The Plymouth Rock Company
695 Atlantic Avenue
Boston, Massachusetts 02111

Chairman's Letter

February 20, 2007

To Our Shareholders:

The year 2006 brought record profits again. Net income was up by 16% over the prior year, to a new total of $53.9 million. That we passed the $50 million milestone in net income is certainly gratifying, but, as usual, the results require more than a few numbers to tell their story. Last year, I expressed more concern about the top line trends than about the profits. Indeed, the trend in our total premiums underwritten and managed underperformed the bottom line substantially. Total group volume fell from $1.06 billion to $1.05 billion, about 1%. While this is not so bad in a year of flat or falling premiums for the auto insurance industry, it is quite far from our long term target. A note of caution about net income is appropriate as well. Like many companies in 2006, Plymouth Rock experienced reserve releases from prior years that added to its reported gains. In our case, this was particularly so. Almost $10 million of the Company's reported income for the year arises from a net reduction of prior period indemnity reserves in Massachusetts auto insurance, including reserves for residual market assessments, a gain not likely to be repeated soon. There is good news that may not meet the eye right away as well. The whole Plymouth Rock group is still in the midst of the most ambitious and expensive systems transformation in the Company's history, so the 2006 results inevitably record substantial costs of that work without yet reflecting its expected efficiency rewards. Perhaps most important, our enterprise prospects for 2007 are looking quite good as the new year begins. Overall, Hal and I would recommend a smile.

Shareholders' equity for our group now stands at $249 million, reflecting a 26% increase since December 31, 2005. The per-share book value is $1,358. Cumulative book value return on capitalization from Plymouth Rock's 1983 inception, a number I provide to you each year, now stands at 18.8%, up a full half point from last year's reading. Remember that the book measure applies no valuation multiple, or a multiple of unity, to the shareholders' equity, and thus it surely understates in our case the internal rate of return for an original investor. Our New England underwriting companies and their subsidiaries, taken as a group, had $336 million in gross premiums written in 2006, and their contribution to net income came in at 8.1% of their gross writings. The three insurance management companies and their subs oversaw $716 million in writings, and they brought 3% of this total to the bottom line. My shorthand targets are for our underwriting companies to return 7.5% on gross premiums and for the reciprocal managers to earn about half that. With the help of reserve releases, the underwriters exceeded this target in 2006. The reciprocal managers fell just a little short. The group as a whole, configured as we are today, should earn 5% on gross premiums. The reported number was a hair better than that. Our investments had a fine year, beating both the fixed-income and equity benchmarks and our own long-term performance statistics handsomely. The increment to overall net income from investing in a portfolio broader than just investment grade bonds in 2006 was $18 million pre-tax, an exceptional contribution to the overall good results given our investment constraints and conservative inclinations.

The greatest source of concern as 2006 began was declining volume in our New Jersey companies. Written premium at High Point and at Palisades had fallen by nearly 10% in 2005, so all eyes were on those companies in 2006. The recent year's news at Palisades was reassuring. The number of vehicles insured by Palisades was 132,000 at the year's start and rose to 138,000 at its close. Although the turnaround is owed in part to the purchase of a small book of business from Parkway Insurance, endogenous growth was also running at a positive annualized rate of over 7% by year-end. The return to growth, moreover, seems not to be an anomaly. Persistency, the percentage share of our policyholders who renew with us, rose steadily in the second half of the year, returning by December to territory past the 85% marker that I consider the healthy company borderline. The fourth quarter was also the best quarter for new business. These improvements appear to be continuing into the current year, with another acquisition adding to the stream as well. Palisades' loss ratio was good, perhaps even too good. According to A.M. Best statistics, in fact, Palisades had the lowest average loss ratio for the 2001 to 2005 period of the top 50 auto insurance writers. The 2006 accident year pure loss ratio was in the low 50's. I'm proud that our agents and underwriters are so skillful, but I'd welcome a drop from best-in-show to merely best-quartile with respect to loss ratio if it came with a fast enough rate of growth. Even better would be to cut the expense ratio that Palisades now shows, so that loss ratio would need to rise only a few points in order to reduce our prices and encourage rapid growth. Now that the Matrix redesign of our IT systems has been largely (and very professionally) implemented at Palisades, Ed Fernandez and his truly first-rate executives are working on exactly that.

High Point, where Gerry Wilson and Jim Tignanelli are the chairman-president team, has a tougher challenge than Palisades. The turnaround is not nearly so complete at High Point, but I am heartened by trends there as well. Historically, direct response companies have drawn more from the market shares of carriers with proprietary sales forces than from independent agency carriers. If that is what happened in New Jersey as the estimable gecko proliferated and threatened the Garden State's various native species, one would expect High Point to have been relatively hard hit. High Point's count of insured vehicles fell by approximately 9% in 2005. In 2006, the count fell again, this time by 7%. The news is actually better, though, than a slight reduction in the rate of decline. High Point has just renewed its contract with the Prudential marketing force for five years following the two remaining in the current contract. This will give both the Pru agents and High Point extra motivation to search for mutually rewarding innovations in sales. High Point, moreover, has recently purchased from Lancers Insurance, effective at the start of 2007, its subsidiary specializing in New Jersey teachers. This is a book of almost 30,000 insured vehicles. Marc Buro will lead an effort to boost our share of that attractive specialty market. Gerry reminds us regularly that every week without growth is a week without sunshine for him. Hal and I have always liked that trait in Gerry.

One contributor to my confidence is that GEICO seems to have exhausted early most of the potential direct response market in New Jersey. Auto insurance has long been a segmented market, where some customers prefer to buy from agents with whom they have a personal relationship and others directly from a carrier. Before its direct response competitors could even get started, GEICO had the smarts to sweep into New Jersey and soak up as much as it could of the readily available direct response share. I can't imagine that its growth will continue at anywhere near the initial clip. Another source of confidence is that our New Jersey service remains spectacular. With other companies just starting to boast of good service in their ads, we have the real thing. Palisades once again had zero valid complaints filed with the N.J. Department of Insurance, making it the best in the state by that test whether one looks at a one-year, three-year or five-year period. High Point also does extremely well by the complaints measure, with only three valid complaints last year, but it still has to catch Palisades to be the state's best. It is also worth noting that, as I predicted in last year's letter, New Jersey is coming back to its senses on the public policy of the automobile insurance market. The free-for-all deregulation that wooed some national players back into the state swept some valid and important urban rate protections away along with more burdensome and less necessary restrictions. The Corzine administration took admirably little time to realize that availability and affordability are unavoidable government responsibilities with respect to an expensive, compulsory product like auto insurance. There is every indication that New Jersey will once again act in 2007 to protect its urban population from unsustainably high relative rates. We will be fully supportive of these efforts, even if much of the industry opposes them. Sound public policy will help level the playing field among carriers and eventually benefit widely accessible carriers like ours as well as the driving public.

Pilgrim Insurance had a big year, though you won't see the impact in the profit numbers for at least another year. Its managed premiums grew by over 40%, including work it does for other companies in our own extended family, and it opened two new lines of auto insurance servicing business, one here in Massachusetts and the other in New Jersey as a joint venture with High Point and Palisades. Pilgrim contributed $2.7 million to the group bottom line, less than last year's number, but this will surely increase as the new business comes fully on line and Ellen Wilcox continues to add to the client base. Return on equity continues high, at 24%, in part because so much of the capital of this business is in its people. Ellen recruited two new officers this year, expanding that strength and setting a good example for our other company leaders.

Plymouth Rock Assurance, by far the largest of the three underwriting companies, had a year that seems too good to be true. While the results are in fact true, they *are* too good to be repeated. The Massachusetts and Connecticut auto insurer produced a profit of $25.1 million after taxes, about half again its budgeted result for the year. The principal reason for the cornucopia of earnings was that, with increasingly timely and accurate estimates of residual market deficits available from Commonwealth Automobile Reinsurers, Plymouth Rock Assurance has accelerated the timing of CAR reserve releases. We had always been very slow on that score over the years, in the interests of conservatism. Our former timing would now be unreasonably slow. Speeding up reserve adjustments after a period when results have been extraordinarily good necessarily has a profoundly positive impact on the bottom line. Had there not been the reserve speedup, the year's results would have underperformed the budget, but would still have been respectable. The loss ratio at that company, even excluding reserve releases, remains absolutely solid, and the growth rate was once again at the top of our peer group. The challenge remains the expense ratio. Put bluntly, we still have not figured out how to be a low-cost producer without sacrificing our unusually high service level. Executives here who contribute to that accomplishment can expect all the kudos and thanks I can give them. Results in Connecticut and New Hampshire remain quite disappointing, with premiums written down for the year in both states. The two states are still small components of our book, but I hesitate to start up fresh in, say, New York or Pennsylvania until we can show that we can build our books in the two states in which we are already writing. Thom Cranley, the man in charge, has a good product manager to the north and several candidates for the same role south of Massachusetts, and there has been a major product redesign for both states, but results are still in the future. Watch this spot next year.

One of the most significant of 2006 events in Massachusetts was an event that did not occur. Once again, the coalition of insurers seeking an overhaul of Massachusetts regulation failed to get their deregulation program implemented. The overhaul coalition of companies had two partial victories, however. One was a smooth implementation of the redistribution of Exclusive Representative Producers (brokers having no voluntary appointments with insurers and assigned to companies involuntarily) among the carriers writing auto insurance business in the state, a step Plymouth Rock joined with the coalition in supporting as a fair method of equalizing the ERP burden. The other was a victory in the Supreme Judicial Court, affirming the authority of the Insurance Commissioner to scrap the current reinsurance pooling mechanism in the residual market in favor of an assigned risk plan similar to those used in most other states. The Court's decision was swiftly followed by the promulgation of implementing rules by the Commissioner, but she did not remain in office long enough for them to take effect. A new administration took office in January and suspended action. The incoming governor, Deval Patrick, appointed his own Insurance Commissioner, a highly respected judge, and established a study group of insurance experts and distinguished citizens to examine the wisdom of proceeding with the proposed changes. We were not a party to the litigation challenging the Commissioner's authority, and we are not opposed in principle to an assigned risk system. We are decidedly not, however, a member of the overhaul coalition of companies, and we would not be saddened to see a return to the drawing boards before such fundamental changes are made to the system of regulation here.

When the government decided to require insurance as a condition of driving a car, which was in 1927 here in Massachusetts, it took on a responsibility to safeguard the availability and affordability of the insurance product. Some members of the overhaul coalition want to blow up the appropriate protections Massachusetts has built up over the years. One such protection is provided by rate tempering, sometimes called flattening, which reduces territorial and other demographic differentials (but not driving record differentials) between the highest and lowest premium rates in the system. Another is a prohibition on companies in our state charging a driver an increased premium based on subjective or unstated criteria by placing that driver in a surcharged residual market pool. A third protection is that Massachusetts, where the Commissioner sets maximum rates and lets each company offer its own discounts below the established rate levels, does not employ rating differentials based on credit scores, occupation or other socio-economic variables other than principal place of garaging. A powerful system of credits, invisible to the consumers, allows the market to work with all of these restrictions and restores company incentives to write in all territories and for most drivers. The residual market in 2006 contained fewer than 5% of the state's drivers. For thirty years, consumers have been relatively content (or as content as they can be in a state with a high overall rate demography), and it is undisputed that companies are doing quite well here. Massachusetts ranks among the two or three best states for percentage of drivers insured, and forty-nine states have had more rapid rate increases over the past four years.

Having said all of this, we at Plymouth Rock believe that the residual market system, even after ERP redistribution, could be fairer in its allocation of costs among companies, and that an assigned risk system, where each company pays 100% of the claims it settles, has better behavioral incentives than a pooling system, where each company has custody of an industry checkbook. For this reason, while most Massachusetts writers are polarized at one extreme of the debate or another, we did not join either the overhaul coalition or the anti-overhaul coalition. We would prefer to work toward the best of both worlds. As long as there are legislative protections for the consumer, reflecting an acceptance that our public's protections do not have to be abandoned just because some other states have accepted a lower standard of fairness, Plymouth Rock is open to any improvement in the residual market. In the end, it is government's job, and not industry's, to set levels of regulatory protections. The new Governor has shown all the right instincts on issues of fairness. Hal, Paula Gold and I will offer to be as helpful as we can to his appointees as they search for the appropriate public policy answers and helpful again in implementing the decisions they make.

Our New England homeowners business at Bunker Hill Insurance grew in both premiums and earnings contribution. Net income exceeded $2 million, up 41% from 2005. All of this was accomplished by John Tierney and his team against a backdrop of systems changes and skyrocketing reinsurance costs. The systems upgrade was part of our enterprise-wide Matrix project and is now essentially complete at Bunker Hill. The reinsurance costs were courtesy of Katrina and Wilma, as well as changes in the various models that attempt to predict damage potential from storms. I worry that all of these models, though well-intentioned, are biased upward in the states where events are fewest and actual data therefore most sparse. The reinsurers who buy the products of the modeling companies would presumably prefer to spread price increases over a broad area than to seek them only where regulators and customers are already in shock. Rating agencies and the modelers themselves have more to lose by underestimating the risk in seldom hit locations than overestimating it. While I cannot prove that these unintended asymmetries actually cause the Northeast storm hazard to be overstated by the modelers, raters, and reinsurers, I am increasingly committed to forming our own considered judgments. A conclusion that there is an overstatement of risk in reinsurance prices could lead us to a cautious increase in retentions within our own family of working layer storm coverage at Bunker Hill.

The Plymouth Rock portfolio at year-end 2006 was invested 41% in investments other than bonds and cash, up from 34% at the end of last year. This seems a healthy change in an era where investment grade bonds seem to be held mainly by institutions externally induced to hold them. A diversified portfolio of publicly traded common stocks seems to have replaced bonds as the conservative vehicle of choice, and alternative equity vehicles have replaced stocks as the standard domain in which to seek higher returns at higher risk. A younger writer might say "Stocks are the new bonds", or something to that effect. The total return on investments during 2006 for the Plymouth Rock portfolio was 13.4%, which is 532 basis points above our from-inception average return and looks even better when compared to the prior year taken alone. The bonds returned 3.75%, beating their modest benchmark by a small margin. We have never had much of an appetite for credit or interest rate risk in order to boost that return. The common stock portfolio, in our case markedly undiversified, produced an immodest return of 24% in 2006, with Morgan Stanley, Merck, ExxonMobil, and Target all star performers. The 2006 result helped secure a record of which we are particularly proud: since Jim Bailey, Rick Childs and I began investing in common stocks back in 1993, our all-time compounded IRR has exceeded 20%. The diversified equity arbitrage funds we call equity equivalents were also big winners in 2006; so, too, was owner-occupied real estate. With the Big Dig about finished on Atlantic Avenue, we are situated in what has to be about the most desirable business neighborhood in the world.

Last year I waxed a bit about private equity investing. I can usually tell when this letter has either been unclear or wrong from the number of comments I receive from its readers; the valuable exercise is then to figure out which sin I've committed. I said last year that no one knew how to quantify the aggregate opportunity for private equity today, but it could be at least as great as implied by the prodigious amounts being raised for that kind of investing today. A number of readers suggested that I have simply gotten caught up in the latest bubble mentality. Let me take another crack at the same discussion. It is incontrovertible that record amounts are being raised these days by private equity buyout fund managers, as well as numerous other alternative equity fund managers whom this discussion is specifically not addressing, and it is similarly evident that published returns for the best known of the private equity fund managers have exceeded returns typically available in the public equity markets. The economist in me wants to know why these events are occurring and whether they will continue. The easy part is that the latter condition, atypically high returns, drives the former, the ready flow of funds. I suspect that the flow of funds is also aided by increasing concentrations of assets in the hands of professional managers. Widely dispersed savings don't seek, and can't find, private equity deals. The vast sources of liquidity from which specialized investments are made today are a product of financial concentration. This is an era in which little heed is paid to the worries of Jefferson and both Presidents Roosevelt about inherent dangers to democracy and economic stability from gargantuan scale in business and financial institutions. Assets today move quickly and in huge quantities according to the decisions of a relatively few professional overseers. They will make their money available to private equity funds, just as they will for hedge funds, as long as these investments suggest high returns. The harder question here is why there appear to be such alluring returns available.

Without question, a goodly fraction of the apparent excess return is simply illusion. Minimally regulated investment pools tell us largely what they choose, and it is human nature anyway that press and public attention tends to be drawn mainly to the best, or spectacularly bad, performers. More careful observers assure me that there is a complete spectrum of results in private equity, from winners to losers and everything in between, and it is next to impossible to compute fully reliable performance averages. In this field, where one knows relatively little about the losers, it is easy to believe the average performance is better than it really is. Reporting, moreover, allows fees, which are highly material, to be obscured and dogs to be held with the true late bloomers for many years in portfolios at cost while successes are realized or revalued early. Both of these reporting imperfections plainly tend to bias published IRR's upward. Still, I remain doubtful that all of the unexplained returns are illusion. It seems unconvincing, as some have asserted, that the high returns are mathematically equal to the S&P common equity returns, adjusted upward for risk. Even with corrections for risk and illusion, the returns for the major private equity firms seem to have been above those for diversified public equity investment funds. If this is the case, I'd look to two principal explanations: leverage and discipline. Private equity investors may be correcting for unnecessarily conservative tendencies in business operators (such as myself) with respect to debt, or they may be overcorrecting. If the higher leverage is effectively compensating for management over-conservatism, the incremental return will be greater than just the payment for risk. If leverage is stretched beyond optimal, private equity managers having been tempted by readily available and cheap debt, on the other hand, the returns achieved could actually be less than the risk should require. We can't really learn which situation applies, case by case or in the aggregate, as long as interest rates remain so low. Today's interest rates are low enough to make both correction and overcorrection look like gloriously brilliant strategies.

The return increment from increased discipline is not dependent in the same manner on economic conditions. Here private equity investors may be compensating for another conservative tendency in business operators (such as myself once again) -- not to rock boats quite as often as they need rocking. CEO's, especially those of us who pride themselves in taking account of the human dimensions to our businesses, tend not to remove veteran executives, reexamine assumptions, shake up our organizational structures, revisit assumptions of corporate culture, or seize new expansion opportunities as often as might be ideal for the pure maximization of profit. Some of us (*not* such as myself, of course) tend to stay on the payroll longer than we should. Private equity managers are an unusually smart and driven subset of the population, and they can be dispassionate, even in some cases to the point of ruthlessness, in dealing with such matters. There is no gain that will survive the market learning curve, of course, when the actions of the new owners are mainly designed to take early dividends and dress up the company for resale, at the expense of its future prospects. Conversely, there can be true economic gain when the added discipline leads to expansion, whether by organic building or intelligent acquisitions. This last point, by the way, may be an argument for avoiding funds too bulked-up, or ill-prepared, to permit active attention to fostering growth. While I sometimes hesitate to admit it, I am inclined to believe that, all in all, the impact of unemotional growth-focused discipline on a typical company's rate of return is likely to be in the positive direction. Note please that I have not mentioned selection of companies in which to invest as the top reason for above-market returns. This was once a powerful contributor, but I doubt it still has the impact it had before the funding boom. With all the private equity funding now in use, virtually every company that wants a private equity owner can find one, and prices paid are, at a minimum, more efficient. Though the advantages, including with respect to investment selection, that the most competent private equity investors have over the less so are durable, the industry-wide edge that existed in smart investment selection, at least in the U.S. domestic corporate sphere, is either diminished or gone.

All market anomalies must end someday. That private equity returns will at some point reflect only the appropriate premiums for risk and liquidity we can be pretty sure, but the timing of all such corrections is tougher to divine than the direction. It is a reasonable bet that those who measure such things are already witnessing an expanding gap among performance quartiles of private equity firms, and seeing a simultaneous diminution of the mean result. Although these trends should continue until the process is complete, market corrections are not constrained to occur in an orderly manner or a predictable pace. At a minimum, reported returns will be boosted as long as real interest rates remain historically low. And when rates rise, the discipline advantage, at least for the builders rather than the superficial arbitrageurs of acquired businesses, can continue as long as there are enough potentially improvable companies to be bought. It must of necessity terminate when there is too much private equity money chasing too few opportunities. The private equity phenomenon is more than a bubble, but less than a miracle, a paradigm shift, or a change in the rules of sensible investing.

Much has happened at Response and Homesite, in my view largely to the good. Both of these companies, in which Plymouth Rock and I hold sizable investment positions, experienced changes of ownership in 2006. At Response, a direct-to-the-consumer automobile insurance carrier, an eleven-year-old shareholders' agreement expired. Mory Katz, Response's veteran CEO, continues in that capacity as president, but I am no longer serving as that company's chairman. Having held the title of chairman of Response since 1995, it was not without some emotion that I relinquished it to Jeff Keil, an experienced leader in financial services who has consulted for Response during much of the last two years. I gave up the chair in November for two reasons. Most simply, my contractual tour of duty was up in 2005, and it had been long understood that I would not extend it indefinitely. More important, I had concluded that the job of building that company required more than I was able to give it in my part-time role. Response has done a credible job of launching itself as a national (other than Massachusetts) player in direct response auto insurance, and building a reputation for fine service and competent administration at its current scale of $140 million in written premiums, but it has not developed a growth engine that permits organic expansion at a rapid rate.

With my strong support, the private equity partnerships managed by Metalmark, which have held a dominant position in Response but shared Board control with us and others during the term of the 1995 agreement, are negotiating to sell more than half of their position to JC Flowers & Co. Chris Flowers is an investor with a reputation as a winner and a person of the highest ability and integrity. He has recently raised a multibillion dollar private equity fund to specialize in financial services, so he would be a perfect partner for Response. I am hopeful that adding Chris and Jeff to the team may allow Response to accomplish what the current leadership has not yet brought it: marketing capabilities and creativity powerful enough to assure rapid growth at profitable metrics and staying power sufficient to attract the best available talent. I have offered to assist the company as a consultant and to return to the Board as a director should the negotiations conclude successfully; Metalmark and a number of its distinguished co-investors would also plan to stay active.

Homesite Group underwrites homeowners insurance throughout most of the country and gets its business largely through referrals from well-known corporate mega-partners. AIG Direct and GMAC Insurance are now the largest of these partners, and this year Progressive, which has the potential to match anyone out there as a homeowners source, is starting up with Homesite as well. Homesite has recently passed the $200 million mark in written premiums, and, under Fabian Fondriest's fine leadership, it continues to grow rapidly. To finance its growth, Homesite raised $120 million in new capital at year-end 2006, all from one new investor. Our new 33% shareholder is Alleghany Corporation, headed by Weston Hicks, whom Hal, Fabian and I, as well as several of our Board members, have known and respected for some years. We are all enthusiastic about working with Weston. Alleghany will, from now on, be a full partner in Homesite's long-term development.

Homesite's metrics are a delight. The pure direct loss ratio for 2006 was 51%, making this the fifth consecutive year in which this essential index of underwriting quality has remained 59% or better at Homesite. Homesite's current scale, though rapidly being left behind, is sufficient to permit Homesite at long last to achieve a competitive expense ratio as well. The combined ratio for 2006 was 94.9% and that was with nearly 40% earned premium growth. The combined ratio on renewal business is even lower, comfortably in the eighties. Homesite earned its first underwriting profit in 2006 and produced $18 million in pre-tax net income. Fabian and his close-knit team have every reason to be proud. The year just starting looks promising for both the top and bottom line and, thanks to Alleghany, Homesite has enough capital on its books to grow at prudent capitalization to at least half a billion dollars in annual premium volume.

On my list of objectives every year is upgrading our talent. We were second to none in Massachusetts for analytics when we started writing business in 1984, but now we need to be the best in the country. That's a more formidable goal, especially with Progressive out there teaching the industry new standards of analytic excellence all the time, but we took a major step this year in that direction. Hal and I had long been convinced that some of the best analytical brains are either inefficiently used for, or not ideally suited to, management tasks. So, we established a group of Plymouth Rock Fellows, at the status of officers but largely exempted from the normal chain of command. Our first three Fellows are proving themselves admirably at pricing and product design and, while the model is new and untested, we expect this arrangement to be a source of great strength for our group over the years. We would welcome a few more university-quality thinkers in that elite group. As always, we could use more traditional officers and managers of the highest caliber as well. That search is constant, so join us in searching. We'll always be willing to create a new job if we find a person with long-term prospects for excellence and don't have the right slot at the moment.

In closing, I'd like to congratulate Hal Belodoff, my partner in every aspect of the enterprise, for taking on the title of President of The Plymouth Rock Company. I've had that title myself since the Company's inception, along with the chairmanship, but Hal has fully earned it now. We have strengthened our Board as well with the addition of Sandra Urie, the first new Plymouth Rock Company director in some years. Sandy is the CEO of Cambridge Associates and a first-class executive in her own right. We will benefit from her wisdom and welcome her warmly as we contemplate what Hal calls our next billion.

James M. Stone