides the opportunity around which Homesite Group was formed. The homeowners line of business industry-wide is too often priced artificially low in order to attract auto insurance business and too often priced with apparent ignorance of its embedded catastrophe risk. Absent elaborate risk management and highly efficient distribution, homeowners insurance simply can not be a moneymaker for most of its writers, here or nationally. A loser for the industry as booked, the results for this line would be far worse if there were a proper accrual of the true costs of catastrophe risk and catastrophe reinsurance. The prices of reinsurance, moreover, took a jump with 2002 renewals and there is an active debate among industry watchers about which way rates will be headed in the new year. Bunker Hill is useful in supporting the Plymouth Rock reputation for providing full service to agents, but the returns to the business must outweigh its costs. Hal is taking a hard look at internal costs, commissions, and Bunker Hill's rates to be sure that premiums cover the full cost of the risks assumed.

Many installments of this letter have complained that Mt. Washington Assurance Corporation has insufficient scale to achieve a decent expense ratio. In 2001 the loss ratio was equally problematic. Mt. Washington will strengthen its senior management in 2002. I suspect that New Hampshire rates have not been given enough underwriting priority for some time, and the consequences were inevitable. Eric Neely, our new Connecticut team leader, will now take responsibility for New Hampshire product management as well. His experience gives him just the right pedigree. Looking back on the decade we have operated in New Hampshire, there is more red ink than black. There is no way to sugarcoat the fact that you would be at least \$6 million wealthier if I had not opened for business there. Having said that, I must add that there is no inclination on Hal's part or mine to give up. I may be accused, perhaps, of being habitually reluctant to give up on good ideas that don't bear fruit on schedule. To that charge, I plead *nolo*. Mt. Washington, in my view, can still succeed for Plymouth Rock, and Eric Neely is off to a good start in proving that. You won't see separate financial results for Mt. Washington, since its numbers are pooled with Plymouth Rock Assurance's, but I promise you will read about it here again next year.

At Palisades, the change in leadership is now complete. Gerry Wilson had the difficult assignment of taking over from Hal, who was at the helm since the day Palisades was licensed. Fortunately, Gerry is among the best insurance executives I have ever had the privilege of working with, and he has taken over smoothly and effectively. After a number of slow growth years in New Jersey, Gerry promptly put his foot on the accelerator. Premiums written in the Palisades insurers rose from \$54 million to \$66 million, about 22%. The pure loss ratio stayed comfortably in the fifties. The expense ratio is still a bit too high, but Gerry is at work on it. The growth is certain to continue into 2002. I say this not because I have acquired the clairvoyance I have long desired, but because, between the close

of the year and the writing of this letter, Palisades closed on a replacement carrier transaction which will add about \$17 million in new volume there. The transaction adds good quality volume while simultaneously increasing the reciprocal's capital. There is likely more to come if companies continue to abandon New Jersey. The Palisades group of carriers there made a profit of about \$4 million in 2001, well above budget, and A.M. Best has upgraded the group's rating to a B++. Our New Jersey management company brought about a million dollars to the Company's bottom line. New Jersey is plainly a source of growth in the next few years, and I look forward to its passing the \$100 million mark in direct premiums written.

Pilgrim Insurance, which provides service on a fee basis to about a dozen other automobile insurance carriers in Massachusetts, grew again in 2001. Two new clients, AIG and Progressive, now round out an already impressive list. Horace Mann, in connection with its planned exit from Massachusetts auto insurance, hired Pilgrim to be a third-party administrator for some of its claims run-off. This broadens our company's menu of services. Pilgrim's total premiums serviced were up by more than 34% and its revenues by more than that. With a small capital base, no net insurance exposure, and a 20% return on capital yet again, this is a nice business to have in our family. Pilgrim added about \$1.4 million to Plymouth Rock's net income. Vin Nieroda, Pilgrim's president, expects an even better year in 2002.

Our investment stakes in Response Insurance and in Homesite Group are significant enough to warrant a discussion of those companies' situations. Our balance sheet reflects the now familiar formula-driven reductions in carrying value of both holdings, but, more important, this may also be a good time to deflate some overly optimistic expectations about the near-term rates of return these ventures appear likely to produce. Response, which is a direct response auto carrier from New York to California, had a decent year on the premium side, and a year of much-needed improvement on the loss ratio side, but its pace of progress continues to disappoint. Let me review some of the facts. Response began the year a \$40 to \$50 million company with a loss ratio of nearly 100% and ended 2001 with volume of roughly \$80 million and a loss ratio close to 80% on a run-rate basis. This is forward movement but the company has nowhere near the size or profitability Peter Wood and I hoped for when we started Response in 1995. We believed then, and believe now, that there is a great prize available for whoever builds the next serious direct response auto insurer in the U.S. Others saw the same opportunity in the mid-'90s as well, and more than half a dozen new entrants joined the field. The new entrants may have spooked the existing captive agency giants, because they soon demonstrated unexpected appetites for competitive combat. State Farm, the nation's largest auto insurer, at a cost to itself literally measured in billions of dollars, took center stage in a reduction in rates for four years in succession, an unprecedented event in the history of the automobile. For a new direct response seller, this was an awful environment.

As I explained last year, a direct response writer's core audience consists of good drivers upset that, despite clean records, they keep receiving premium increases. When those drivers are not, in fact, seeing increases, and enjoying successive rate decreases instead, a

direct response writer can sell only at a greatly increased marketing cost per unit of business acquired and the business that *can* be attracted tends to be of substantially worse risk characteristics. As a consequence, even the largest direct response carriers had three bad years. Most of the other direct response start-ups have dropped out of the game. Response was forced to shift its strategy toward acquisitions rather than direct marketing, and most of the growth in 2001 was from buying other companies. Only this year have there been signs that prices are firming and, as a consequence, Mory Katz and his team at Response are beginning to assess the market again, place by place and audience by audience, to see where and when it can resume its direct marketing.

Response's book of business has suffered also from the choice of New York as Response's first state. When Response looked for a large state in which to begin revenue generation while it expanded its national footprint of infrastructure, New York looked attractive. It had a profitable multi-billion dollar market and a history of reasonable regulation. None of us anticipated that New York would enter a period of rampant personal injury fraud that would make it one of the least profitable states in the country. Though the issues in the New York market are now well documented, Mory is not hopeful that these systemic problems can be resolved in the near future. Response is now diversifying the book geographically. In 2001, it reduced its New York concentration from 80% of its book to less than half. While there were certainly plenty of other good and bad decisions that have influenced that company, the New York choice and the national price pressure have been the salient determinants of the Response story to date.

Does the current situation change my belief that Response can be a success? No. It does, however, change the timetable. To build a self-sustaining and successful engine of growth and profit will probably require at least four years more than originally contemplated. Response has fared better than its class of start-up competitors, and it has survived the first battle of attrition. Absent discouragement, Response should get where it needs to be -- but your rate of return on this investment, and that of the other investors, can not be what we had hoped.

Homesite Group, Inc. is trickier to analyze. That company is still too young to make confident predictions about its future. Charlie Kline left Homesite in 2001, and Fabian Fondriest, an exceptionally able and well-rounded leader, has replaced him as CEO. Homesite's opportunity arises out of the very same homeowners market problems I was discussing above with respect to Bunker Hill. Most writers of homeowners insurance are auto insurance carriers who believe (correctly, I would add) that offering a companion product increases customer retention. Yet most of these carriers would just as soon not offer this particular companion product. Sold as a loss leader, homeowners insurance has not had a good rate of return for many years. It has traditionally high commissions, and terrifying catastrophe exposure, especially if built with the high geographical concentration typical of automobile insurance books. Many carriers, moreover, see its economics as more dismal than usual right now, since reinsurance prices rose across the board after September 11. In this environment, Homesite is finding no shortage of carriers interested in unloading some of their present or future exposures to a partner. Its flagship relationship with GMAC is

proving a benefit to both parties. Homesite can succeed where others fear to tread because it has lower acquisition costs for its business than the average writer, and because it is highly focused on catastrophe management through reinsurance and portfolio underwriting. I am not even convinced that the tight market in reinsurance will continue once the wave of new Bermuda writers floods the market with capacity. But Homesite, like Response, has a national infrastructure to pay for, and it must add partners faster than it has to date in order to pay for that infrastructure. While Homesite does not need as much volume as Response to break even, it probably needs at least twice the \$30 million in volume it has today. The jury (and, therefore, the sales force) is still out.

The investments in Response and Homesite are carried on our books according to the equity method of accounting. This means that each is carried at cost less a proportional share of the respective operating losses. The total carrying value of the two investments on Plymouth Rock's books is now about \$5.7 million. If we were permitted to carry these investments at current book value, i.e., our minimum percentage of the common stock (after conversion of all preferred shares) times the company's yearend 2001 shareholders' equity, the holdings would be carried at something over \$20 million. Should either company do well, of course, the investments can be worth more than this amount. Given that the investments have just under four and six more years, respectively, before they can be sold, I can still hope for exactly that result.

The vast majority of Plymouth Rock's portfolio is held in non-strategic investments. That portfolio did better than one might expect in a year in which the total return on the S&P was a negative 12%. As much as I envy companies with so much capital that they don't have to hold bonds in order to maintain high ratings, this year the fixed income instruments were a blessing. The bottom line was a total return of 7.8% on invested assets. This number is best understood by examining its components. The single largest ingredient of our portfolio is bonds, where falling interest rates lifted values and the pre-tax gain for 2001 was almost 8%. Next in magnitude would come equities, which include both individual company shares and equity equivalents, mostly funds that own equity securities. The combined class came in about a point in the red in 2001, with the equivalents having performed well for the year and the directly held marketable equity positions doing about the same as the market as a whole. To do as the market does is not our goal in the individual marketable equities. You don't need to hire Jim Bailey, Rick Childs and me to accomplish that. But we should draw a bit of security from the long-term performance. Our from-inception marketable equity gain is still around 25% per annum, which beats most, if not all, of the comparables we look at. The third largest element of the portfolio is owner-occupied real estate, which gave us a fine total return of 21%, due to a rise in appraisal values and continuing excellent cash-on-cash returns. It seems that our two downtown Boston buildings have maintained their value and then some despite the softening in the national economy.

Stock prices continue to look inflated to us. Jim, Rick and I are all fundamental value investors and we are frightened when we see price earnings ratios as lofty as they are now. One credible student of the markets says that P/E multiples calculated as of the first quarter of 2002 will be above their levels of early 1929, pre-crash 1987, or boom time in 1999.



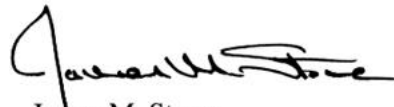
While most market analysts suggest that the current conditions are aberrant, driven by an unusually poor final quarter of 2001 and about to be negated by a swift economic turnaround, we are never confident of equity market predictions. Accordingly, we remain reluctant to add to our marketable equity exposure at these prices. In one stock we own, we are adding to our position because the share prices have returned to our comfort zone, but overall we did more selling than buying during 2001. If we continue to see prospective returns looking pretty skimpy from here, we may repeat that posture in 2002. The dot.com boom may be over, the country may be in a recession, and the market peak may have been passed, but it does not follow that the stock market yet offers many bargains in the kind of stocks we buy. We will switch back happily to being a net buyer if prices fall relative to values, but we make no forecast as to whether this will occur in the next year. One unknowable in that forecast would have to be whether there are further terrorist strikes. The economy, and the markets, are more vulnerable to that kind of blow than most analysts and policy makers have suggested, at least in public pronouncements. Time alone will reveal what is in store on that front.

What can an investor do when prospective returns on publicly traded equities look drab? One can revert to cash or bonds. Or look to real estate and other asset types that may be less than fully correlated with the market indices. One can hunt for well-known marketable equities that other investors have misunderstood and thus remain bargains. Or look at small-cap stocks that are more likely to have been understudied by sophisticated investors. An arena where markets are certain to be inefficient enough to offer particularly good -- and particularly bad -- investment opportunities is the private equity market. We own plenty of bonds and real estate already, and our alternative equity holdings include funds that seek small-cap bargains. This year, we will add a \$10 million private equity commitment to the portfolio. This is not something I would have predicted a few years ago at the peak of the high-tech boom, when private equity and venture capital would have been about the last places to look for bargains. Investing in this area, moreover, depends more than elsewhere on personal faith in the managers who are running the funds. Private equity is an easy venue for losing a lot of money quickly. So, the conditions had to be just right. We think they are. The environment is one where private capital is getting scarcer, especially at the larger end of the financing spectrum, which means that bargains are becoming more available. More important, the operators of the particular fund we are investing in are well known to us and enormously respected in the marketplace.

Lindsay Goldberg & Bessemer Fund brings together Bob Lindsay, the CEO of Bessemer Securities, and Alan Goldberg, the former head of Morgan Stanley's private equity division. I am not unbiased about them because, as you know, I will be a member of the new firm's general partnership myself. This, incidentally, means that (a) it would be inappropriate for any of the money invested through LGB to be reserves or capital of our various insurance company subsidiaries; and (b) we have all agreed that no transaction between the Company and LGB should be conducted without an explicit and affirmative recommendation from Jim Bailey. But Rick and Jim independently reached the same conclusion that led me to want an involvement with Bob and Alan: both bring a rare combination of proven investment talent, an inclination and knack for building successful businesses rather than sitting back passively

after the picks are made, and -- most important -- absolutely unimpeachable integrity. We look forward to investing with Bob and Alan through their fund, and perhaps from time to time as a co-investor in their projects if the opportunity presents itself.

There is one piece of unfinished business that ought to be mentioned. A year ago, I told you that Response was looking for a new COO. That job remains open. Fabian has decided he could use a similar person at Homesite, and Hal is searching for a COO at Plymouth Rock. Finding three executives of the required quality for entrepreneurial entities such as these is no easy assignment. I can guarantee, though, that all three jobs will be interesting day and night, challenging in the extreme, and potentially rewarding. No experience in business is more satisfying than partnering in building a well run and profitable company with your own stamp on it. So, please, search your address books for candidates with the talent, focus and intensity that these jobs call for. I will be glad to print extra copies of this report to use as a sales brochure for the search.



James M. Stone