

Boston University School of Management
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SMG Fund – Financial Sector

Executive Summary – Recovery Underway In the P&C Insurance Industry

- Prospects for the US P&C insurance industry, including the automobile insurance segment, are finally improving. The short to medium-term outlook is positive. A recovery in industry earnings is underway as a result of: 1) improved premium revenues, 2) a turnaround in investment income and 3) declining claims. This has been reflected in a massive jump in the industry's net income this year (over 220% y/y) and a decline in the combined ratio, to the lowest level since '78.
- This improved outlook reflects the cyclical recovery, which allows companies to raise premium prices (and margins) and improve investment returns, but it is also the result of restructuring and consolidation within the P&C insurance industry over the past few years.
- Specific automobile insurance underwriters in Massachusetts, such as The Commerce Group and Safety Group, also benefit from strict state legislation - which has created unique barriers to entry in this segment. Companies with dominant market share in both private passenger and commercial auto insurance will benefit as the smaller, less profitable firms continue to exit the Massachusetts auto insurance market. This segment is unique given that large, international insurance companies have, historically, avoided the market as a result of the regulatory environment.
- The main risks to the outlook for the Massachusetts automobile insurance segment include: 1) renewed economic and stock market weakness, 2) lower than expected state-mandated premium increases (decision due in December 2003), 3) a further rise in the state's accident statistics and 4) regulatory changes. Although the Division of Insurance Commissioner opened the door for a review of the state's auto insurance regulation this year, reform is not anticipated for several years.
- On the basis of current valuation ratios, profitability (revenue efficiency, earnings, margins), credit worthiness ratings, the selected small cap auto insurance stocks are ranked as follows for performance recommendations:

Ranking	Stock	Ticker
1	Commerce Group	CIG
2	Safety Group	SAFT

Overview of the US Property & Casualty Insurance Industry

The property and casualty ("P&C") insurance industry in the US is represented by companies which offer part (or all) of a broad range of products that provide insurance coverage against the loss and/or damage of property, income or tangible assets, including¹:

- 1) accident and health insurance
- 2) automobile and vehicle insurance
- 3) commercial insurance
- 4) homeowners' insurance

¹ www.hoovers.com

Property & Casualty Insurance Industry

Overview of Automobile Insurance Writers (Massachusetts)

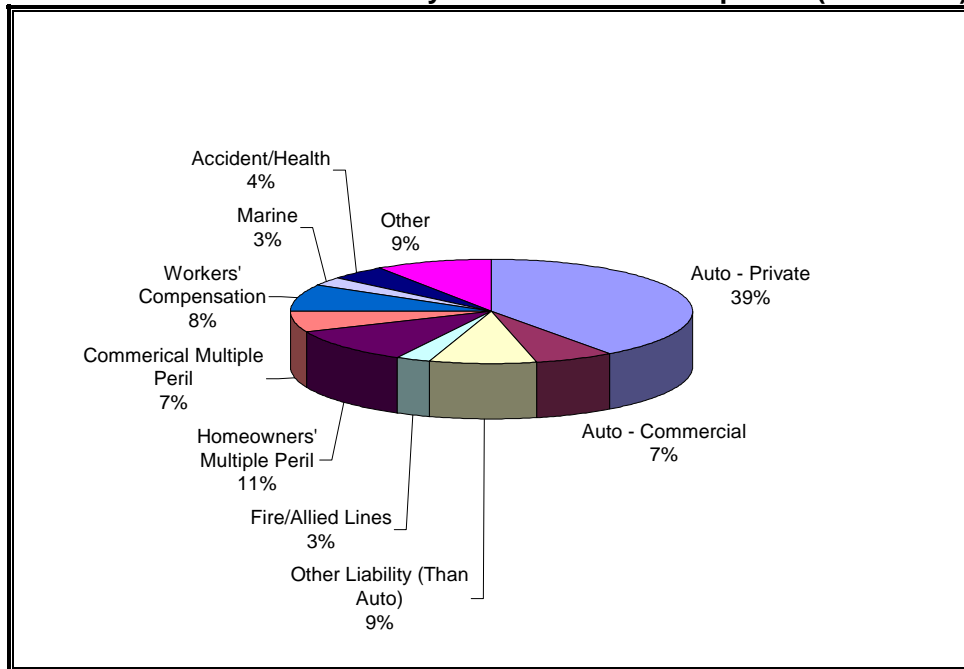
- 5) liability insurance
- 6) workers' compensation

Most P&C insurance companies specialize in a limited product group of the aforementioned areas of coverage, particularly state-concentrated, small cap companies. The P&C insurance industry is further segmented into three main types of insurance companies – primary insurers, re-insurers, and “excess” insurers. This analysis will examine the business model of primary insurance companies, with a particular focus on the automobile insurance segment.

- Primary insurers write policies for individuals or organizations that wish to insure against potential risks.
- Re-insurance companies buy or are allocated a percentage of the outstanding insurance premiums written by primary insurers.
- Excess insurers offer insurance coverage levels above \$US10 million.

Looking at the US P&C insurance industry, automobile insurance represents the largest segment in terms of net written premiums (defined as premium revenues less the amount paid for re-insurance). Private and commercial automobile insurance represented approximately 46% of the total net insurance premiums written in 2000, or \$USD 139.1 billion. Of this, private auto insurance premiums represented the larger proportion, at 39% (\$USD 119.6 bn) versus 7% for commercial auto insurance premiums.

Net Premiums Written – Primary P&C Insurance Companies (% of Total)



Source: The Fact Book, Property & Casualty Insurance Facts

The Business Model of Property & Casualty Insurance Companies

P&C insurance companies primarily operate two main business lines: 1) insurance coverage and 2) investment management.

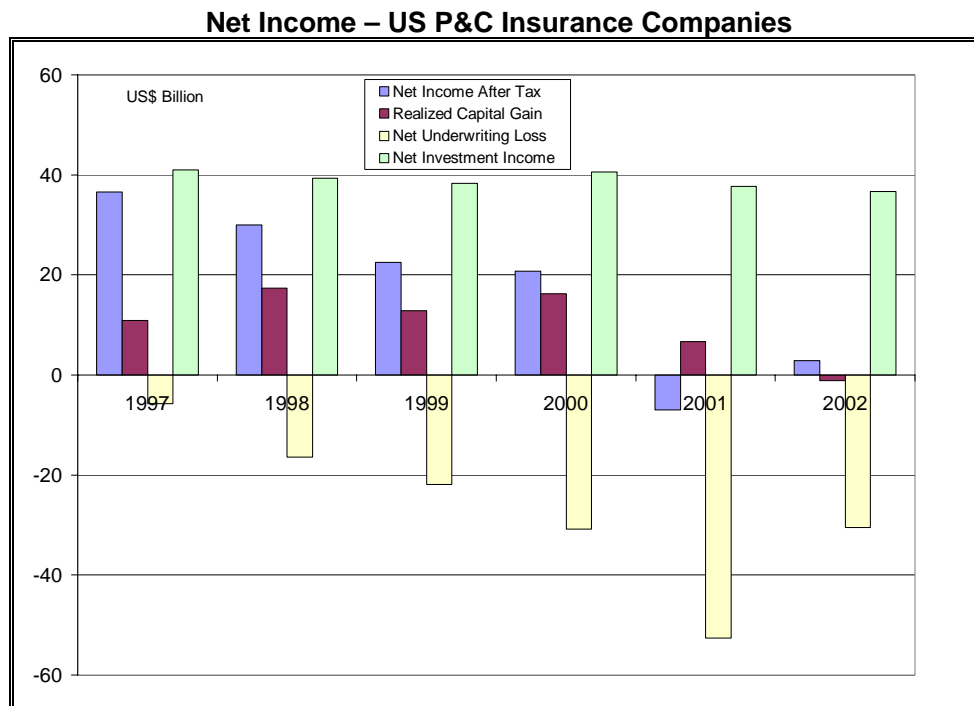
- Insurance coverage involves writing and selling the appropriate insurance premiums, assessing and managing risks and settling outstanding customer insurance claims.

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- To support sufficient reserve levels for outstanding and potential claims, P&C insurance companies also act as investment managers. Revenues from premiums (and excess investment returns) are invested in varying assets - primarily bonds, equities and property. (As of 2001, around 66% of US P&C insurance companies' investment holdings were in bonds, with around 20% in common stock²). Most P&C insurance companies build up surplus funds from retained earnings, in the event that reserves (built up from premiums) are not sufficient to meet claims.

It is interesting to note that P&C insurance companies have not usually shown a profit from underwriting activities. This has been compensated by positive net investment income.



Net underwriting loss = Net premiums earned – Total underwriting expenses

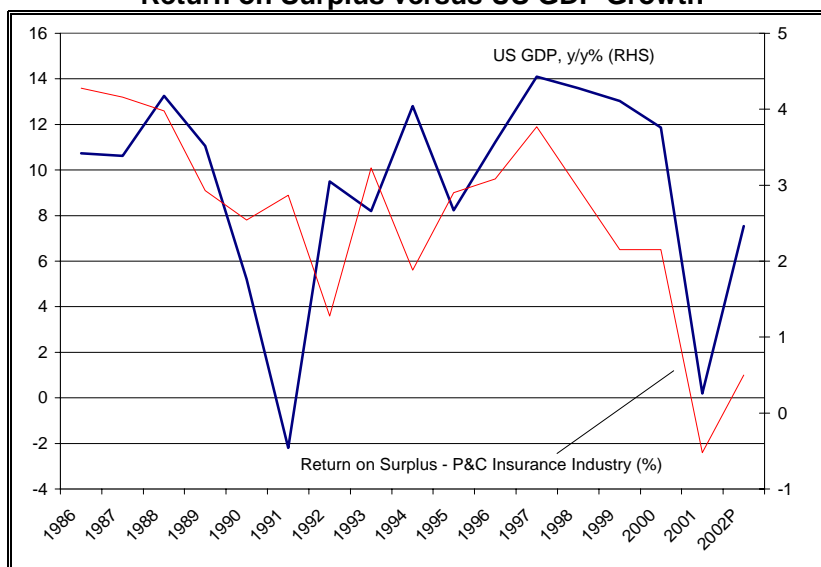
Sources: Insurance Information Institute, www.insurancejournal.com

There is some evidence of cyclicity in the P&C insurance industry. In periods of excess capacity, insurance premium prices have tended to decline, putting pressure on companies' margins and overall profitability. The cyclical impact on profits appears to occur without a notable lag, as shown in the following chart. The return on surplus is a well-utilized profit measure for the industry, given that it incorporates earnings from both underwriting and investment activities³.

² Insurance Information Institute, 2001

³ Return on surplus = Ratio of net operating income/statutory surplus where the statutory surplus = net income after taxes - dividends + unrealized capital gains/losses on investments + net balance sheet adj. For more information, see page 8.

Return on Surplus versus US GDP Growth



Source: US Dept of Commerce, NCCI Holdings

Correlation – P&C Industry Profits versus US Growth

	1985-2002	1995-2002
Net Income (y/y%) vs US GDP (y/y%)	0.39	0.60
Return on Surplus (%) vs US GDP (y/y%)	0.37	0.85
Net Premiums (y/y%) vs US GDP (y/y%)	NA	0.06

Source: III, US Dept. of Commerce

Distribution Channels for Insurance

P&C insurance products have primarily been sold through agents – either “direct writers” that work for a specific insurance company, or independent agents that represent numerous companies. As of 2001, 49% of insurance products were sold through direct writers and 51% through other agents⁴. The method of distribution is important for insurance companies as it determines the proportion of commissions that are paid out as well as the volume of premiums sold.

During the late '90s, however, insurance companies have actively sought other distribution channels to sell insurance products, such as “insurance malls” or through professional organizations. From '99, increasing public use of the internet led insurance companies to actively use e-commerce to conduct business, for the purpose of sales as well as on-line research. Although the US insurance industry has trailed other financial services in the implementation of e-commerce, and agents remain the primary channel for sales, on-line insurance sales have grown rapidly over the past few years. On-line insurance sales represented \$1.9bn of net written premiums (less than 1% of the total) in 1999 and are estimated to have grown to \$11.1bn in 2003⁵. Notably, the fastest growth in insurance sales via the internet has been for the automobile insurance segment.

⁴ A.M. Best Company

⁵ Forrester Research, Deloitte & Touche, 2003

Focus on Recovering Profitability

The environment for the P&C insurance industry has been a particularly difficult one, following numerous catastrophic and terrorist events over the past three years. The overall industry has been faced with rising claim settlements at a time when investment income has been declining as a result of the weakness in the equity markets and lower interest rates. This has been matched with evidence of rising premium prices, financial restructuring and consolidation within the industry. Nevertheless, prospects for the P&C insurance industry have been improving in 2003, considering:

- Return on equity jumped to 9.7% in H1 2003, which compares to 1.0% in 2002 and -2.4% in 2001⁶.
- Net written premiums jumped 12.7% y/y in Q1 2003, to \$101.3 billion.
- The combined ratio – a measure of profitability for the underwriting business – fell to 99.8, the best level since 1978.
- Underwriting losses are expected to decline to \$4-6 billion this year, compared to \$52 billion in 2001.
- Net income after taxes jumped to \$14.5 billion in H1 2003, up 229% y/y from H1 2002⁷.
- The statutory surplus increased around 10% in H1 2003, to \$312.5 billion, from end-2002.

There are a number of factors to focus on over the next few quarters, to gauge the turnaround in the P&C insurance industry.

- Improved matching of insurance premium prices with the undertaken risks, and a return to an underwriting surplus (from a consistent underwriting loss).
- A required turnaround in investment income, considering that it has declined in 4 out of the past 5 years.
- The strength of the recovery in the US economy, with real GDP expected to grow almost 4% y/y next year.
- Insurer insolvencies have been rising, to 1.33% in 2002 versus an average 10-year rate of 0.72%, primarily related to reserve deficiencies⁸.

Overview of the Automobile Insurance Segment – Performance Drivers

Focusing on a subset of the P&C insurance industry - automobile insurance - primary insurers' revenues are dependent upon written premiums, which includes private auto insurance and commercial coverage.

- Looking at a sample universe of US insurance companies that offered auto insurance as a core product, net written premiums accounted for 55-96% of total revenue. (Companies that offer more diversified financial products, such as Metlife, are more dependent upon other revenues aside from premiums, such as investment income/commissions).
- In contrast, investment income accounted for 5-36% of total insurers' revenues. Companies such as The Safety Group, which have a lower proportion of investment income, depend upon other revenue sources, such as financial services income.

⁶ Insurance Information Institute, 2003

⁷ www.insurancebroadcasting.com, September 2003

⁸ A.M. Best Co., 2003

Property & Casualty Insurance Industry

Overview of Automobile Insurance Writers (Massachusetts)

- The final key component of total revenues is the companies' net realized gains/losses on investments, given that investment portfolios must be "marked to market". From 2001 to 2002, most of these companies posted net realized losses (around 1 to 7% of total revenues) with the exception of Travelers, Chubb and White Mountains⁹.
- The highest expenses are insurance policy claims, and associated claims costs, comprising over 60% of total expenses.

Revenues (% Total)	2001	2002	Expenses (% Total)	2001	2002
Allmerica Financial Corp.			Allmerica		
Net premiums	68.1%	74.0%	Policy claims	64.3%	57.4%
Net investment income	19.8	17.8	Policy expenses	14.2	28.1
AIG			AIG		
Net premiums	87.5	92.7	Policy claims	65.4	70.6
Net investment income	13.1	10.5	Insurance & op. exp.	30.9	29.3
Chubb Group			Chubb Group		
Net premiums	85.8	88.5	Insurance claims/exp.	68.5	67.6
Net investment income	11.8	10.4	Amortization - def. costs	22.7	23.2
EMC Insurance			EMC Insurance		
Net premiums	89.1	90.6	Losses & Settlement expenses	73.1	67.7
Net investment income	10.4	10.0			
Horace Mann			Horace Mann		
Net premiums	76.5	81.0	Claims expenses	61.3	59.0
Net investment income	25.4	24.8	Other op. expenses	17.2	15.9
Metlife			Metlife		
Net premiums	55.1	59.7	Policy claims	60.5	62.0
Investment income	36.0	34.0			
Premier Insurance (Travelers)			Premier Insurance (Travelers)		
Net premiums	76.9	78.2	Claims expenses	71.6	78.4
Investment income	16.6	13.2			
The Commerce Group			The Commerce Group		
Net premiums	90.5	96.3	Insurance claims	74.7	75.5
Investment income	8.6	7.8	Underwriting costs	25.3	24.4
Safety Insurance Group			Safety Insurance Group		
Net premiums	86.4	92.4	Insurance claims	73.1	72.5
Investment income	5.3	4.9	Underwriting costs	24.5	24.9
White Mountains (One Beacon)			White Mountains (One Beacon)		
Net premiums	82.1	85.4	Losses and LAE	68.1	64.9
Investment income	8.7	8.4	Other ins. expenses	14.5	19.8

Source: Company SEC Filings, 2002 * Sum of revenue may be greater than 100%, given realized capital losses

- Therefore, earnings of automobile insurance underwriters are primarily determined by the value of written insurance premiums plus investment income versus policy claims and operating expenses.

⁹ Company SEC filings, 2002

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Overview of Automobile Insurance Writers (Massachusetts)

- Revenues are dependent upon the pricing of insurance premiums for various driver and vehicle categories, as well as the volume demand for coverage. Notably, the auto insurance segment appears less cyclical than the P&C insurance industry¹⁰. This is due to the influence of heavy state legislation, which distorts premium pricing and causes demand to be relatively stable and inelastic.
- Investment income is cyclical, and correlated to the performance of equity markets and bond yields. Using quarterly time series data from 1990, the correlation between the annual percent change in investment income for the P&C insurance industry and the sum of the 10-year Treasury yield and the total return on the S&P 500 is around 0.60. Looking at a further breakdown of investment holdings of P&C insurance companies, of the 66% invested in bonds in 2001, around 20% was held in US Treasuries and 78% in investment grade bonds¹¹. Given state legislation regarding investment holdings, and considering that most automobile insurance claims are settled quickly, auto insurance companies invest in assets that are highly liquid and less risky.

Looking at expenses, the value of policy claims is determined by a number of factors, including:

- The proportion of insurance premiums written for different driving classes (favorable versus bad driving records)
- Trends in automobile liability awards (considering that most are settled out of court)
- Automobile accident rates (injury and fatal)
- Crime rates (theft, vandalism, fraud)
- Inflation – the cost of cars, medical care, legal and car repair costs
- The time period of payouts

The latest trends in the determining factors for claims are:

- The median automobile liability award has remained relatively steady, at around \$17,500.¹²
- The total number of automobile crashes in the US has declined by an average 1% y/y per year, from 1997 to 2002, and the number of injury accidents has declined by an average 2.5% y/y.¹³
- The proportion of large monetary awards (over \$1 million) has increased, to 6% of total awards in 2000-2001 compared to 4% in prior years.¹⁴
- Automobile theft has been rising, 1.2% y/y in 2002 and 5.7% in 2001.¹⁵
- Inflation in medical care services has been rising sharply, as have auto repair costs. The average rate of US inflation was 2.3% y/y over the period from 1998 to 2002, yet the price of hospital services rose at an average annual rate of 5.8% and auto repair costs rose at an average 3.0% y/y. On the favorable side, the price of cars has continued to decline, at an average annual rate of -0.6%¹⁶.

¹⁰ Insurance Information Institute, www.iii.org

¹¹ Insurance Information Institute

¹² Insurance Information Institute, 1996-2001

¹³ US Dept. of Transportation, 2003

¹⁴ Jury Verdict Research, 2001

¹⁵ FBI research

¹⁶ US Bureau of Labor Statistics

Risk Management

The profitability of P&C insurance companies is also determined by the management of risks, considering the uncertainty of the highest proportion of expenses - claims. Automobile insurance companies are exposed to three main risks, including:

- Asset risk (credit, market)
- Liability risk (catastrophe, non-catastrophe)
- Operating risk (business, event)

More specifically, the main risk faced by auto insurers is liability risk, associated with uncertainty regarding the filing of insurance claims. Therefore, in the event that automobile insurance companies do not have sufficient premium revenues to cover claims, the industry has to maintain excess reserves.

Auto insurance writers actively manage liability risk through the use of effective reserve management, which involves maintaining sufficient financial reserves to cover reported and unreported claims. Reserve levels are determined by staff actuaries, with ratio guidelines set by individual states. Insurance underwriters also reinsure a proportion of its underwritten policies with other insurance companies to share the risk. The time lag between customers' premium payments and the potential payment of claims allows the insurance companies to earn investment income on premium revenues before the losses are potentially paid out.

Measures of Profitability – Automobile Insurance

There are several key, industry-specific metrics that are used by analysts and employees to evaluate the profitability (and solvency) of automobile insurance segment.

- Combined ratio, which is a ratio that is the addition of the loss ratio, the expense ratio, and the dividend ratio
 - Loss ratio = losses plus loss expenses divided by earnings
 - Expense ratio = other underwriting expenses divided by written premiums
 - Dividend ratio = policyholder dividends divided by premiums
- Return on premiums, which is the earned profit as a percentage of total premiums
- Return on surplus, which is net operating income over the statutory surplus
- Expense ratios, including the loss adjustments expense ratio which is equal to the operating costs to settle claims/incurred losses
- Losses paid ratio, which is the proportion of losses paid to loss reserves
- Investment income ratio, which is investment income as a % of premiums

GAAP vs SAP – Accounting Principles for Insurance Companies

Insurance companies in the US are required to use certain accounting practices to file annual reports with state regulators, as well as the IRS, called Statutory Accounting Principles (SAP). SAP accounting rules are considered to be stricter than GAAP, and the purpose of these rules is to ensure that insurance companies have sufficient capital to cover claims. The main difference is that SAP rules recognize liabilities at a higher value (and earlier) and assets are recorded at a lower value. The annual statutory surplus for automobile insurance companies is one key metric that is a product of SAP.

Main Drivers of Insurance Stock Valuations

Given the earnings model of automobile insurance companies, it can be determined that the main drivers of stocks in this segment are:

1) Operating profit margins

There is a relatively strong correlation between changes in the Operating Margin and the performance of the stock price, as measured by the P/E ratio. This, however, varies per company, with certain stocks - such as Commerce - witnessing a continued rise in its P/E ratio despite the fact that operating margins have declined over the past decade. Efficiency ratios - revenue per employee - have a stronger correlation for stocks such as Commerce, at 0.56 from 1997 to 2003.

Correlations Between Operating Profit Margins and P/E Ratios

	1993-2002 (Annual)	Q1 1999 - Q2 2003 (Quarterly)
Allmerica Financial Corp	+0.30	+0.12
Commerce Group	-0.20	+0.25
EMC Insurance	+0.50	+0.23
Meadowbrook	+0.44	+0.38
Travelers P&C Insurance	NA	+0.98
Vesta Insurance	+0.18	+0.35
White Mountains	+0.10	-0.16

Source: www.simplystocks.com, Company SEC filings (P/E ratios from continuing operations)

* Change in Ratios

* Insufficient stock information for Safety given that it was only public as of 2002.

2) Earnings estimates

Automobile insurance stocks that have outperformed the S&P 500 and the P&C insurance industry index over the past several years have produced strong revenue growth, and sustained earnings results, as will be outlined in the following section.

Overview of Automobile Insurance in Massachusetts

In Massachusetts, as of 2003, there are about 20 companies that write automobile insurance to 4 million cars, including private and public companies. This is the lowest number of companies offering car insurance in any US state¹⁷. The state's differentiated structure and legislation has meant that the automobile insurance market is largely dominated by small to medium cap firms or private, local companies. Only a few large cap, national insurance companies – such as American International Group, Metlife, and Travelers - compete in the auto insurance segment in Massachusetts. These companies, however, have only limited market share. Further details regarding the competitors in the Massachusetts automobile insurance market can be found in the Appendix A.

Insurance products that are sold by underwriters in Massachusetts can be grouped into two main categories: 1) private passenger insurance and 2) commercial insurance. Although this analysis will largely focus on the private passenger insurance segment, there is an overlap given that a number of companies offer both types of products. The low number of competitors that sell private passenger automobile insurance in Massachusetts has meant that the market is dominated by the top five insurers, which control almost 65% of the total market¹⁸. The

¹⁷ Automobile Insurers Bureau of Massachusetts, www.aib.org

¹⁸ C.A.R., The top 5 companies include Commerce, Safety, Arbella Mutual, Travelers & Liberty Mutual

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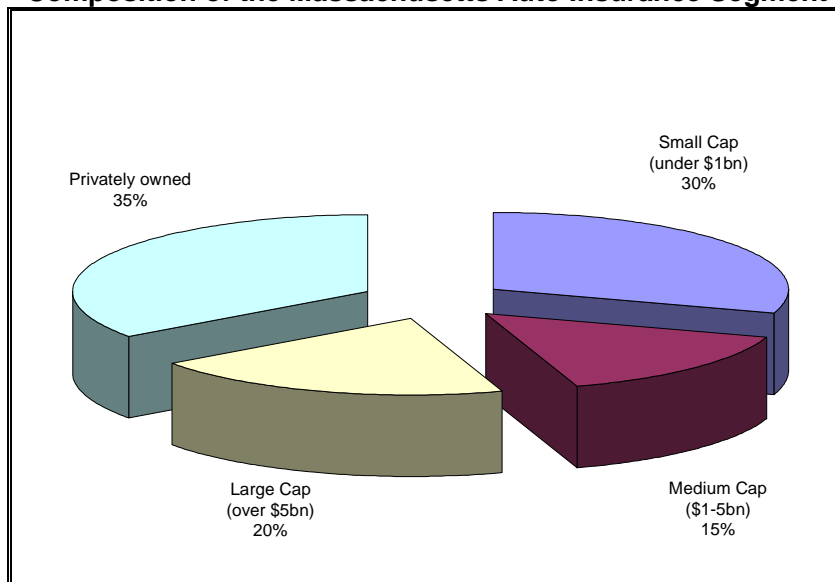
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commercial insurance market is slightly more fragmented, with the top five insurers controlling just over 50% of the total market¹⁹

The current total market capitalization for the automobile insurance segment in Massachusetts is \$220.2 billion, with total revenue of \$136.1 billion and net income of \$7.8 billion²⁰. The companies fit into categories, as follows:

- 6 small cap companies, with market cap under \$1 billion
- 3 medium cap companies, with market cap between \$1 and 5 billion
- 4 large cap companies, with market cap over \$5 billion (American International Group alone has a market cap of \$158 billion)
- The remaining insurance companies are not publicly traded

Composition of the Massachusetts Auto Insurance Segment



Source: www.yahoo.com, C.A.R

% represents number of firms in the segment versus the total number of firms

The P&C insurance industry is not regulated on a national level in the United States. It is, instead, regulated at the state level by insurance commissioners, with the National Association of Insurance Commissioners acting as the coordinator. This has an impact on the industry's revenues, considering that approximately half of the states have the responsibility for regulating insurance premium rates.

Massachusetts is the most heavily regulated state regarding automobile insurance, with state regulators overseeing the underwriting and investment activities of insurance companies. It is a "no-fault" state for automobile insurance, which means that individuals involved in a car accident are entitled to benefits, regardless of who caused the accident. Regulation of automobile insurance in Massachusetts has created a unique business environment by creating artificial barriers to entry and stifling competition.

¹⁹ C.A.R., The top 5 companies include Commerce Group, Arbella Mutual, Safety, Travelers & Allmerica

²⁰ Based on chosen universe of companies, see Appendix A. Revenue/net income = 2002 data

The main factors that differentiate Massachusetts from other states include the following²¹:

- 1) Drivers must obtain auto insurance before registering their vehicles with the Registry of Motor Vehicles.
- 2) Auto insurers are required by law to issue an insurance policy to any applicant, regardless of their driving record. The basic insurance policy must provide several coverages, including “no-fault” insurance, minimum limits of body injury and property damage liability coverage. Other optional coverages that must be offered are: higher body injury/property damage coverage and collision/comprehensive.
- 3) Once coverage is provided, it can not be cancelled (except for premium non-payment).
- 4) There is limited price competition. Maximum personal insurance rates for driver class, vehicle type and territory are set by the State, under a complicated rate setting process that sets premiums on the basis of historical information (prior years’ rates and claim costs) as well other factors. The case for premium rates is presented to the Commissioner every year by the Automobile Insurers Bureau (on behalf of the insurance industry), the State Rating Bureau, and the Massachusetts Attorney General. As per law, the Commissioner’s premium rates must be “sufficient to allow a reasonable rate of return”²² for insurance companies. The specific rate of return is somewhat subjective but is determined by the use of a CAPM model (for the risk-adjusted rate) and a Myers-Cohn profit model (to discount future cash flows). A “fair” premium is derived from the expected losses/expenses (including taxes on income) of the auto insurance segment, discounted to the present value with the risk-adjusted rate²³. This is used as a base for setting state-mandated premium rates.
- 5) Individual insurance companies are allowed to give discounts on premiums to drivers with good driving records, but only under the “Safe Driver Insurance Plan”. Additional discounts (below the set premium rates) can only be offered to a particular class of motorists once it is approved through legislation.
- 6) An unusually high percentage of insurance premiums is sold through independent agents (three-quarters of automobile insurance premiums sold versus one-third for the nation average)²⁴. This requires that companies have successful strategies to encourage the best agents to sell their premiums, such as higher commissions. As such, the average commission expense for Massachusetts auto insurers was 13.2% (of premiums) in 2000, compared to the US insurance industry average of 9.4%²⁵.
- 7) The Commissioner sets, on an annual basis, a minimum commission rate that insurance companies must pay their private automobile insurance agents. A decrease was announced in 2003, to 11% of written premiums, following on from 11.7% in 2002, 12.3% in 2001 and 11.8% in 2000.

²¹ www.mass.gov

²² www.mass.gov

²³ “The Myers-Cohn Profit Model: A Practical Application.”, Mahler, H. 1998

²⁴ www.insweb.com

²⁵ “Private Passenger Auto Insurance Profitability in Massachusetts”. J.W. Wilson & Associates, December 2002

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- 8) Undesirable risks of insurance companies – for example, policies which are deemed to be unprofitable - may be ceded to a state-run reinsurance pool, Commonwealth Automobile Reinsurers (CAR). Given that CAR runs a deficit, this deficit is allocated to all local automobile insurance companies on the basis of market share and business given to CAR.

Recent Developments in Massachusetts Automobile Insurance

- Over the past several years, automobile insurance companies in Massachusetts have been granted smaller than requested increases in insurance premiums, related to the already high insurance cost per vehicle in the state. For 2003, the Massachusetts automobile insurance segment received an average 2.7% premium increase, despite the industry's requested increase of 7%. This follows on from no rate change in premiums in 2002. Insurers are requesting an increase of 12% for 2004, with the deal to be settled by mid-December 2003²⁶. Expectations are for an increase in premium rates of 3-4%²⁷.
- Nevertheless, premium rate increases for individual companies can turn out higher than state imposed increases, accounting for drift and higher levels of coverage. The state-mandated rate is only a basic rate for the industry and does not fully account for the make or year of the insured automobile or the purchase of additional coverage. Over the past several years, the average premium rate change for the Massachusetts auto insurance market was higher than the mandated change, particularly for companies with the largest market share in the private passenger insurance market (Safety, Commerce). At the same time, however, rising costs have kept margins in this industry under pressure.

Premium Rate Increases (Private Passenger Insurance)

	AIB Proposed Increase	SRB Proposed Rate Change	State Mandated Rate Change	Actual Avg. State Change	Commerce Avg. Rate Change	Safety Avg. Rate Change
1999	15.5%	-12.3%	0.7%	NA	NA	10.9%
2000	7.8%	-6.0%	0.7%	6.2%	6.2%	7.4%
2001	2.5%	-14.1%	-8.3%	-3.5%	-1.9%	0.0%
2002	7.8%	-9.0%	0.0%	5.0%	5.3%	5.2%
2003	7.0%	2.0%	2.7%	8.1%	8.0%	7.2%

Source: Mass Dept of Insurance Website, AIB 2002 Profit Filings, Commerce & Safety Annual Reports

Average Automobile Insurance Expenditure per Insured Vehicle – Top 5 States

(\$ USD)	1995	1998	1999
United States	667	704	683
New Jersey	1013	1138	1034
Washington DC	959	1,031	988
New York	906	960	943
Massachusetts	898	816	889
Connecticut	881	901	824

Source: National Association of Insurance Commissioners

- Given the limited competition in the auto insurance segment, and high insurance charges to the consumer, there continues to be speculation regarding deregulation. In May 2003, the Massachusetts Insurance Commission held a hearing to address what regulatory changes were required to improve competition in the automobile insurance

²⁶ AIB

²⁷ "Bureau Pushes Car Rate Increases". The Boston Globe, October 11, 2003

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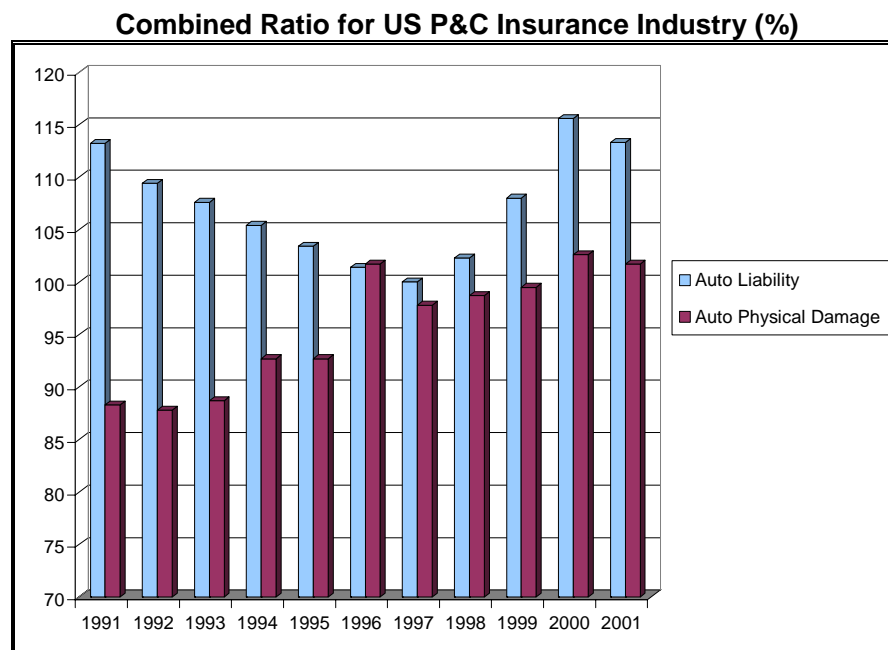
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market within the state. So far, however, it looks unlikely that the price setting mechanism will become more competitive, considering that premiums have been state regulated since 1977.

- There has been a unique trend in Massachusetts, with regards to fraud. Over recent years, there have been an unusually high number of customers staging automobile accidents – which is driving up the cost of claims for companies. Already, Massachusetts has the highest accident rate in the US²⁸. This is being met with higher insurance premium charges.

Outlook for the Massachusetts Automobile Insurance Segment

The business of writing automobile insurance policies in the US has not been profitable for the industry over the past several years, as measured by the combined ratio. This ratio has been rising and, as of 2001, had risen above 100% for auto liability and auto physical damage coverage. This indicates that the auto insurance segment has continued to operate with an underwriting loss, paying out more claims and expenses than are covered by premiums. Although this loss has been offset by net investment income, the decline in investment income and the increase in realized capital losses for many insurance companies, have resulted in a trend decline in net income (with the exception of 2003).



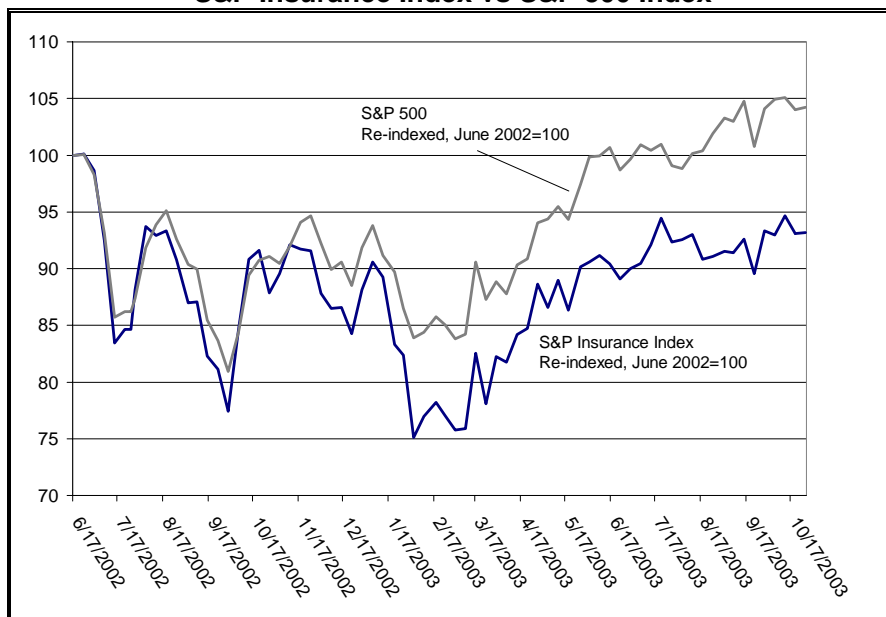
Source: A.M. Best Co., Sum of loss, expense and dividend ratio
Above 100% = unprofitable in written premiums

The deterioration in the financial performance of the insurance industry is clearly reflected in the industry's stock underperformance versus the market. On the basis of available data, since June 2002, the index of insurance company stocks (S&P-compiled) has lagged the recovery in the S&P 500.

²⁸ Insurance Information Institute

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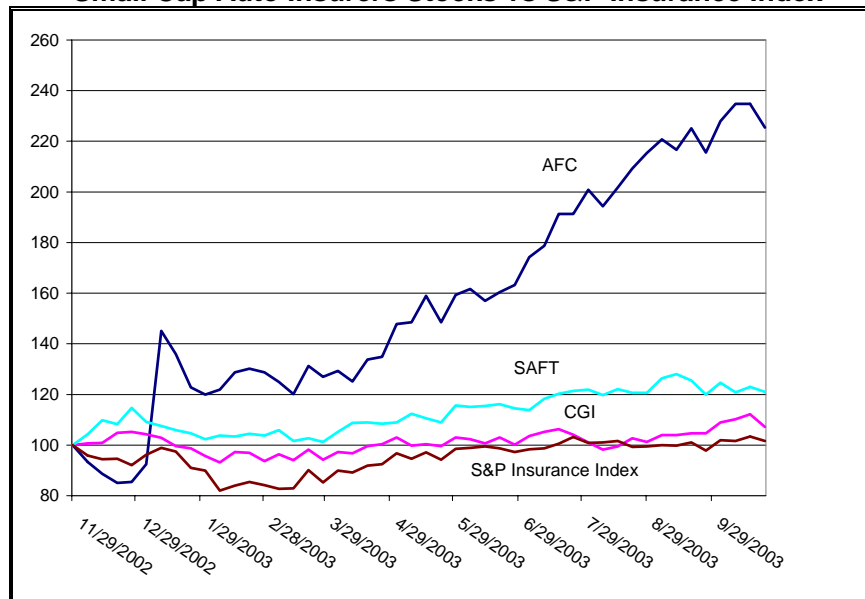
S&P Insurance Index vs S&P 500 Index



Source: www.yahoo.com

Nevertheless, a number of small to medium cap companies that operate in the Massachusetts automobile insurance segment have outperformed the market over this time period, including Allmerica Financial Group (AFC), Safety Group (SAFT) and the Commerce Group (CGI).

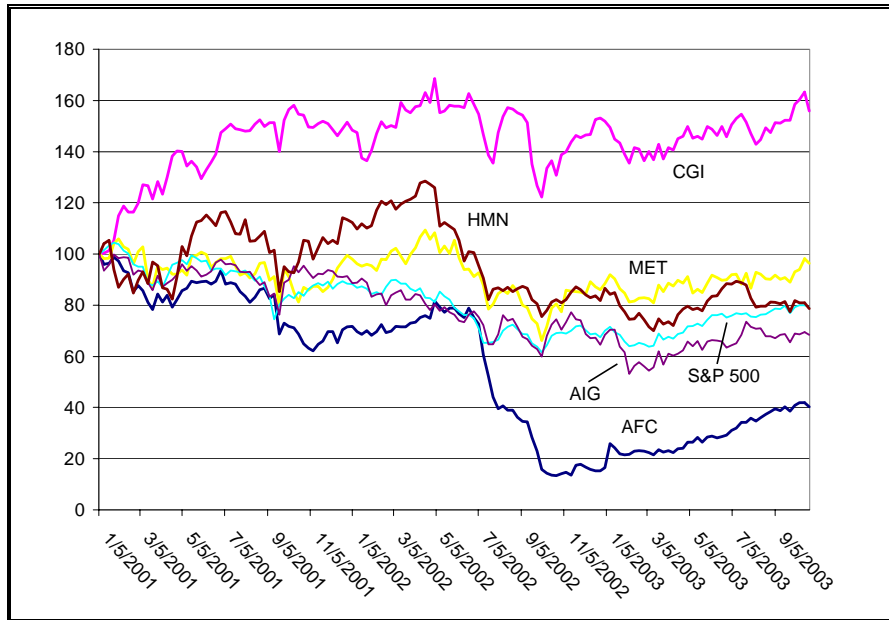
Small Cap Auto Insurers Stocks vs S&P Insurance Index



Source: www.simplystocks.com, Re-indexed Nov. 29 2002 = 100

However, looking at the longer-term equity performance of these stocks versus the S&P 500 index tells a more interesting story, and shows that specific small to medium cap auto insurance stocks have continued to outperform the market, such as the Commerce Group.

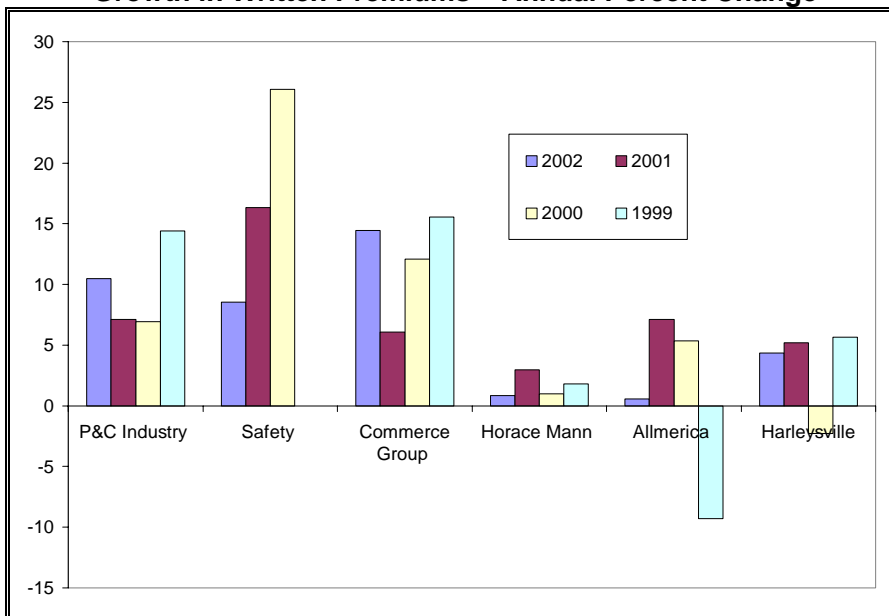
Massachusetts Auto Insurers Stock Performance vs S&P 500



Source: www.simplystocks.com, Re-indexed Jan. 5 2001 = 100, Safety's stock price unavailable before Nov. 2002 & therefore omitted

With early signs that the US P&C insurance industry is starting to recover, given rising premium prices and an improvement in investment income, the outlook for the automobile insurance segment has also improved. The focus will be on small cap automobile insurance companies that were able to sustain earnings during the downturn, and look to outperform in the coming months. In analyzing the stocks that have value, we can observe the following indicators:

Growth in Written Premiums – Annual Percent Change

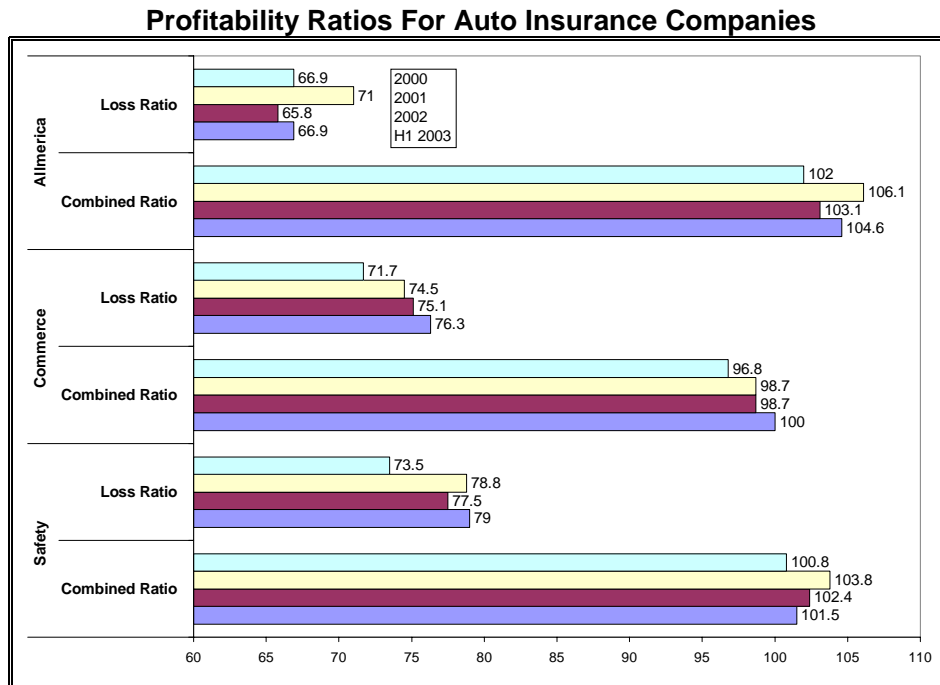


Source: www.simplystocks.com, 1999 not available for The Safety Group

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Overview of Automobile Insurance Writers (Massachusetts)

Compared to the P&C insurance industry, Safety (2000-2001) and the Commerce Group (2002, 2001, 2000) have witnessed higher growth in the value of net written premiums. In contrast, other small to medium cap insurance companies such as Horace Mann, Allmerica and Harleysville have lagged.



Source: Company SEC filings

Combined Ratio for P&C Insurance Industry

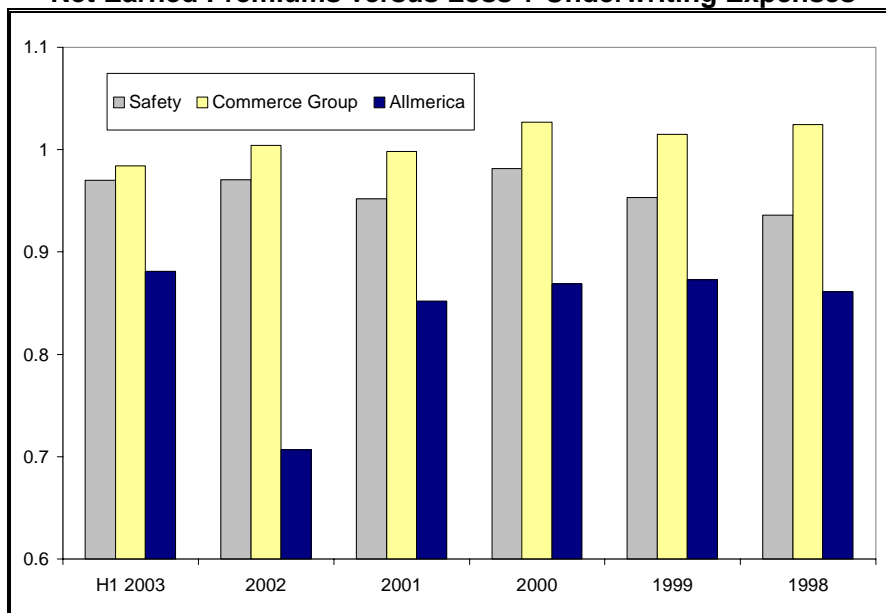
2000	2001	2002	2003 (H1)
110.0	116.0	107.2	99.8

Source: www.insurancejournal.com

- Regarding underwriting activities, Massachusetts auto insurance companies have been more profitable than the US P&C insurance industry, looking at the combined ratio. Although the combined ratio for the industry has declined to just below 100 in the first half of this year, companies such as Commerce had a combined ratio below (or at) 100 over the past few years.

Property & Casualty Insurance Industry
 Overview of Automobile Insurance Writers (Massachusetts)

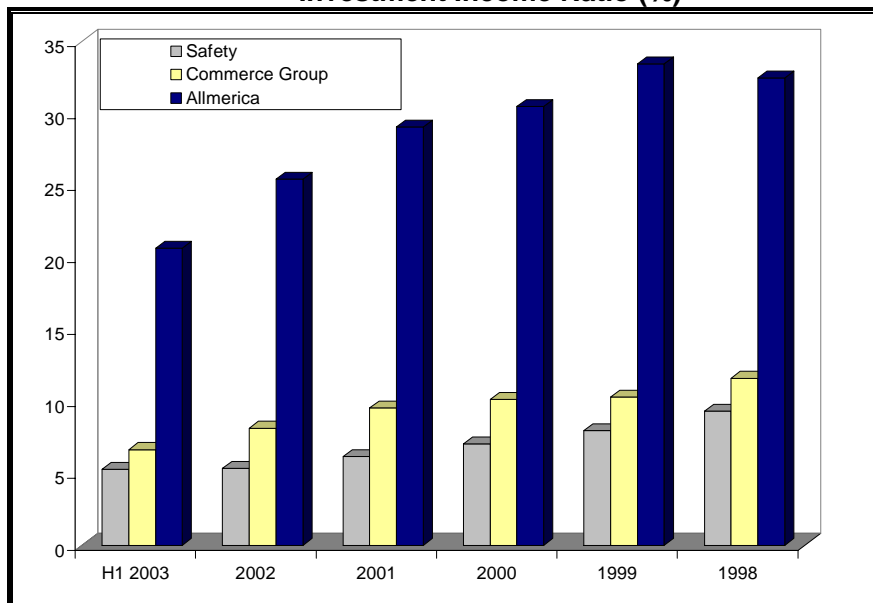
Net Earned Premiums versus Loss + Underwriting Expenses



Source: Company SEC filings, Ratio of net premiums/loss + underwriting expenses

Unlike most P&C insurance companies, certain auto insurance companies in Massachusetts have had sufficient premium revenues to cover claims as well as underwriting expenses. The ratio of premiums to claims + claims expenses has been at, or close to, 1.0 for the Commerce Group over the past several years.

Investment Income Ratio (%)



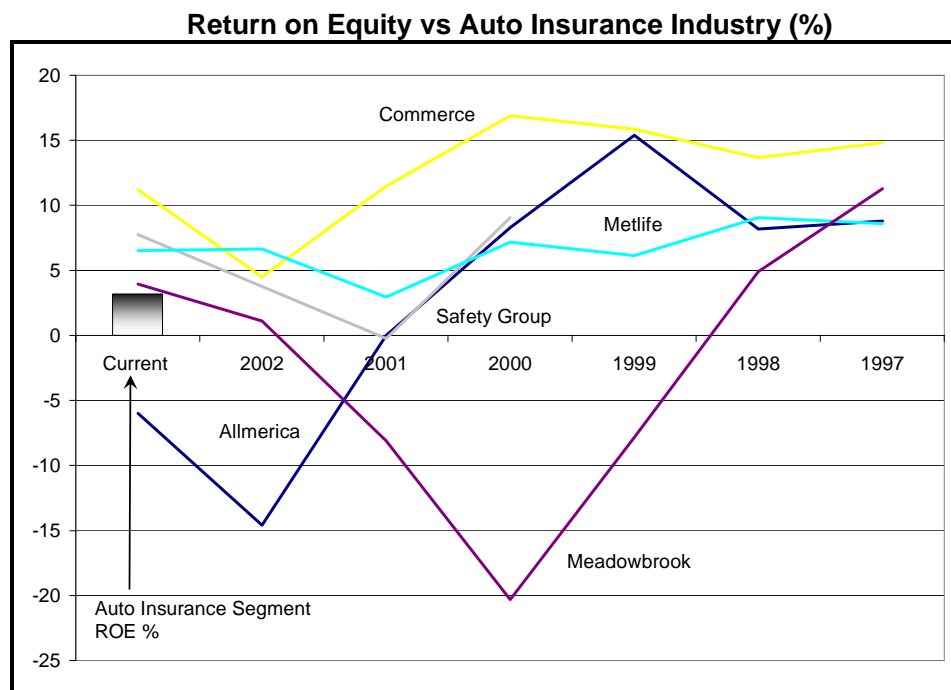
Source: Company SEC filings
 Investment ratio = Net investment income/earned premiums

The largest automobile insurance writers in Massachusetts have produced below average investment income over the past several years, related to the smaller agents' balances. This explains the required increase in premium revenues. The investment

Property & Casualty Insurance Industry

Overview of Automobile Insurance Writers (Massachusetts)

income ratio for these companies has been declining steadily over the past several years while net premiums have been rising.



Auto insurance companies are witnessing a rebound in their return on equity (ROE) in 2003, after a downturn in 2001 and 2002, with the exception of Allmerica. Both Commerce and Safety have outperformed the automobile insurance segment as of H1 2003.

P/E and Price/Sales Ratios Compared

	Commerce	Safety	Allmerica	Harleysville	Industry Avg.
Current P/E (LTM)	13.2	8.88	-4.02	16.98	16.79
P/E (Q2)	34.7	17.1	39.1	69.85	43.75
Avg. last 5 years	15.5	68.6*	10.6	14.26	15.92
Current Price/Sales	0.87	0.32	0.29	0.74	0.86
Avg. last 5 years	1.08	0.18	0.83	0.88	1.14

* P/E as calculated for continued ops, diluted. For Safety - represents previous year only, given lack of data

* Differences (P/E) with Appendix B reflect calculation differences

* Industry average is calculated from selected universe of small and medium cap stocks

Source: www.simplystocks.com

Looking at the valuation multiples – P/E ratios and price to sales – Commerce and Safety are trading below the industry average, and below the medium-term averages for these stocks. Although the price to sales ratio for Commerce is below its historical average, it is currently at the industry average. This contrasts with Safety, which has traded well below the average.

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Overview of Automobile Insurance Writers (Massachusetts)

Taking into account the current valuation ratios, profitability (revenue efficiency, earnings, margins), credit worthiness ratings, and given the outlook for the industry, the small cap auto insurance stocks are ranked as follows for performance recommendations. Please see Appendix B & C for a more complete list of stock rankings (by financial indicators).

Ranking	Stock	Ticker
1	Commerce Group	CIG
2	Safety Group	SAFT

APPENDIX A – COMPETITORS IN THE MASSACHUSETTS AUTO INSURANCE MARKET

Given the degree of concentration in the auto insurance segment in Massachusetts, the universe comprises 13 publicly-traded companies – chosen on the basis of decent market share. The universe of comparable companies included small to large cap stocks, for comparison purposes, industry and competitive analysis. A list of the companies that are active in the Massachusetts auto insurance market are in the table below, ranked by market share. Although this analysis focuses on small to medium cap companies that operate in the personal auto insurance segment, several of the largest writers of private passenger auto insurance in Massachusetts also dominate the commercial automobile insurance market (such as Commerce and Safety Insurance). Other auto insurers (such as One Beacon) have little presence in the personal auto insurance market but are one of the largest players in the commercial auto insurance market, which is much more fragmented in terms of market share. The commercial insurance market in Massachusetts also has a presence of foreign-owned insurance companies, such as Zurich Insurance (which are not included in the universe).

Largest Writers of Passenger Auto Insurance in Massachusetts – Market Share

<i>(% of total premiums)</i>	Status	2000	2001	2002	July 2003
Commerce Group	Public	22.4	23.3	26.4	27.2
Safety Insurance	Public	9.8	10.4	10.5	10.7
Arbella Mutual	Private	11.6	10.8	10.5	10.1
Premier Insurance (Travelers)	Public	6.3	6.9	7.7	7.9
Liberty Mutual	Private	7.1	7.0	7.1	7.3
Metlife Inc.	Public	7.3	7.5	7.3	6.8
Hanover Insurance (Allmerica)	Public	6.2	6.4	6.2	5.4
One Beacon (White Mountains)*	Public	6.6	5.6	4.7	4.4
Plymouth Rock	Private	3.3	3.5	3.8	4.1
AMICA	Private	3.2	3.3	3.3	3.2
Total (Top 10)		83.8	84.7	87.5	87.1
American International Group	Public				
Chubb Group	Public				
EMC Insurance	Public				
Harleysville Worcester	Public				
Horace Mann	Public				
Meadowbrook	Public				
Vesta Insurance Group	Public				

Source: C.A.R., Ranked as of July 2003, *One Beacon was formed when White Mountains purchased CGU Corp. in '01

APPENDIX B – Equity Valuation Ratios

Company	Ticker	Market Cap (\$ bn)	Share Price (Oct. 24)	Share Price High/Low 52 weeks	P/E	EPS	Book Value /Share	Div. Yield (%)
Allmerica	AFC	1.35	\$24.77	\$7.35/26.73	-1.77	-4.48	41.99	0.00
America Int. Gp.	AIG	157.99	\$60.18	\$42.92/68.25	24.46	2.46	26.20	0.43
Chubb Group	CB	12.69	\$66.27	\$41.78/69.29	39.85	1.66	44.79	2.18
Commerce Gp.	CGI	1.26	\$38.92	\$31.50/41.04	11.51	3.38	26.78	3.26
EMC Insurance	EMCI	0.20	\$16.70	\$13.80/21.64	10.97	1.52	14.93	3.57
Harleysville	HGIC	0.64	\$20.97	\$21.16/29.09	16.37	1.32	21.55	3.19
Horace Mann	HMN	0.63	\$14.62	\$12.43/16.95	25.29	0.58	13.81	2.80
Meadowbrook	MIG	0.13	\$4.46	\$1.55/4.51	21.65	0.21	5.29	0.00
Metlife Inc.	MET	23.11	\$30.42	\$22.20/30.98	16.47	1.85	27.13	0.76
Safety Group	SAFT	0.24	\$15.55	\$12.00/16.85	11.09	1.82	17.26	2.58
Travelers P&C	TAP	16.06	\$15.98	\$12.98/17.42	39.75	0.40	11.42	1.99
Vesta Ins.	VTA	0.09	\$2.33	\$1.97/3.84	-9.82	-0.26	6.47	4.26
White Mountain	WTM	3.83	\$428.50	\$307/435.99	18.53	23.13	339.53	0.23

Source: www.simplystocks.com, www.yahoo.com, www.msn.com

Brief Corporate Description (Top 3 publicly-traded, small cap underwriters)

Commerce Group, Inc. is the largest provider of private passenger automobile insurance in Massachusetts through its principal subsidiary, Commerce Insurance Company. Direct premiums written on passenger auto insurance in Massachusetts represented 73.4% of the Company's total premiums written in 2002. The Commerce Group also offers homeowners insurance (8.2% of total written premiums in 2002), commercial automobile insurance (5.7% of premiums), marine, fire, general liability, and personal/ commercial umbrella insurance. Total insurance premiums written outside of Massachusetts only represented 13.4% of total premiums written in 2002.

The Safety Insurance Group, Inc. is a leading provider of automobile insurance in Massachusetts, with the private passenger market segment representing around 81% of the Company's direct written premiums in 2002. The Company also offers commercial auto insurance and a number of property and casualty insurance products, including homeowners, fire, other commercial and umbrella policies. The Company has expanded its market share in its primary market, private passenger automobile insurance, although still lags the number one position.

Allmerica Financial Corporation is a holding company that operates a diversified group of insurance and financial service companies. The Company's products and services are offered through two main business segments - Risk Management and Asset Accumulation. The insurance products/services offered under the umbrella of Risk Management include: personal/commercial automobile insurance, homeowner insurance, group property and casualty insurance as well as workers' compensation. Around 20% of the firm's personal line net premiums were written in Massachusetts (as of 2002), and the Company is the largest writer of property and casualty insurance in Michigan. Commercial insurance lines in Massachusetts represented 13% of Allmerica's 2002 net written premiums.

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APPENDIX C – Summary of Financial Statistics (Annual, 2002)

Small Cap Stocks

Rank	ROE (%)	ROA (%)	Op. Profit Margin (%)
1	EMC Insurance 10.21	EMC Insurance 3.50	Harleysville 7.84
2	Harleysville 7.32	Harleysville 2.85	EMC Insurance 7.58
3	Safety Group 3.77	Safety Group 1.55	Safety Group 6.35
4	Horace Mann 2.14	Meadowbrook 0.75	Horace Mann 3.14
5	Meadowbrook 1.12	Horace Mann 0.36	Meadowbrook 2.30
6	Vesta Insurance -3.9	Vesta Insurance -0.1	Vesta -0.39

Sources: www.simplystocks.com, www.yahoo.com, Company SEC filings

Medium Cap Stocks

Rank	ROE (%)	ROA (%)	Op. Profit Margin (%)
1	Commerce Group 4.50	Commerce Group 2.3	OneBeacon 6.48
2	OneBeacon (White Mountain) 2.55	OneBeacon 0.24	Commerce Group 4.14
3	Allmerica -14.59	Allmerica -1.83	Allmerica -18.63

Large Cap Stocks

Rank	ROE (%)	ROA (%)	Op. Profit Margin (%)
1	AIG 9.34	AIG 1.55	Metlife Inc. 14.05
2	Metlife 6.64	Metlife 0.8	AIG 12.26
3	Chubb Group 3.25	Chubb Group 0.53	OneBeacon 6.48
4	Travelers 2.13	Travelers -0.17	Travelers -0.72

Small Cap Stocks

Rank	Revenues (\$mn)	Net Income (\$mn)	Assets (\$ mn)
1	Harleysville 847.7	Harleysville 46.3	Horace Mann 4,512.30
2	Horace Mann 771.9	EMC Insurance 16.1	Harleysville 2,311.50
3	Vesta Insurance 634.1	Horace Mann 11.3	Vesta Insurance 2,042.90
4	Safety Group 529.3	Safety Group 10.46	Safety Group 978.60
5	EMC Insurance 327.5	Meadowbrook 1.7	EMC Insurance 674.9
6	Meadowbrook 197.6	Vesta Insurance -31.7	Meadowbrook 674.8

Medium Cap Stocks

Rank	Revenues (\$mn)	Net Income (\$mn)	Assets (\$ mn)
1	OneBeacon 4,185.40	OneBeacon 728.7	Allmerica 26,578.90
2	Allmerica 3,316.60	Commerce 46.8	OneBeacon 16,033.60
3	Commerce 1,257.10	Allmerica -306.1	Commerce Group 2,382.70

Large Cap Stocks

Rank	Revenues (\$mn)	Net Income (\$mn)	Assets (\$ mn)
1	AIG 67,482.00	AIG 5,519.00	AIG 561,229.00
2	Metlife 33,147.00	Metlife 1,605.00	Metlife 277,385.00
3	Travelers 14,269.70	Chubb Group 222.9	Travelers 64,137.50
4	Chubb Group 9,115.60	Travelers -27	Chubb Group 34,114.40

Total Debt/Equity Ratios

Rank	Small Cap	Med Cap	Large Cap
1	Harleysville 15.13	Commerce Group 0.0	Travelers 39.87
2	Safety Group 15.81	Allmerica 24.1	Chubb Group 48.31
3	Meadowbrook 22.05	OneBeacon 30.2	AIG 137.13
4	EMC Insurance 24.91	---	Metlife 142.15
5	Horace Mann 27.36	---	---
6	Vesta Insurance 120.85	---	---

* Ascending order

Property & Casualty Insurance Industry

Overview of Automobile Insurance Writers (Massachusetts)

APPENDIX C Cont. – Summary of Financial Statistics (Annual, 2002)

Industry Specific Profit Ratios – Small Cap

Rank	Combined Ratio	Investment Income Ratio		A.M. Best Rating *
1	EMC Insurance	101.3	11.0	A-
2	Harleysville	101.9	11.3	A
4	Safety Group	102.4	5.3	A
5	Horace Mann	103.6	31.2	A
5	Vesta Insurance	102.2	10.7	B
6	Meadowbrook	117.0	9.6	B+

Sources: Company SEC filings, A.M. Best

* Under the AM Best classification, a "B+" is considered the minimum rating to be classified as "secure".

Ranked by a combination of the combined ratio, investment income ratio and rating

Industry Specific Profit Ratios – Med Cap

Rank	Combined Ratio	Investment Income Ratio		A.M. Best Rating *
1	Commerce Group	98.7	8.14	A+
2	Allmerica	103.0	25.43	B++
3	OneBeacon	108.7	9.86	A

Industry Specific Profit Ratios – Large Cap

Rank	Combined Ratio	Investment Income Ratio		A.M. Best Rating *
1	Travelers	94.2	16.9	A++
2	Metlife Inc.	98.9	67.6 (7.5 for Insurance)	A+
3	AIG	106.0	11.4	A++
4	Chubb Group	106.7	15.6	A++

* A.M Best is a ratings agency that specializes in producing ratings for the insurance industry. The letter grading denotes the judged credit worthiness of the company, regarding its ability to meet future insurance claims.

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