MARKEL

# TO OUR BUSINESS PARTNERS

We measure our success in building shareholder value by focusing on growth in book value per share over the long term. Book value per share declined 11% to $68.59 due to disappointing investment results. In spite of that, 1999 was a very good year overall. Our core underwriting results remained exceptionally good at virtually every operating division in the Company. This is a real tribute to our underwriters given the very difficult market conditions they faced. Additionally, we should remember that over the past five years we compounded book value per share at a 22% annual rate. While it would be pleasant to report consistently improving results, it would be unrealistic given the nature of our business. Insurance and financial markets are volatile by nature and the volatility itself creates significant business opportunities for Markel.

The year also included the acquisition and amalgamation of Gryphon as well as the announcement of the plan to acquire Terra Nova (Bermuda) Holdings, Ltd. and the agreement to acquire the renewal rights to Acceptance Insurance Companies' Scottsdale business. Despite the setback in our book value growth during 1999, we believe we continued to build the intrinsic value of the company and positioned ourselves to take advantage of even more opportunities in the future.

## 1999 Financial Review

After several years of very modest growth, operating revenues increased 23% to $524 million in 1999. While the acquisition of Gryphon was responsible for the largest part of this increase, in the closing months of the year we saw significant increases in written premiums in virtually every line of business. In the fourth quarter, excluding the Gryphon acquisition, written premiums increased 26%. This is a very positive sign and we are certainly hopeful it will continue.

Earned premiums increased 31% to $437 million and we had a small underwriting loss with a combined ratio of 101%. This was the result of excellent performance from almost every operating division enabling us to partially offset the costs associated with acquiring Gryphon. Our core business units enjoyed a combined ratio of 96% exclusive of the Gryphon business. This is truly excellent performance and compares favorably to our 1998 combined ratio of 98%.

Net investment income increased 23% to $88 million primarily due to the growth in the investment portfolio as a result of the Gryphon acquisition. In the fourth quarter, to create tax savings, we realized $10 million in investment losses. At the same time we replaced the bonds sold with bonds of similar quality and duration. As a result, we reported $1 million in net losses from the sale of investments in 1999 as compared to $21 million in realized gains in 1998.

1999

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Net income was $41 million compared to $57 million last year. Earnings per share were $7.20 on a diluted basis compared to $10.17 last year. As a result of the reduction in the market value of our invested assets, we had a comprehensive loss of $40 million compared to comprehensive income last year of $68 million. Shareholders' equity declined 11% to $383 million, or $68.59 per share.

## Excellent Results From Core Underwriting Businesses

The brightest spot of the year was the outstanding underwriting performance of our core insurance company subsidiaries, which produced an enviable 96% combined ratio in spite of another year of intense, irrational competition. This is clear testimony to our straightforward and continuous focus on underwriting profits and the unwavering dedication of our associates to that goal.

The Excess and Surplus Lines units, Essex (Excess and Surplus Lines), Evanston (Professional and Products Liability) and Investors (Brokerage Excess and Surplus Lines) generated a 94% combined ratio while showing some solid, well-controlled growth.

Essex volume grew to $186 million from $122 million as a result of the smooth assumption of the Gryphon DIC property book and moderate increases in their other core lines—property, casualty, inland marine and ocean marine. Steve Vaccaro, President of Essex, and his troops continue to produce results that are the envy of the industry.

Evanston, led by continued increases in its Employment Practices Liability volume, along with the addition of a book of Errors and Omissions business acquired as a part of the Gryphon transaction, grew to $154 million from $124 million. In addition, they successfully experimented with some creative new production sources. At year end, Mike Rozenberg accepted sole responsibility for this subsidiary, as a result of Paul Springman's promotion to President, Markel—North America. Mike has been Paul's partner in the management of Evanston for over eight years, so the transition will be completely seamless.

In October, Jeremy Cooke, President of Investors, accepted the Chief Operating Officer role of Terra Nova, passing the mantle of leadership on to Rod Ayer, previously Senior Vice President. Under the combined leadership of Jeremy and Rod, Investors put impressive numbers together exhibiting both a volume increase ($85 million from $65 million) and a gratifying underwriting profit.

The Specialty Admitted subsidiaries, Markel Insurance Company (Specialty Programs) and Markel American Insurance Company (Specialty Personal and Commercial Lines), made notable strides in both size and profitability during 1999 as the combined ratio improved to 101% from 102% in 1998 and 110% in 1997.

Markel Insurance Company, which has historically produced outstanding loss ratios, aggressively attacked its expense ratio through a combination of significant expense reductions, a new corporate structure with emphasis on sales and marketing, and some creative new product experimentation. We are comfortable that Britt Glisson and his energized staff will significantly contribute to the underwriting profits this year and for many years to come.

Markel American Insurance Company, now led by Timberlee Grove, who was promoted to President in August 1999, also had an outstanding year of growth and profitability. Their operation, bolstered by the acquisition in April 1999 of a book of yacht business, grew to $50 million in volume. They also completed the transition to a completely autonomous unit with all product underwriting and support services under the same roof in Pewaukee, Wisconsin.

As important as acquisitions have been, and will continue to be, we could not expand our horizons without the knowledge and comfort that our core operations are well managed and will continue to produce the outstanding results that we have come to expect. We are fortunate and extremely grateful to have this talented, motivated group of associates.

## Investment Philosophy and Results

Our fixed income portfolio, the largest part of our investment portfolio, has a duration that ranges between 4 and 5 years. At the beginning of 1999 we were earning a tax equivalent yield of approximately 6.1%. By year-end, this yield increased to 7.1%. This rise in yield caused a decline in the value of our portfolio. Unrealized gains declined $67.3 million and we realized losses of $13.7 million. This market value decline was about 6% and almost completely offset our return from the investment income of 6.9%, resulting in a total return on our fixed income portfolio of only .9%.

Changes in interest rates cause changes in book value, which can be extreme in any particular year. However, over a longer period of time, the fluctuations in value related to interest rate movements tend to have only a modest impact on our results. This is why we prefer to measure our performance over five year periods. Additionally, the duration of our fixed income portfolio is conservatively matched to the duration of our liabilities and is well within a reasonable tolerance for interest rate risk.

We believe that in the long term we can significantly enhance shareholder value by allocating significant investment funds to common equities. We do not think about risk in the context of short-term volatility but rather in the context of a permanent loss of capital. We buy shares of companies where we believe the business will earn good returns on capital and which are being run by honest and talented, shareholder oriented managers who are building the value of the enterprise. We expect to share in the increased value of the business over the long term. (We hope you, as a shareholder of Markel, have a similar view with regard to your investment.) Our result in equity investing was disappointing in 1999. In most cases we are pleased with the companies we have selected and believe the business fundamentals are sound even though stock market prices have suffered.

We concentrate our equity portfolio in relatively few securities. At year-end our top five positions represented over 32% of our portfolio and the top 20 represented 71%. While diversification might reduce short-term volatility, we do not believe it maximizes long-term total return. We believe we can earn the best returns by concentrating our focus and our portfolio in promising areas where we have the best understanding and knowledge. In 1999 our concentration in other insurance stocks contributed to our disappointing results, and our failure to invest in the red hot portions of the NASDAQ market prevented us from enjoying the well advertised, but narrowly based, returns of the bull market.

In 1999 our total return on equity investing was a loss of 10%. This compares very unfavorably to the major indexes, which include the Dow Jones Industrial Average (up 25%), the S&P 500 (up 20%) and the NASDAQ Index (up 86%). Over the past five years our performance in equities was up an average of 14%, and for the past ten years 13%. These results are obviously much better than 1999 and are

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results which we believe will in fact be more like our long-term performance in the future. In managing equity investments, we do not seek to match or beat any specific market index. In addition to selecting individual businesses with good returns on capital as well as honest and talented management, we seek to invest at prices that allow for some margin of safety for our inevitable mistakes in judgement about those attributes. Our goal as investors, rather than traders, is to earn returns similar to those intrinsically earned by the companies themselves in the course of conducting their business. We invest in the equity markets because over time we expect to earn more than we would earn by investing in the fixed income market, always attempting to do so without taking on significant risks of permanent loss of capital.

We have avoided the technology sector due to our view that many of the businesses represented by the stocks that might be exciting trading vehicles were not clearly businesses with sufficiently durable returns on capital, management attributes, and reinvestment opportunities to qualify for what we seek in equity investments. While you as a shareholder may be justifiably unhappy about the opportunities that have passed us by so far, we think you may also someday appreciate the fact that we have not put any of your capital at risk in stocks with valuations that make ownership an extremely high risk proposition. The seesaw of risk versus reward has been all focused on the reward side with too little regard for risk. We invest with a serious regard for the risks we assume.

## Acquisition of Gryphon

In January 1999 we completed the acquisition of Gryphon. This purchase was intended to provide profitable premium volume as well as investment opportunities at a reasonable cost. In the first year of this transaction we believe we are very much "on schedule as planned," however it remains too early to proclaim the deal a success.

Our first goal was to acquire profitable premium volume. We completed our re-underwriting and currently expect the acquired business to contribute about $70 million in gross written premium in the year 2000. We also expect this business to generate underwriting profits. This premium forecast is slightly short of our original goal of $80 to $100 million.

A second goal was to re-underwrite and discontinue the unprofitable lines of business as quickly as possible. We completed this very effectively as we eliminated all of the business that we believed caused problems for Gryphon. The underwriting loss on this run-off business was somewhat higher than we originally estimated, however, this cost is now behind us.

Another goal was to increase our investment leverage. With the addition of $300 million to our portfolio, this goal was achieved. Because interest rates increased throughout the year, we did not earn the returns we anticipated on this portfolio, however the investments are productive and will be with us for years to come.

The acquisition price of Gryphon was $146 million. Because a majority of the business is being transferred to other Markel business units, we have sold as licensed shells some of our insurance companies to recapture as much of our capital investment as possible. We sold the Calvert Insurance Company for $22 million in August 1999 and although not directly related to Gryphon, sold Investors Insurance Company as a shell for $54 million in January 2000. These transactions effectively enable us to re-allocate $76 million in capital. In addition, the gain on Calvert reduced goodwill by $6 million and the sale of Investors will represent a gain of $8 million.

Our final objective is to manage the claims process in an effective manner and to maintain appropriate loss reserves for our outstanding exposures. In last year's report we said that we believed the Gryphon reserves were adequate but not with the margin of safety we would prefer. To date we have made a great deal of progress in evaluating, reserving and settling the outstanding claims. As might be expected, there have been some areas where we have had good news and some where we have been disappointed. Unfortunately, we had to deal with several lines of business where Gryphon did an extremely poor job of managing its risk. As a result we have continued to strengthen Gryphon loss reserves but are still slightly short of our desired margin of safety.

The process of merging the Gryphon organization into Markel involved a great deal of work by numerous associates throughout the organization. To the extent that this has prevented us from doing other things, it certainly represents an additional cost. However, we learned a great deal from this experience and developed new skills. We appreciate the extraordinary efforts of so many of our associates to make the Gryphon acquisition successful.

## Planned Acquisition of Terra Nova

In August 1999 we announced an agreement to acquire Terra Nova (Bermuda) Holdings, Ltd. Terra Nova is a specialty property and casualty insurance and reinsurance company with headquarters in Bermuda and principal operations in London. The Terra Nova business is split between direct insurance and reinsurance; the London market and Lloyd's; and marine and non-marine. It largely writes short tail business.

Throughout the fall we worked with Terra Nova to begin the integration process and to complete the transaction. Unexpectedly, Terra Nova reported significant losses for the fourth quarter and for the year. As a result, in January we renegotiated this transaction and agreed to revised terms. The transaction is currently expected to close on March 24, 2000.

In purchasing Terra Nova we believe we will acquire a high quality international insurance business at a fair price. While the company suffered from some recent problems and will probably finish the year 2000 with a combined ratio in excess of 100%, we believe that its people will embrace the Markel Style and return their focus to consistently earning underwriting profits.

The total purchase price will be approximately $660 million. Approximately half is being paid in cash and half in securities. We expect to issue approximately 1.8 million common shares to complete this transaction. In addition, we will issue contingent value rights which are intended to increase the likelihood that a Terra Nova shareholder will be able to realize a minimum value of $185 for each share of Markel received. While the potential cost is very real, the contingent value rights will become worthless if our stock consistently trades over $185 in the next 30 months. We are always thoughtful about the cost of issuing stock and believe the contingent value rights were an effective way to complete this transaction and minimize the number of shares we would need to issue.

Terra Nova is slightly larger than Markel. In 1999 its gross written premium was $865 million, and at December 31, 1999 its investment

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portfolio was $1.5 billion and its shareholders' equity was $439 million. Terra Nova has 698 associates in its organization. Acquiring Terra Nova gives Markel shareholders significant increases in premium volume and investment portfolio per share as shown on the following table. We believe this additional operating and financial leverage will add value to the company, although it will only do so when we achieve underwriting profitability. Book value per share also increases substantially, however, this is simply because we are issuing additional Markel stock at a price in excess of our book value.

**MARKEL AND TERRA NOVA COMBINED**
**SELECTED PRO FORMA INFORMATION**
**DECEMBER 31, 1999**
*(in millions, except per share data)*

| | Markel | Pro Forma Combined |
|---|---|---|
| Premium Volume | $ 595 | $ 1,460 |
| *Per Share* | $ 106 | $ 186 |
| Investment Portfolio | $ 1,623 | $ 3,003 |
| *Per Share* | $ 290 | $ 409 |
| Shareholders' Equity | $ 383 | $ 677 |
| *Per Share* | $ 69 | $ 92 |
| Investment Leverage | 4.2 to 1 | 4.4 to 1 |

The transaction will also add a significant amount of goodwill to our balance sheet. This will be amortized over 20 years so we will have an additional non-cash annual amortization charge. Goodwill on any balance sheet should be viewed with caution and only future results can truly validate its real value. We believe the premium volume, investments, business relationships and experienced staff will more than justify the goodwill.

Since the transaction was announced in August, we have been working very closely with the Terra Nova organization to make the transition as seamless as possible. In most respects we share similar values and as a result we believe the transition will be smooth. The Markel Style and our "Commitment to Success" is being shared throughout the Terra Nova organization.

## Expanding the Board and Management Team

The acquisition also gives us the opportunity to strengthen our Board of Directors and our management team. We are particularly pleased that Nigel Rogers, Jack Byrne and Mark Byrne will be joining our Board of Directors. Nigel Rogers has been President and Chief Executive Officer of Terra Nova since May 1998 and has been working in the London insurance market for over 20 years. Nigel will continue to run our international operations following the transaction. Jack Byrne is a director and large shareholder of Terra Nova. He is also Chairman and Chief Executive Officer of White Mountains Insurance Group, a Bermuda-based reinsurance holding company. Jack has enjoyed a long and illustrious career in the insurance industry having previously served as a senior executive of both Fireman's Fund and GEICO. Mark Byrne is Jack's son and is also a director and shareholder of Terra Nova. Mark is Chairman and President of West End Capital Management (Bermuda) Limited, a Bermuda-based investment management company. Mark was previously a Managing Director, Global Fixed Income Arbitrage, for Credit Suisse First Boston.

One of our strengths is that we have an experienced, talented and motivated staff. An unexpected benefit of acquiring Terra Nova is that it has created new opportunities for our associates. With our expanding organization we promoted Paul Springman to President of our North American operations. Paul previously served as President and Chief Operating Officer of one of our largest operating units, Shand/Evanston. Paul has over 20 years of experience in the insurance industry and is a past President of the National Association of Professional Surplus Lines Offices (NAPSLO). We are confident that Paul will help us continue to meet our performance objectives in our U.S. operations. Another change made possible by the acquisition is the transfer of Jeremy Cooke to Chief Operating Officer of Terra Nova in London. Jeremy previously served as President and Chief Executive Officer of our Investors

Insurance Group. Jeremy began his career at Lloyd's over 25 years ago, then founded and built his own brokerage business which he sold in 1986. Jeremy is also a past President of NAPSLO. We are extremely pleased that Jeremy will be working with Nigel and his team in London.

We are proud of the depth of the team we have built and our bench strength.

## Quality Balance Sheet and Loss Reserves

We have often stated that maintaining a quality balance sheet with a strong loss reserve position is a fundamental principle of our Company. In the past year many insurance companies had to fix balance sheet problems and acknowledge their corresponding underwriting problems. Our approach is to seek to maintain a high degree of confidence in the quality of our loss reserve provisions and to do so without being influenced by the desire to achieve short-term earnings goals. We continue to believe that our strong balance sheet means more than our quarterly earnings statement.

This philosophy, coupled with our disciplined underwriting standards, puts us in a position to take advantage of volatility and market opportunities. Many others today are suffering from poor underwriting and in many cases, worse accounting. The economic reality created by these events is now manifesting itself. Our discipline, both in underwriting and in managing our balance sheet, is creating real business opportunities and value for our shareholders.

## Acceptance Business

In late December we were able to reach an agreement with Acceptance Insurance Companies to purchase the renewal rights to their excess and surplus business produced from their Scottsdale office. As a result we formed Markel Southwest Underwriters and staffed it with former associates of Acceptance. The business we retain will be priced and underwritten to our standards.

In this transaction we are assuming none of the existing business. We will administer the runoff on behalf of Acceptance and may offer renewals in one of our companies based on our underwriting and pricing guidelines. Our goal is to manage this process to achieve an underwriting profit. We will be administering the runoff of approximately $100 million and expect to walk away from half or more of this business. As Paul Springman wrote to our new associates, "We fully expect that premium volume (at Markel Southwest) will fall this year, and will fall significantly! That's not only expected, it's OK! When we look at our numbers at the end of this year, the only meaningful barometer will

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be the combined ratio, not the top line. No one should be concerned about market share. Our focus needs to be on underwriting profits."

Paul's comments are a good example of our culture of focusing on underwriting results. This philosophy extends throughout our organization and is a major reason for our success.

## Trends in the Market

Beginning late in 1999 and continuing into this year we are seeing many more opportunities to write business on our terms and conditions. There are many examples of areas where companies are exiting classes of business that have proven to be difficult to write profitably. Additionally, many are looking to get rate increases. While it is far too early to call this a change in the market cycle, it represents the first time in many years that the insurance market environment showed any signs of improvement. There remains too much capacity in the industry, however, it is clear that the industry's return on this capital has been dismal. Maybe the time is coming when the industry will run its affairs to earn reasonable returns.

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## Markel Associates

As we enjoy the success of the past and look forward to our bright future, we are especially thankful for the hard work and zealous pursuit of excellence demonstrated by our 883 associates, nearly all of whom are also shareholders. Our greatest pleasure stems from the fact that we are building an outstanding organization. Our results depend on each associate making important contributions and achieving individual goals every day. These individuals working as a team make our success possible. They share a vision and a passion for what our Company represents and we are confident that they will help us continue that success into the future.

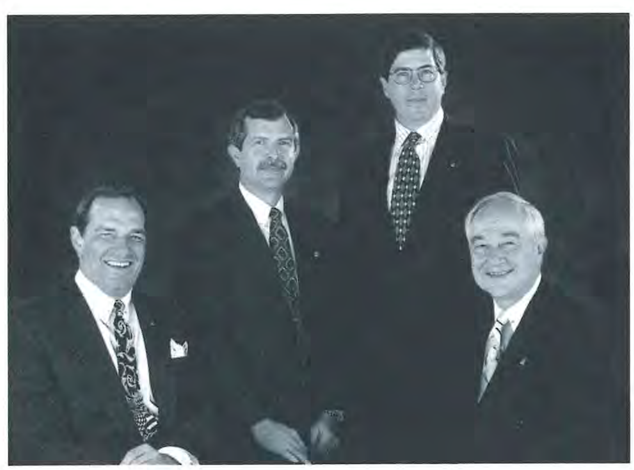
On behalf of all our associates, we appreciate our shareholder partners, whose long-term confidence and support helps us achieve our goals.

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

Anthony F. Markel
*President and Chief Operating Officer*

Steven A. Markel
*Vice Chairman*

Darrell D. Martin
*Executive Vice President and Chief Financial Officer*



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