

## To our business partners:

**I**t was quite a year. It began with a major earthquake, followed by eleven months of aftershocks from unruly interest rates. Generally, we were very pleased with our results, particularly with our continued underwriting profitability and growing premium base. On the other hand, our investment

returns were disappointing, as rising interest rates reduced the current value of our investment portfolio.

The bottom line tells some, but not all, of the story. Net income in 1994 totaled \$19 million, or \$3.33 per primary share, compared to \$24 million, or \$4.23 per primary share in 1993.

Stockholders' equity at December 31, 1994 was \$139 million, or \$25.71 per common share, down from \$151 million, or \$27.83 per common share, at December 31, 1993. Although net income and equity compare unfavorably to the prior year, there is plenty of good news to relate.

### **Underwriting performance**

Our underwriting performance was outstanding. Gross premium volume advanced 12 percent over 1993, to \$349 million. Higher gross premiums and increasing net retentions propelled earned premiums to \$243 million, representing a 26 percent gain over 1993. This increase exceeded our expecta-



Danger is part of the appeal of amusement rides. For Essex Insurance Company, risk is part of the challenge of providing insurance coverage. We devote special attention to

track design, maintenance schedules, operator experience and legal liability issues in order to make this type of insurance yield high financial returns.

tions, and we are optimistic about continued growth in 1995. Of course, increasing earned premiums doesn't make much sense if the business isn't profitable. So, of all our accomplishments for the year, we are most proud of our continued underwriting profitability. This was the third consecutive year in which we have reported under-

writing profits — a record we will work toward extending.

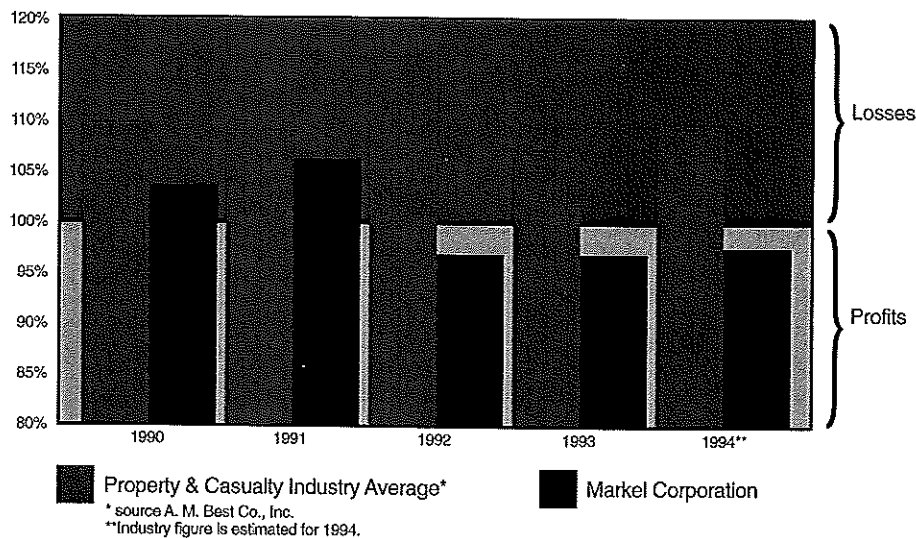
In 1994 losses and expenses amounted to 97 percent of earned premiums, producing an underwriting profit margin of three percent. In 1992 and 1993 we also reported a 97 percent combined loss and expense ratio. While the Northridge earthquake contributed to an

increase in 1994's loss ratio to 64 percent from 62 percent in 1993, we improved the expense ratio by holding the line on underwriting expenses. Underwriting expenses as a percentage of earned premiums declined to 33 percent from 35 percent in 1993.

Over the past several years, our growth strategy has been to focus on increasing our own

insurance companies' share of the premiums we control. Our net retention of total premiums has increased from 38 percent in 1991 to 74 percent in 1994. Coupled with higher levels of written premiums, these increases have had a significant impact on our earned premium revenue. However, as we reach our target retentions, future

### Underwriting performance COMBINED RATIO



The combined ratio measures the underwriting success of an insurance company by comparing the total of losses and expenses to earned premiums. With this ratio, less is more. A combined ratio higher

than 100% indicates a loss from underwriting activities; a combined ratio below 100% indicates underwriting profits.

For the last three years, we have reported combined ratios of

97%, producing an underwriting profit margin of 3%. Our results provide a sharp contrast to the losses sustained by the industry over the last five years.

growth must come from an added emphasis on new products, new customers and acquisitions.

We are constantly searching for niche markets and opportunities where we can provide quality products and excellent service with the expectation of earning underwriting profits. In mid-1993 we introduced a special property program that provided commercial property coverage for large property schedules or risks exposed to natural hazards. In 1994 Special Property premiums grew to \$21.6 million from \$7.5 million in 1993, making it our fastest growing product line. Despite claims from the Northridge earthquake, the program ended the year with highly profitable results.

We also added or expanded product lines which we hope will contribute to our future underwriting results. We developed a program for businesses that specialize in local and intermediate distance freight, and extended our animal mortality and farmowners' program into the thoroughbred horse industry.

For 1995 we have added a book of business that provides property coverage for mobile homes and low value dwellings. We remain fully committed to our primary goal of underwriting profitability; however, we also expect to find and take advantage of future growth opportunities.

#### **Investment performance**

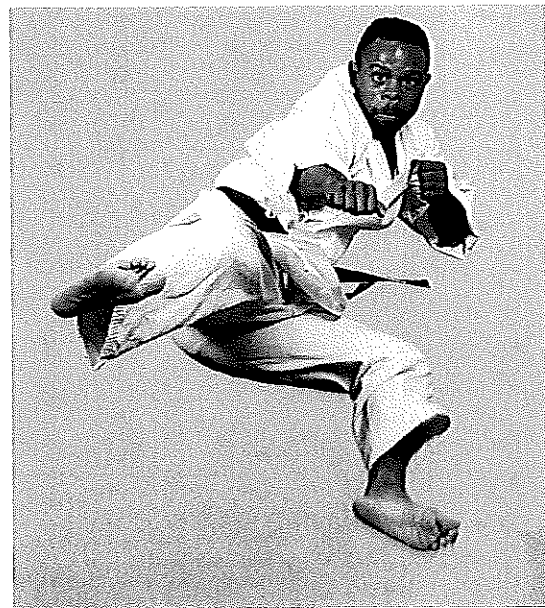
Although we enjoyed strong underwriting results, interest rate shocks took their toll on our investment performance. Rising interest rates were both a blessing and a curse. Rate increases finally began to reverse the long decline in current yields, but at the same time caused erosion in the market values of our investments, which reduced realized and unrealized gains over the course of the year. In addition, due to the implementation of a new accounting standard in 1993, stockholders' equity was adversely affected.

Most of our reported investment income comes from interest and dividends and is influenced by the size of the portfolio

as well as the yields of individual investments. Our investment portfolio includes tax-exempt bonds that provide slightly lower than average interest income in return for tax advantages, high quality bonds that generate interest at market rates, and common stocks which contribute modest dividend income.

The yield of our investment

portfolio tends to track prevailing interest rates. Our net investment income returns have declined since 1990, as a result of the steady decrease in interest rates over the same period. Yields fell from 7 percent of average invested assets in 1990 to 5 percent of average invested assets in 1994. Net investment income has also decreased, from



Would you want to insure schools that teach people how to fight? Markel Insurance Company has been doing it profitably since the early 1980s. We found that martial

arts studios' insurance risks could be controlled with certain safety precautions and practices. Both Markel and the martial arts studios benefit from our efforts.

\$32 million in 1990 to \$29 million in 1994. The decline in income was not as sharp as the decline in yields because our average invested assets grew significantly over the same period.

Reported income also includes realized investment gains. Over the long-term, investment gains are an important part of our reported income.

However, it is difficult to predict precisely when gains are likely to be realized. Since 1990, cumulative realized investment gains have amounted to \$38 million, but the timing of those gains has been highly variable. To illustrate, although we earned \$16 million in investment gains in 1993, rising interest rates limited our 1994 gains to \$4 million.

### The total return concept

Reported investment income is important, but our investment strategy focuses on our long-term total investment return. Long-term total return differs from reported results primarily because it includes changes in the market value of our investments, or unrealized gains and losses, and certain

adjustments for taxes.

Last year, we commented that realized gains were inherently volatile and difficult to predict. No kidding—and it's doubly true for unrealized gains and losses. Unrealized gains and losses can change by large amounts from one year to the next and introduce significant variability in short-term total returns.

### Investment earnings

<i>in millions</i>	1990*	1991	1992	1993	1994
Net investment income	\$ 32	\$ 31	\$ 27	\$ 24	\$29
% Avg. inv. assets	7%	7%	6%	5%	5%
Net realized gains	3	8	7	16	4
% Avg. inv. assets	1%	2%	1%	3%	0%
<b>TOTAL</b>	<b>\$ 35</b>	<b>\$ 39</b>	<b>\$ 34</b>	<b>\$ 40</b>	<b>\$ 33</b>
% Avg. inv. assets	8%	9%	7%	8%	5%
Average invested assets	\$ 433	\$ 462	\$ 463	\$ 503	\$ 605

\* pro forma

Our investment earnings depend on the size of our portfolio as well as the yields of the investments in the portfolio. Over the past five years, net investment income has declined as lower yields from declining interest rates have offset the benefits of a growing portfolio.

Realized investment gains are unpredictable from one year to the next. Over time, however, these returns are more stable. A portfolio of high quality investments and a long-term outlook can buffer the short-term ups and downs of the financial markets.

Because realized and unrealized returns are volatile, short-term performance measures are not particularly meaningful. An evaluation of total returns over several years is a better test of the effectiveness of an investment strategy. Our tax equivalent total returns over the last five years are strong. The five year weighted average return of our portfolio was 7.9 percent. Bonds earned 7.8 percent, and equities were even higher at 11.0 percent. We're proud of these results, and we will work to do even better in the future.

### **Investment results & the balance sheet**

In December 1993 we adopted a new accounting standard that required our bond portfolio to be carried on our balance sheet at its market value. Previously our bond portfolio was shown at amortized cost. Under this new standard, changes in the market value of the bond portfolio are reflected

in stockholders' equity as unrealized gains or losses. When we implemented the standard in December 1993, our bonds and equity investments had unrealized after-tax gains of \$22 million, and we adjusted stockholders' equity accordingly. In 1994 increased interest rates caused the market value of our portfolio to decline significantly. As of December 31, 1994 our investment portfolio had unrealized after-tax losses of \$6 million, a change of approximately \$28 million, or \$5.31 per common share.

### **Investment outlook**

The good news about investments is that we can expect higher yields in 1995 due to the interest rate increases of 1994. The unrealized losses associated with our bond portfolio will decline as bonds mature at par value and the proceeds are reinvested at higher rates. Also, we will benefit from continued growth in our invest-

ment portfolio, which increased to \$612 million at December 31, 1994 from \$360 million at December 31, 1990.

Although our equity returns in 1994 were less than we hoped, we are optimistic with respect to the future. We remain convinced that our long-term, value-oriented approach to equity investments will result

in enhanced returns to our shareholders.

### **Runoff issues**

Since the acquisition of our Shand/Evanston subsidiary in 1987, we have been trying to conclude several of the underwriting programs and reinsurance contracts which pre-date our ownership. In 1994 we



One-Call systems help construction crews locate underground pipes and cables. But if a One-Call system provides information that results in damage, that system may be held liable. Some insurance companies don't have the expertise to develop small markets like One-Call systems. The Evanston Insurance Company prides itself on underwriting for unique risks and specialized professions.

made significant progress in resolving many of the issues surrounding the runoff of these programs and contracts.

Perhaps our most important accomplishment was the reduction of our exposure to environmental impairment liability (EIL) and pollution and pollution-related bodily injury (toxic-tort) claims. These types of

claims are among the most unpredictable the property & casualty industry has confronted. Unlike many companies which have adopted a "wait and see" attitude to the complex legal, economic and social issues surrounding these exposures, we have worked hard to set reserves realistically and to close claims as aggressively as reasonably

possible. In 1994 we reduced our EIL exposures to 11 active sites from 109 active sites in 1993. More important, the uncertainty with respect to our remaining exposures has also diminished. Our open toxic tort claims, which tend to be less severe than EIL claims, also declined significantly to 307 from 417.

We continued our program of offering certain Shand/Evanston reinsurers the opportunity to commute, or prepay, their liabilities in return for a release from further exposure to changes in reserve estimates. While our net loss reserves increase because of the commutations, we benefit from the cash they generate and lower

### Total investment returns

#### ANNUAL TAXABLE EQUIVALENT TOTAL RETURNS

(in percent)	1990*	1991	1992	1993	1994	5 yr. weighted avg. ann. return
Equities	(7.0)	26.9	13.1	28.7	(3.3)	11.0
Fixed maturities	10.3	15.1	7.8	9.1	(0.2)	7.8
Total portfolio	6.2	17.0	8.2	11.8	(1.1)	7.9

\* pro forma

We emphasize long-term performance measures because realized and unrealized investment returns are volatile. A good test of our investment strategy is an evaluation of total returns over several years. Although returns in 1994 did not meet our expectations, our taxable equivalent total returns over the last five years continue to be strong.

collection and administrative costs. Of course, there is always the risk that we will have less reinsurance protection if reserves develop beyond our estimates, but we believe we have adequately provided for this risk. Balances for unpaid losses due from reinsurers declined to \$181 million at December 31, 1994 from \$261 million at year-end

1993 and \$380 million at year-end 1992.

Finally, we were successful in reaching an agreement with Shand/Evanston's former owners concerning indemnification agreements related to our purchase of Shand/Evanston. These matters have occupied a great deal of our time and energy over the past four years. Now, with

the uncertainty of these issues significantly reduced, we can focus our full attention where it belongs — on the future.

#### Passages

Markel's growth and strategic evolution from a small family-owned brokerage firm to a publicly-held underwriting operation has been a gratifying

adventure for all of us who have taken part in it. On a sad note, we report the death of one of our leaders in that adventure, Stanley B. Markel. Stanley retired from "active duty" after more than 50 years of service, including 29 years as our President and Vice Chairman. We can attribute a large measure of our success to the corporate

### Overall performance

#### EARNINGS PER PRIMARY SHARE

	1990	1991	1992	1993	1994
Core operations	\$ 1.95	\$ 2.61	\$ 3.03	\$ 3.31	\$ 3.77
Realized gains	(0.06)	0.94	0.89	1.83	0.45
Non recurring	(0.41)	0.28	1.90	—	—
Amortization expense	(0.43)	(1.15)	(1.18)	(0.91)	(0.89)
<b>NET INCOME</b>	<b>\$ 1.05</b>	<b>\$ 2.68</b>	<b>\$ 4.64</b>	<b>\$ 4.23</b>	<b>\$ 3.33</b>

We believe the earnings power of our business is best reflected in the results of our core underwriting and investment operations. Core operating results exclude realized gains, which can be volatile, and expense related to the amortization of intangible assets, which does not stem from our current activities. We

also exclude income and expenses related to one-time events, such as the sale of product lines or business units.

Underwriting profitability, increasing premiums and a growing investment portfolio have all contributed to an 18 percent average growth rate in core operating earnings since 1990.

mission and values that Stanley helped establish — the mission and values that are today expressed in the *Markel Style*. Stanley's intelligence, wit and disdain for bureaucracy will be remembered by all of us who knew and worked with him, and his commitment to success will always be the cornerstone of Markel Corporation.

### In conclusion

We expect the landscape of the property & casualty insurance market to change, either by man or by nature, and we're ready to meet the challenges of that change.

The risks of our business will never be completely avoidable, but they are manageable. We manage the insurance and

financial risks of our business with a commitment to consistent underwriting profits and superior investment returns. Our success in accomplishing those objectives is due in large part to the principles that guide us and form the *Markel Style*. We really do believe in the ethics outlined in our *Style* — hard work and a zealous pursuit of excellence,

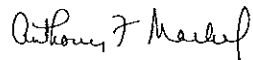
market leadership through quality products and services, and constant improvement. We believe it because time and time again, we've seen it work.



Alan I. Kirshner  
Chairman & C.E.O.



Steven A. Markel  
Vice Chairman



Anthony F. Markel  
President & C.O.O.



Darrell D. Martin  
Executive Vice President & C.F.O.



Clockwise from left:  
Tony Markel, Darrell Martin,  
Steve Markel, and Alan Kirshner