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

Chairman's Letter

February 15, 1993

To Our Shareholders:

Nineteen ninety-two was both arduous and prosperous. Prosperity can be calibrated by the group's net income, which grew more than 40 percent from the prior year to $9.8 million. The difficulties elude such quantification, but their cause is apparent enough. It is easier to decentralize management than entrepreneurship. Last year's letter had warned that starting three new businesses would place an unprecedented burden on our officers. No one here objects to hard work, but an unbalanced load can degrade the quality of thought and dull the keenness of insight. Some additional senior hiring is required before the proper balance can be achieved.

The biggest news of 1992 was from New Jersey. In May we completed a long-gestating arrangement with the Commercial Union group and the New Jersey Insurance Department, resulting in the licensure of a new insurance enterprise called Palisades Safety and Insurance Association. That company, a reciprocal, will be administered by Palisades Safety and Insurance Management Corporation, a subsidiary of our SRB Corporation. The names here are a mouthful, so a bit of explanation is called for. The following text is excerpted from my statement at the ribbon cutting in Trenton, an event which New Jersey Governor Jim Florio was kind enough to host:

"The use of the name Palisades, rather than the Plymouth Rock name, reflects our view that to succeed in this business one must have a local focus and a local base. Our company is chartered in New Jersey. It will be headquartered in Hoboken. And all of its staff will be there.... The next word in the name is Safety, and here is the guide to our most innovative feature. For many years, people have accepted their insurance costs passively, and with resentment. Palisades is designed to be a membership organization that seeks out drivers who will take some of the responsibility for auto insurance costs into their own hands. Those people who select cars with the best possible safety equipment, the nucleus of our group, will receive dividends based on the company's performance....

"Insurance is in the name as well because even the safest cars and the best drivers are involved sometimes in accidents. We will be providing automobile and homeowners coverage statewide and emphasizing customer service as the hallmark of our product.... Finally, we describe ourselves as an Association. This is because Palisades Safety and Insurance Association is organized under New Jersey law as a reciprocal exchange, rather than a corporation. The capitalization provided by Commercial Union will belong to the Association's members.... Our investor owned companies can succeed only if the Association prospers. The management fees are largely proportional to premium revenues and revenues in turn will expand only if the Association is able to pay healthy dividends to its safety conscious members."

The Commercial Union arrangement was unusual. New Jersey, like Massachusetts, is going through the painful process of depopulating a bloated residual market pool. The New Jersey method is to assign each company a quota of automobiles that must be written "voluntarily" by April of 1993. Commercial Union, which had been exiting from auto insurance in that state for some years, had no desire to build back its book. The alternative to enforced growth in New Jersey is to find another carrier willing to take one's place, and to provide the replacement carrier with the necessary capital. So, to complete its exit from personal lines automobile coverage in New Jersey, CU provided Palisades a capital base, and Palisades has assumed its obligation to write 16,192 cars by next April. If, as I expect, the current set of reforms will eventually set New Jersey back on a sound course, and if we can meet the April quota, this is a good time and an appealing method for entering the business. For a company any less committed to local focus it would not make sense.

Our immediate goals in New Jersey are to meet the depopulation quota we inherited and to build an operation capable of servicing its agents and policyholders at the same standard of quality for which Plymouth Rock Assurance has become known in Massachusetts. Then we can turn to the next set of tasks: providing Hal Belodoff with an internal team strong enough to loosen his Boston bonds and setting up a safety dividend and membership program with an eye to the Association's long term future and its exciting public policy potential. For the interim, Keith Rodney finds himself traveling southward far more than he enjoys.

Our company in New Hampshire, Mt Washington Assurance Corporation, is off to a solid start. Peter Jones, its president, predicted that Mt Washington would do more business in its first year than Plymouth Rock Assurance had done in its initial year. Since New Hampshire has only one-fifth the cars Massachusetts has, this seemed unlikely. Plymouth Rock had written $3.7 million in premium in 1984. Mt Washington closed last year with $4.5 million in writings. So congratulations are due. Mt Washington, though, is still losing money. Plymouth Rock in 1984 lost money too, but it made money the next year and every year thereafter. Since the bottom line test is the more important of the comparisons, we will chill the champagne now but leave the cork in place until next year's results are known.

Our alternative markets effort remains the most challenging at this point. We have lost none of our original faith that the fundamentals are opportune. The traditional workers compensation business shows no sign of recovery from its various plagues, and the logic favoring increased client participation in loss results is clearer all the time. The tools for reducing costs are available, including before-the-fact loss prevention through workplace safety, after-the-fact claim minimization through better directed care, and underwriting to select those employers and employees willing to share in the common task. We have assembled, moreover, at Boston Risk Management and Pilgrim Insurance Company a fine team of talented individuals to lead the effort.

The vision of our eventual workers compensation product, however, is still unrefined, and the revenue stream is not yet sufficient to cover costs. The issues of interim scale and leadership in this area are perplexing. Fortunately, there is a growing demand for Boston Risk Management's expertise, and Pilgrim's automobile processing services in 1992 were about as profitable as the alternative markets effort was unprofitable. The group's net income, therefore, was virtually unaffected by our service entities taken together.

Plymouth Rock Assurance Corporation had another successful year in 1992. That company's annualized volume in Massachusetts auto and homeowners business now exceeds $113 million, which translates after deduction of reinsurance and unearned premium reserves into a contribution of about $63 million to the group's net premiums earned. We now insure roughly one out of every thirty automobiles in the state and one out of every fifty homes. Our financial statements make it appear that premiums for the group were up by 35 percent. This is true with respect to the net premiums earned, but don't be too impressed. Most of the change is a reflection of residual market depopulation at Plymouth Rock Assurance, which raises the share of our gross writings tracked by the income statement. The increase in Plymouth Rock Assurance Corporation's gross writings, the index of our customer base, was closer to 15 percent.

Size, of course, has never been our motivator. Plymouth Rock's comfort comes from believing that no other company in its arena has a better population of policyholders, a more respected force of independent agents, a more loyal and capable staff, or a higher standard of service excellence. These are the core components of durable performance in our industry. An especially pleasing confirmation that we are on track occurred in August, when Boston Magazine published its annual "Best & Worst" edition, memorializing consumer opinion of area merchants. Though no insurance company had ever been cited for service excellence before, Plymouth Rock Assurance was named Boston's "Best Insurance Company."

Business success, as I would define it, requires a two part test: profitability of operations and pride of association. Profits are the proof that your ideas actually work, the public's imprimatur on your product and service. Customer willingness to pay more than cost for what you offer is a fair measure of contribution. But it is not enough. The most likely, and most worthy, long term survivors of competition are those companies that meet a second test. The individuals who own and run the business, those who work there, and those who deal with it must be proud to do so. Pride in association promotes productivity, enhances quality and thus attracts customers, permits the hiring of superlative individuals, and more generally helps keep a company away from trouble. So, when I say that 1992 was a successful year, I mean not only that profits were satisfactory but also that our various constituencies seem proud to be associated with Plymouth Rock.

Our profits are a function of claim experience, of efficiency in operations, and of investment performance. Our 1992 loss ratio, which measures claim results, is owed primarily to adequate statewide rate levels. The once-controversial residual market rules are no longer a key factor. The residual market itself, in fact, has become less important, as depopulation of the pool continues apace. The depopulation of the C.A.R. pool and the "direct pay" law for property damage claims (which underlies our Crashbusters program) remain among the most productive regulatory reforms of the 1980's. The most disappointing auto insurance reform was the increase in the no-fault tort threshold, which appears to have had a neutral or negative influence on burgeoning bodily injury costs. The Massachusetts legislature will probably revisit the no-fault issue in 1993. Let us hope, for the sake of the public as well as the industry, that legislators contrast the approaches of comparable states and settle on a no-fault format that really works. Neither a return to the tort system nor maintenance of the status quo can stave off unsustainable cost pressures on the bodily injury coverage rates.

The report on operating efficiency is mixed. We continue to do our work with a staff complement of just under two people per million dollars of premium volume. This compares to an industry average which has only recently fallen below three per million and still rounds to three. We are convinced, in the long run, that the most efficient insurers will be those with the smallest and best trained work forces. Ours fits that description, but it is a more expensive work force than most. We remain an average-cost producer of the insurance product. This is not to imply that the year was without signs of progress in operating efficiency. Our gross expenses, including both claims adjustment and investment costs, absorbed about 38 percent of premiums, a favorable contrast to the prior year's 39 percent and 40 percent the year before that. Expense ratio points, we have learned, must be eked out one at a time.

Investment income in 1992 was $10.4 million for the group. The growth in income from the year prior was less than the increase in our asset holdings. Since we still invest only in high-grade fixed income instruments, this is a direct reflection of falling interest rates. The same phenomenon brought us some capital gains, which amounted to $1.0 million of the total after federal income taxes. If interest rates remain low, the economy will probably benefit more than we will. Our business always generates a float, the consequence of customers letting us hold their money while we wait to see whether they have claims. As long as premiums are less than fully responsive to cost changes, a safe bet in regulated environments, reduced interest earnings on an insurer's float will tend to depress its overall performance.

Some years ago I wrote that our investment appetite would be confined to the plainest of vanilla until research costs could be covered by their probable performance increment. Our relatively low maintenance approach to investing has also been a valuable technique for marshalling management focus around basic insurance skills. We have accepted, as a consequence, a diminished return on our portfolio. In the long run, ownership instruments should outperform debt instruments, and investments with some risk must outperform Treasuries. Our capital base, at $44 million, and our portfolio, at $130 million, are now large enough to justify a more balanced strategy...but not by much. We will walk before we run, and we may well be satisfied with walking.

None of us at Plymouth Rock are speculators by temperament, nor do we think insurance executives ought to be. Our plan is to permit a relatively small portion of each insurance company portfolio and a larger share of the holding company portfolios to be invested in common stocks. Initially, the maximum share of any insurance company portfolio committed to common stocks will be five percent. Investment management will be made available to our operating units by SRB Corporation, under the supervision of Jim Bailey and a full time staff. We consider this structure consistent with our general notion of decentralized management, because investment tasks are outside the property and casualty insurance skill set and, in fact, would represent a distraction for the various operating management teams. Were SRB not prepared to offer these services, we would expect the various companies to seek some other vendor for portfolio services.

Since we have made no common stock investments as yet, it may be premature to describe our selection criteria. On the other hand, this letter has always been a useful invitation for comment and criticism, so even a preliminary description serves a purpose. We plan to use three principal standards in judging potential stock investments. Here is my admittedly oversimplified shorthand for the three criteria.

First, we will buy with an expectation that our holding period is to be measured in decades. Second, we will buy shares only in companies whose products are understood, and preferably used, by one or more of our directors. And, third, we will consider only companies with whose chief executives we would all be willing to be photographed.

These criteria are versions of tests we apply to our own business decisions. In effect, we are looking for companies with whom we would like to have an operating partnership, albeit our stake may be too small for them to know that. Since our initial equity portfolio will total less than ten million dollars, and we are not seeking a broad and diverse portfolio, our average holding will probably involve about two million dollars. By next year at this time, there will actually be some. But we never intend to lose perspective on our investment activities. Good insurance companies are more readily separated from the mediocre by their technical insurance proficiency than by their investments.

Our business in 1993 will be more complex and more demanding. If all goes well, we will approach break-even in New Hampshire and New Jersey, we will keep Plymouth Rock Assurance away from both rocks and whirlpools, and we will define our mission in the alternative markets area. What success we have had to date has come from choosing the right people and bringing out the best in them. The ambitious agenda before us will be realistic only if we find more first-rate individuals who want to work as hard as our present crew and take pride in having done so.

James M. Stone