# The Plymouth Rock Company

**695 Atlantic Avenue**
**Boston, Massachusetts 02111**

## Chairman's Letter

February 8, 2019

To Our Shareholders:

There is nothing like a storm to wipe the smile from an insurer's face. This past year, 2018, visited mercifully little storm activity on Plymouth Rock's neighborhoods - until the end of December. And the storm that caused us concern at the year's close was not of Mother Nature's making. It was a sudden stock market dip. We have always been clear that profits in 2018 would not match 2017 because the earlier year had profited from a tax cut that boosted the after-tax value of accumulated capital gains. Hal and I had hoped, though, that -- taxes aside -- the past year's performance would rival that of 2017, and we were optimistic until late autumn that the results could approach that mark. The market's year-end decline deflated those aspirations. Nonetheless, let me offer you some comfort by noting that our enterprise-wide insurance underwriting results in 2018 -- more fundamental to us than any single year's investment gains or taxes -- were very similar to those of the prior year.

That the operating results were robust in this period is especially reassuring since, as you well know, we took on a lot of new challenges recently, and new efforts of that magnitude always risk overreach. Yes, we committed to four simultaneous growth goals: supercharging our once-passive homeowners business, building an Internet-driven direct response book, adding two states to our geographical footprint, and creating a state-of-the-art national insurance agency. Yes, we began moving most of our New Jersey staff from their familiar offices to a new unified headquarters. And, yes, we reshaped our entire enterprise reporting structure around product and channel lines rather than jurisdictional lines. But, no, (with vigilance still heightened and Hal skillfully juggling all the pieces into place) we don't appear to have sacrificed performance and regular order by doing all of this.

It is difficult to point to any single set of numbers on our financial statements as a definitive summary of the year's progress. From habit, you may look first at the net income of your stockholder-owned entity, The Plymouth Rock Company, Inc. But this year straightforward comparability is problematic, not just due to the one-time effects of the 2017 tax reduction but also owing to a newly mandated accounting change. Whereas in the past only dividends and *realized* gains from common stock holdings were reflected in net income, beginning in 2018 the net income definition encompasses unrealized capital gains on equities as well. The income statement presented for 2018 shows both treatments. Net income before unrealized securities gains (last year's treatment) was $63.6 million, versus $80.0 in the prior year. This year's accounting treatment brings net income in our situation close to what is called "comprehensive income" and defined to include all equity gains. Comprehensive income was $71.4 million for 2018 as compared with $95.9 million in 2017. To get closer to an apples-to-apples exercise, one can subtract out the tax bonanza from the 2017 number. The comprehensive income numbers for 2017 less the one-time tax relief would have been $78 million, much closer to 2018 comprehensive income. The 2018 results, of course, would have looked more impressive had the stock market behaved similarly in the two years.

When I look at our numbers, I pay at least equal attention to the financial results for the entire Plymouth Rock enterprise as to those in the stockholder-owned segment. After all, we manage through a New Jersey based reciprocal more premium than we underwrite with our own capital. The comprehensive income of the whole enterprise is reported as $125 million in 2018, as compared with $172 million in 2017. These figures are unadjusted for the non-repeating tax benefit that elevated 2017 profits and the 2018 market perturbation.

Shareholders' equity rose during 2018 by $29.0 million or 5.6%, and, like our net income, it would have risen a good deal more had there been no year-end market dip. A more revealing number than the recorded book value is the true economic gain in shareholders' equity, which supplements the change in equity by the dividends that were paid to you from that account in cash and by real estate gains not reflected in book value under generally accepted accounting principles. Unusually large 2018 dividends and after-tax real estate gains, the latter according to independent appraisals, totaled $52.0 million. The addition of this sum to the actual shareholders' equity would have multiplied by 2.8 the year's increase in per-share book value. Taking true economic gain as a percentage of starting equity for the shareholders, the 2018 advance represents a 15.7% return. Since I view Plymouth Rock's return corridor as bounded on the weak side by 10% and on the strong side by 20%, this was all-in-all a quite satisfactory year and would have been superlative had our stock market returns as of September survived the last quarter. The thirty-four year compounded internal rate of return on book value for your Company's owners, including dividends but excluding real estate gains, now stands at 18.0%. The scale of the Plymouth Rock Group, as measured by direct underwritten and managed premium in force, is close to $1.4 billion. Despite our being only a regional carrier, a respected trade publication in our industry has listed us as the 28th largest personal lines insurer in the nation; and the Boston Business Journal shows us as the 14th largest privately owned company in Massachusetts of any stripe. With an ambitious agenda of expansion projects under way, I aim to see us climb on both lists.

Our financial statements are organized according to legal entities, but that is no longer the way Hal and I talk about our business or the way its internal reporting structures work. So I will present my detailed commentary on the year gone by in our preferred format, by line and channel. A good starting point is the Independent Agency Group, our largest operating profit center. Chris Olie, who captained a good portion of that automobile insurance business for nine years, has now entered semi-retirement, and he has been replaced by Mary Boyd. I'd be less than candid if I denied having worried about finding a suitable new chief for our cornerstone business, but the search ended beautifully. Mary has the business judgment, the ambition, and the brainpower to meet all the hopes with which we went into recruitment mode. She comes to us with an unusually strong background in both claims and product management. While she might face some pretty powerful headwinds in her new role, she will, at the same time, enjoy a few tailwinds.

Growth will be the hardest challenge for the Independent Agency Group. As in years past, Plymouth Rock's agency business could not keep pace in 2018 with the expansion of the national direct response companies in the Northeast. The ever-looming fear is that if Massachusetts, still the rare state where auto insurance writings are predominantly controlled by independent agents, continues to evolve toward a more typical channel mix, the independent agency writers may all lose significant market share to the direct response giants. That's the strongest of the potential headwinds on the nearby route forward. That said, our company's independent agency business experienced premium growth of 5%, once again outrunning most of the independent agency companies we consider our rivals in that channel. Beyond the immediate horizon, of course, looms the emergence of autonomous cars and super-safe vehicles, which will someday cut premiums for direct and agency writers alike. As a vector in the opposite direction, Mary will be aided by our expansions into New York and Pennsylvania, and the acquisition of a seasoned book and agency force in New York and beyond. Meanwhile, our existing sports team affiliations and advanced agency partnering capabilities continue to be winners on the marketing side. Mary has the chance to turn a three-quarter of a billion dollar business into a billion dollar business in relatively short order -- and she and I both suspect the dangers may be farther removed in time than many industry commentators seem to recognize.

The fully consolidated net income for the Independent Agency Group represented, before unrealized investment gains, over 40% of the total for the enterprise as a whole. In Massachusetts and New Jersey, independent agency auto insurance produced a combined ratio of just over 96%, which is better than we had expected and superior to results in any recent year. The outcome was greatly helped by favorable development of reserves for prior years. It is my profound wish that our reserving will prove as sensibly conservative as this every year. The combined ratio for our small but relatively stable book of automobile insurance policies in New Hampshire was no better than break-even. Connecticut continues to be more problematic, with an automobile combined ratio close to 107%. The losses, however, are less than last year's, and our Nutmeg State wizards remain confident that they can keep us on their predicted glide path to all-lines black ink on the bottom line in 2019. Volume in Connecticut declined slightly to just over $34 million as a result of curative rate increases. Pilgrim Insurance Company, a third-party service provider to the industry, is a part of the Independent Agency Group as well. Pilgrim makes its money through highly specialized hard work rather than by taking underwriting risk. This past year's hard work helped Pilgrim contribute solidly to enterprise profits.

Our Direct Group, under Gerry Wilson, is comprised of policies we write through a contract with the financial giant Prudential and a direct response book of business, the latter sold over the Internet and telephone by members of Gerry's staff and through various strategic partnerships. The volume from these two sources is now approaching $500 million. While time has eroded more than half the count of our Prudential policies over the fourteen years since that relationship began, the book is still nearly two-thirds its original scale in dollar terms. This balancing of vectors cannot hold forever, as any decent mathematician can tell you, so Ed Fernandez and his team have worked hard with Prudential to expand our New Jersey relationship into Pennsylvania, New York, and Connecticut, and to aim for growth in customer count and written exposures as well as dollars. The growth in Gerry's domain has come from the direct-to-the-consumer business. This segment grew to over $140 million in premiums during 2018, which is 16% more than in the prior year. Tom Lyons, who runs that business unit, predicts he can raise the volume by just short of 20% in 2019. He has as available tools a population footprint quadrupled by the addition of New York and Pennsylvania licenses, increased access to Connecticut and New Hampshire opportunities, and an enhanced ability to link an attractive homeowners offering to auto insurance sales.

The 2018 profit performance story for the Direct Group was solid this past year. Aided, as were the Independent Agency results, by prior-year development in the right direction, the all-lines combined ratio was 92.5%. Gerry's business experienced a small bump in its expense ratio but this is hardly surprising given the costs of direct response acquisition and of moving so many people to a home office that was stripped to the shell at the start of the year. The new space, by the way, is great – light, orderly, and airy with modern styles, ergonomics, and amenities. People seem to love it, and all those who helped make it happen deserve a round of applause. As you are aware, the seasoned Prudential business continues to subsidize the rapidly growing direct response book, at least on a current-year basis. Eventually, the direct response business will have to pay for itself every year. This can occur only with continued improvement in acquisition efficiency and the analytical segmentation that underlies smart pricing. All of us believe that expanded use of telematics with respect to driving quality can help us considerably in both areas. There is no limit to the improvement potential in either acquisition or segmentation. No matter how good a company is at these skills, the treadmill is moving and those who rest will fall off the back.

Our Home Insurance Group had a gangbuster year. Bill Martin has now successfully presided over the transformation of a business we had purposely kept small to its current state of dynamic expansion. Written business was up by about 23% over the prior year, with an even more ambitious growth projection for this year. Some of the progress is already baked-in due to acquisitions of business from Farmers Insurance Group and MAPFRE that are producing a sustained flow as policies reach their renewal dates. Home insurance premium in force at year-end was $112 million. Organic growth should be helped by the upgrade that our whole enterprise received from A.M. Best, our principal rating agency. All of our companies are now rated A-. If that's the good news, the better news is this: despite the costs and risks of rapid growth, the homeowners business has so far remained profitable. The combined ratio for Bill's group in 2018 was under 95%. This past year was relatively gentle with respect to catastrophes, but we feel better protected than ever before if the coming year is rougher. Our homeowners catastrophe protection stretches to higher limits than it used to; the risks are more systematically spread throughout our enterprise; and our treaties run longer than in the past.

All eyes are now on the bold experiment this group is undertaking, with on-line binding of coverage based on pre-fills of data for virtually every home in Pennsylvania. This easy-to-use product has already become one of the most popular offerings Plymouth Rock makes. Most customers can put in nothing but name and address and up will come a bindable quote. We will be thrilled if this past year's profit level can be maintained as more of the incoming business arises from pre-fill. While we will always have to worry about catastrophe risk, perhaps now compounded by climate change, our reinsurance program has been strengthened in every recent year and our underwriting has simultaneously grown stronger. Environmental risks cannot be erased entirely, but we are convinced they are worth accepting for the rewards that a large homeowners business will bring. We will be especially happy if the customers that populate this growing business also buy their auto insurance from us.

Marc Buro is the leader of our effort to build a significant national broker. InsuraMatch has shown impressive growth, from less than $35 million in volume placed to over $75 million in just a few years. Its operating losses, though, exceeded their agreed allowance this past year. The costs were small enough in dollar terms to have had minimal impact on our family of companies as whole, but we don't want them to keep expanding without the disciplines that successful entrepreneurship tend to benefit from. Because the operating losses have arisen largely from imperfections in the sales and service approach that InsuraMatch's economics forced it to employ in its infancy, as well as a few disappointing experiments with outside business originators, Marc and his team have proposed that the year just starting will be a time of fewer irons in the fire and a heavier concentration on building the efficient infrastructure required for rapid growth. Hal and I are not discouraged by InsuraMatch's growing pains. We had no illusions that this would be an easy business to build, and we continue to believe that InsuraMatch's longer-term prospects for economic contribution, coupled with the learning required to make this venture a winner, will strengthen our whole enterprise.

As always, our enterprise's investment portfolio is divided in roughly equal parts between fixed income and equity instruments. Both halves are over a billion dollars in scale now. There is little to report on the bond holdings. We keep such a large portfolio of bonds because we feel effectively required to do so, and we operate it through a professional manager with instructions to take little credit risk and even less duration risk. The obvious consequence is that our bonds return reliably little, and especially little in years when interest rates rise. The tax-adjusted 2018 return on the fixed income portion of our investment portfolio was only 2.2%. We have little or no confidence that we can predict future interest rate changes or credit spreads better than the market, so we have no inclination to stretch credit risk or duration risk to boost yield an inch or two. Jim Bailey, Rick Childs, and I spend most of our time on the equity half of the portfolio.

It's no secret to you that 2018 was the worst year for common stocks since the financial crisis a decade ago. The Standard & Poor's 500 Index, dividends reinvested, fell by 4.4% during the year. Plymouth Rock's marketable equity portfolio did considerably better than the index, with a full-year gain of nearly 9.4%. Our long-term investment record remains a source of satisfaction. Common stock investments have returned in annual capital gains and dividends about 14.7% since we started investing in stocks during the 1990's -- which compares with an 11.1% per annum return for an S&P Index investment. And the Plymouth Rock portfolio has beaten the S&P in four out of the last five years of index decline, having just tied it in the other one. While our investment calls have given us little cause for regret, Jim and I are certainly not exempt from the occasional misstep. Retreating oil prices kept us in the red on the one Master Limited Partnership we still hold, after exiting our positions in three others at a modest profit. We lost a little money in Tapestry, having expected that retailer (previously Coach) to transition to Internet sales more effectively than it has. And our newest position, in India's dominant reinsurance company, is selling below our buy price. That investment is just beginning the long march we found to have attractive potential, so it is not yet costing us sleep. Real estate values in Boston enjoyed a bounce once again. The combination of operating income and appraisal increases on our office buildings in Boston produced a return of 14.6% in 2018. The two office buildings we own, bought for a total of $23 million, are now worth over $131 million. We have been reducing our various hedge fund positions for a while, so their performance year had only a modest impact on overall equity performance. Our private equity investment in Lindsay Goldberg had quite a good year, returning more than 45% on the amount of our capital still actively at work.

A word on the December stock market storm is in order here. A first observation is that the turbulence looks less ominous viewed today than it appeared on Christmas Eve, when the decline in the S&P 500 from its September high hit 20%. As of early February this year, about two-thirds of the surrendered territory had been recaptured. Equally important, while December trashed the calendar year's performance, even at its most painful the dip represented only a fractional retreat from the stock market's rise from its 2016 trough of 60%. For our own enterprise, the pre-tax cost of the final quarter's bear market was over $80 million, no small potatoes, but our 2018 gains to date through September had been over $120 million, so we are hardly a suitable case for tears. As to the causes of the tempest, neither I nor anyone else can offer an explanation with authority, since it is rare that a single dominant cause underlies sudden stock market jolts. The forces that influence the market's balancing point at any moment are many, and they interact in a complex manner. In today's environment, rising interest rates (more feared than experienced) and the irresponsibly expanding deficit brought on by the 2017 tax cut would likely have played some part in destabilizing prices. It is hard to think that the trade conflicts with China, which rationality suggests could have ended by now, can offer other than a downward push. Widespread concern over incivility and worsening paralysis in the nation's capital is now accompanied by fears among laissez-faire aficionados that the open season on all forms of regulation and taxation is over. It cannot help market confidence that so many senior jobs in the current Administration are empty or occupied by what businesses would call "temps". Predictability is the preferred diet of bulls; only bears feed on chaos. International affairs are looking uncomfortably dicey as well. Investors have surely noticed the rise of bullying personalities to positions of power around the globe. If taken much further, this trend could begin to recall the 1930's, which played out in a horrific manner both for humanity as a whole and for those nations that had anointed the bullies of that era. We should all pray that nothing even vaguely paralleling that nightmarish period develops now.

A less catchy, but equally important, source of the December retreat was simply that the market had been running hot. Unbuttressed heights make markets especially susceptible to the effects of negative signals. Markets, like our own bodies, suffer most when intrinsic weaknesses and exogenous threats coincide. With an average common stock holding period of close to a decade, Jim Bailey and I are anything but market timers. I do, however, try to keep an eye on some basic ratios to maintain a view of the market's cyclical rationality. For some time, the relationship between the S&P earnings yield and the yield on long-term Treasuries has made the market look historically rich. The ratio of stock market capitalization to gross domestic product has conveyed a similar case for caution. This vulnerability, when joined by political uncertainties, would be sufficient to explain what happened. While Jim and I might slow down a bit on buying when the market is exuberant and speed up when it is glum, I should emphasize that even this degree of market timing influences our actions only at the margin. Far and away the most important number to us is the long-term return on common stocks. The total return for the S&P 500 Index over the 100-year period ending in 2018 has been 10.1%. It was 11.1% over the last 75 years; 9.8% for the last 50 years; 9.1% over the last 25 years; and 13.1% for the last 10 years. Hold long enough and common stocks will always beat bonds, bank accounts, and most everything else you might store your assets in. A growing private company with no need to spend down capital is in an enviable situation where it is better off being paid for volatility than giving up return to avoid it. That's why our interest in market timing or asset class diversification is so marginal. Our investment core will always be an undiversified portfolio of methodically chosen common stocks, bought with sights only on maximization of total return over the long horizon. Another way to describe this philosophy might be that we purchase "a careful selection of a few investments...having regard to their cheapness in relation to their...intrinsic value over a period of years ahead..." [and we maintain] "a steadfast holding of these in fairly large units through thick and thin." But I can claim no authorship of this cogent phrasing. The words belong to John Maynard Keynes, who hit the nail on the head 80 years ago.

From an underwriting perspective, the year just gone by was a lucky one for an insurer of automobiles and homes in the Northeast. There was no unexpected surge in underlying claims costs or exposure to anything like the awful fires that devastated parts of California, and no hurricanes reached the North Atlantic shores. The challenges and tensions came from our own decision to ratchet up growth. My (less-than-impartial) observation is that, despite the incremental workload, most of our staff relishes the exhilaration that comes from a more ambitious agenda and new experiences. I can say for sure that the top leadership team is taking pleasure from the challenges. It is also clear that, with no small help from Human Resources chief Mary Sprong, Plymouth Rock has today the strongest officer team it has ever had – and by an impressive margin. That bodes well for the future whatever the natural and metaphorical weather patterns may hold in store.

James M. Stone