The Plymouth Rock Company

695 Atlantic Avenue
Boston, Massachusetts 02111

Chairman's Letter

February 23, 1998

To Our Shareholders:

An iceberg floats with only a small fraction of its mass visible above the waves. Plymouth Rock in 1997 moved further toward that profile. While the financial statements that follow are accurate and complete, they describe less than in past years about the true state of your investment. Of the seven property and casualty insurance businesses in which we have either positions of influence or outright control, three are related to our group by contract or investment. The Company's positions in these three businesses are of a kind or quality which does not permit consolidation of their financials with Plymouth Rock's. About a quarter of the total volume for the seven carriers lies outside the financial statements and, more important, about three-quarters of the committed capital. In addition, we have an investment portfolio containing many positions that are marked to market -- such as publicly traded equities and bonds -- but also quite a few that are not regularly revalued -- such as private equities and real estate. Looking beyond the income statement and balance sheet should be increasingly important under these circumstances to anyone who would estimate the value of Plymouth Rock shares.

The 1994 letter to shareholders warned that the economics of Massachusetts automobile insurance were too good to keep and that we were past the peak of a cycle. Ever since then, my primary business goal has been to reduce dependence on that line, which at one time represented over 80% of Plymouth Rock's capital allocation and premium volume. Measured by volume, the underwriting of this state's personal auto insurance now produces less than half of the total revenue implicated in either management or ownership relationships with the Plymouth Rock group. More important, of the shareholder capital committed or pledged to our various relationships, a total of over $500 million, only 10% is in our initial line and state. As a consequence, Plymouth Rock is less dependent, by a wide margin, on Massachusetts automobile coverage than our peers who grew up in the same era. As you read the news from that line of business, I expect you will be convinced that this is fortunate.

A moment to describe the Plymouth Rock group is of value here. While any number of ways to sort and classify our activities may be equally valid, I now think of three subsets

of business relationships when I describe my own job to others. First, there are five insurance companies in our family offering property and casualty insurance coverage through independent agents. With respect to strategic direction, these companies, together writing $203 million in annual gross premiums, are overseen by a committee of their four chairmen: Keith Rodney, Paula Gold, Hal Belodoff, and myself. Leadership at the operating executive level in the agency companies is provided by some of the same individuals, plus Bill Kelley, president of Mt Washington Assurance Corporation, and Vin Nieroda, president of both Pilgrim Insurance and Bunker Hill Insurance. Next, there are two major start-ups in which Plymouth Rock, Peter Wood and I have significant shareholder positions, and Peter and I have contractual duties of board direction. Direct Response Corporation and Homeowners Direct Corporation were financed in 1996 and in 1997, respectively, in each case with over $200 million in preferred stock commitments from blue chip investor groups led by Morgan Stanley Capital Partners. These companies are not controlled by any one of the participants, and are therefore outside the Plymouth Rock group, but their success can bring great benefit to Plymouth Rock. Finally, there is our investment business, which has no outside clients but manages the capital and policyholder funds for all of the companies with whom we have operating relationships. This group is run by Jim Bailey, with more than a little help from Rick Childs and his staff.

The major companies whose results are consolidated in the financial statements are Plymouth Rock Assurance Corporation, the Massachusetts auto carrier; Bunker Hill Insurance Company, the homeowners carrier; Pilgrim Insurance, our fee-based servicing insurer; Mt Washington, writing personal lines in New Hampshire; and our Palisades management company, which oversees the New Jersey reciprocal writer, Palisades Safety and Insurance Association. The 1997 results for the Plymouth Rock Companies, which represent about an 11% return on common equity including both net income and net unrealized investment gains, are shown on the financials. Profitability is better than last year's but far short of the 20% return on equity we set as our long-term target. The main culprit is the ugly and continuing price war in Massachusetts auto insurance. While I can report that return on capital since inception in 1983 still exceeds 20% on a cumulative basis, that can not keep up much longer with sub-par current returns.

Plymouth Rock Assurance is in the hot seat these days, and through no particular fault of its own. For years, that company's goal was to provide the best service to customers and agents, while running the lowest loss ratio in its industry arena. The theory was that, whatever might be the level of industry profitability, Plymouth Rock would be at or near the top, while excellence in service would assure loyalty among customers and agents and attract new growth. The company has succeeded over the years at this task, so everything should be fine -- and it is not. The problem is that Plymouth Rock's larger competitors, entranced by the glitter of easy profits a few years back, began a destructive scramble for top line growth. They discounted prices below the Commissioner's state-set rates,

sometimes as much as 20%, and found themselves in a tar pit of poor results that is painfully tough to climb out of. The Commissioner, answerable to the public, would seem compelled by politics to reduce her rates each year that the regulatees voluntarily give so much of the money back. While the state-made rates have been by and large responsible under the circumstances, it is not surprising that she has just ordered another 4% overall reduction. If her rates were about right last year for an adequate return on industry capital, the reduced and discounted rates for 1998 will produce seriously negative industry returns.

Meanwhile, the less price-aggressive companies, such as Plymouth Rock Assurance, must come up with innovative discounts of their own to keep from losing valued customer relationships. The largest carriers have recently responded to the competition they induced with still more cuts. Although it had looked briefly as though the price war was moderating, a recent round of discounts has renewed its intensity. The good years, it seems, were simply too good. Reserve redundancies from those years continue to roll into results, including our own, and temporarily mask the rate inadequacy. The price leaders, who have captured some benefit on the top line, enjoy a temporary expense efficiency that further masks the truth. Strong financial markets provide even more cover. I can't tell if our peers realize how far from statistical accuracy their premiums are today, but I am sure the picture at Plymouth Rock Assurance will worsen as the latest round of cuts works its way through the premium cycle. There is every reason to expect, moreover, that it will worsen again in 1999, when reserves from the good years have finally worked their way out of the results. If there is a silver lining for the industry to be found here, perhaps it will be an evolution to a better blend of competition and regulation in Massachusetts.

Plymouth Rock Assurance, now principally under Keith Rodney's able leadership, will respond by seeking to discount only groups whose customer quality will enhance the long term loss ratio and whose mechanics offer promise of expense ratio reductions. For a while Plymouth Rock may lose money on these groups, but we intend to be a stronger company at the close of the price war than when it began -- with a still more select book of business, a better combined ratio than our peers, and a more widely recognizable service differential than we already have. Of this result I can feel reasonably confident. Of the timing and the interim cost, alas, I can not.

Plymouth Rock Assurance Corporation is no longer in the homeowners business at all. That line is served by a separate and distinct company in our group, Bunker Hill Insurance Company. Bunker Hill had a good year in 1997. It wrote about $25 million in premiums, representing something like three percent of the homes in Massachusetts, and it earned $1.9 million in profits. The management team would undoubtedly agree that some of this prosperity is due to their skill, especially in underwriting, and some to old-

fashioned good luck. The nightmares for any homeowners executive are price wars, irrational regulation and natural disasters. Bunker Hill saw none of these in 1997.

Vin Nieroda wears two hats, and his Pilgrim's hat fit him as handsomely this year as his Bunker Hill outfit. Long ago Vin established the goals that Pilgrim should return at least $1 million in annual profits on the tiny capital base that suits its service-only format, and do so in a way that makes all associated feel proud. Once again, Pilgrim has met these objectives. Managed volume this year was $21 million, and profits were $1.4 million. Pilgrim's worry is always that, with a small number of large clients, neither business retention nor profit margin is as predictable as when the clients are many and none have special bargaining power. Every year the company has faced situations that result from these threats, and every year Pilgrim has overcome them and grown stronger. This is in large measure because Pilgrim has the same lofty aims in terms of service quality as Plymouth Rock Assurance. Pilgrim's new chairman is Paula Gold, who has proven herself especially qualified to help with the large client relationships Pilgrim must maintain.

The big news at Pilgrim this year was *un*-diversification. When we began to worry about Massachusetts automobile insurance some years ago, we selected workers compensation as a business that could relieve some of our dependence on personal auto coverage. Workers compensation was a line of business with enough volume, and enough troubles, to be a worthy focus, and we admired the proactive loss reduction and self-insurance approaches that some alternative market companies had developed. The right combination is a benefit to both provider and client. That reasoning led us to create Boston Risk Management Corporation as our vehicle for entering the workers compensation service business. This year Pilgrim, which was BRMC's corporate parent, sold that company's assets and its name to the state's leading health maintenance organization rather than continue in the building of BRMC's business. Two considerations motivated the sale. First, we had not made enough progress to see a large business ahead of us anytime soon. The concept still seems right; we just may not have been the right people to do it at this time. Second, and more important, we found in Direct Response and Homeowners Direct a preferable mode of reducing dependence on Massachusetts auto insurance, allowing geographical diversification without requiring us to learn the intricacies of another line of business. We can now redouble our efforts to build, with no intellectual dilution, the most expert and best informed writers of autos and homes anywhere in the country.

Mt Washington Assurance is our smallest agency carrier. It remains too small to return substantial profits but well enough managed to keep making progress. Bill Kelley stands by his promise that he will get Mt Washington to between twenty and twenty-five million dollars in volume before he retires. If this can be done, and that company can earn $1.5 to $2 million in profits each year in northern New England, it will be a little gem for us.

This year the volume was more like $8 million and the bottom line was around break-even again, so Mt Washington is only a semi-precious stone at this point. Frankly, I have been surprised at how difficult growing in the New Hampshire market has been. Good service and good prices have seen only moderate recognition. Perhaps the volume goal is somewhat ambitious for a small state with no unusual market disruptions. If so, Bill may seek to experiment a bit with new marketing methods to achieve his target. Hal Belodoff became Mt Washington's new chairman this year, and he should be just the right partner for Bill in any such endeavor.

Our New Jersey companies are all members of the growing Palisades family. There is a management company owned by the Plymouth Rock group and two licensed insurance carriers: Palisades Safety and Insurance Association and its newly chartered subsidiary, Palisades Insurance Company. Palisades, with two licensees, is now able to offer an appropriately priced product to a wide cross section of the New Jersey marketplace. The two insurers, taken together, have more than $52 million in annual written premiums. That amount, remember, is one of the items not consolidated with the Plymouth Rock group results. The Palisades companies are profitable for the second consecutive year, with a pure loss ratio of about 60% and a direct expense ratio a bit better than that of their Massachusetts cousins. It has always been my view that Palisades will someday be larger than Plymouth Rock Assurance. The New Jersey companies need to double their volume for that prediction to come true, but Hal Belodoff took the reins in Hoboken when Palisades had no volume at all, so the task may be less daunting to him than it would be to a less entrepreneurial executive. While catch-up may take some time, the New Jersey price environment is preferable to that in Massachusetts today, and the Palisades reciprocal is considering its first profit-sharing dividend to the Association members. That is an announcement we have all looked forward to since the day the New Jersey companies were created.

"If you think it's impossible to get a fair rate on auto insurance, you should meet some Response Insurance customers. You can't spot them in a crowd -- they come in all shapes, sizes, ages and colors. You *can* spot them on the road because they're all responsible drivers. At Response Insurance, we specialize in insuring as many of these drivers as possible -- wherever we can find them. This way, we can keep your rates as low as possible while giving you the great service you deserve." That is a quote from the media-supported direct mail campaign of Response Insurance Company. Last year I reported on the founding of Direct Response Corporation and its $215 million financing commitment through Morgan Stanley Capital Partners. DRC, as we call it, has two insurance subsidiaries, Response Insurance and Response Indemnity, which have now started writing in the Westchester County area of suburban New York. The quote and the theme, "Response Insurance for Responsible People", convey the flavor of the appeal. Under a license agreement with Direct Line Insurance, the DRC companies will fortify

their brand recognition with the use of the red telephone logo that worked so brilliantly for Direct Line in the U.K. over the years.

DRC is now engaged in its first marketing campaign. It has a team of excellent vice presidents, and a mainframe systems capability unusually powerful for a start-up company. Among its goals for the coming year are to find a chief executive officer who can allow Peter and me to step back into the role of strategic guidance, to begin a marketing campaign and writings in the California market, and to launch at least one marketing effort based on a select affinity relationship. Time after time, industry executives remind us that creating a direct writer on a significant national scale is not a modest undertaking. They are right, of course. GEICO and USAA took about seventy years each to get to their current positions of strength. There is a huge amount to be done, but it would be hard to imagine a better mix of ingredients for a full-fledged try. I have kiddingly boasted that DRC passed the first milestone for any ambitious insurer in that it now has more policyholders than employees. A more serious milestone will be reached when DRC proves it can add new customers at a sustainable cost per dollar of acquired premium volume.

In November of 1997, the same common shareholders who founded DRC -- Plymouth Rock, Peter and I -- received a commitment to fund another personal lines direct response carrier, Homeowners Direct Corporation. The investor group, again led by Morgan Stanley Capital Partners and including many (but not all) of the DRC participants, subscribed to $205 million in preferred stock. Plymouth Rock is once again to be a $5 million preferred stock investor as well as a common stockholder. A company separate from DRC was created because the founders came to the conclusion that there is a fundamental incompatibility between an ideal automobile insurance book of business and an ideal homeowners book. The lessons of Twentieth Century's pain from the Northridge earthquake, Allstate's memorable loss from Hurricane Andrew, and GEICO's carefully considered exit from the homeowners line all served to educate us to this reality. In the auto line, a company can minimize its costs of acquisition and maximize its profits by writing in highly concentrated clusters. High market share in a compact area can be extremely valuable. In homeowners, this is a recipe for disaster. While it should be theoretically possible to build two separate books of business under the same corporate roof, one concentrated and one widely spread, separation seems the more prudent course.

Homeowners Direct will be headquartered here in Boston, despite the fact that, like DRC, it will not be writing in Massachusetts or northern New England. It will write virtually everywhere else, keeping an ultra-cautious eye on its spread of risk. The company expects to compete by virtue of three simultaneous advantages: low acquisition costs, a planned spread of risk that should lower catastrophe reinsurance expenses, and a sophisticated approach to conventional loss underwriting that has eluded those carriers who see homeowners as an adjunct product for their automobile insurance customers.

Like DRC, Homeowners Direct has begun a search for a chief executive officer who can release Peter and me to more strategic roles. Meanwhile, we have begun the systems planning for that company; initiated our catastrophe modeling with a licensing agreement for software and data from RMS, the industry's leading supplier of hurricane and earthquake analysis; and started down the path to licensing in some key target states.

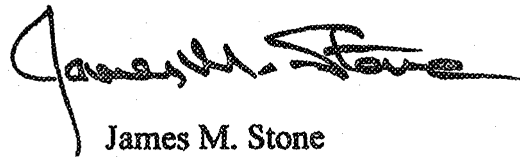
The investment side of our business, centered in SRB Corporation, has an increasing load to carry. Not only are invested assets augmented by the addition of the two new direct response writers, the traditional vehicles for putting these funds to work are all looking ever less appealing in today's market environment. We consider neither the public equities market, with the Dow Jones Average hovering near 8000, nor the bond market, with rates at some maturities near twenty-five years lows, easy places to find the bargains around which good investing must be centered. Low bond yields, moreover, often provide capital gains at the expense of reinvestment opportunities. Price to book ratios, price-earnings ratios, and price to GNP ratios are all a bit frightening. Some say that a "new paradigm" can explain all of this, but, in old-fashioned terminology, the present U.S. market levels seem to presume a continuing vibrant economic growth with a less than customary risk of inflation. I suspect this combination in turn depends on a three-legged foundation: a peaceful new world order replacing the cold war, the accelerating expansion of free trade, and continued growth in foreign markets for U.S. goods. If so, there is vulnerability just as there has been in the past. When the whole market is bullish, even the relative bargains may be too expensive for us.

This situation is more than a little painful, since SRB has espoused -- and performed well with -- a balanced debt and marketable equity strategy that would work in any normal environment. As a consequence of today's abnormal environment, Jim and Rick would either have to move toward cash or search out alternative equity vehicles. Current thinking leans toward the latter. The managed investment portfolio, including funds of the new direct companies, is just under $400 million and rising. With market performance strong, the balances already invested enjoyed a good year. Plymouth Rock group's stocks rose by 29% in value, a bit less than the S&P index. Five-year average returns, however, remain a full sixteen points better than the S&P's 20% average annual increase. Bonds did fine as well, with unrealized capital gains bringing total pre-tax return on the bond portfolio to 7.6% for the year. Jim and Rick are now adding to the mix investments in other asset classes.

We purchased our headquarters building this year, bringing Plymouth Rock group owner-occupied real estate holdings -- our favorite kind -- to $20 million. We are loath to be a real estate lender but reasonably comfortable as an owner. There is every reason to believe we have done quite well on real estate bought to date, though no gains are reflected in our financials. The same is true for our private equity investment in CAT Limited, perhaps the best respected of the Bermuda reinsurers spawned by Hurricane

Andrew. While we may have done better in private investments overall than on the marketable stock and bond portfolio, it will nonetheless be a great relief when someday we can return with comfort to investing principally in the U.S. public securities markets.

The year ahead promises to be busy, and probably downright difficult. With both new and continuing challenges, there are too many goals to list them all here. Among my hopes, though, are that the next annual report records no more unpleasant surprises in New England (or, better yet, that Massachusetts auto insurance has begun to recover its balance), that Palisades has continued both top line growth and bottom line acceleration, and that each of the direct ventures has found the outstanding CEO it deserves. Putting this last wish another way, Plymouth Rock's value will be much enhanced when Direct Response Corporation and Homeowners Direct have found chief executives as inspiring and well suited for their assignments as the current roster of officers now in place at the Plymouth Rock Companies.



James M. Stone