The Plymouth Rock Company

INCORPORATED
177 Milk Street
Boston, Massachusetts 02109

Chairman's Letter

March 1, 1988

To Our Shareholders:

Nineteen Eighty-Seven was Plymouth Rock's best year, but the general deterioration of the Massachusetts automobile insurance market haunted the landscape. The company grew, it earned a solid profit, and it raised a substantial amount of new capital. At the same time, though, the statewide rate inadequacy for automobile coverage continued. We do not fool ourselves into thinking that any insurance company, no matter how skillfully run, can long prosper in a world of artificially depressed premiums. We count on 1988 as a year of relief.

Several companies exited the state this year. Peerless, Shelby, Fireman's Fund and General Accident have all released their Massachusetts books of business. Kemper has publicly warned that it too will leave if it can not protect its capital from unlimited and continuing losses. We are convinced that the regulators now understand the seriousness of a cumulative inadequacy in the billion dollar range, and the new Commissioner of Insurance has plainly indicated his willingness to take the decisive actions required. It will take some years, however, to restore industry confidence. Growth in this climate is easy to come by. We ended the prior year as a $21.3 million company; in 1987 our Gross Premiums Written rose to $39.4 million.

Out of our total writings, we paid nineteen million dollars to Commonwealth Automobile Reinsurers for coverage of pooled risks and we paid eight million dollars to General Reinsurance for excess and quota share coverages. The remainder of $12.4 million is the Company's net written premium. A final subtraction of one million dollars for the increase in unearned premium reserves (billings made in 1987 for 1988 coverage) produces the $11.4 million in Premiums Earned that begins our income statement. Our book of business is now about 86% automobile and 14% homeowners, a ratio of over 6 to 1. We have always told our agents we will be satisfied to write these two lines in the proportions they are produced in the agencies. This would call for a ratio more like 4 to 1 than the present 6 to 1. But just as the current climate makes it

easy to get additional automobile volume, it makes the competition for the still-profitable homeowners business all the more intense.

We could have grown even more in the automobile line, but there were a number of informal constraints serving to hold us back. One is the mix of business. We have no desire to let our automobile volume so outstrip our homeowners volume as to render us an auto-only writer. Another constraint is quality. Our pure loss ratio, measuring voluntary market claims as a percent of premiums before accounting for any reinsurance, is less than 50%, which makes it one of the lowest in the industry. This is among our crown jewels, and we never want to take so much business that our advantages in risk selection evaporate.

A third constraint, and probably the most influential in 1987, is related to staffing and service. We may get business now because others do not want it, but this is an aberrant market. It is our reputation for excellence in service that will attract and keep good business in the longer run. In a state with genuinely full employment, it is not always easy to hire the friendly, cooperative and dedicated people we constantly seek. And it is hard after they are hired to make sure they are properly trained and supervised. So we are fearful of too much growth. No amount of short-term volume would be worth a loss of our enduring reputation for fine service.

Capital constraints on volume have not been a problem. Regulators traditionally begin their analyses of capital sufficiency with a look at the ratio of net premiums written to policyholders' surplus. Our purchases of ample reinsurance help keep our ratios well within the conservative range. Even excluding the additional capital Plymouth Rock raised this year, we ended the year with a premium to surplus ratio of 2.1 to 1. By rule of thumb for property-casualty companies, anything under three to one is considered prudent. We raised $6 million in equity this year to provide financing for continued strength in our capital position as we grow and diversify in the future.

The recapitalization of our ownership in connection with the financing also accomplished some important non-monetary objectives. The changes were undertaken in two stages. First, we started a new business, which is called the SRB Corporation. This company was funded by the purchase on the part of Fireman's Fund Corporation of $3.5 million in preferred stock. The company will involve itself in the fee-for-service aspects of the insurance business, perhaps doing work for other insurers, handling insurance processing for self-insurers and captives, or selling insurance management software. Its businesses will be those at which we need to be expert in order to do Plymouth Rock's work well. We had hoped that Fireman's Fund would be our first customer as well as our backer, but, in July, Fireman's Fund decided to terminate its Massachusetts operations completely. Plymouth Rock owns an option to purchase all the common stock of SRB, and we assume that the two companies will be consolidated at some point in the near future.

Plymouth Rock itself raised $6 million in additional capital. At the same time all of our preferred stock was retired, leaving the company free of dividend obligations. The entirety of the company's capital is now in the form of common stock. There are two classes of common stock. The Class A shares, owned by investors, are intended someday to enjoy a public market. Class B shares, owned by the founding management, have the right to elect 80% of the Board of Directors but may not be transferred. We sold 40,000 Class A shares at $150 per share in December to raise our incremental capital.

During the period of the recapitalization, my attention was drawn to the public policy debate over super-voting stock. It seems clear enough that the creation of special control rights involves some delicate issues. When managers seek to deal with unadmiring owners by creating more voting rights for themselves over the objections of dissenting minorities, extra protections would seem to be in order. When special voting privileges are designed to pass over time to parties unknown, there may be valid economic concerns for both the affected parties and the society. Where the judgment of the shareholders is unanimous and no uncertainty of succession is infused into the company's valuation, however, the merits would seem to weigh differently.

Our owners want the management to share in their objectives, which include the creation of a public market and the building of a more substantial capital base than internal growth may permit. Management looks at these goals with trepidation if they threaten to divert energies away from the consuming (but rewarding) task of building a business and toward fears of hostile takeovers. Thus arises a temptation to keep the common stock base small and private. This can create a wedge between ownership and management that bodes ill for the corporate enterprise. Our two classes of stock have eliminated this conflict, and we all now share the same goals. This helps the company's prospects and enhances its potential for economic contribution. Plymouth Rock will now raise more capital by sale of stock when it is favorable to do so, and we look forward to a public offering of our shares within the next five years.

With the new funds came new and distinguished shareholders. Venture capitalist Benno C. Schmidt of J. H. Whitney and Company has joined the Board of Directors. Michael J. Johnston, Executive Vice President of The Capital Group, Inc., one of the nation's leading investment managers, has also joined the board. Progressive Casualty Company, a large national insurer which holds in common many of Plymouth Rock's values with respect to the treatment of employees and policyholders, became a shareholder. Central Securities Corporation remains our largest shareholder. This gives us an exceptional list. If executives are shaped by the constituencies they serve, Plymouth Rock's executives are fortunate indeed. Our agency force, our owners, our employees and our policyholders are a match for those of any company in the business.

Our loss ratio was about the same as in 1986. The pure loss ratio, reflecting the

continued success of our underwriting model and other analytical techniques, remained highly favorable. Loss adjustment expenses are still above industry norms. Our cost of financing the C.A.R. pool's deficit was once again reduced by our willingness to accept market share growth and business other companies avoided. The deficit, which embodies the lion's share of the rate inadequacy, is of gargantuan size. If enough companies leave the state, those of us remaining will eventually have to shoulder its full burden. So we are vulnerable to unanticipated rule changes and also vulnerable to just staying put if the market continues to deteriorate. The cure is adequate rates, and in Massachusetts this responsibility lies with the regulators.

Expense ratio performance was about as anticipated in the budget for the year. The expense ratio derived from the income statement is potentially confusing, since it reflects as credits to expenses both the C.A.R. reimbursement for handling pooled risks and reinsurance commissions on business ceded to General Reinsurance. Plymouth Rock's budget tracks instead the ratio of gross expenses to gross premiums, including claims and investment expenses and before any reinsurance considerations. By this measure, the expense ratio in 1987 was 40%, down from 44% in 1986 and 54% the year before that. We are now within three points of achieving our original goal of a gross expense ratio of 37% on the budgetary scale. In earlier reports, I said that we hoped to be at this point by the end of our fifth year in business. The 1988 year is our fifth year, and if we miss our target it won't be by much. That will put us on a par with the competition among companies using independent agencies. We will still have a way to go before we can match the direct writers.

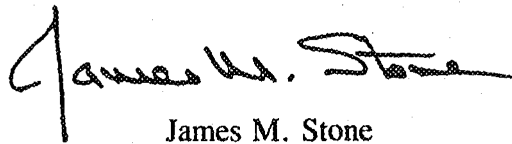
Pre-tax net income from insurance operations for the year was $3.0 million. Half of this amount came from underwriting profit and the other half was from investments. Our portfolio strategy continues to be somewhere between conservative and ultra-conservative. We hold our entire $33 million investment fund in fixed-income securities of the U.S. Treasury or state and local governments. As a consequence, we were unaffected by the stock market crash in October. Our average duration continues to be very short, and thus we were hurt less than most bond investors by the rise in interest rates that occurred in the middle of the year. Still, as net holders of fixed-income obligations, we must have some interest rate risk. The fall in bond prices took our portfolio's market value to about a percent and a half below its carrying value.

Although we have no intention of altering our conservative approaches to credit risk and interest rate risk, we think it may be time to reexamine the passivity of our portfolio. Bond markets for relatively illiquid municipal securities are not always perfectly efficient, and we believe that there should be incremental benefits to occasional swaps. Other investors may have greater liquidity needs than we do or may simply be impatient from time to time. In a very small company, the fixed costs of looking vigilantly for such opportunities will not pay for themselves. Plymouth Rock's investment portfolio is now approaching the size at which the benefits should cover the management costs.

The big challenge for next year once again is growth. Plymouth Rock will almost certainly exceed the $50 million mark in 1988, and some strains are unavoidable. Right now our most stressed department is claims. Our clerical staff, adjusters and supervisors are seen all too often at their desks on weekends. This speaks wonderfully of them, but we can not expect the staff to bear these burdens forever. Claims is the sole area of the company in which we have discovered no innovative techniques to allow us to get more work done than our competitors with fewer staff hours.

Data processing suffers from another kind of growth pains. We are rapidly outgrowing some of our basic systems and hardware. The task of creating replacement systems has begun, employing where possible fourth generation languages that are relatively machine-independent and permit sophisticated data base operations. We are experimenting with Digital Equipment's VAX line on the hardware side because it appears to us to have attractive upward mobility and communications features.

We are also moving. Next year's annual report cover will feature a different building. Our new headquarters will be at 695 Atlantic Avenue in Boston, another beautifully restored Turn-of-the-Century building. We have taken a ten year lease there, and we look forward to creating in that location memories as fulfilling as those we accumulated on Milk Street in our infant years.



James M. Stone