The Plymouth Rock Company
695 Atlantic Avenue
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Chairman's Letter

February 8, 2011

To Our Shareholders:

The year 2010 was the worst in Plymouth Rock's history. There is no sugarcoating that fact. Not since Plymouth Rock's first year in business has the net income for our owned and managed companies, taken together on a combined basis, been less than 1% of their gross premiums. Our planning for 1984 had assumed a start-up operating loss; the poor bottom line results this past year were unanticipated. They cannot be blamed, moreover, on the financial market crash of 2008 or the state of the general economy. The cause was not in our stars but in a series of reserving and pricing misjudgments at Palisades, the reciprocal insurer we have managed for eighteen years in New Jersey.

Due to our reciprocal management structure in New Jersey, the results of the Palisades insurer are not reflected in the net income of The Plymouth Rock Company. Net income in 2010 for the company you own was $44.0 million, representing a 13% return on shareholders' equity. Please do not be comforted. We run our group of companies as though all were shareholder-owned, and it is only a matter of time before unsatisfactory results in any one company, owned or managed, are felt by all. You will see the overall results in a new format on our financial statements for this year. A change in financial accounting standards requires us to combine both owned and managed companies into a single set of statements for the first time in 2010. This may confuse some readers who don't appreciate the distinction between the owned and managed companies, but it presents the numbers more as we experience them – especially this year. In that sense, the coincidental timing of the accounting change seems almost karmic.

Most of this letter will be devoted to perspective on all the companies taken together, but a few more words on the shareholder-owned subset of the total are required for consistency of our presentations over the years. The consolidated net income of The Plymouth Rock Company for the year fell below 2009's $51.5 million, but you will probably recall that $12 million of the 2009 after-tax profit came from shareholder and real estate gains related to the sale of our ownership stake in Response Insurance. Continuing income in 2009 was more like $39 million. The 2010 number, absent the sale of Response, represents a modest improvement. Neither year's profit number is truly satisfactory, though, and neither matches our five-year plan goals or our long-run profitability targets. Those higher standards would have required a net income in 2010 that rounds to $60 million. Still, our book value is now $1,951 per common share, up 7.4%. The cumulative book value rate of return over the full twenty-seven years of the

Company's history, which takes account of shareholder dividends as well as equity, is 18.4%, a tenth of a point below last year's number.

Palisades is the right place to begin the longer, and more meaningful, version of the 2010 story. The numbers themselves are stark. The contributing causes are more complex and numerous. In the years from 2001 through 2005, Palisades prided itself on having the lowest loss ratio of all the major automobile insurance writers in New Jersey. Enough time has now gone by to be sure this was not just self-delusion. Palisades' results were just plain good, presumably reflecting skilled selection and care of agents, sound reserving and pricing, and professional claims practices. New Jersey results for the automobile insurance industry as a whole were quite attractive by national standards during the same period. To be the best performing competitor in a solidly profitable environment is an insurer's dream. During the early years of the decade, Palisades' underlying claims cost per vehicle insured (called, confusingly, in our industry "pure premium" and computed by multiplying the average frequency of claims by their average cost, or severity) was falling while the average premium charged to customers rose gradually. As a consequence, both recorded profits and reserve redundancies were on the increase, another element of a dream scenario.

Then, around 2006, there came an inflection point. The industry's pure premium cost, or claims cost per car, turned sharply upward in New Jersey. In the second half of the decade, the pure premium costs at Palisades rose 24%, even faster than those for the industry as a whole. Palisades' average premium charged per automobile exposure, a standard measure of revenue per unit, during the same period fell by nearly 10% instead of accompanying the costs upward. This gap, experienced over an expanding Palisades book of business, explains the painful outcome. The worsening problem wasn't remedied until now because Palisades' management, for a variety of reasons, failed to diagnose it properly until 2010. Neither, I must add, did any of us at the Plymouth Rock enterprise level. Reallocating profit and loss by year with the benefit of hindsight, we can now see that 2006 was a year with $7 million in profits for the Palisades insurer and manager combined, not nearly the $15 million booked at the time. By 2009, the actual combined result was a loss of $3 million while the company thought it was earning over $17 million. The booked result for 2010 must now aggregate all of the previously unreported losses, so you should expect to see a $39 million statutory loss for the year in our filed statements. Of this total, about $6 million in losses actually belong to 2010 results and the rest corrects the inadvertent over-reporting of income in years past.

Palisades was not, of course, the only New Jersey carrier to be taken by surprise. In fact, 2009 loss ratios for the best known carriers were almost all terrible, and sharply spiking bills from 2010 rate increases will almost certainly shock New Jersey policyholders in 2011. In 2009, for which data is freely available now, the five largest New Jersey automobile carriers, excluding those we manage, had an average pure loss ratio of 77%. That ratio, which the industry usually hopes to keep in the low 60's, was over 80% for State Farm, Amica, GEICO, and Travelers. Palisades can take only a pinch of solace from having such esteemed company in its discomfort. Palisades, like those companies listed above, did worse than the industry averages for the two recent years taken together. Palisades, however, is a New Jersey-only company so it can't subsidize its poor performance in that state with decent results in 49 others. Precisely because it is a one-state domestic company, we expected that Palisades would be more in tune with the trends in that state and less likely to make errors than the national companies. So what went wrong? And what can we learn from this series of events? One observation is that success tends to breed over-confidence. The excellent results earlier in the decade probably delayed recognition of the problems and created an illusion that Palisades might be less vulnerable to industry adversities than its competitors. At the same time and more generally, there was perhaps an insufficiency of numerate skepticism on the part of some Palisades managers, resulting in too little emphasis on the fundamentals of the business. Third, Palisades may have grown too quickly to maintain its unusually high standards. The rapid absorption of over $100 million in premiums from the Proformance acquisition in 2008, in particular, introduced many untested agency relationships and magnified the consequences of the wider rating errors that originated with inadequate reserve estimates.

These three observations specifically apply to Palisades. A fourth applies industry-wide. When the big national direct response writers entered the state of New Jersey about five years ago, they had multiple motives for stretching toward the lowest possible rates. They wanted to secure handsome market shares in the explosion of deregulation-induced shopping; they wanted to imprint first-time shoppers with an association of their names with bargain prices; and profitability conditions looked pretty rich to begin with, so they thought they could afford the low rates. Oblivious to the incipient turn upward in underlying cost trends occurring in the background, the traditional New Jersey carriers followed the new entrants' lead and cut their prices. It now seems they all went too far. To correct its excesses, GEICO, the most aggressive of the entrants, has filed for 25% in increased premiums since 2008. The average New Jersey auto insurance carrier has taken rate increases in excess of 19% over the same three years. I deeply doubt that the direct response writers intended to lose as much money as they did, in part because that would define their pricing strategies as predatory. Nonetheless, they probably ended up with a winning outcome from the mistakes. The harsh truth for the rest of us is that in any price shock situation, and virtually regardless of which carriers raise their rates the most, the direct response writers will tend to gain market share as shopping accelerates and relationship-grounded retention falls off. Branding oneself as a money-saver really matters during periods of rapid premium increases. So, too, does Internet presence.

The events at Palisades catalyzed a major change in organizational structure for our New Jersey operations. After much consultation with our Board members, Hal and I decided to combine the management companies that oversee the Palisades and High Point insurers, and we have renamed the combined business Plymouth Rock Management Company of New Jersey. Gerry Wilson, whose focus was solely on High Point in recent years, will now be more of a New Jersey czar, with all of that state's actuarial, claims, and finance staffs reporting directly to him. Ed Fernandez will continue as president of the Palisades independent agency business, reporting to Gerry. The new structure will save the group money, making both High Point and Palisades more competitive, and should help with future branding efforts. For these reasons, the combination was probably an inevitability that the 2010 financial results only served to accelerate. The imposition of High Point's disciplined and analytical style on the entire New Jersey team should increase the accuracy of future reserves and rates. Recognizing that some of us received bonuses over the last few years that reflected mistaken views of profitability, Jim Bailey, Hal and I have cut our salaries for 2011 to adjust our cumulative pay to what it would have been had the correct numbers been used in the calculations. Ed, always a pro, asked to join us in taking a pay cut for a similar reason.

While there is no silver lining to the cloud that surrounds Palisades' 2010 results, there is no sense of panic either. A few facts may help explain why. Most important is that our newly combined New Jersey operation, already long viewed by the regulators and rating agencies as a unified whole, is quite solvent. The ratio of premiums to surplus for the Palisades and High Point insurers at year-end 2010 is actually below the average level of that important metric over the last decade. Only the sizable cushion we thought we were building is gone. Palisades' 2010 losses, as unpleasant as they are, should be taken in the context of an overall enterprise with revenues owned or managed of over $1.1 billion (a total almost identical to the prior year's scale metric) with net income in the other segments of close to $45 million. Second, the long-term track record of building value for the Palisades reciprocal and its policyholders remains hard to fault. The statutory surplus of Palisades in 2001 was $17 million; at the close of 2010, it stands at $314 million. That is an average compound rate of increase in excess of 30% in the capital belonging to the New Jersey reciprocal and managed by our companies. Similarly untarnished by this event is Palisades' standing with agents and reputation for superior customer service. It remains effectively tied with Travelers for the honor of being the largest independent agency writer in the state, and it is unbeatable on the Insurance Department's ranking of companies by valid complaint ratios. And finally, although the rate increases that Palisades has recently needed are hefty, its filings do not place it in the top half dozen companies sorted by their cumulative filed increases over the past few years. A nice feature of the business of automobile insurance is that, absent permanent scarring of a company's reputation or harm to its regulatory standing, a bruised insurer can reset its rates and reserves completely within a couple of years. We have no reason to think that Palisades has anything less than a healthy reserve position already, and our team anticipates a return to profitability in 2011.

High Point's year was nothing like that at Palisades, but it was nothing like the good old days either. Most of the New Jersey auto insurers sustained what I call a windless hurricane, partly of their own making, and High Point was not unscathed. The High Point insurer did little better than to break even for the year, a result you can compare with profits averaging over $15 million annually for its five prior years within our New Jersey group. The combined ratio for the insurer and the management company together was 101%, and the insurer's filed rate increases for 2009 and 2010 have approached 13% with pure premiums still on the upswing. You may reasonably wonder whether there could be hidden under-reserving there as well, just as there was at Palisades. This is a question only the passage of time will answer with certainty. Reserves are, after all, predictions, and the most robust canon of prediction is that arrogant predictions flag likely losers. You can rest assured of this much. High Point's claim reserves have been reviewed and reconsidered with that concern as a spotlight; its past reserves have held up well; and its actuary, Tom Myers, a former president of the Casualty Actuarial Society, has always leaned toward caution.

High Point's premiums written were up about 4% for the year, reflecting a small decline in unit volume offset by an increase in average premiums per unit. High Point's level of customer service remains stellar, with no valid complaints at all showing on the New Jersey Insurance Department's annual survey. Additional congratulations are due, moreover, to High Point's claims department. The New Jersey Insurance Fraud Prosecutor named High Point's Special Investigations Unit as "The Outstanding SIU Staff" in the state; and Rick Adam, who runs High Point claims, was selected for its top "Claims Executive Award" by the New Jersey Special Investigators Association. High Point's principal challenge remains just as it was when I wrote to you a year ago: it must keep the loss ratio under control as it adds new business from new sources. In the face of statewide headwinds, this will be no trivial task.

Last year's letter described Plymouth Rock Assurance Corporation, our New England carrier, as the most under-performing company in our group. That it is no longer a problem child relative to Palisades in 2010 provides scant consolation. But Plymouth Rock Assurance is also looking better in absolute terms and relative to its local peers, a combination that provides considerable relief. Plymouth Rock Assurance posted a combined ratio just under 101% for the year, a marked improvement over the prior year's 104%. Equally important, the gap between Plymouth Rock's statutory combined ratio and that of the average of its four most comparable peers, once as much as six points to our disadvantage, is now negligible. The pace of change in the Massachusetts regulatory environment has, meanwhile, slowed a bit. While not everyone is as worried as I am about disparities between rates in the wealthiest neighborhoods and those in the poorest, the Attorney General has picked up on a related issue and is proposing to limit the use of rating variables that are proxies for credit score. With these uncertainties at play, the recent national entrants remain cautious about investing in Massachusetts growth, and it appears that the new owners of the state's largest personal lines carrier, Commerce, may be looking for geographic diversification.

We look to Chris Olie for leadership at the smaller New England companies in the Plymouth Rock group as well as at Plymouth Rock Assurance. Pilgrim Insurance, the insurance services company, and Encharter, the holding company for independent agencies we have invested in, report directly to Plymouth Rock Assurance officers. Pilgrim lost some business this past year, but continues to produce a seven-figure profit for our group. Encharter has operated with paltry profits for some years now, but it impressed all of us in 2010 with innovative advances in the use of social media and the Internet to sell insurance. If you read my report last year, you know that I believe these are indispensable elements to our success, and that of Plymouth Rock's independent agents, in the near future. Encharter's pioneering use of the new tools, which we will make available to all of our independent agencies over time, earned it five significant awards during 2010, including the "Excellence in Social Media Award" from the National Association of Professional Insurance Agents. Encharter has yet to turn this creative progress into meaningful increases in volume, but I'll wager that they will do so going forward. No parent of teenage twins could fail to appreciate the importance of this modern communications revolution.

Connecticut automobile insurance results, once again, were unsatisfactory, but they have improved noticeably over past performance levels. Written premiums in the automobile line fell by 12%, and the combined ratio was 105%. On the other hand, homeowners insurance in that state did well for Bunker Hill, and the result was that Connecticut business returned an overall profit for the group in 2010. I am surrounded by persuasive optimists who think Connecticut will do better still next year. Mt. Washington Assurance, writing in New Hampshire, and Bunker Hill, the homeowners insurer, maintain boards of directors separate from those of Plymouth Rock Assurance but Chris plays a role in these subsidiaries as well. Mt. Washington continues an upward progression and earned a small profit in 2010, with written premiums having increased by 5% and a combined ratio under 99% for the second consecutive year. Bunker Hill turned in a particularly good year. Operating profits were almost $3 million, a record contribution to our group, and represented a 10% return on equity. I'd like to see better given the intrinsic catastrophe risk in writing homeowners insurance, but I recognize that substantial benefits to our group in excess of the direct profits arise from offering homeowners coverage. It seems beyond dispute that our agents prefer a full service personal lines carrier and that customer retention is improved when related companies provide both automobile and home insurance.

Investment results for Plymouth Rock look like those of many institutional investors in 2010. Cash basis returns on fixed income investments were between skimpy and non-existent, as even the modest upward interest rate adjustment during the year was sufficient to wipe out the bond market's paltry yields. Though 2010 provided a lower yield than 2009, and the overall bond yield may decline further as older holdings are replaced with new ones, we resist the temptation to reach for higher returns by taking more interest rate or credit risk. The bond portfolio is not where we satisfy our appetite for risk, and we simply have no confidence at all in our ability to outguess other fixed income investors on the future direction of interest rates or issuer credit premiums. Our perpetually undiversified marketable equities portfolio returned 15% after dividends in a year that the Standard & Poor's 500 Index also returned 15%. A mild reversal of the flight to quality in a strengthening market explains why stocks we still believe to be superior to the market as a whole performed only as well as the indices last year. This is hardly a cause for concern. The 2010 results lowered our all-time internal rate of return on marketable common stock investments to 16.6%, which you may compare to the 10.6% annual return on the S&P for the same period. The lower number is just about all we could have achieved had we invested in a thoroughly diversified portfolio of common stocks, so you can easily see why we remain committed to the undiversified approach. Six extra points on a fixed investment compounded over a couple of decades is enough to nearly triple the overall return for the period. In the common stock arena, we have consciously bet against the market's wisdom and, so far, we have come out well ahead.

Our hedge fund holdings returned 9% and private equity positions gave us a 15% return in 2010, both quite satisfactory against the backdrop of a continuing becalmed market for both initial public offerings and acquisitions. Excluding earnings from agency loans and premium finance, the income statement shows $14.7 million of investment income and realized capital gains for 2010. This is unsurprisingly down from the $35 million on the same line in the 2009 statements when the profits on our Response shares were realized. Some of the changes in the investment portfolio's value, as always, flowed directly to the balance sheet without affecting income. Unrealized gains on our equity positions, which grew by just under $10 million in 2010, are reflected only on the balance sheet. Real estate, considering both operations and the annual appraisal, gave us a 17% return, as Boston commercial real estate activity showed signs of recovery. Changes in the market values of our real estate holdings are reflected on neither the income statement nor the balance sheet but they are part of our economic return nonetheless.

Our position in Homesite Group, where we remain a shareholder, is carried for 2010 at close to $1 million less than it was in the year prior. That is because our valuation moves up or down with Homesite’s profits, and not necessarily with that company’s economic value. Homesite saw yet another year of impressive growth and poor returns. This past year, its top line grew by over 20% to $412 million in written premiums as Homesite further solidified its position as the national homeowners partner of choice for giant automobile insurers who find writing homeowners insurance not worth the risk or diversion of talent. This is a wonderful accomplishment for Fabian Fondriest and his team. The bottom line, however, showed a $4 million net loss. Once again, Western and Midwestern hailstorms cost more than the policyholders provided Homesite to cover them. Higher premiums and regression to the mean in hailstorm activity should both contribute to easing this imbalance in the future. And, of course, there is an up-front cost to growth that should be recouped as the business seasons and lower renewal expenses replace high first-year charges. Nonetheless, unless a solid profit picture emerges, the shareholders of Homesite will be faced, not soon but inevitably, with a Hobson’s choice between curtailing its growth and raising money on poor operating numbers.

The overall economic and employment picture looks better than it did a year ago, but not by as much as most of us had hoped. It is easy to understand the widespread sentiment that nearly everyone has paid for the excesses that spurred the financial crisis except the instigators. While their shareholders, in fact, suffered whopping losses in some cases, most of the titanic institutions bailed out at taxpayer risk are making strong profits again, and the banking sector is ever more concentrated. I continue to hold that the menacing overhang of public debt and entitlements represent no greater threat to our national economic future than does the supersizing of the financial sector. Investment banking, fundamental investing, and commercial lending are essential in a free market economy. While trading can be useful as a lubricant as well, if carefully applied by the drop, dumping oil by the barrel into the machinery isn't. Today’s financial sector, engorged with trading and leverage, is draining talent from productive enterprise, increasing disparities in wealth and income, and drawing unhealthy levels of rent from the non-financial businesses it exists to serve. Tax policy and regulation should be used to reduce the prevalence of short-term speculative trading, debt-driven financial engineering, opaque instruments traded at undisclosed prices, and systemically risky leverage. Yet, tellingly, the realities of political campaign finance seem to have eclipsed a multi-trillion dollar lesson, and it takes a Pollyanna to expect much will be done soon about the root causes of the current distress. We will endeavor here at Plymouth Rock not to rely on any capital structure, or make portfolio investments dependent on capital structures, that cannot withstand another financial dislocation of similar origin.

The most realistic hope for reform may lie with bipartisan promises to re-think the well-intentioned but malfunctioning incentives for home ownership embodied in the government-sponsored mortgage companies. Fannie and Freddie will be the jumbo sinkholes when the bailouts have all played through. Here are a few facts. In 1890, the percentage of Americans owning homes was 48%. In 1930, it was still the same 48%. The percentage fell in the Depression, and then grew over 20 points in the 30 years that followed until it reached 64% in 1970. This occurred in a marketplace without the benefit of securitization. In 1970, Ginnie Mae, Fannie Mae and Freddie Mac began securitizing mortgages. Over the next 30 years, as securitization caught fire, the home ownership percentage rose by a modest total of 2.6 points. Growth spurted briefly in the new millennium, as mortgages were extended with underwriting standards that we now understand were at best negligent, and the home ownership percentage peaked at just short of 70% in 2004. By 2009, the percentage of homeowners had retreated to its 2000 level of 67%, and foreclosures are now pushing it lower. Economic historians will someday write that the principal impact of the securitization craze was not on the level of home ownership but on the prevalence in the U.S. of the otherwise unrealistic thirty-year fixed mortgage and, of course, on the Crash of 2008. I am unsure just how much of the blame for the crash lies with mortgage securitization. I am not sure there isn't a place for a useful, well-regulated and constrained mortgage securities market, or a sensible government reinsurance program. I am dead sure, however, that the societal benefits of a multi-trillion dollar securitization market, and the supposed public interest case for keeping regulation in the field to a minimum, are oft wildly overstated.

While this was a bummer of a year for The Plymouth Rock Company, I can still close on a positive note. Financially sound and unsullied, our New Jersey companies will soon get a fresh start. Ideally, they will prove Nietzsche's not-so-reliable rule: "That which does not kill us makes us stronger". At a minimum, the order of the day can be the more dependable epigram: "This, too, shall pass". This tough year, in fact, ended with all the winds blowing in the right direction. Plymouth Rock Assurance in New England has strengthened noticeably. The revised New Jersey structure should pay off relatively quickly in pricing and claims effectiveness as well as reduced expenses. We are in the process of adding substantive peer review processes and controls at the enterprise level as further protection against errors in the future. While we are still seeking a Chief Underwriting Officer to enforce best practices throughout our businesses and to spur our pace of analytical innovation, our leadership lineup is assuringly deep. Nobody ever said it was supposed to be easy to build an admirable and profitable billion-dollar business. Nobody said there wouldn't be bumps along the way. This past year, as our parents used to say, was character building. There were surely some disappointing moments as 2010's events unfolded, but I can speak for the whole senior management in assuring you that, thanks to strengths our companies have accumulated over many better years, there was never an instant of disarray, a shadow of disheartenment, or a hint of defeatism. We look forward cheerfully, if somewhat humbled, to a brighter 2011.

James M. Stone