MARKEL annual report '96

To Our Business Partners

We finished 1996 pleased with our achievements and long term success, yet challenged and committed to do even better in the future. Despite problems in a few products and storm losses from Hurricane Fran, we were able to achieve our primary objective of earning an underwriting profit. We closed 1996 with a combined ratio of slightly less than 100%, achieving our goal by a small margin. The extraordinary underwriting success of Essex Insurance Company saved the day.

Despite our modest underwriting profit, 1996 proved quite successful financially. For the year, total operating revenues grew 7% to $366.7 million; core underwriting and investing results were $33.9 million, up 17% from the prior year; and net income was $46.7 million, or $8.30 per share, a Company record. Additionally, we enjoyed a significant increase in the value of our investment portfolio. Together, these items resulted in an increase in shareholders' equity per share of 25% to $49.16.

In the ten years that we've been a public company, we've enjoyed consistent success in almost every financial measure. Revenues have increased at a 31% compound annual growth rate; we have earned underwriting profits in nine out of the ten years; our investment portfolio has grown at a 44% compound rate and now totals $1.1 billion or $207 per share; and most importantly, book value has risen to $49.16 per share, a compound annual increase of 31% over the past 10 years.

We attribute this success to a number of factors. Maybe the most important factor is a strong corporate culture which has enabled us to build a team focused on a common goal, building long-term shareholder value. Very much a part of this culture is the common sense business principle of operating and decision-making using what Ben Graham described as a margin of safety.

Ben Graham is widely recognized as the founding father of modern security analysis. He developed and taught an investment decision-making framework based on sound business principles. His primary investment concept was to operate with a margin of safety.

Graham's margin of safety, simply stated, is the attempt to build a safety net into investment and business decisions. The margin provides a cushion against errors and unfavorable results. This margin is achieved by acting on facts rather than emotions, conservatively forecasting outcomes, diversifying risk and erring on the side of safety when presented with options. Consistently applied, the concept is a powerful business tool. At Markel we attempt to apply Graham's concept to all our decisions.

Regardless of whether we are dealing with accounting philosophy, loss reserving, underwriting, or investing, we seek to operate with a margin of safety.

Accounting Philosophy

At Markel we believe in conservatively stating our financial picture. Financial strength is an important component of our success. Our insurance clients are entitled to the greatest security we can offer, and our shareholders seek to increase the value of their investment. We believe the best way of achieving both of these goals is by building book value per share.

In the insurance business, earnings per share is not the best measure of financial performance. It is more important to establish adequate loss reserves and maintain a strong financial position. We value a strong balance sheet more than current earnings in any single year. Management is rewarded, as are shareholders, by building book value on a per share basis over long periods of time.

Because we believe in the importance of conservative accounting, we often make choices which make economic sense but do not always enhance current earnings. For example, in 1990 we negotiated as part of the purchase price of Shand/Evanston a non-compete agreement that was amortized over four years rather than 40 years as goodwill. While this resulted in an annual charge against earnings of approximately $5.0 million rather than $0.5 million, it was beneficial in at least two ways. We received significant tax benefits, and we built a stronger and more conservative balance sheet due to the accelerated amortization.

Another recent example of this philosophy is the $18.4 million tax benefit recognized in the second quarter of this year. Over the past several years, we conservatively established our financial statement tax reserves. We determined that our estimated tax liabilities were actually less than previously accrued and adjusted the tax liability accordingly.

Most recently, in order to reduce future expenses, we made the decision to sell our office building in Evanston, Illinois. This property was acquired as part of our purchase of Shand/Evanston. Over the years, the commercial office market in Evanston has declined. Because the expected proceeds will be significantly less than the carrying value of the building, we immediately recorded the after tax loss of $6.8 million in 1996.

Loss Reserving

Because it is the largest and most difficult to measure, the provision for unpaid losses and loss adjustment expenses is the most important account on an insurance company's financial statement. This is certainly the case for Markel. This account also best represents our philosophy of conservative accounting and providing a margin of safety. As we have said many times, our goal is to establish loss reserves at a level that is more likely to prove redundant than deficient. This standard of setting loss reserves is somewhat different from other insurers.

A.M. Best Co. recently estimated that the Property and Casualty industry is under-reserved by $82.8 billion, or 23% of total reserves. We believe that much of this shortfall is related to companies' desire to report earnings.

This illustrates why we do not stress current earnings. At Markel we seek to establish loss reserves at a level that anticipates the inevitable surprises that can and do occur and to provide for an appropriate margin of safety.

We constantly review our businesses and try to make sure the reserves we provide are adequate to meet future exposures. Getting the loss reserves right is critical to being able to make an underwriting profit. Current loss estimates not only affect financial results but also influence many pricing and risk selection decisions. Each year we try to make sure our margin of safety is as strong as it was in the prior year.

In the insurance business, we sell the product before we know the actual cost. Claims often take many months or years before they are fully reported and settled. Obviously, as the underwriting years mature, we are better able to estimate the ultimate cost. Consequently, we regularly adjust loss reserves as more information is available.

The best way to understand and analyze this process is to review the loss reserve development schedule shown in Management's Discussion and Analysis on page 55 of this report. From this schedule you can see that we have consistently benefited from redundant loss reserves. For example, in December of 1991 we had loss reserve provisions of $557.6 million. This estimate was reduced in each of the following years as we became more confident that the actual results were better than originally provided. However, in each year we have attempted to maintain a margin of safety. Five years later we've recognized $56.5 million or 10% of the beginning estimate in redundancy. Looking at 1995 loss reserves you will see the same trend. During 1996 we realized approximately $24.1 million in redundancy from the prior year. This represents 4% of the original reserve amount. We continue to believe that the remaining reserves have a margin of safety and hope to see continuing positive development.

The very nature of the insurance business makes it difficult to establish loss reserves with certainty. In fact it cannot be done. But what we can do is make provisions with a view that to the extent we're wrong, we have erred on the side of safety.

It is unfortunate that in the world of financial reporting and security analysis that current earnings receive more attention than the quality of loss reserves. That does not make it right. We would much prefer to be pessimistic when setting loss reserves than optimistic about current earnings. This philosophy benefits every aspect of our business. It supports our underwriting profit orientation; it supports our investment activity; and it helps build our margin of safety.

Underwriting

Earned premiums in 1996 amounted to approximately $307.5 million, spread over more than 40 different product lines in our five operating divisions. In the past five years, we have enjoyed modest underwriting profits, reporting a combined ratio from 97% to slightly under 100%. Because this ratio has been relatively consistent, one might assume that each of our product lines produces predictably consistent results. This is not the case. Our aggregate combined ratio is a result of many profitable lines of business balanced against some which are having difficulty. Each product line has unique characteristics and different profit objectives.

New products often experience a higher than desired combined ratio because the costs associated with new product development are higher than after the product is fully established. Occasionally, expectations are not met and products simply develop more losses than we plan. Some products are exposed to weather events, and the results will vary accordingly. Fortunately, most of our businesses do in fact generate underwriting profits so that we enjoy a sufficient margin of safety to cover underwriting losses which inevitably occur.

During the past few years, our specialty personal and commercial lines unit entered the mobile home insurance business. Over time, we expect this product to earn underwriting profits of 10% or more to achieve our return on equity goals. The business does not generate large amounts of investment income since claims are paid quickly. Additionally, the results from this line of business can be volatile because the insured structures are exposed to wind and hail losses. Unfortunately, 1996 was a bad year for this business as we absorbed approximately $1.7 million in losses from Hurricane Fran. While the impact was modest to Markel, this product line suffered an underwriting loss in 1996. In spite of these problems, we still expect to see combined ratios in the low 90's over time.

Within the same unit, we also provide insurance for motorcycles and personal watercraft. These products have enjoyed steady growth and consistent underwriting profits over the past several years, and we expect they will continue to make a nice contribution to our results in the future.

In 1996 we also experienced underwriting losses in our physicians' medical malpractice area. One problem involved a program providing insurance for a large group of emergency room physicians. This particular program did not provide enough rate for the exposure. Unfortunately, we were unable to correct the problem, so we exited the line of business. In another segment, we found certain classes and territories which needed rate adjustments, and we acted accordingly. We are now comfortable with this business.

The same division also has a variety of programs for other medical professions. These include coverage for exposures such as ambulance services, dialysis clinics, home health care agencies and outpatient centers. Also included is coverage for medical and allied health professionals, such as emergency medical technicians, x-ray technicians, paramedics and social workers. These segments of our medical malpractice business have proven to be consistently profitable over a number of years, and 1996 was no exception.

In late 1993 we began a new property program, Markel Special Property, which provides large commercial coverage with some catastrophe exposure. Fortunately, the Northridge Earthquake in January 1994 occurred before we had written much business. While this event hurt our 1994 results, it actually was positive for us as it expanded our market opportunity as competitors exited the market. The lack of major catastrophes since then has contributed to our success. In 1996 we earned substantial underwriting profits in this line of business on increasing premium volume.

Our most consistently profitable product line has been our small, commercial general liability business written on an excess and surplus lines basis by Essex Insurance Company. This product line includes a very broad list of categories including contractors, bars and taverns, offices and habitational risks, manufacturing and small products coverage. In this area we excel in providing customer service due to our expertise and responsiveness. As with most of our businesses, our success is the result of the efforts of a group of highly talented, seasoned insurance professionals.

Investing

We believe it is important to manage our investment operation with the same thought, diligence and margin of safety as our underwriting operations. Excellent investment results combine with our underwriting profits to produce superior long-term growth in book value. Our investing philosophy is based on the goal of achieving the best after tax total return and protecting the integrity of our insurance operations. We focus on total return rather than current income. We seek to build value.

We allocate our investment dollars by segregating our portfolio based on the source of the funds. Funds provided by our policyholders are invested in high quality, short duration, fixed income securities to assure the funds will be available to meet claims liabilities. Funds provided by shareholders are generally invested in common stocks of companies we believe will grow and build long-term value. We try to buy these companies at prices at or below our estimate of their intrinsic value. This method of allocation and investment approach helps build a margin of safety.

Our fixed income portfolio is managed to minimize interest rate and credit risk. We therefore have a short duration and high quality portfolio. To maximize after tax total returns we own tax-exempt municipal securities. We also purchase bonds with unique "put" features to provide additional returns if interest rates fall.

In our equity portfolio, we try to avoid undue risk of loss by knowing as much as possible about the companies we purchase. We do extensive research on the companies, and we visit and talk with their managements. Because of our knowledge and comfort with the insurance industry, we often buy other insurance stocks. We are long-term holders.

We like the idea of building large unrealized capital gains. To the extent that gains are not realized and taxes are deferred, we can continue to invest money that would have been used to pay taxes. At December 31, 1996, our unrealized gain on equity securities amounted to $60.8 million. For accounting purposes, taxes of $21.3 million have been provided on this unrealized gain. Among its other virtues, this also creates a margin of safety. When future markets cause lower stock prices than today, the book value impact will be cushioned by this tax provision.

While we expect to continue to benefit from our investment flexibility, we are extremely aware that our ability to do so is dependent upon continuing to conservatively provide for our loss reserves and earning underwriting profits.

Other Events

In October 1996 we completed the acquisition of Investors Insurance Holding Corp. While this company has had a difficult history, the former owners brought in a new management team and began to develop a sound business plan in 1995. We liked what we saw and had an opportunity to buy the company at an attractive price. This acquisition enables us to expand our product offerings in the excess and surplus lines market.

In January 1997 we saw the opportunity to raise $150 million on terms that we felt were very attractive. Somehow it is always easier to raise capital when you don't need it. Believing that we would find a sound use for the funds in the not too distant future, we took advantage of the opportunity. The security we sold to raise the capital was a trust preferred stock at a cost of 8.71%. The security matures in 49 years, although we can redeem it in ten years. One unique feature of this security is that we can defer interest payments for five years. As a result of the long maturity, the interest deferral and the subordination provisions, this security has many of the benefits of equity, yet its cost is like debt. In the short run we will lose money as a result of this financing because the proceeds have been invested in short-term securities earning less than the 8.71% cost. Obviously, in the long run we think this financing will benefit our total capital structure.

A Look to the Future

Every year we spend a lot of energy with each of our businesses reviewing the past and planning for the future. At the corporate level we also analyze our results and try to figure out how to best take advantage of the opportunities we face. We approach 1997 with a good plan and expect to achieve continued success. In spite of our plan, we will face both problems and opportunities that we have not anticipated. The insurance industry continues its evolution and reorganization. Markel is stronger and better prepared than ever before. We face our future with great optimism.

Thank you for your loyal support and encouragement.

Alan I. Kirshner

Alan I. Kirshner
Chairman of the Board and Chief Executive Officer

Anthony F. Markel

Anthony F. Markel
President and Chief Operating Officer

Steven A. Markel
Vice Chairman

Darrell D. Martin
Executive Vice President and Chief Financial Officer