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

## Chairman's Letter

February 8, 2015

## To Our Shareholders:

There seemed every reason to anticipate a good year in 2014 throughout our family of companies. While a repeat of the prior year's record results, boosted by the sale of Homesite, was beyond the borders of the possible, Hal and I hoped that your company would report net income of nearly \$50 million, approaching 2013's profit net of the Homesite gains. The year was still young, though, when Massachusetts automobile underwriting results began to fall behind; and they worsened as the months went by. Since that line of business is key to the shareholder-owned portion of our enterprise, income for the shareholders suffered. In the end, we earned little more than half of what was expected. The Plymouth Rock Company's net income was \$29.2 million, down 56% from the 2013 number and 39% below 2012's less extraordinary profit of \$48 million. Return on starting 2014 equity for the shareholders was 8.4%.

The complete picture is not quite as bad as this lead-off might suggest. There was good news from New Jersey, where the reciprocals we manage produced another \$20 million in net income. The fully consolidated net income for the whole group was \$49.0 million. The equity investment portfolio helped as well. In addition to the realized gains that flowed into income, the securities portfolio provided us substantial unrealized gains, of which \$23 million flowed into shareholders' equity — although they aren't considered a part of net income. Plymouth Rock's per-share book value now stands at \$3,089 per share versus \$2,720 a year ago, up 14%. The 2014 results reduce the cumulative annual book value rate of return since inception (in 1983) by less than a tenth of a point; it still rounds to 18.2%. If real estate gains were included on the balance sheet or measurement of return, along with the other unrealized gains, the single-year rate of return in 2014 would exceed 16%, a solid number by American business standards though less than our own historical average return.

Another positive note is that Plymouth Rock grew in both of its markets. The group's underwritten and managed premium volume now stands at \$1.11 billion, up almost \$40 million from a year ago. New England's premium growth approached 9%. We were the only Massachusetts independent agent carrier to significantly expand market share. Our premium growth in New Jersey of 1% may not seem impressive, but it is satisfying enough given our recent history and market conditions there. After experiencing several years of declining volume in that state, we welcome the upward slope, however humble. Another 2014 plus is that the construction of a top quality analytical underwriting staff,

something I had identified as my top priority a few years back, is now complete. We finally have the math and statistics brainpower a modern company needs, and in fact a strong enough team to set our sights on breaking ahead of the pack. I'd like at some point to have the same with respect to social media and other contemporary marketing methods, a capacity we will try to build in both our core business and our new insurance brokerage firm.

In order to finance 2013's stock buy-back without decimating our equity portfolio, we added in that year a collateralized loan of \$45 million to our balance sheet. Since I am habitually debt-averse, I had every expectation that we would rid ourselves of that troublesome loan by now. We moved part way in that direction, but I just couldn't bring myself to finish the job. Federal Reserve policy and a lukewarm economy have rendered this a freak period for interest rates, where debt appears a true bargain. Jim Bailey and I still expect prospective equity returns to exceed borrowing costs by a solid margin. Recall, moreover, that the debt is fully collateralized, with a large cushion to spare, so we are far from betting our legacy on market predictions. We are conforming to the advice I received 45 years ago from a mentor, Georges F. Doriot, who insisted, "You must never borrow money when you need it; only when you don't." We ended the year with \$15 million of the original loan still on our balance sheet.

New England results get the front page among individual operations this year, not usually a coveted spot. Chris Olie runs our New England businesses. Three-fourths of his domain's volume comes from Massachusetts auto insurance. This line has been a solid performer for us since the Company's inception, with reasonably consistent top and bottom lines gains. By February, Chris was already warning us that 2014 would fall short. This past year brought the coldest, longest winter Massachusetts has experienced in the new century. March temperatures were five degrees below the fourteen-year norm. Elevator conversations, among folks bundled up even for short walks, were suddenly riddled with a new phrase: Polar Vortex. The relentless cold begat icy roads, and the slippery roads begat unanticipated accident frequencies.

The frigid winter would have been bad enough, but there was a second drag on New England earnings – this one of our own making. It became apparent by midyear that our prior-period automobile insurance claim reserves were inadequate. Reserving is by its nature an inexact science. The task is to predict the final claims cost to an insurer for a stated period at a time when some of that period's claims are yet to be adjusted and paid, some may be awaiting arbitration or trial, and others have not even been reported yet. An actuary uses historical patterns and professionally honed reasoning to make an educated guess about the ultimate costs, and we book a number based on that estimate as a reserve. We do not expect these predictions to be precise, but we always hope that they will prove neither insufficient nor so inaccurate as to misinform our pricing process or the readers of our financials. Our record in Massachusetts auto insurance reserving had been acceptable for most of the last ten years, but it is clear that the reserves set aside for 2012 and 2013 were inadequate. While the shortfalls were within the range of imprecision our industry expects from time to time, less than 4% in each of the two years, the double catch-up for two years of inadequacy was painful for our calendar year performance in 2014. Add the reserve strengthening to the impact of the long, cold winter, and the year was bound to disappoint. The combined ratio for Massachusetts auto was 103%, and the net income for the whole of our New England underwriting businesses was less than \$3 million, almost \$14 million under budget.

Our joint marketing program with AARP, a cheering bright spot, gained steam in 2014. The growth in New England writings reflected this special opportunity and healthy independent agency relations in general. The latter assertion is evidenced by the fact that our premiums written in Massachusetts have grown by a cumulative 33% in the past three years, not bad for a company some thought couldn't thrive under the state's managed competition regime. A number of our agents in both New England and New Jersey have told us that we are the best of their company partners for this rapidly evolving insurance marketing environment. That's a lead I would like to widen. The direct response giants, GEICO and Progressive, now share a Massachusetts market penetration of 8.5%, up about a point and a half from a year ago. They could perhaps have grown faster, but they still chafe at Massachusetts' admirable consumer safeguards, restricting the use of credit scores and other socio-economic variables in pricing.

Bunker Hill is our New England homeowners carrier. For some years now, it has been shifting emphasis away from writing business when it covers a customer's home but no company in our group insures the auto. Bunker Hill now concentrates on attracting account-written business, where we write both. Premium grew by nearly 13% to \$47 million during 2014, and the transition to account-written business is nearly complete. The harsh winter that hurt our auto results so badly had reassuringly little impact on our homes, and the net income contribution of Bunker Hill to our group exceeded \$3 million. Pilgrim Insurance Company does work for other insurers on a fee basis. It does a fine job for its customers, and thus continues to add clientele. The Massachusetts public's gain, though, has been Pilgrim's loss. Our Pilgrim's progress has been slowed by healthy conditions in the insurance marketplace, which have caused the involuntarily placed pool of drivers to shrink. Servicing that pool is where Pilgrim had always earned plaudits, but when that residual pool is small, so is the available revenue. The personal auto residual market a few decades ago in Massachusetts was larger than the voluntary market. Now it represents just one to two percent of the total. Still, Pilgrim this year added an important new account, and it kept its contribution to 2014 profit at \$2.3 million, about the same as in the prior year. Our forays into other New England states haven't moved any needles much. Mt. Washington Assurance, in New Hampshire, contributed a tiny profit to the group on a \$17 million book of business. Our Connecticut earned premium jumped by 50% to \$21 million, but it is still written at a loss.

Plymouth Rock Assurance of New Jersey is a tale of three channels. Our industry generally classifies distribution methods into three sales buckets: Independent Agency, Exclusive Agency, and Direct Response. In New Jersey, we use all three approaches, and all are important to us. Our Independent Agency business is our oldest New Jersey channel. Only by comparison to some recent past years would we celebrate its 2014 performance. Its overall profit contribution was negligible, and the number of cars and homes it covers rose by almost 4%. On the growth front, though, this handily beat that channel's last five years' track record, so we hope we are seeing a trend that will continue into 2015. The auto insurance market in New Jersey continues to be quite competitive, with the direct response carriers continuing to drain market share from the two agency

channels. Plymouth Rock's New Jersey profit in the Independent Agency channel came entirely from homeowners writings in 2014.

The Exclusive Agency business we write in the Garden State has always been profitable, except in the year of Superstorm Sandy. It suffers, however, from The Shrinks. The number of autos covered was down 5% in 2014. Since Prudential homeowners is our most profitable New Jersey line, and Prudential auto is next, Gerry Wilson's most enduring task as New Jersey CEO, and among his most challenging, is to expand that business. The New Jersey direct response channel is the newest and the fastest growing of the three distribution methods, but its business has yet to reach profitability. Building a direct response book that loses money is not actually a tough challenge. Internet and telephone shoppers are price sensitive enough to arrive in droves if a company purposely underprices its product. The task is to attract them at prices that make the company money. Direct automobile premium has now reached \$86 million, and is expected to approach \$100 million in 2015. Scale will help the expense ratio, and seasoning will help the loss ratio, so we are counting on the net losses in this channel to decline from this point forward. Gerry, Hal, and I are all, in any case, committed to a three-channel strategy in New Jersey, so we will press forward on all three fronts.

The course of my own work at Plymouth Rock took a bit of a detour in 2014. Hal was out on a well-earned sabbatical in the spring, and Chris took a sabbatical in the fall. It is just coincidence that these relatively rare events occurred in the same year, but the confluence provided me an opportunity for more involvement than normal in the Company's day-to-day management. It was a little like a rerun of a movie from decades ago when I touched everything. My principal focus turned out to be our expenses, since Gerry and Chris took the long oars in moving ahead with the IT team on our essential systems alignment project and Mary Sprong led the successful effort to earn us a coveted spot on the Boston Globe's roster of Best Places to Work in Massachusetts. With much help from other officers, and competent input from an expert outside consultant, I definitively established what we all already knew. Plymouth Rock's overall expense levels, considering all spending other than claims checks, have been about two points higher than industry norms, properly adjusted for marketing channel mix. All officers have now joined me in a pledge to lower our all-inclusive expense ratio by a full point in calendar 2015. We will then endeavor to do the same again in 2016. This will be no small effort, but it is long overdue.

Our bonds returned close to nothing on a GAAP basis, a reflection not of poor management but the current interest rate environment. Stocks, though, made up for the bonds, and our portfolio is more weighted toward equities than those of most insurers. It would scarcely have been possible for the 2014 stock market to have matched its 2013 gain of 32%. Those returns are the stuff of dreams, or more precisely they exemplify the occasional spurts that provide the rationale for a buy-and-hold equity strategy. You don't know when the express train is coming, but you certainly don't want to miss it by staying away from the platform in the delusional belief that you can predict when the fast trains are coming and then rush in to catch them. The Standard & Poor's index returned 13.6% this past year, which isn't all that bad. The overall equity return on our always undiversified portfolio was over 18%. The best performing stock was Intel, which rose 44% during the year. At the other extreme, we have a loss on Coach, a position that

prevailing accounting standards require us to record as Other Than Temporarily Impaired. We haven't sold our Coach stock, which you can take as a sign that we remain convinced the retailer's recent weaknesses are reversible. The compound annual gain on Plymouth Rock's common stock investments now stands at 16.7% from inception. This compares nicely with the S&P return of 13.2% for the same period.

Our various companies' investments in competitor Safety Insurance appreciated 18% during the year. We recently sought, and obtained, permission from the state's Insurance Division to allow the combined portfolios we manage to exceed the (almost) 10% of Safety's common stock already held, and we are watching its price carefully now to see if we should purchase more. Yes, this effectively increases our concentration in a single market and product line, but it's one we know well, and we continue to think that Safety is a conservatively run company with more upside than downside. Massachusetts automobile insurance gained a poor industry reputation because of its consumer protections, not its lack of opportunity to earn a fair profit. Had we bought more Safety shares (or, in fact, more of our own shares) in the past, our book value would have grown faster over the years.

Boston real estate enjoyed price rises in excess of long-term trends as well. Gains in the value of our two downtown buildings are not reflected anywhere on our balance sheet or income statement. For historical reasons likely related more to pressure from major financial institutions than public policy goals, Generally Accepted Accounting Principles require that our real estate be carried at amortized cost, no matter how much it may have appreciated in value. Our Massachusetts insurer was able to reflect the full appraised value of the Plymouth Rock Building on its statutory accounting statements by selling it to the parent holding company, but the parent can only carry the building at cost. Consequently, while 695 Atlantic is now worth close to twice our cumulative cost, this gain is not reflected on the consolidated balance sheet. Consider the tax-adjusted gain a component of book value, as real as any other, even though you need to search the footnotes to find it.

The equity securities in our portfolio, other than marketable stocks and real estate, include hedge funds and private equity partnerships. These did not match our marketable equities in performance for the past year. I hear more and more these days that hedge fund indices generally are slipping in return relative to the market, which presumably is related to their over-proliferation. Hedge fund management is the very peak of fashion for talented young people making career choices in this decade, a danger sign that glows ominously in the dark. This observation provides a decent bridge to my next topic.

I often devote a bit of this letter's space to public policy. Excesses in the financial sector have been my recent topic, with a focus on the large banks. This is in part because the banks were at the center of the 2008 crisis and will likely be, if not reined in, similarly central to a next crisis. Hedge fund activity was not the proximate cause of the crash, and the hedge funds are not as vital a part of our economic system as the banks, so they are generally given less attention. More and more, however, I hear from regulators, scholars, and bankers that the reforms needed in banking can never be implemented because the partially regulated banks would then simply lose their business to the unregulated shadow banking world. That world is where hedge funds dominate.

The phrase "hedge fund" is a misnomer; there is no requirement that these entities offset, or hedge, their risks in any way. The phrase, at least in the United States, really means any money management vehicle exempted from regulation under the Investment Company and Investment Advisers Acts of 1940. The Dodd-Frank Act has recently required registration by hedge fund managers under the advisers' law, but it did not apply the regulatory strictures or disclosure requirements that the two Acts' framers intended to go with this registration. My view is that, although a number of hedging techniques not visualized in 1940 are useful to our economy, the very existence of exempted investment funds is an error of public policy. What began as an exemption for family offices (with no money from the general public) morphed into an exemption for any collection of wealthy investors, which in turn evolved into an exemption for all large investors, including pension funds and other repositories of the general public's savings. One of the most successful regulatory regimes in history was thus gutted.

The consequences include these. We are denied regulatory repair in the banking sector. Tax dollars are lost in untraceable overseas dodges. Wealth and influence have become all the more concentrated in the hands of a few. Much of the country's best talent is drained into unproductive trading activity and its defense. And all other market participants are disadvantaged by a host of strategies, too many of which are on a spectrum that runs from blatant illegality to financial freeloading – scarfing food from the table of slower or more scrupulous investors. I don't presume hedge fund operators to be any more or less honest than anyone else, but under the cloak of invisibility many more will misbehave than would do so in plain sight. Louis Brandeis famously said that sunlight was the best disinfectant. The shadow banking world should now undergo a major cleansing with that disinfectant. The best start would be to revoke most all of the current exemptions from a modestly updated 1940 Act. The next step would be to require full disclosure of holdings and strategies, and then the forbiddance of those that harm markets and disadvantage ordinary investors. Plymouth Rock invests in some carefully vetted hedge funds, and will continue to do so, but would have no objection whatsoever to their losing the special and unearned privileges of secrecy they now enjoy.

Among the subjects on my mind these days as I ponder Plymouth Rock's future is the impressive progress being made in automobile safety. I am unconvinced that there is a driverless car right around your corner. Truly autonomous cars may someday ferry this letter's younger readers from place to place, but for now they are still too experimental for practical use. Engineering and legal issues still unsolved will take at least a decade to work through. On the other hand, cars with radar and automatic braking are already a reality. Gradually, they will come to dominate the assembly lines and, some years after that, the nation's existing fleet of private vehicles. It seems a dead certainty that they are coming, and, hurrah; this is a wonderful development. Roughly 30,000 people are still killed every year in road accidents, and many times that are injured. Technology can prevent the vast bulk of those tragedies. There will still be accidents when cars hit jaywalkers or kids chasing balls and puppies, and a good number on icy roads where brakes fail, but overall frequency is bound to fall. As it does, revenue to the automobile insurance industry will decline with it. This will not happen suddenly, and it may be preceded by some years in which premiums are generous for the descending indemnity costs, but there is no use pretending that ours will be a twenty-year growth industry.

Plymouth Rock must accept this, shift its emphasis to a growing insurance line, or alter its business direction more fundamentally. All three of these options are available, and none is catastrophic. Companies in most other industries have to reinvent themselves regularly to survive.

One place to look for a shift of emphasis with minimal disruption is the homeowners line. Plymouth Rock has been in the business of insuring homes since the Company's inception, so it's a familiar line of work. And I have some extra knowledge of it from my role in the founding of Homesite Insurance Group, which went on to become the most skilled homeowners writer in the country -- and may soon, as a subsidiary of a large mutual insurer, catch Plymouth Rock in scale. The problem with homeowners insurance is that it is subject, now and forever, to catastrophe risk from natural disasters such as earthquakes and hurricanes. Automobile insurers are largely protected by the law of large numbers; homeowners insurers have no guardian angel. This is why the smartest auto insurance executives I have known stayed away from accepting homeowners risk -- and brokered their potential homeowners customers to others. Progressive was one of the absentees, but, with the 2014 purchase of one of its homeowners partners, it has now signaled a change in course. The average premium for a home was just a fraction of the average premium to insure a car when I entered this industry. Now the two are about equal, and the pace of homeowners premium growth shows no sign of abating. As homes get larger and more expensive, skilled repair craftsmen become rarer, and a higher percentage of people live near the sea, the trend seems plain enough. I am open to a cautious expansion of Plymouth Rock's footprint in the homeowners insurance business, but only if we can develop an expertise in both reinsurance and home-specific risk analytics that matches Homesite's and, at the same time, maintain an effective wall between the auto and homeowners lines.

I reported to you last year that Hal and I had birthed a new insurance brokerage firm with national ambitions. That company, called InsuraMatch, will absorb our existing New England agency and is intended, beyond that, to help lead our whole group into better use of the Internet. It will also provide us some welcome diversification by line and location. Its start in year one was a bit uncertain, with sales not at the levels forecast, but that has been the case for virtually all of the entrepreneurial ventures I have helped to foster. Hal and I still feel highly confident of its prospects. Marc Buro, a veteran Plymouth Rock executive, is now the broker's Chief Executive. And that may not be our only expansion. Entrepreneurship runs in our corporate veins, and some of our best past successes have come by acquisition. Hal, Chris, and I looked hard at a Connecticut company for sale this year, and even made a rational bid for it. Another insurance company put in a higher bid, though, and won the prize -- a result we are used to by now. We always remain open to possible acquisitions, but only when a bargain presents itself. If only the Company were more famous, our patience would be legendary.

James M. Stone