# 2003 TO OUR BUSINESS PARTNERS

We enjoyed a very good year in 2003 and achieved record results. However, in our ongoing effort to thoroughly communicate with you, our partners, we will attempt to fully discuss both the good and the bad of 2003.

First, here is some of the good news. Gross written premiums grew 16% to $2.6 billion, most business units earned exceptional underwriting profits, investments and cash reached a record $5.3 billion and net income totaled $123 million. Our investment returns were superior with equity investments earning a 31% rate of return. Book value increased 19% to $140 per share.

Despite this good news, the year included some disappointments as well. We suffered adverse loss development in three areas resulting in charges amounting to $181 million. Given the magnitude of these charges, we are pleased to have achieved a modest underwriting profit for the company as a whole.

The bad news in 2003 included the recognition of significant loss reserve deficiencies at our Investors Brokered Excess and Surplus Lines unit. While we pride ourselves on disciplined underwriting and conservative loss reserving, we clearly missed the mark in this business unit as we increased reserves, primarily for the 1997 to 2001 accident years, by $91 million during the year. We believe the underwriting and pricing issues identified in 2003 were resolved over the past two years as market conditions significantly improved. Our

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internal claims review is complete and we believe the current business is well priced and underwritten and reserves for all periods are adequate. This experience reminds us that even in our culture of conservative reserving and underwriting, constant vigilance is a necessity.

Additionally, asbestos claims continued to be an expensive issue for Markel. We are fortunate that we and the companies we acquired were only minor players when asbestos exposures were written by the industry. Our market share in the pre-1986 period was less than 1%. We wish it were even less. As a result of our modest participation, we are not in a position to control what seem to be totally irrational claim settlements. While it is true that on an individual basis a plaintiff and his attorney may hit the lottery with an insurance claim, in the aggregate, the cost of claims is ultimately recycled in the form of future insurance premiums. There are no free lunches. We are fortunate, however, that we are participating in today's market in a much more material way as industry pricing recovers the losses from these frustrating events. The problems with asbestos as well as other tort reform issues are now on the agenda of Congress and many state legislatures and we hope for improvement in the current system.

Finally, discontinued business and prior year development at Markel International were also a drag on our 2003 results. Although you can never be completely confident about ultimate results early on, we feel extremely good about our risk selection and pricing in the most recent years and look forward to the day when we will be sharing better news about Markel International's success.

We set high standards and goals for ourselves, and are naturally disappointed when we fail to achieve them. 2003 was a very good year, but it could have been a great year. Nevertheless, we remain proud of our long term record of compounding book value and are optimistic about our ability to continue to do so.

## 2003 FINANCIAL REVIEW

Now for some more about the good news.

Revenues increased 18% from $1.8 billion to $2.1 billion as we continued to enjoy growth in both price and volume of our business. Earned premiums increased 20% to $1.9 billion and, more significantly, our combined ratio was 99%. While smaller than we would like, we are pleased to report an underwriting profit, our first since the acquisition of Gryphon and Markel International.

Total investment returns for 2003 were 10.5%. Our equity returns were 31% while fixed income securities earned a 4.5% return. Investment income increased 7.3% to $183 million as the average size of the portfolio grew to $4.8 billion. Net realized investment gains were $45 million and the change in gross unrealized gains was $141 million. These results represent an excellent year for our investment operations and demonstrate the importance and value of superior investing activity for our business.

Net income was a record $123 million, up from $75 million in the prior year, or $12.52 per diluted share as compared to $7.65. Comprehensive income was $222 million as compared to $73 million last year.

During the year investments and cash increased by $1 billion to $5.3 billion at year end. In addition, during the year we steadily increased our allocation of the portfolio to equities and at year end have $969 million invested in great companies.

Shareholders' equity increased to $1.4 billion. Year end book value per share is $140, up 19% for the year. In the past 5 years we have compounded book value per share annually by 13% and in the past 10 years by 18% (including the effect of stock issuance).

## EXCESS AND SURPLUS OPERATIONS

Gross written premiums in 2003 for our Excess and Surplus segment were $1.5 billion which represents a 15% increase over the prior year. We continued to have more opportunities to write business and at higher prices, although the rate of increase was at lower levels than we experienced in 2001 and 2002. While we believe price increases will moderate, we expect the market to continue to be very favorable. It is important to emphasize that our current prices should generate good underwriting results.

Excess and Surplus earned premiums increased 34% to $1.0 billion reflecting the strong growth in written premiums in prior years. More importantly, the combined ratio was 90% despite the development at Investors compared to last year's very respectable 93%.

Each business unit in our Excess and Surplus segment is participating in a very favorable insurance environment. Premium volume, pricing and underwriting profits are attractive throughout the segment. Our talented and experienced underwriters are continuing to respond to the needs of our clients by providing quality specialty insurance solutions.

## SPECIALTY ADMITTED OPERATIONS

Our Specialty Admitted segment also had an excellent year as gross written premiums increased 15% to $271 million, earned premiums increased 27% to $235 million and the combined ratio declined to 90%. Price levels achieved in the past few years along with our underwriting focus are providing sound underwriting profits. The marketplace for this segment continues to provide a positive platform for both organic growth in our current niches and for new product development and expansion opportunities.

## LONDON INSURANCE MARKET OPERATIONS

For 2003, Markel International wrote $738 million in gross written premiums, an increase of 19% over last year.

Earned premiums were $575 million with a 104% combined ratio which was slightly better than the 107% reported last year. Unfortunately, underwriting profitability still evaded us as in the fourth quarter we recognized $15 million in adverse loss development from prior years. Throughout the past three years we have seen progressively better underwriting results from new business that we put on the books. We continue to be dedicated to a conservative loss reserving discipline. We also continue to resolve old issues and we are cautiously optimistic regarding the profitability of the current business.

In 2003, we changed the management team at Markel International. Gerry Albanese moved to London to become President and Chief Operating Officer after serving us extremely well as the chief underwriting officer at the Shand Professional/Products Liability operation. Additionally, Richie Whitt joined Gerry as Executive Vice President and Chief Administrative Officer having previously served the company as our Corporate Controller and Treasurer. Gerry and Richie have a combined 30+ years at Markel and reinforce the Markel Style in London. Their presence in London demonstrates our commitment to Markel International. They are off to a strong start, our London associates are excited, and we are confident that our team in London will be successful.

Business in the London Insurance Market segment is showing continual improvement and we expect underwriting profits and solid returns on our capital. We will never underwrite business just to generate cash flow and have not yet reported underwriting profits. However, it is important to point out that Markel International has a growing investment portfolio which reached $2 billion in 2003. While we do not allocate investments for purposes of segment reporting, we should not forget that the returns on the investment portfolio mitigate the impact of underwriting losses.

## OTHER

"Other" includes programs and lines of business related to previous acquisitions which have been terminated or placed into run off. It also includes certain matters involving disputes and litigation. The majority of this business is related to our acquisition of Markel International in March 2000 when we discontinued about 35% of the then existing business. Other also includes our exposure to environmental and asbestos claims which were acquired with our purchase of Evanston Insurance Company in 1990, Associated International Insurance Company in 1999 and Terra Nova Insurance Company in 2000. Finally, included in this segment is the operation of our French reinsurance company, Corifrance, which while small, is operating with good underwriting results.

During 2003, we made meaningful progress in resolving a number of outstanding issues involving our exposures in discontinued programs; however, in doing so we discovered that it was necessary to increase our reserves by $75 million.

Of this amount, $55 million was for asbestos and $20 million for several other discontinued programs. We cannot precisely forecast when these legacy issues will cease, but are confident that we are effectively managing this process.

## INVESTMENTS

Our business model emphasizes the importance of superior investing, significantly more so than most insurance companies. Having a disciplined approach to investing and managing investments to achieve sound returns adds significant value for Markel shareholders. In 2003, we earned a 10.5% tax equivalent total return, including the effects of foreign currency, on our investments where equities returned 31% and fixed income securities returned 4.5%. Given the environment, this was a truly superior investment performance. The following chart shows our performance over the past year, as well as 5 and 10 year periods and compares our returns to those achieved by standard market indices. We do not manage against an index nor do we think in relative terms, however, the comparison does demonstrate the value added by our approach to investing over long time frames.

| | One Year | Five Years | Ten Years |
|---|---|---|---|
| Markel Total Return | | | |
| Fixed maturities | 4.50% | 7.00% | 7.20% |
| Equity securities | 31.00% | 13.20% | 15.10% |
| Market Indices | | | |
| Lehman Aggregate Index | 4.10% | 6.62% | 6.95% |
| S&P 500 | 28.37% | (0.55)% | 10.56% |

Over the past year we continued to shorten the duration of our fixed income portfolio as we remain leery of increasing interest rates. We believe interest rates are more likely to move up than down and we are unwilling to stretch for yield by either extending the duration or giving up credit quality. The relatively low interest yield in fixed income securities also makes the choice to allocate more funds to equity securities easier. While maintaining our high quality and relatively short duration portfolio, we are pleased with our performance.

It is important to think about our investment returns in dollar terms rather than just percentages. Over the past decade, our investment decisions regarding equity allocations, as well as specific security selections, have added literally hundreds of millions of dollars to shareholders' equity.

During the year we steadily increased our allocation to equities. A year ago equities were $551 million or 13% of the portfolio and 48% of shareholders' equity. Today we have $969 million in equity investments which is 18% of the portfolio and 70% of shareholders' equity. This increase results from higher equity allocation (as discussed in last year's report) because we found more quality opportunities at favorable prices and the value of what we owned increased. Additionally, our insurance operations are generating significant cash flow with very good margins, which provides capital and regulatory flexibility to increase our equity portfolio.

At year end the total unrealized investment gains before taxes were $417 million. After providing for the deferred tax liability in the amount of $146 million, the net unrealized gains included in book value were $271 million. It is important to note that the deferred tax will not be paid until and unless the individual securities are sold and the gain realized. The ability to defer this tax payment for a long time (maybe forever) is an important benefit. It is very much like having an interest free loan from the government. It is one of the reasons we prefer unrealized gains to those we realize and why we prefer to invest in good companies which we can own for the long term. And, of course, it is an additional reason why we measure our success by looking at growth in book value per share over the long term. Our equity portfolio turnover is typically less than 10%. This is quite unusual in the institutional investment world where turnover is frequently well in excess of 100%.

## BALANCE SHEET/CAPITAL ISSUES

Investments and cash grew 24% to $5.3 billion from $4.3 billion last year. The $1 billion increase is primarily the result of $631million in operating cash flow, $141 million in increased unrealized gains in the portfolio, and an increase in net borrowings of $115 million. Our investment leverage (the ratio of investments and cash to shareholders' equity) was 3.9 to 1.

As previously discussed, we increased loss reserves for prior years' exposures by $181 million. At the same time we recognized net favorable prior year development of $52 million. This softened the impact of the bad news and the net adverse development for the year was $129 million. We continue to maintain our long standing policy of seeking to establish loss reserves at levels which we think are more likely to be redundant than deficient.

At year end shareholders' equity grew 19% to $1.4 billion or $140 per share. We are well capitalized to achieve our current business plans.

It is absolutely critical for any insurance company to maintain a strong financial position to honor the promises it makes to its policyholders. At Markel, we firmly believe we offer our clients the security and financial protection they need through the combination of our sound underwriting, diligence in establishing loss reserves, superior investing and our strong capital position.

## CORPORATE GOVERNANCE

Corporate governance issues continue to be an important topic. This is nothing new to Markel. To quote Barbara Mandrell, "we were country when country wasn't cool." We believe we have always met the true spirit of sound corporate governance in making good decisions, treating all shareholders fairly and fully disclosing all important aspects of the Company's business and operations. To comply with the most recent regulatory requirements which dictate that a majority of the board be independent directors, Tom Gayner, Gary Markel and Darrell Martin will not stand for re-election as directors at the next annual shareholders' meeting. As a result, our Board will be comprised of 7 directors, 4 of whom are independent. Tom, Gary and Darrell have been valuable directors and have represented our shareholders well. While they will not continue to serve as directors, their voices will continue to be heard by the Board. Additionally, Tom and Paul Springman will join the expanded executive management committee.

While many of the new regulations are well intentioned and seek to achieve admirable goals, these rules cannot guarantee honesty and integrity. Unfortunately, these new requirements will add bureaucracy and cost and the ultimate benefit is not clear. We estimate that in 2004 we will spend as much as $3 million to comply with these new procedures. While we will clearly have additional paper, procedures, flow charts and documentation, it is important that the additional bureaucracy not get in the way of good decisions.

At Markel we believe we have consistently met both the letter and the spirit of the law in providing full and complete disclosure. We have reported all the news, both good and bad, in an honest and forthright manner. More importantly, we have always treated our shareholders as our business partners, as in fact they are.

## THE FUTURE

The insurance industry experienced 15 years of soft pricing and poor underwriting before the market began to turn in 2000. After only two full years of a truly "hard" insurance market, many are forecasting the next turn. While price increases are starting to slow, they are still going up with only a few exceptions. As the year unfolds there will undoubtedly be additional examples of a more competitive insurance environment. We will not enjoy the "hard market" forever. But having said that, we believe we are more likely to see a "good" market for some period — maybe several years. Industry-wide balance sheet problems continue to exist, the asbestos problem has not gone away and investment yields in the fixed income markets do not justify irrational cash flow underwriting. We expect the favorable market conditions to last a while longer, but even more importantly, we believe we can earn good returns throughout all market cycles.

In 2003, we earned only a modest underwriting profit as several disappointments offset some truly remarkable underwriting results. In 2004 and in future years, we will be looking for solid underwriting margins as well as superior investment returns to continue our growth in book value.

Over the long term we've achieved significant success in spite of our share of things that have gone wrong. Clearly we've done a lot more things which have proven to be successful. While we will strive to make fewer mistakes, do more things right and fix our mistakes as quickly as we can, we will not avoid all risk, take no chances and stand still. We will continue to seek out challenges and capitalize on new opportunities.

We believe that the best way to learn to ride a bike is to get on it and start peddling. The bruises and scrapes we encounter along the way are an inevitable part of building our successful organization.

## OUR ASSOCIATES

One of Markel's greatest strengths is our wonderful and talented team of some 1,700 associates. While making important contributions to their individual business units, they have also been available and willing to pitch in with company-wide projects and needs. Examples include the design and implementation of our global financial system, the work of our multi-unit peer claims review team and various joint projects involving both our U.S. and international associates. Our associates embody the Markel Style each and every day. In an effort to continue to build and enhance our human capital, we recently established more extensive in house training and career planning programs which will help cultivate and develop our outstanding associates.

In closing we would like to thank all Markel associates who have worked tirelessly to serve our clients as well as our shareholders and have achieved great results. Likewise we thank our shareholders who have entrusted their capital with us.

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*

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