To Our Business Partners

Virtually every measurement system involves the element of time. In this year's letter, we will discuss the relevance of time in measuring results and how we focus on the value of long-term thinking.

In December new business was disappointing, but investment returns were excellent. Financial results in the fourth quarter set company records, and 1997 was an excellent year. This past summer our camp insurance business suffered more large losses than usual; however, we enjoyed good results among most of our other lines of business. Since the Northridge earthquake in January 1994, the earthquake business has been great, yet current prices have declined to levels which suggest many have forgotten what can happen. The insurance industry has experienced a cyclical softening of prices since 1987... much longer than any previous cyclical downturn. Maybe it's not a coincidence that the investment cycle has enjoyed an equally impressive run in the opposite direction. Monthly, quarterly and even annual results do not necessarily mean much if your goal is to build shareholder value over a long period of time. Yes, 1997 was a good year, but we are especially proud to report that in the past five years, we have compounded book value per share at a 26% rate, and since our initial public offering in 1986, we have compounded book value per share at a 31% rate.

1997 Results

In spite of a very difficult property and casualty insurance market, our results in 1997 set records in just about every measure. For the sixth consecutive year and eleven of the last twelve, we reported underwriting profits with a combined ratio of 99%. Earned premiums grew only 8% to $332.9 million; however, investment income increased 34% to $68.7 million. The strong investment environment also allowed us to realize $15.8 million in investment gains. Total revenues increased 14% to $419.0 million. Net income was $50.4 million, or $8.92 per diluted share. In addition, the net unrealized appreciation of our investment portfolio increased $41.5 million, resulting in comprehensive income of $91.9 million. Also during 1997 we further strengthened an already strong balance sheet: total investments increased to $1.4 billion; provisions for loss reserves continued to be, in our opinion, very strong; we raised $150 million in 49 year trust preferred securities and increased shareholders' equity by 33% to $356.8 million, or $65.18 per share.

For many years we have spoken of the importance of measuring growth in book value. This year the accounting profession recognized the same thing by adopting the concept of comprehensive income. This is a measure of total performance because it includes both net income and changes in unrealized gains or losses. Over the past five years, our net income amounted to $173.8 million; cumulative unrealized gains were $73.1 million; and comprehensive income was $246.9 million. The variations year to year are shown below:

COMPREHENSIVE INCOME

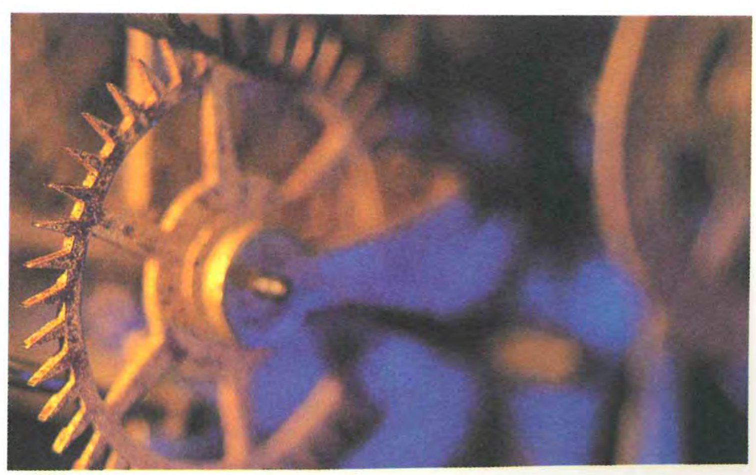
(dollars in millions)

	Years Ended December 31,					
	1993	1994	1995	1996	1997	Total
Net income	$ 23.6	$ 18.6	$ 34.5	$ 46.7	$ 50.4	$ 173.8
Change in unrealized gains (losses)	10.3	(28.7)	40.3	9.7	41.5	73.1
Comprehensive income (loss)	$ 33.9	$ (10.1)	$ 74.8	$ 56.4	$ 91.9	$ 246.9

These results point out two significant facts. First, unrealized gains represent an important part of the value created for shareholders. In the past five years, almost 30% of our comprehensive income came from this source. Secondly, and certainly not to be forgotten, changes in unrealized gains from year to year can be quite unpredictable. Having a long-term view is especially important when looking at investment results.

New York Stock Exchange

In June 1997 we were listed on the New York Stock Exchange. While we were generally pleased with NASDAQ and certainly enjoyed a great deal of support from NASDAQ market making firms, it was our desire to try to reduce the spread between the bid and asked prices of our stock. We believe this has occurred and we are pleased to be a NYSE listed firm. We continue to see no valid reason to split our shares. (In fact, NYSE fees are based on number of outstanding shares, so we save money by not splitting.) However we would caution our fellow shareholders and



potential new shareholders to be thoughtful when buying or selling our stock. If you see a $2 spread between the bid and asked prices, remember that it represents only a 1.3% spread on a $160 stock price. Most transactions in other securities are likely to be more expensive. Additionally, we enjoy a very loyal base of shareholders and have low share turnover. As a result, the stock price can move on very little volume so it is wise to be patient when buying or selling.

Intrinsic Value

During 1997 our share price increased from $90 to $156, a 73% increase. As previously mentioned, our business results were the best ever, and book value grew by 33% per share. Ideally, the growth in share prices and the growth in intrinsic value should be identical. This rarely happens in the short term but should occur over long periods of time. We are hopeful that the increase in our share price in 1997 represents an alignment of our share price with the long-term growth in our intrinsic value.

We want to share with you important information about your company so you can estimate its intrinsic value. We have no desire for our stock to trade at levels either significantly higher or lower than its intrinsic value. Unfortunately there is no exact science in determining that number. Today the stock is priced higher in relationship to many determinants of value than in previous years; however, we remain committed to building book value at a 20% annual rate, and we think the Company will continue to be an excellent investment for those with a long-term view.

Accounting Cycle

Due to the number of estimates required in the insurance accounting cycle and management's great leeway in setting those estimates, quarterly and annual accounting periods do not reflect the complete picture of an insurance business. Only when viewed over a much longer time period can you begin to determine accurate results.

Insurance for property along coastal areas subject to hurricanes is more at risk during hurricane season, which runs from June to November. Likewise, hurricane activity varies greatly from year to year. While 1997 was a very mild season for hurricanes, that certainly doesn't have much meaning when trying to estimate the risk for the 1998 season. The same applies to insurance for earth-

quakes. The ground has been relatively still since 1994 when Northridge shook violently; yet surely another earthquake will occur. Based on the declining prices for this coverage, you would think the property and casualty insurance industry has no memory.

Other insurance products like professional liability coverages require a long period of time for claims to be reported and paid. Long-tail insurance represents yet another problem for the annual accounting cycle. While premiums are collected today, claims are not paid for many years. At the end of each accounting cycle, estimates are made with regard to outstanding losses. These estimates are just that, estimates. They may be too high or too low but never exact. Unfortunately, many companies report lower losses than are actually occurring in order to inflate current income. This cannot go on forever; companies can underestimate reserves, but claims are settled in cash.

Loss Reserving

We have often described our philosophy in setting conservative loss reserves. Our standard has consistently been to set reserves at a level which we believe are more likely redundant than deficient. The very nature of the insurance business is that surprises in loss occurrences will happen from time to time. Usually surprises represent bad news. Unfortunately, we are not immune

to surprises. But we have been successful in avoiding a negative impact on our loss reserves from these surprises because we establish reserves to cover that unpredictable but inevitable event. We seek to allow for that by establishing a margin of safety in our reserves. This policy again proved sound in 1997 when we determined that it would be prudent to add an additional $28 million to our reserves for environmental and toxic tort claims. While our existing reserves were more than adequate to cover this development, we certainly thought our previous estimates had been sufficient, and we can say the same today. We think the specific reserves for environmental and toxic losses are adequate but if they are not, we have made provisions which give us a margin of safety.

Investments

Our investment activities continue to be very important to our success in building shareholder value. In 1997 the stock market was unusually strong and interest rates trended down which helped us achieve exceptional investment results. The total returns from equities were 31.4% and from fixed maturity securities were 9.2%. As a result our portfolio produced a total return of 12.8%. Over the past ten years our total weighted average annual return was 10.3%.

With the stock market trading at all time highs, we are cautious and concerned about where the market might be headed; however, we have never tried to time the market. We focus on individual securities of companies which we believe will generate good returns, and we invest in these companies at what we believe to be fair values. Fortunately, we own many good companies which are building value and we continue to invest in more which we believe will add value in the future.

The general decline in interest rates has added to the total return in our fixed maturity securities. This is certainly a double edged sword as lower interest rates will make it more difficult to earn high rates of return on this portfolio in the future. With our fixed income portfolio, we will continue to invest in very high quality securities with fairly short durations. We will continue to take advantage of our tax position to invest in tax-exempt securities where they will add value.

Acquisitions

Over the past several years, we have developed our business through the growth of existing businesses as well as through acquisitions. In January 1997 we raised $150 million to help fund future acquisitions, so it seems appropriate to look back at our acquisition history and evaluate our performance. (Also, an interested investor asked us to do so.)

Our most important acquisition was the purchase of Shand Morahan and Evanston Insurance Company. We initially invested in 1987 and acquired the remaining interest in 1990. Our total investment was less than $85 million.

When we acquired the company, it was suffering from several major problems as a result of the very competitive professional liability insurance market of the early 1980s but was well on the way to solving them. Since we purchased the company, we have received more than $83 million in dividends. In 1997 the business generated over $100 million in earned premiums at a small underwriting profit and investment income on a portfolio of almost $650 million. The current equity in this business is approximately $210 million. We wish we could do many more transactions just like this.

In 1989 we acquired a book of business from the Rhulen Agency which placed program business in an unrelated insurance company. In the years following this transaction, we transformed the agency business into a full service insurance company which now trades as Markel Insurance Company. In addition to the original acquisition, we have contributed an insurance company to this business for a total investment of approximately $57 million. No dividends have been received from this investment, although we expect to see them in the future. In 1997 the business reported earned premiums of $68 million and an improving, but still unacceptable, underwriting loss. At this point in time, we believe the difference between our reported underwriting loss and an underwriting profit is equal to the difference between the actuarial point estimates and our more conservative margin of safety. The investment portfolio generated by this business amounts to approximately $178 million. We have not yet achieved our return on investment objectives with

this business; however, our total return in 1997 was approximately 15%. In spite of the less than desired return, we believe this business will be a significant contributor in the future.

The Lincoln Insurance Company was acquired for $24 million in 1995. Our purchase anticipated merging selected business into our excess and surplus lines unit and liquidating the balance of the business. In the short time we owned the company, we received a total of $35 million in dividends and proceeds from the sale of the licenses. We continue to manage the runoff of $22 million in claims liabilities with a like amount of invested assets. In 1997 we enjoyed almost $6 million in premium volume from this acquisition. Our return on this investment was good, but unfortunately it is nonrecurring.

Our most recent transaction was the purchase of Investors Insurance Group in late 1996. This company also had a difficult history and found itself with several problems. About a year before we acquired the company, they began their third reorganization in five years. We knew and respected the new management team and believed it could become an important part of our organization. The purchase price was $38 million. In 1997 this business generated approximately $30 million in earned premiums with a combined ratio of slightly over 100%. Invested assets are approximately $160 million. Total return on our investment in 1997 was about 18%. At year end 1997 the equity in this business amounts to $46 million. While it is probably too early to make a meaningful evaluation of this transaction, we are clearly pleased and excited about the opportunity that Investors brings to us.

We continue to believe that future acquisitions will be an important part of our growth and development. We look at many opportunities but find few that meet our requirements. We expect an acquisition to have the ability to earn underwriting profits and contribute to our goal of building book value at a 20% annual rate. In addition over the years we have developed a strong corporate culture; one we call *The Markel Style.* In any acquisition, we expect the people involved to embrace and be comfortable with our corporate values.

Markel Associates

The Markel Style is our value system. It describes how we conduct our business. Among the values we believe in are "a pursuit of excellence, honesty and fairness in all of our dealings...a respect for authority but a disdain of bureaucracy." Our organization today includes 830 associates. With such a large group, it is not easy to build a strong corporate culture; however, it has been and will con-

tinue to be an important part of our success. One of the primary reasons for this success is that we have a large group with long tenure. Over 25% (227) of our associates have been with the company for ten years or more. Over forty associates have been with the company for twenty years or more.

Another important fact is that all Markel associates own stock in the Company, and many have very significant investments. Several years ago we essentially eliminated the use of our stock option plans and instead have offered our associates stock purchase plans with subsidized interest on loans used for the purpose of purchasing Company stock. This past year over 250 associates participated in the plan and purchased over $6.3 million in stock.

Our goal, of course, is for our associates to be and feel like owners of the Company. We believe this will promote *The Markel Style,* encourage everyone to work hard and enjoy what they are doing and focus on building long-term value.

We recently lost a much loved associate, Jim Brinson. Affectionately called "the Governor," Jim began his career at Markel in 1948. Jim was always a big producer, no matter what we asked him to sell. At age 75 he asked if he could cut back his work schedule to 30 hours a week. He continued this schedule until his death at age 82. Jim exemplified *The Markel Style.* Associates like Jim who embrace our core values are the reason that we are successful.

Clockwise from left to right: Anthony F. Markel, Darrell D. Martin, Steven A. Markel, Alan I. Kirshner

Profitable Growth

In managing our company we have consistently tried to focus on generating long-term results. We have sought to build shareholder value not just for the next quarter or year but with a view to the next ten or even twenty years. In contrast, today's fast paced world is one where almost everyone is focused on today's activities and results. Typical measures of success are often oriented to short-term results. The line from a Broadway play, "Instant gratification just isn't quick enough" typifies this short-term focus. But today's instant gratification will be long forgotten five years down the road.

The insurance business continues to be competitive, and profitable growth is extremely difficult to achieve. Anyone can write more business if they are willing to meet unrealistic pricing demands and operate at inadequate returns, or even a loss. Those willing to optimistically estimate loss experience can even fool themselves for a short while. But in the end, these strategies do not work. Losses must be both accounted for and ultimately paid.

While we would prefer to grow quickly, the current environment demands patience. Those who resist the temptation to write business recklessly will be rewarded. Ten years from now, we want to be able to tell you, our shareholders, of additional years of record earnings and exceptional growth in shareholder value. Underwriting profit, not growth, will continue to be our standard.

We thank our Markel associates for their hard work, dedication and commitment to success, and we thank you for your loyal support, encouragement and confidence in our future.

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

S.A. Markel

Steven A. Markel
Vice Chairman

Darrell D. Martin

Darrell D. Martin
Executive Vice President and Chief Financial Officer