The Plymouth Rock Company

695 Atlantic Avenue
Boston, Massachusetts 02111

Chairman's Letter

February 8, 2020

To Our Shareholders:

The choice of a banner headline for 2019 is easy enough: Fully Consolidated Comprehensive Income for the year was $341 million, more than two and a half times last year's number. This is ample cause for a taste of celebration. Hal and I have already lifted a glass or two, and you might do the same. Before you go entirely wild, though, you might pause over a couple of tempering nuances. First, no number of equal scale is likely to reappear any time soon. And, second, this income figure is presented under accounting conventions that differ from those you became accustomed to seeing for most of our past.

The year gone by was an outlier for calm weather, better for our results than what we expect in a more typical year. Capital gains in 2019 were also unusually generous, because the stock market had tanked sharply at Christmas time in 2018 and it recovered (and then some) in 2019. In addition, our reserving for 2018 and prior claims as of year-end 2018 proved to be conservative and produced favorable development that flowed into 2019 profits. None of these boosters can be counted on in future years, and the enjoyment of such pleasant surprises in all three categories has to be a rare year's blessing. But that's not all. There were other contributors to 2019 income that are all the more certain not to be repeated. When results from the last five-year plan engendered hefty stock appreciation rewards, you suffered some ownership dilution but the corporation itself actually registered an after-tax gain. That can't occur again until 2024, after the current stock appreciation plan has matured. Next, our purchase of another insurance carrier resulted in the recording of an accounting profit. As much as we might like it, we can hardly expect an accretive purchase every year. We settled a long-disputed tax matter in New Jersey, resulting in yet another one-time benefit. And, finally, we sold the Bedford Building in Boston soon after we bought our companion building at 711 Atlantic Avenue. The Bedford sale produced a large capital gain, on which we were able to defer federal taxes due to the nearly simultaneous purchase event.

To put these likely or certain one-time items in perspective, you might consider that the net gain on the sale of 99 Bedford Street was close to $30 million. The New Jersey tax settlement resolved some past and future tax treatment questions and gave us $10 million in non-recurring tax recapture during 2019. The accounting gain from paying out the completed five-year plan rewards rounded to another $5 million. Favorable prior year reserve development, which we never count on, added over $25 million. We can hope that good luck of this magnitude visits us again someday, but I am not going to hold my breath.

While the change in accounting conventions should be familiar to you by now, it is easy to underestimate its impact. Since the Company's founding and until 2018, bottom line income was presented before the impact of unrealized capital gains on the stock portfolio. I was always comfortable with that bird-in-the-hand treatment, which tends to deemphasize market fluctuations that have little to do with our operating businesses. But the convention has been changed, and the bottom line on the Statement of Income is now comprehensive income, which is shown after tax-affected unrealized gains on equity securities. Given the unusual magnitude of our gains this last year, the difference in treatment has quite a substantial impact on the presentation of the numbers.

It is no easier this year than usual to point to any single line on the financials as a complete apples-to-apples summary of the year's progress. Instead of looking right away at Comprehensive Income, if you share my view of unrealized equity gains you might focus first on the net income of The Plymouth Rock Company and Subsidiaries before taking account of those unrealized gains. The income before unrealized gains was $113 million, which compares with $64 million as reported a year ago. Including unrealized equity securities gains, the equivalent numbers for the stockholder-owned entities are $204 million and $72 million, respectively. Alternatively, you might look at the results for the entire Plymouth Rock enterprise and not just its stockholder-owned segment. I pay more attention to this set of numbers than the narrower totals. After all, we are responsible for more premium, and to more policyholders, through the reciprocal we manage than through the companies you actually own. Comprehensive Income for the whole enterprise is the fulsome $341 million I cited above, as compared with $125 million in 2018. Excluding unrealized investment gains, those enterprise-wide numbers are $126 million and $97 million, respectively.

Turning back to the stockholder-owned companies, you can see that our recorded book equity rose during 2019 by $167 million, or about 30%. This is less than the true economic gain by the amount of the dividends paid out to you, and it also excludes any increases in the appraised value of our real estate holdings, which are never included under generally accepted accounting principles. These adjustments are not inconsequential. Dividends and after-tax unrealized real estate gains totaled $49 million this past year. The addition of this sum to the recorded shareholders' equity would have enlarged the percentage gain for us as shareholders to 39%. This is a better economic measure of shareholder gains than the unadjusted book value increment, though it still ignores progress in the reciprocals - where the book value does not belong to us but prosperity helps assure a growing stream of management fees. As you know, I see the acceptable return corridor for any year as bounded on the weak side by 10% and on the strong side by 20%. Years in which the corridor is busted are all exceptional years; and this was the good kind. The 35-year compounded internal rate of return on book value, including both retained earnings and dividends but without benefit of unrealized real estate or portfolio gains, has now risen to 18.2%. Your actual gains on a book value basis, of course, compounded at this pace only in the felicitous event that your dividends were all reinvested well enough to beat the Company's own returns by enough to make up for acceleration of taxes on the dividends. The scale of the Plymouth Rock Group, as measured by direct underwritten and managed premiums in force, has passed $1.5 billion. We are finally closer to the $2 billion milestone than the $1 billion mark, near which we sat for quite a while. And growth is the essence of this year's story.

When, in 2017, we reshaped our entire reporting structure, it was explicitly with accelerated growth in mind. Each of our three major operating units, the Independent Agency Group, the Direct Group, and the Home Insurance Group, now has ambitious growth projects on its front burners.

We take the measure of our enterprise by group now, so the narratives in this letter are presented on a consolidated basis by operating group, and they make no attempt to separate results by legal entity. The largest of the three groups is the Independent Agency Group, run by Mary Boyd. A year ago, I reported that this group's premiums had, despite competitive headwinds, grown 5% year-over-year. In 2019, the growth picked up to a brisk 10.6%, bringing total Independent Agency automobile writings to $822 million. Mary is aiming longer term, though, for sustained annual growth in the double digits, and Hal and I are fully supportive of the ramp-up. Our sports team affiliations and the advanced systems capabilities we offer our agents, such as our innovative Quick Quote process, are helping with this. The New York State launch has already proven a powerful contributor, and we fully expect Pennsylvania to follow suit. In addition, Mary is seeking to expand our affinity and partnership business. We are proud to report that we have become the exclusive co-branded partner for some large AAA organizations in New York and a lead partner for AAA organizations in New Jersey and Pennsylvania. I'd like to think we earned that privilege by making excellence in customer service a higher priority than most of the competition from the very inception of the company. We love the relationship we are building with the universally respected AAA folks, and there are other big names with whom we hope to build relationships along the same lines.

For reasons of historical scale, the bottom line for the Independent Agency Group is still dominated by results in Massachusetts and New Jersey. Massachusetts contributed nicely, with a combined ratio of about 96%. New Jersey, on the other hand, failed last year to earn an underwriting profit. The biggest problem there is growth in the average severity of bodily injury coverage claims. Fighting fraud in that line, and otherwise repairing New Jersey's automobile loss ratio, will rank high among Mary's goals for this coming year. Connecticut and commercial auto, two small businesses whose disappointing results I have called out in the past, both kept to their improvement goals, and neither remains on the injured list. Connecticut lost in 2019 only a little more than our smallest state, New Hampshire, earned for us, and commercial auto was solidly in the black for the year. The new and unseasoned states were not expected to earn underwriting profits yet, and, sure enough, they didn't. Taking all of Mary's states together, the Independent Agency Group posted a combined ratio of 102%, enough to provide a modest overall profit but nothing like the return we hope to see when the initial expansion spurt matures into a steady growth stream. Pilgrim Insurance Company, our service provider to the industry, is also a part of the Independent Agency Group. Pilgrim is a Steady Eddie, never extravagantly profitable but always doing its part for enterprise net income. The all-inclusive expense ratio for the whole of the Independent Agency Group this past year was 39%, a higher expense total than we target but a foreseeable consequence of the growth initiatives.

The most important event affecting our Direct Group is that, after 20 years with us, Gerry Wilson has decided to retire in 2020. Gerry has run that group well, with tandem responsibilities. He oversees all of the automobile policies written in a long-standing partnership with Prudential Financial as well as a legacy Prudential homeowners book. Gerry also supervises Plymouth Rock's growing direct response business. Gerry has become a friend of Hal's and mine as well as part of our senior-most management team. Filling his shoes will be among our most difficult high-priority jobs in the coming year. This past year's Direct Group story continues a tradition in which the New Jersey legacy homeowners volume remains highly profitable but is waning, while the direct-to-the-consumer book is still unprofitable but expanding. The total of premiums from the Pru book and the direct response book taken together exceeds $500 million, up 3.5% over the prior year. This is not as good a top line result as we had hoped for. One element of disappointment was that our seasoned homeowners business for Pru customers suffered net attrition of almost 6%, and the group's net growth owes not so much to organic growth as to our recent acquisition of the Rider Insurance Company, a motorcycle insurance specialist. On the positive side, Prudential, which had permitted us only New Jersey writings up to now, has agreed to let us write new business in several of our other states, and Gerry has begun adding customers in Pennsylvania, New York, and Connecticut. It will be a savored victory when the total of Prudential volume can be counted on to rise each year instead of slowly fading.

The challenge for the Direct Group is to achieve acceptable cost of growth statistics for its direct-to-the-consumer channel. This segment grew to $170 million of premium in force during 2019, up 20% for the year, but the cost of the organic increment to the direct business was too high. There are several ways to measure cost efficiency in a direct response environment. One test is a comparison of the discounted lifetime stream of expected profits from each insured risk with the marginal cost incurred in taking on the business - including both acquisition expenditures and high early-year loss ratios. A second is comparison of the aggregate lifetime returns with total cost, including fixed costs, opportunity cost, and overhead. This latter test is necessary to assure that the whole effort is worthwhile and not just minimizing harm from an unsustainable business. In both of these tests, among the most salient variables are the costs of adding new business, expected general expense and loss ratios, and anticipated policy persistency. All of these variables can be estimated, of course, but even a modicum of precision requires a crystal ball with a degree of clarity we haven't developed at this stage. From what we see through our murky crystal-in-formation, though, Hal and I are not comfortable that the tests show passing grades, and all agree it will remain hard to raise these grades until we can lengthen policy persistency and cut acquisition costs.

Another, and simpler, way to examine the economics of the business is to look only at near-term results. We think we know enough about how a book of business will mature to draw approximate conclusions from first-year data without a magic crystal. The essence of the near-term test is to compute the ratio of annual gain in premiums to the bottom line cost for the matching period of achieving that gain. While there are differing views about what the precise target should be for that statistic, we can tell easily when it is way off the norm in either direction. Even easier is to see whether the ratio is improving each year, as it must if we are ultimately to reap the rewards of our direct response efforts. Alas, the relevant ratio surprised us by turning south in 2019, so we have moderated our growth targets for next year while we contemplate re-tooling of our marketing techniques. If the current year plays out as we expect, our tightly budgeted spending will result in direct response premium growing to at least $185 million. While this is not shabby progress, it is unlikely we will get over the $200 million mark I once imagined we would pass in that channel by the close of 2020. There is nothing I'd like better than to speed up again.

The difficult conundrums described above do nothing to dim the luster the Direct Group as a whole provided in 2019. The bottom line for the group was as pleasing as the top line was concerning. The combined ratio for 2019 for the Direct Group, all-in, was 93%. Aided by favorable prior-year development, the fully consolidated profit contribution of Gerry's team was a whopping $121 million after consideration of unrealized capital gains and the New Jersey tax settlement. A special thanks is due the diligent attorneys who guided that tax settlement to a fair conclusion. The Pennsylvania auto insurance results showed rapid improvement after a bumpy start, and the relatively mild 2019 weather provided additional contributions to the group's income, both directly and through our internal catastrophe reinsurance program.

Marc Buro is the leader of InsuraMatch, an effort that lies outside our three major operating groups but shares a challenge similar to that facing the direct response team. Marc is building for us a state-of-the-art national brokerage firm. A problem he hasn't shaken yet is that business easily drawn from Internet shoppers tends to be of less persistency than traditional agency business. While this would be tolerable if the business were cheap enough to acquire, the secret sauce that lengthens tenure or reduces acquisition cost has so far eluded InsuraMatch. It still depends on subsidies from its parent company and from Encharter, its traditional bricks-and-mortar agency division. No one is discouraged yet, and Hal and I still feel that becoming expert in Internet marketing is a vital skill for our future. Losses for InsuraMatch are only around $1 million a year, which we can readily afford, so the striving to make our mark in brokerage continues unabated.

Our Home Insurance Group had a year to remember. Bill Martin's team increased in-force premium volume by 57% to $176 million – and made a profit at the same time. Favorable loss ratios emerged for both catastrophe claims and more routine claims. The catastrophe results may be owed in part to good luck, but it would be hard to argue that the non-cat results are other than a reflection of underwriting skill and discipline. The combined ratio for Bill's group stayed in the low 90's. Bill's near-instantaneous quoting engine has been a hit everywhere with customers and agents, and my initial skepticism about the quality of business it would generate has evaporated. The Home Group's expenses beat plan as well. Bill has set for his group the goal of making those savings a permanent element of competitive advantage.

In candor, it must be said that the decision to rapidly expand our homeowners writings came with a degree of apprehension. Fearful of catastrophe exposure in a relatively young company, we had for many years written real property coverages mainly as an accommodation to our agents. The expansion to our now portlier corporate proportions, the prospect of ever-safer cars eventually shrinking the auto insurance industry, and the experience we gained as a founding investor in Homesite helped open our minds. But still, with climate uncertainty on everyone's lips, the thought of multiplying our exposure to catastrophe risk, and especially in coastally exposed areas of New York and New Jersey, has not been altogether easy to absorb. Only recently have we gotten comfortable with our implementation of the two-part strategy required to contain the exposure. The first element is careful underwriting selection and pricing, including multi-variate, house-by-house risk analysis well beyond typical industry standards and a portfolio approach to concentration of risks independent of their individual characteristics. The other element is a more sophisticated reinsurance program than we have ever had (or needed) in the past, with an increased retention at the bottom now shared by our own automobile writers and much higher limits at the top purchased in the open market. So, yes, we will take on more coastal exposure than we have had before, but we will also feel safer in doing so than we could have before. It may convey a bit of comfort for you to know that we periodically test our vulnerabilities with a worst-case simulation. In this year's testing, we assumed that a storm equivalent to Super-Storm Sandy, a stock market crash in the magnitude of the one in 2008, and a nightmarish winter storm season like the one in 2015 all occurred within the same year. While the stress tests don't show us miraculously immune from bruises after an imaginary triple hit like that, they satisfy us that the Company's liquidity, solvency and capital cushion would not be impaired.

This past year was nothing short of sensational for the investment side of our business. Just as the previous year had been the poorest for common stock performance since the financial crisis, 2019 was about the richest. There is a message here about attempts to time the markets. Nothing fundamental had really changed. Our investment portfolio of nearly $3 billion is, as always, divided between fixed income and equity securities, with a slight tilt toward the latter. The hefty gains were on the equity side. The S&P 500 scored a total return in excess of 30%. Our portfolio did just about the same, and without the benefit of holding high-multiple tech megaliths with extreme valuations that scare us off – though not nearly as thoroughly as the valuations of the "unicorn" stocks. Our long-term investment record in common stocks remains a source of satisfaction, with 27-year annual returns from capital gains and dividends of 15.2%. This compares with a 9.8% per annum return over that period for an S&P indexed investment. While Jim Bailey and I cannot claim to be immune from occasional missteps, we feel good that we haven't (yet) made any egregiously costly errors. Our poorest performing equity investment continues to be in India's dominant reinsurance company, which is selling well below our buy price. That position, an experiment in international exposure, was kept intentionally smaller than the holdings in our other equity picks, so the impact is little, and we still view it as a long-horizon opportunity as India's insurance sector matures.

The report on our bond holdings is less exciting. We keep such a large portfolio of bonds only because we feel effectively required to do so. We consider investment grade bond markets to be relatively efficient, and we think the interest rate predictions of economic pundits are generally worthless. For that reason, we take very little duration risk and settle for low fixed-income returns. We did make one adjustment, however, in our risk profile at year-end. When we were a smaller company with less excess capital we felt constrained to allow only 20% of our bond holdings to be in BBB-rated instruments. Now that we are bigger and better cushioned against a downturn, we are allowing the triple-B allocation to rise to 35%. The incremental returns seem well worth the risk, but you should have no worry that we have thrown our concern for credit quality out the window. Bonds in the BB range, or otherwise below investment grade, still have no appeal for us. The tax-adjusted 2019 return on the fixed-income portfolio was 4.0%, beating the prior year's 1.6% handily but still a pale shadow of either the 2019 or the long-term equity returns.

Real estate values in Boston continued in 2019 on their long-running bullish path. This may be grounds for caution, but I prefer to believe that, in an increasingly knowledge-based economy, Boston and Cambridge business locations are ever more attractive. We now own, based on the most recent year-end appraisal, over $180 million worth of property on Atlantic Avenue, which is - not coincidentally - the leading transportation hub of the Boston metro area. The Mass Turnpike ends on Atlantic Avenue; Amtrak as well as most of the commuter rail trains end their Boston journeys just a few hundred feet from our offices; and the MBTA Red Line at South Station provides a short and direct connection to both MIT and Harvard. Operating income and appraisal increases on our office buildings in Boston produced an unusually high return in this past year. The 2019 gain in the appraised value of our headquarters, the Plymouth Rock Building, was over $18 million. We have owned the neighboring building, now called the Assurance Building, for only about six months but its appraised value is already $4.5 million above our purchase price. We are continuing to reduce our hedge fund positions, which produced only minimal gains for us in 2019. We placed a small amount recently with a young fund manager Jim, Rick Childs, and I have gotten to know and trust. Our private equity investments in Lindsay Goldberg funds (where I was a founding partner) had a quiet year, but we are hoping that their still-maturing Fund IV will soon return Lindsay Goldberg to its former status in the top tier of the private equity world.

I have repeatedly noted the lack of faith Jim Bailey and I have in timing the market as a whole. While we often look for exaggerated dips and peaks in individual stocks to spur portfolio adjustments, we have never altered our predilection for permanent maintenance of a fully invested posture. Our agnosticism on the future path of stock valuations writ large, though, is not sacred doctrine. We remind ourselves on occasion of Benjamin Graham's 1949 secular sermon on Mr. Market, the bipolar spirit of Wall Street, who can be at times unreasonably and exuberantly euphoric and at other times irrationally glum. With year-end 2019 market indices at all-time highs, trade relations with China and other nations precarious, and political comity in Washington at an all-time low, this might be a moment to ponder the relevance of Graham's metaphor. The bearish side of the argument can cite that two key metrics we watch, the Shiller PE Ratio and the ratio of total market capitalization to GDP, both signal caution. The latter ratio has seldom exceeded 1.1. It greatly exceeded that value in 2000, and the market soon busted. It exceeded this again in 2007, with a worse slide to follow. An unsettling characteristic of the current bull market is that the same ratio has now reached an all-time high of nearly 1.6. Periodic recessions and cyclically retreating markets are natural characteristics of a free economy, and presumably we will see one or both of these events before too long.

One source of particular concern arises from the present interest rate environment. The low rates we see around the world today are not so much products of market forces as results of purposeful government strategies. The temptations are obvious enough. Low interest rates are stimulative; they appeal to politically influential investment and business sectors; and they allow governments to afford more deficit spending. But artificially low interest rates have unintended consequences as well. Low borrowing costs in this country have sapped the incentive for responsible deficit management at the federal level, disguising the potential cost of the debt and encouraging what I consider an irresponsible shifting of burdens to future generations. Consumer and corporate indebtedness in proportion to GDP, too, has risen sky-high, increasing everyone's vulnerability to a credit crunch. Paltry fixed-income yields have simultaneously diminished household savings. Artificially depressed interest rates along with the tax deductibility of interest, moreover, tend to accelerate corporate takeover activity, in turn exacerbating anti-competitive industry concentration. And, more relevant to our investment posture, a near-zero interest regime depletes the anti-recessionary weaponry in the arsenals of central banks. When the Fed next needs to turn its guns on an incipient turndown, its remaining bullets will be dangerously few in number.

The nature of reasonably efficient markets, of course, is that both bulls and bears will have credible arguments at every turn. The best case for the bulls today, and a powerful one, is that the nation's economy is fundamentally strong. There is no proximate threat to the prolonged and continuing expansion that has followed the last crash. Inflation is tame, and the unemployment rate in December was at an historically enviable 3.5%. Even the labor force participation rate, a stickier measure than unemployment, appears to be rising. And our country's characteristically entrepreneurial culture seems to provide us a stronger competitive edge around the world at every turn. But, then again, even continued prosperity could play tricks on today's equity markets. If full employment and prodigious consumer spending should engender a renewed bout with inflation, and the Fed responds by raising rates, stock prices could react precipitously. We weigh all the various risks against the fact that protection of investments from turndowns, whether by the purchase of hedging instruments or holding cash, is not cheap and all too often results in missing out on the next market spurt. Though cognizant of the warning signs, we are not inclined to cut back now on equity exposure. Plymouth Rock is less sensitive to volatility in its results than public companies, investment managers, and endowed institutions. We expect to take some cyclical lumps whenever markets fall, but this is part and parcel of staying on our chosen path toward the long-term maximization of total after-tax returns. The benefit of the doubt for the Plymouth Rock portfolio always goes to long equity positions, long horizons, and long holding periods.

There is a lot going on at our Company these days. A glance at a recent to-do list from the IT Department may tell the story as well as I could. Paul Luongo and his IT team have done a remarkable job behind the scenes of keeping the growth engines tuned up for action. Here are just some of the recent items on their technology project list: Conversion to our rates and systems of an acquired three-state book of business; migration of books of business from two other acquisitions; improved New York State pricing and product offerings for both auto and home; an upgrade of our data metrics architecture; enhancement of pre-fill capabilities for rapid auto premium quoting; a new cloud-based e-sales platform; support of stand-alone umbrella policy issuance; a rebuild of the financial reporting system and our reinsurance accounting software; establishment of direct electronic connectivity with the Massachusetts Registry of Motor Vehicles; installation of a sophisticated Voice Over Internet Protocol for telephony; a (further) strengthening of cyber security and records protection; comprehensive Disaster Recovery and Business Continuity testing; development of text notification to subscribing customers of key policy renewal and billing dates; introduction of a do-it-yourself home inspection app; unveiling of an automated and near-instantaneous home and auto claims resolution approach; two new digital communication platforms for user-friendly customer interaction; and refinement of our capacity for direct and instantaneous electronic deposit of claim payments to customers' bank accounts. And this is only part of what is going on behind the scenes, as we continue to bat down even the slightest propensities to complacency and to thrust Plymouth Rock, cheerfully I might add, toward a bigger and bolder corporate future.

James M. Stone