The Plymouth Rock Company

695 Atlantic Avenue
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Chairman's Letter

February 28, 2012

To Our Shareholders:

Calendar year 2011 was our second poor performance year in a row. Shareholder profits in 2010 had remained at a reasonable level; this year they were down by 35%. By that rather visible standard, this was the uglier year of the two. In fact, though, I feel far, far better about the recent year than the prior one. In 2010, the problems that confronted Plymouth Rock were caused by our own errors, while in 2011 the worst culprit was the weather, the adverse impact of which was shared by all of our competitors. Just as important to keep in mind when comparing the two years, the shareholder profits that fell precipitously do not reflect the results of the New Jersey reciprocal premium volume our group manages. The fully consolidated net income for the enterprise, including both underwritten and managed businesses, does not display a dramatic year-to-year contrast. Profits for the entire group on a consolidated basis were similarly disappointing in 2010 and 2011. The consolidated net income was actually up by 51%, but it is more revealing to say that profits once again round to $10 million, a small fraction of what the group's income ought to be. After an embarrassing year, it would have been refreshing to have had a particularly good (and lucky) one, but that was not to be. Still, a careful look at the Company's position as we enter the new year may give you some cheer.

This is not to say that you, as Plymouth Rock Company stockholders, can ignore the shareholder-owned subset of the total. Reflecting the adverse New England weather, net income for The Plymouth Rock Company fell from $44 million in 2010 to $28.7 million in 2011. We haven't recorded shareholder profits this low since 2003. In a year when nature hit so hard, nonetheless, we are glad our business is robust enough that it still earns an 8.0% return on equity. I am reminded of the comment last year of a friend from a large bank who told me to stop whining that the Company's income was disappointing. He reminded me that the institution he worked for reported losses in the tens of billions in 2008 and 2009. Plymouth Rock's book value is now $1,994 per common share, up 2.2% from a year ago. The cumulative book value rate of return over the twenty-eight years of the Company's history, which takes account of shareholder dividends as well as equity, is 18.2%, two-tenths of a point below last year's number. The scale of our enterprise is not a line on the financial statements. Scale is best measured by the consolidated premium volume before the impact of reinsurance. Underwritten and managed premiums at year-end totaled $1.06 billion, down by $54 million from the count at last year's close.

The weather is topic one for all of us at the Company. Let me describe what occurred in 2011 and then turn to the elephant of a question that has wandered into our room. Four separate and unusual weather events slugged the insurers of the Northeast hard in this past year. The year opened with snowstorms. The month of January was the whitest in New Jersey in 62 years, and it was worse in New England. Boston's January was the third snowiest in its oft-wintry history. Heavy snow has, to the surprise of folks who don't know our business, been the most expensive natural hazard throughout Plymouth Rock's existence. Built-up snow on roofs, repeatedly thawing and refreezing, all too often produces leaks. Ice dams and nail-hole trickles were both plentiful and expensive for our companies on the homeowners side of the business, while snow accumulation and slick roads added to the auto claim count. By the end of January, a banner year for Plymouth Rock results was already out of the question. There was a respite in the early spring, but on June 1 a trio of tornadoes touched down in western Massachusetts, destroying lives and homes without notice. Killer tornadoes are rare in this area; these were the first in 16 years. There were about 10,000 claims, and we got our full share.

The years from 2006 to 2010 were a rare and fortunate period for the Atlantic coast of the United States, without a single hurricane making landfall there. In August of 2011, Hurricane Irene, an enormous storm, brought that hiatus to a close. Irene made landfall on the East Coast three times: first in North Carolina, then in New Jersey as a tropical storm, and finally in New York before heading forcefully onto dry land in New England. The total damage from the storm is estimated loosely at $10 billion. For our group of companies, the New Jersey assault was particularly bad news. Since 1903 no Atlantic storm of Irene's strength had come to land in New Jersey. As if this were not enough pre-winter trouble, a still rarer incident occurred in October when an early snowstorm buried the whole Northeast. This was another ten-figure cost event for our industry. The key to the Halloween storm's destructive power was that the wet snow fell on tree limbs still richly adorned with leaves. Countless more branches collapsed to damage insured property than would have done so in a comparable but more seasonal winter storm. Two million homes in the Northeast found themselves without power. All four of our states were among the hardest hit.

The immediate impact of the disastrous weather was, of course, a reduction in profits. The bigger and more troubling question the weather events of 2011 raise in everyone's mind is whether they are reflective of a long-term trend in the climate. Our industry commonly refers to catastrophic events as one-in-fifty-year or one-in-a-hundred-year events or the like. This has the effect of discounting their information content and dampening their impact on rate indications. Bad results are smoothed over five or ten years, or, in some cases, disregarded altogether. Regulators encourage this gradualism and de-emphasis of outliers for obvious reasons. When patterns of events presumed to appear once in a century occur with regularity, however, one must question whether the characterization of the probabilities is justified. Conditions can change over time; and models that simply extrapolate from past data, just as the world has learned in financial markets, do not always predict the future. The National Oceanic and Atmospheric Administration has reported that there were a record fourteen United States weather events serious enough to cause at least a billion dollars in damage in 2011. You can compare this with an average of one per year in the decade when we started writing this business and four per year in the 1990's.

The direction is plainer than the causes. Whether there is global warming due to greenhouse gasses, or we are witnessing an inflection point in a natural climate cycle largely unrelated to human activity, it is increasingly plausible that more extreme weather than in the past is now a fact to be reckoned with. Any recent and fundamental change that renders past data an understatement will cause near-term rate increases phased in over five or ten years to be insufficient. Assuming that the pattern of adverse climate change is not endlessly accelerating, in which case the insurance industry's problems will be minor compared to the general scope of the calamity, this would not necessarily be bad for our industry over time. It would surely underscore to customers the need to keep purchasing our products even as prices rise, but there could be some rough intermediate years as rates lag the experience.

As we entered the year just ended, Hal and I both felt confident that Plymouth Rock Assurance, our New England carrier, had put behind it a time of inadequate performance relative to its peers and its opportunity. That company's chief since 2009, Chris Olie, is a natural leader, a sound insurance executive, and an admirable colleague. Looked at on a competitive basis, his company's combined ratio has improved and any peer gap that existed has been effectively closed. Exposure growth, which had been falling while unsuitable business fell away, moved into the black again by the last quarter of the year. Dollar volume was, due to rate increases, on the upward slope all year, ending 2011 up 4% over the prior year with $233 million of automobile insurance premiums in force. Any gains, though, were overridden in 2011 by the year's harsh weather. Plymouth Rock Assurance's combined ratio was over 102%, just low enough to earn that company a skimpy profit. Our major domestic competitors suffered similarly from the weather.

The greater part of the problem was at the homeowners writer, Bunker Hill, where the loss and loss adjustment expense ratio was a horrendous 127%. The combined ratio was 165%, with the four weather events having contributed $21 million in covered losses. This was the first year since 1991 that insured catastrophe losses in Massachusetts and Connecticut for all carriers exceeded one billion dollars. Not surprisingly, the results for Bunker Hill's Massachusetts-based peers were similarly grim. The first quarter's unusual weather losses, mainly from heavy and continuous snow, were almost half of the total. Bunker Hill and its competitors will have to raise rates and consider underwriting and coverage changes to protect against a repetition. About the only silver lining to the storm clouds of 2011 was that both Plymouth Rock Assurance and Bunker Hill managed not just to keep on top of the unusual claims load but to do so throughout this difficult year without sacrificing their characteristically high levels of service.

Pilgrim Insurance, an insurance services provider, actually does a bit better in a rough year than a calm one. Part of its revenue is tied to claims volume. That company's sales emphasis in 2011 was on the servicing of personal lines policies for the relatively new Massachusetts assigned risk plan, for which it is emerging as the contractor of choice. In the past, Pilgrim's business had also included work on a fee basis for this state's residual market in commercial automobile coverage. Residual market commercial writings have contracted in recent years, though, and Pilgrim is not included among the current servicing carriers. Pilgrim secured a seven-figure profit once again for our group. Encharter, the corporate home of our investments in independent insurance agencies, had a relatively flat year, generating again only a low six-figure pretax profit. It has yet to find its special sauce that realizes the savings and growth opportunities that ought to be accessible through vertical integration and its innovative use of the Internet. Absent the exceptional weather, Mt. Washington Assurance, writing in New Hampshire, might have continued apace, earning a small profit in 2011. Instead, its contribution was a loss of $1.4 million. At some point, a harder headed person than I would probably have given up on Connecticut, where the automobile insurance volume is less than $10 million and the cumulative profits nonexistent. This year's loss was about $1.2 million dollars. Rather than surrender, we are trying again to rev up the engines there with new talent and a redesigned product. Watch this space next year for a report on the results.

New Jersey remains our largest state by volume. The first thing to be said about High Point and Palisades is that you won't be hearing those names much anymore. While they remain identifiers of the individual legal entities that issue our group's policies in New Jersey, there has been an effort to simplify branding. In the age of the Internet, it was becoming too expensive and inefficient to brand ourselves in the public mind with multiple names. We will refer collectively to the various Garden State entities as Plymouth Rock Assurance or, when needed, Plymouth Rock Assurance New Jersey. This change coincides with a managerial reorganization completed in 2011. All of the companies comprising Plymouth Rock Assurance New Jersey are now under the well-proven leadership of Gerry Wilson.

For two years now, New Jersey has been the locus of our toughest challenges. The business written there through independent insurance agencies, after years of excellent loss ratio results, had become under-reserved and underpriced by 2010. The problem was industry-wide, but our team was relatively late to see it. Since that time, our New Jersey companies and their competitors have taken unusually large rate increases. Although our companies' volume suffered more from the price shocks than did the writings of some of the other carriers, this was not because we needed more rate than they did, but because the tardiness caused us to take our price increases more suddenly. Plymouth Rock is in fact relatively near the middle of the New Jersey pack in total rate taken over the last few years. Its average filed premium is up 24% since the start of 2010. Largely as a consequence, the New Jersey companies together closed the year with written premiums down nearly 7% from the prior year-end, to $752 million.

The consolidation of the various New Jersey companies under Gerry has proved a boon for at least two reasons. Expense savings from the consolidation have approximated $6 million. Even better, under the spotlight that can accompany a reorganization, the application of our statewide talent pool to the agency company's bodily injury claims has resulted in reducing ultimate payments in that line by roughly $20 million. Had there not been about the same $20 million in weather-related claims over and above historically driven budget estimates, and higher than expected Personal Injury Protection claims in all of the New Jersey distribution channels, this would have given a welcome boost to the bottom line. As things turned out, the entire New Jersey operation, taking management company and underwriting entities together, operated at only a modest profit. If the current year does not show a healthy recovery by this time next year, the problem will likely have arisen from New Jersey PIP, where claims continue to escalate at an unabated rate. The state regulators have so far been understanding of the situation, sympathetic to inevitable price increases, and supportive of experiments in cost-saving reforms. As in New England, the New Jersey staff – and particularly the claims staff –

deserves a compliment for handling a difficult year and exceptional claims volume without any loss at all of service quality. Given that this year there was also a major reorganization in New Jersey, with many changes in reporting structures, that accomplishment is all the more impressive. No competitor enjoyed a better valid complaint ratio according to New Jersey Insurance Department data. In fact, Gerry reports, Plymouth Rock Assurance had no valid complaints at all during 2011, a notable accomplishment in any year.

The Standard & Poor's 500 Index closed last December 30 just about where it began the year. To say that the public equity markets were flat in 2011, though, would totally fail to convey the excitement surrounding their intra-year volatility or the considerable anxiety they caused investors, much of which was related to an ongoing European governmental and banking crisis. Flat was indeed the final result at year-end, with the Index returning only 2.1% including dividend payouts. Our undiversified portfolio of marketable common stocks beat the market index, as it has in 14 out of the 19 years since we began equity investing. It returned 4.3%. The 2011 results lowered our all-time internal rate of return on marketable stocks to 16.1%, which we still compare with some pride (and plaudits due Jim Bailey and Rick Childs) to the 10.0% annual return on the S&P Index stocks for the same period. Returns on fixed income investments were skimpy once again, as interest rates remained near record lows. Results for our bond portfolio are more influenced by Fed policy than specific investment picks within the conservative guidelines we set. This year, bonds gave us a tax-equivalent return, with both coupon and price changes considered, of 4%. The insurance industry, and particularly a carrier disciplined not to stretch for higher yields by taking more interest rate or credit risk, needs stronger underwriting results in such periods. When fixed income yields are so much lower than their historical norms, our targets for combined ratios must be set well below 100% to generate any reasonable return on capital.

Hedge funds had a poor year by historical standards, the market's anxieties having suppressed the financing and acquisition activities on which they earn their money. Unlike most prior years, when we have enjoyed returns on hedge fund investments in the double digits, their return in 2011 was just 1%. The private equity industry as a whole suffered from much of the same, but our holdings did better than the pack and provided a return in excess of 10%. The overall earnings contribution of the investment portfolio's income and realized capital gains was quite similar to the prior year's contribution. Some of the changes in the investment portfolio's value each year flow to the balance sheet without affecting income. Unrealized gains, which declined by $0.5 million, are an example. Our Boston real estate did well according to the appraisers and, counting both operations and increases in valuation (the latter of which is reflected in neither income nor balance sheet equity), yielded a healthy high-teens return.

Homesite Insurance group, in which we have a significant investment position, was battered even harder than Plymouth Rock by weather. That carrier's worst problems were in the Midwest, once considered the safest place to write with respect to natural disaster potential, but hit for three consecutive years now by unprecedented storms. We take our proportionate share of Homesite's gains and losses each year into income, and that company had its worst year by far in 2011, recording pretax losses of around $40 million. Its expenses are admirably managed; its claims from non-weather perils were right near its targets; and even its hurricane, wildfire, winter storm, and earthquake claims came in as anticipated in its pricing. The losses from hailstorms and tornados created the entire shortfall and then some. Homesite, of course, expects hail-tornado losses every year and budgets accordingly. The historical cost of these losses per policy, averaged nationally, has been about $70 per policy. The problem is that, for the past three years, hail-tornado losses have cost that company something more like $200 per policy. Data from competitors shows a similar spike, with each of the last three years worse than the prior period. Homesite's top line has continued, meanwhile, to grow rapidly. Premiums written by that company expanded in 2011 from $410 million to just over half a billion dollars, mainly via partnerships with leading insurers who write automobile insurance but choose not to cover homeowners. The value of a Homesite partnership in improving their auto insurance customer retention is clearer all the time to these carriers. There is no other company in the country, moreover, that can match Homesite's skills and expertise in a homeowners partnership. Because Homesite has added to its reinsurance coverage, its growth can continue into 2012, but the owners of Homesite are all aware that, regardless of demonstrated partner satisfaction, the current rate of expansion cannot continue indefinitely without profit.

A key question for both Homesite and Plymouth Rock is whether the recent experience with weather is better described as a spike or by the ominous T-word: a trend. Rather than return the claim costs to historical norms, a trend could flatten to an elevated new plateau or continue in a further upward trajectory. Plainly, one must wonder if the extremes of weather expressed as Midwest hailstorms and tornadoes are related to the East Coast weather events and signify a shift to a generally more turbulent climate. No one, not even the most gifted academic experts in the world (one of whom we regularly consult), can give us an answer to these questions. In Bob Dylan's words, you know "something is happening here, but you don't know what it is…". I expect, at a minimum, that provisions in the rates for weather-related perils need to rise more than one would calculate by the traditional tempered methods. As 2012 begins, the weather is not just elevator conversation; it is at the center of our thoughts.

The general economy is still fragile. Even if its closely watched measures improve, there is reason to remain wary of the economic future until the root causes of the 2008 financial sector crash have been addressed. The concentration of market shares in the financial services industry is even greater now than before the crash, and, all the more troubling, derivative leverage is still at absurd levels. It was the systemic risk arising from oversized and interconnected derivative positions that turned a real estate price correction into a general collapse, and now exacerbates the European debt crisis. The open interest in derivative instruments held by U.S. banks alone is a staggering $250 trillion, which is more than 17 times the nation's entire GDP and about 150 times the aggregate balance sheet equity of the banks. This is out of scale with any legitimate hedging function, incompatible with the notion of financial services as a lubricant rather than a driver in a free economy, and a source of risk beyond the ability of any executive or board member to fathom, let alone manage prudently. The true leverage faced by the banks, which can net their derivatives holdings for accounting purposes to show only the market gain or loss rather than the nominal position size and offset one position against another according to internally generated models, is many times the published numbers.

Because the markets for derivatives have minimal price transparency, allowing them to be sold to less expert buyers for inflated prices, and because non-financial client companies insist on over-purchasing proffered hedging instruments, profits have been lofty for the dealers. In fact, since derivatives came on the Wall Street scene, financial sector profits have roughly quadrupled, while the total profits of the non-financial U.S. corporations for whom the banks provide hedging services have increased at an average annual rate of only 1 percent. To revive an old question: "Where are the customers' yachts?" The financial sector in recent times has come to absorb between 30% and 40% of all U.S. corporate profits, an unprecedented share. The portion of these profits that comes from trading requires a loser for every winner. The former must surely be the non-financial businesses and traditional investors, exactly the economic entities on whom real prosperity depends. No one else has that much wealth to lose.

Why then have our political leaders not united in trimming back this hazardous excess? Campaign contributions presumably have their intended effect, but there are substantive concerns as well. Some politicians and their advisors have been convinced that banking requires its present scale of trading to support its mortgage and small business lending. The data suggests, though, that since the advent of derivatives small business loans are decreasingly a sweet spot for the large money center banks. And, as I pointed out last year, so-called financial innovation, including mortgage derivatives and securitization, hasn't even moved the dial on one of its early heralded contributions, the promotion of home ownership. In 1980, before the securitization boom, the fraction of American families owning their own homes rounded to 66%. The home ownership percentage today is once again about 66%. Other public policy leaders wonder aloud if imposing limits on derivatives trading would cause this country to lose its pre-eminence as a world banking center. Some of the other developed nations might sensibly follow suit if we acted for restraint, but surely not all would drop out of the race for the most super-sized banks. I'd be comfortable wagering, though, that the countries that shared this prize would be the ones that would regret it. There is nothing to envy in what oversized and overleveraged banks did for Japan, Iceland, and Ireland.

Never wishing to disregard babies when throwing out bathwater, I should affirm that prudently purchased and well used hedging instruments can indeed serve to reduce risk for commercial businesses, just as insurance policies can. But we insurers properly face capital charges, and add to our bulk reserves for future claims, every time we add a new policy. One giant step toward enhancing the stability of worldwide banking would require nothing more radical than that. Banks, just like insurers, should post a reserve for every new position opened, thus recognizing that counterparty risk and basis risk (as well as systemic risk when the institutions are large) are always and necessarily non-zero. Consider what a reserve requirement of a small fraction of a cent per dollar of new notional value, with no netting permitted, would do for soundness and rational scale in the derivatives business and the banking sector as a whole. The benefits of derivative instrument trading might once again outweigh the microeconomic and macroeconomic risks and costs of an activity grown beyond all reason, prudence, and good sense.

Since most of you are directors, you have by now seen Hal's objectives and mine for the coming year. Our greatest defensive commitments of time, influence, and effort will be devoted to homeowners results and the New Jersey dislocation in the Personal Injury

Protection line, while two voluntary initiatives will occupy our energies equally on offense. One of the latter initiatives is an enterprise-wide project that Hal calls alignment. A brilliant figure in our industry once told me that there was no logically right balancing point between centralization and regional autonomy in a company. He suggested that a company should simply go in one direction or the other until that approach becomes the accepted norm, and then reverse course to gain the benefits of change, new thinking, and the purging of tired assumptions. Without needing to reach a universal judgment on this provocative theory, our senior management has determined that this is a time for greater congruence in some of Plymouth Rock's business activities.

You have already heard that there will be more uniform branding around the Plymouth Rock name. With that effort will come a more unified presentation of the Company's value proposition to its agents and customers. Product management provides another case in point. The analytical modeling on which we want to rely for the future works best with a maximum of data and a modular product design that allows prompt deployment of what the data teaches in our rates and policy forms. There is little benefit to our current level of diversity in billing plans, policy documents, and invoices across our various states. Another case for greater congruence can be found in claims and customer service, where quality standards, workflows, and measurement techniques can all be improved in a better aligned regime. We are not, however, taking the path of maximum change or purging all of our old assumptions. If there are benefits to radical reinvention as a centralized organization, we will forgo them. We simply do not wish to surrender the proven advantages of the neighborhood focus and strong local leadership around which this company was built. We are not changing the basic recipe for the stew of autonomous regionalism and scalable centrality that has fed us well up to now. That stew, however, needs at least a pinch more of alignment.

The enhancement of our analytic underwriting capabilities referred to above deserves its own place on the marquee of high priority projects. The Plymouth Rock Companies' new Chief Underwriting Officer, David Bassi, is off to a fine start in creating a peer review process for reserving, working with the underwriting officers to enhance staff capacity and techniques for predictive modeling in both New England and New Jersey, and instituting a serious retrospective testing regime for rate indications and claim cost modeling at the enterprise level. His greater charge, though, is to help our company presidents construct an even more data-driven analytical culture than we have now, with loss ratio results and methodologies that will be the envy of our industry. Data wizards and modelers are invited to apply (dbassi@plymouthrock.com).

James M. Stone