

# Management's Discussion and Analysis

## Overview

We are a holding company that underwrites selected property and casualty insurance through major subsidiaries collectively known as RLI Insurance Group, or the Group. The Group has accounted for approximately 90% of our consolidated revenue\* over the last three years by providing property and casualty coverages primarily for commercial risks. As a “niche” company, we offer specialty insurance products designed to meet specific insurance needs of targeted insured groups. A niche company underwrites a particular type of coverage for certain markets that are underserved by the insurance industry, such as our commercial earthquake coverage or oil and gas surety bonds. A niche company also provides a type of product not generally offered by other companies, such as our stand-alone personal umbrella policy, which we offer without the underlying auto or homeowners coverage. The excess and surplus lines market provides an alternative for customers with hard-to-place risks and risks that admitted insurers specifically refuse to write. When we underwrite within the excess and surplus lines market, we are selective in the lines of business and types of risks we choose to write. Often the development of these specialty insurance products is generated through proposals brought to us by an agent or broker seeking coverage for a specific group of clients. Once a proposal is submitted, underwriters determine whether a proposal would be a viable product in keeping with our business objectives.

Management measures the results of our insurance operations by monitoring certain measures of growth and profitability across three distinct business segments: casualty, property and surety. Growth is measured in terms of gross premiums written and profitability is analyzed through GAAP (accounting principles generally accepted in the United States of America) combined ratios, which are further subdivided into their respective loss and expense components. The GAAP combined ratios represent the profit generated from our individual segments as presented in the footnotes to our consolidated financial statements.

The foundation of our overall business strategy is to underwrite for profit. This drives our ability to provide shareholder returns in three different ways: the underwriting profit itself, investment income from fixed-income portfolios, and long-term growth in our equity portfolio. Our investment strategy is based on preservation of capital as the first priority, with a secondary focus on generating total return. The base fixed-income portfolio is rated investment grade to protect invested assets. Regular underwriting profits allow a large portion of our shareholders' equity to be invested in a value-based, large-capitalization common stock portfolio. With the exception of a small warrant position in a private equity investment, the portfolio contains no derivatives or off-balance sheet structured investments. In addition, we employ

stringent diversification rules and balance our investment credit risk and related underwriting risks to minimize total potential exposure to any one security. Despite recent realized and unrealized losses in the equity portfolio, the overall portfolio's asset allocation strategy has contributed significantly to our historic growth in book value.

The property and casualty insurance business is cyclical and influenced by many factors, including price competition, economic conditions, natural or man-made disasters (for example, earthquakes and terrorism), interest rates, state regulations, court decisions and changes in the law. One of the unique and challenging features of the property and casualty insurance business is that products must be priced before costs have fully developed, because premiums are charged before claims are incurred. This requires that liabilities be estimated and recorded in recognition of future loss and settlement obligations. Due to the inherent uncertainty in estimating these liabilities, there can be no assurance that actual liabilities will not exceed recorded amounts; if actual liabilities do exceed recorded amounts, there will be an adverse effect. In evaluating the objective performance measures previously mentioned, it is important to consider the following individual characteristics of each major insurance segment.

The casualty portion of our business consists largely of general liability, transportation, multi-peril program business, commercial umbrella, personal umbrella, executive products and other specialty coverages. In addition, we provide employers indemnity and in-home business owners coverage. The casualty book of business is subject to the risk of accurately estimating losses and related loss reserves because the ultimate settlement of a casualty claim may take several years to fully develop. The casualty line may also be affected by evolving legislation and court decisions that define the extent of coverage and the amount of compensation due for injuries or losses.

Our property segment primarily underwrites commercial fire, earthquake, builders' risk, difference in conditions, other inland marine coverages and, in the state of Hawaii, select personal lines policies. Property insurance results are subject to the variability introduced by perils such as earthquakes, fires and hurricanes. Our major catastrophe exposure is to losses caused by earthquakes, as approximately 42% of 2003's total property premiums were written in California. We limit our net aggregate exposure to a catastrophic event by purchasing reinsurance and through extensive use of computer-assisted modeling techniques. These techniques provide estimates of the concentration of risks exposed to catastrophic events.

The surety segment specializes in writing small to large commercial and small contract surety products, as well as those for the energy (plugging and abandonment), petrochemical and refining industries. The commercial surety products usually involve a statu-

\* Definitions for industry jargon, acronyms and RLI-specific terms can be found in our glossary on page 64.

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tory requirement for bonds. This industry has historically maintained a relatively low loss ratio. Losses may fluctuate, however, due to adverse economic conditions that may affect the financial viability of an insured. The contract surety market guarantees the construction work of a commercial contractor for a specific project. As such, this line has historically produced marginally higher loss ratios than other surety lines. Generally, losses occur due to adverse economic conditions, inclement weather conditions or the deterioration of a contractor's financial condition.

## Critical Accounting Policies

### GAAP and non-GAAP Financial Performance Metrics

Throughout this annual report, we present our operations in the way we believe will be most meaningful, useful and transparent to anyone using this financial information to evaluate our performance. In addition to the GAAP presentation of net income and certain statutory reporting information, we show certain non-GAAP financial measures that are valuable in managing our business, including gross revenues, gross written premiums, net written premiums and combined ratios.

Following is a list of non-GAAP measures found throughout this report with their definitions, relationships to GAAP measures, and explanations of their importance to our operations.

#### *Gross revenues*

This is an RLI-defined metric equaling the sum of gross premiums written, net investment income and realized gains (losses). It is used by our management as an overall gauge of gross business volume across all operating segments.

#### *Gross premiums written*

While net premiums earned is the related GAAP measure used in the statement of earnings, gross premiums written is the component of net premiums earned that measures insurance business produced before the impact of ceding reinsurance premiums, but without respect to when those premiums will be recognized as actual revenue. We use this measure as an overall gauge of gross business volume in our insurance underwriting operations with some indication of profit potential subject to the levels of our retentions, expenses and loss costs.

#### *Net premiums written*

While net premiums earned is the related GAAP measure used in the statement of earnings, net premiums written is the component of net premiums earned that measures the difference between gross premiums written and the impact of ceding reinsurance

premiums, but without respect to when those premiums will be recognized as actual revenue. We use this measure as an indication of retained or net business volume in our insurance underwriting operations. It is an indicator of future earnings potential subject to our expenses and loss costs.

#### *Combined ratios*

This ratio is a common industry measure of profitability for any underwriting operation, and is calculated in two segments. First, the expense ratio reflects the sum of policy acquisition costs and insurance operating expenses, divided by net premiums earned. The second component, the loss ratio, is losses and settlement expenses divided by net premiums earned. The sum of the loss and expense ratios is the combined ratio. The difference between the combined ratio and 100 reflects the per-dollar rate of underwriting profit or loss.

In preparing the consolidated financial statements, our management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosures of contingent assets and liabilities as of the date of the consolidated financial statements and the reported amounts of revenues and expenses for the reporting period. Actual results could differ significantly from those estimates.

The most critical accounting policies involve significant estimates and include those used in determining the liability for unpaid losses and settlement expenses, investment valuation, recoverability of reinsurance balances and deferred policy acquisition costs.

### Unpaid Losses and Settlement Expenses

The liability for unpaid losses and settlement expenses represents estimates of amounts needed to pay reported and unreported claims and related expenses. The estimates are based on certain actuarial and other assumptions related to the ultimate cost to settle such claims. Such assumptions are subject to occasional changes due to evolving economic, social and political conditions. All estimates are periodically reviewed and, as experience develops and new information becomes known, the reserves are adjusted as necessary. Such adjustments are reflected in the results of operations in the period in which they are determined.

Generally, we have not experienced significant development, favorable or unfavorable, either with the liability in total or within industry segments. Additional information with respect to reserve development patterns for 2001-2003 year-end liabilities can be found in note 6 to the financial statements. Adding to the complexities inherent in the reserving process are issues related to coverage, expansion of coverage, and reinsurance program applicability.

We have insignificant exposure to asbestos and environmental policy liabilities, as a result of entering liability lines after the industry had already recognized it as a problem. What exposure does exist is through our commercial umbrella, general liability, and discontinued assumed reinsurance lines of business. The majority of that exposure is in the excess layers of our commercial umbrella and assumed reinsurance books of business. Although our asbestos and environmental exposure is limited, management cannot determine our ultimate liability with any reasonable degree of certainty. This ultimate liability is difficult to assess due to evolving legislation on such issues as joint and several liability, retroactive liability, and standards of cleanup. Additionally, we participate primarily in the excess layers, making it even more difficult to assess the ultimate impact.

### Investment Valuation

Throughout each year, our external investment managers buy and sell securities to maximize overall investment returns in accordance with investment policies established and monitored by our board of directors and officers. This includes selling individual securities that have unrealized losses when the investment manager believes future performance can be surpassed by buying other securities deemed to offer superior long-term return potential.

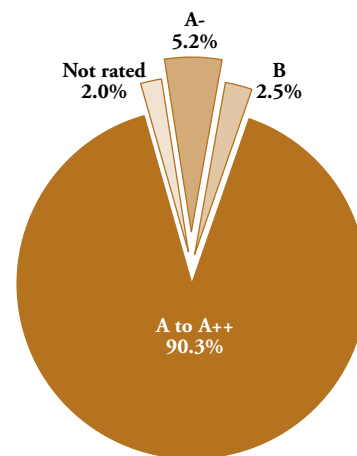
We classify our investments in debt and equity securities with readily determinable fair values into one of three categories: held-to-maturity securities are carried at amortized cost, while both available-for-sale securities and trading securities are carried at fair value.

Management regularly evaluates our fixed maturity and equity securities portfolio to determine impairment losses for other-than-temporary declines in the fair value of the investments. Criteria considered during this process include, but are not limited to: the current fair value as compared to the cost (amortized, in certain cases) of the security, degree and duration of the security's fair value being below cost, credit ratings, current economic conditions, the anticipated speed of cost recovery, and our decisions to hold or divest a security. Impairment losses result in a reduction of the underlying investment's cost basis. Significant changes in these factors could result in a considerable charge for impairment losses as reported in the consolidated financial statements.

Part of our evaluation of whether particular securities are other than temporarily impaired involves assessing whether we have both the intent and ability to continue to hold securities in an unrealized loss position. We have not sold any securities for the purpose of generating cash over the last several years to pay claims, dividends or any other expense or obligation. Accordingly, we believe that our sale activity supports our ability to continue to hold securities in an unrealized loss position until our cost may be recovered.

### Reinsurance recoverables

*95.5% of our reinsurance recoverables are due from companies rated A- or better by A.M. Best.*



### Recoverability of Reinsurance Balances

Ceded unearned premiums and reinsurance balances recoverable on paid and unpaid losses and settlement expenses are reported separately as assets, rather than being netted with the appropriate liabilities, since reinsurance does not relieve us of our legal liability to policyholders. Such balances are subject to the credit risk associated with the individual reinsurer. Additionally, the same uncertainties associated with estimating unpaid losses and settlement expenses impact the estimates for the ceded portion of such liabilities. We continually monitor the financial condition of our reinsurers. Our policy is to periodically charge to earnings an estimate of unrecoverable amounts from troubled or insolvent reinsurers. Further discussion to the security of our recoverable reinsurance balances can be found in note 5 to the financial statements.

### Deferred Policy Acquisition Costs

We defer commissions, premium taxes and certain other costs related to the acquisition of insurance contracts. These costs are capitalized and charged to expense in proportion to premium revenue recognized. The method followed in computing deferred policy acquisition costs limits the amount of such deferred costs to their estimated realizable value. This would also give effect to the premiums to be earned, related investment income, anticipated losses and settlement expenses as well as certain other costs expected to be incurred as the premium is earned. Judgments as to ultimate recoverability of such deferred costs are highly dependent upon estimated future loss costs associated with the premiums written.

## Operations

Consolidated gross revenue for 2003 totaled \$798.8 million, up 7.7% from \$741.5 million in 2002, which was a 35.2% increase from 2001. This result is largely driven by gross written premiums which grew a modest 5.0% in 2003, to a total of \$742.5 million, compared to \$707.5 million in 2002 and \$512.0 million in 2001. This result reflected a mix of continued growth in the casualty segment, softening markets (primarily in property), and re-underwriting of some surety products. Net investment income grew 17.3% to \$44.2 million in 2003, following a 17.0% growth rate in 2002, up from \$32.2 million in 2001. Realized gains in 2003 were \$12.1 million, compared to losses of \$3.6 million in 2002 and gains of \$4.2 million in 2001. The losses in 2002 were the result of securities impairment of \$6.5 million. Further details of the investment gains and losses and impairment analysis follow in the investment income section of this discussion.

Gross revenue (in thousands)	Year Ended December 31,		
	2003	2002	2001
Gross premiums written	\$742,477	\$707,453	\$511,985
Net investment income	44,151	37,640	32,178
Realized investment gains (losses)	12,138	(3,552)	4,168
Total gross revenue	\$798,766	\$741,541	\$548,331

Consolidated revenue for 2003 was \$519.9 million, up from \$382.2 million in 2002 and \$309.4 million in 2001. Net premiums earned, the main driver of this measurement, jumped 33.2% in 2003, compared to an increase of 27.5% in 2002.

Net earnings for 2003 were \$71.3 million (\$2.76 per diluted share), compared to \$35.9 million (\$1.75 per diluted share) 2002 and \$31.0 million (\$1.55 per diluted share) in 2001. Underwriting profits more than doubled in each of the last two years, posting pre-tax results of \$37.3 million, \$15.6 million and \$7.7 million in

2003, 2002 and 2001, respectively. The following table illustrates the trends in all components of net earnings over the last three years.

Net earnings (in thousands)	2003	2002	2001
Underwriting income	\$37,337	\$15,608	\$ 7,674
Investment income	44,151	37,640	32,178
Realized investment gains (losses)	12,138	(3,552)	4,168
Debt interest	(1,010)	(1,860)	(3,211)
Corporate expenses	(3,886)	(3,505)	(2,636)
Investee earnings	5,548	4,397	2,845
Pretax earnings	\$94,278	\$48,728	\$41,018
Income tax	(22,987)	(12,876)	(10,771)
Earnings before cumulative effect	\$71,291	\$35,852	\$30,247
Cumulative effect of initial application of SFAS 123	-	-	800
Net earnings	\$71,291	\$35,852	\$31,047

Comprehensive earnings rose dramatically, to \$97.7 million, compared to \$13.7 million in 2002 and \$11.4 million in 2001. This result reflects our commitment to a long-term-focus investment strategy, which has not changed. We believe this will maximize value for shareholders in the future, as it has done historically.

## RLI Insurance Group

As indicated earlier, the hard market conditions of 2002, which drove growth in virtually all lines that year, did not maintain the same pace in 2003, although the experience varied by segment. Underwriting profits increased considerably for the second consecutive year. These trends demonstrate our disciplined approach to risk selection and understanding of our markets. The following table and narrative provide a more detailed look at individual segment performance.

Gross premiums written (in thousands)	2003	2002	2001
Casualty	\$497,692	\$434,075	\$288,577
Property	193,359	210,310	169,953
Surety	51,426	63,068	53,455
Total	\$742,477	\$707,453	\$511,985
Underwriting profits (in thousands)	2003	2002	2001
Casualty	\$ 4,968	\$ (768)	\$ (2,187)
Property	38,959	24,472	7,525
Surety	(6,590)	(8,096)	2,336
Total	\$37,337	\$ 15,608	\$ 7,674
Combined ratio	2003	2002	2001
Casualty	98.4	100.4	101.4
Property	63.8	72.6	89.3
Surety	114.2	116.0	94.9
Total	92.0	95.6	97.2

The following table further summarizes revenues by major product type within each segment:

(in thousands)	2003	2002	2001
<b>Casualty</b>			
General liability	\$131,896	\$ 75,906	\$ 47,742
Commercial and personal umbrella	42,842	33,796	56,273
Executive products	13,876	8,444	4,504
Specialty program business	50,840	28,458	8,483
Commercial transportation	50,566	44,199	23,481
Other	19,528	17,310	16,487
Total	\$309,548	\$208,113	\$156,970
<b>Property</b>			
Commercial property	\$100,579	\$ 82,231	\$ 62,904
Homeowners/residential property	7,099	6,997	7,856
Other	—	—	4
Total	\$107,678	\$ 89,228	\$ 70,764
<b>Surety</b>	\$ 46,371	\$ 50,724	\$ 45,274
Grand total	\$463,597	\$348,065	\$273,008

Casualty gross premiums grew at 14.7% in 2003, down from a 50.4% increase in 2002. This was a mixed result as the general liability, personal umbrella, executive products and transportation lines recorded increases ranging from 18.9% to 56.3%. This was offset by reducing writings in, most notably, our program business, due to exiting one unprofitable program late in 2002 and tightening risk selection in several remaining areas.

The combined ratio for the casualty segment fell below 100.0 for the first time since 2000, to stand at 98.4 for the year. The decline, compared to results of 100.4 and 101.4 in 2002 and 2001, respectively, was the result of our ability to increase volume and rates without a commensurate increase in expenses. The loss ratio rose slightly in each of the last two years, reflecting a change in mix of business toward products with slightly higher expected claims costs. Nevertheless, we believe that our continued conservative reserving approach will result in a level of loss reserves adequate to pay future claims without negatively affecting future earnings. The time lag between recognition of reserves and their ultimate settlement or payment allows for significant investment income potential.

Gross written premiums in the property segment fell 8.1%, to \$193.4 million, after a 23.7% increase in 2002 compared to 2001. This definitely was emblematic of the trend in this market, where a strong rate environment in 2002, coupled with subsequent solid profitability, brought competitive pressure to bear and reduced writings in all product lines. The impact was mitigated to a degree by adjustments to our reinsurance program that increased

our retentions in selected areas and resulted in lower reinsurance premium costs.

Profitability in the property segment was extraordinary in 2003, posting a combined ratio of 63.8, compared to 72.6 and 89.3 in 2002 and 2001, respectively. As was the case in each of the last two years, our strategic focus continued in the areas of rate and deductible increases, commission restrictions, reinsurance revisions and other types of exposure control. These trends manifested themselves primarily in the commercial earthquake and fire lines, while our construction book fell from profitability largely due to losses from a single insured.

Surety gross premiums written dropped \$11.6 million, or 18.5% in 2003, compared to increases of \$9.6 million in 2002 and \$10.1 million in 2001. The 2003 decline is related to underwriting changes made in bonds written for contractors as part of corrective actions designed to return this segment to profitability. Certain relationships with the primary producers of these bonds were terminated in the fourth quarter of 2002, resulting in targeted reductions to writings.

The surety segment reported a \$6.6 million loss in 2003, which was a slight improvement from the \$8.1 million loss in 2002. Both years' performance was far removed from the \$2.3 million profit shown in 2001. As was the case with premium writings, the bonds written for contractors line impacted profitability as well. While losses continued to impact 2003, we expect to see improvements from changes made over the last 18 months. Careful monitoring of our results appears to indicate improvements in business written since the fourth quarter of 2002. We will continue to closely monitor the effectiveness of underwriting changes made to this segment.

We are in litigation regarding certain commercial surety bond claims arising out of a specific bond program. We believe we have meritorious defenses to these claims and are vigorously asserting our positions in pending legal actions in multiple jurisdictions. See note 10 to the financial statements for further discussion.

### Investment Income and Realized Investment Gains

Net investment income increased by 17.3% during 2003, due to increased cash flow allocated to fixed-income investments. On an after-tax basis, investment income increased by 19.0%. Operating cash flows were \$191.0 million in 2003, up from \$162.0 million and \$77.9 million in 2002 and 2001, respectively. Cash flows in excess of current needs were used to purchase fixed-income securities, which continue to be comprised primarily of high-grade, tax-exempt, corporate and U.S. government/agency

issues. The average annual yields on our investments were as follows for 2003, 2002 and 2001:

Pretax yield	2003	2002	2001
Taxable (on book value)	5.11%	6.00%	6.49%
Tax-exempt (on book value)	4.41%	4.80%	4.96%
Equities (on market value)	3.10%	2.91%	2.60%
After-tax yield	2003	2002	2001
Taxable (on book value)	3.32%	3.90%	4.22%
Tax-exempt (on book value)	4.18%	4.55%	4.70%
Equities (on market value)	2.66%	2.49%	2.23%

During 2003, the average after-tax yield of the fixed-income portfolio decreased 0.48% (3.68% vs. 4.16%) due to decreases in both taxable and tax-exempt yields on new purchases. The decline in yields is primarily due to fluctuations in interest rates and the subsequent reinvestment of called and matured bonds at lower yields. Despite the lower yields, the overall impact on investment income has been limited due to the continued growth in operational cash flow and the investment of the proceeds from our December 2002 equity offering. During the year, we again focused on purchasing high-quality investments, including corporate bonds, municipal bonds, mortgage-backed securities and asset-backed securities, primarily in the 0-10 year part of the yield curve.

The fixed-income portfolio increased by \$299.5 million during the year. This portfolio had realized gains of \$1.7 million and a tax-adjusted total return on a mark-to-market basis of 5.2%. Our equity portfolio increased by \$48.7 million during 2003, to \$276.0 million. For the year, this portfolio had pretax portfolio appreciation of \$40.4 million and realized gains of \$6.9 million. The total return for the year on this portfolio was 25.0%.

Our investment results for the last five years are shown in the following table:

(in thousands)						Annualized	Tax
	Average Invested Assets <sup>(1)</sup>	Investment Income <sup>(2)(3)</sup>	Realized Gains <sup>(3)</sup>	Change in Unrealized Appreciation <sup>(3)(4)</sup>	Return on Avg. Invested Assets	Return on Avg. Invested Assets	Equivalent Annualized
1999	\$ 684,269	\$26,015	\$ 4,467	\$(16,263)	2.1%	3.0%	
2000	723,677	29,046	2,847	20,537	7.2%	8.1%	
2001	774,826	32,178	4,168	(30,268)	0.8%	1.6%	
2002	896,785	37,640	(3,552)	(34,091)	0.0%	0.7%	
2003	1,166,694	44,151	12,138	40,096	8.3%	9.0%	
5-yr Avg.	\$ 849,250	\$33,806	\$ 4,014	\$(3,998)	4.0%	4.8%	

<sup>(1)</sup> Average amounts at beginning and end of year.

<sup>(2)</sup> Investment income, net of investment expenses, including non-debt interest expense.

<sup>(3)</sup> Before income taxes.

<sup>(4)</sup> Relates to available-for-sale fixed maturity and equity securities.

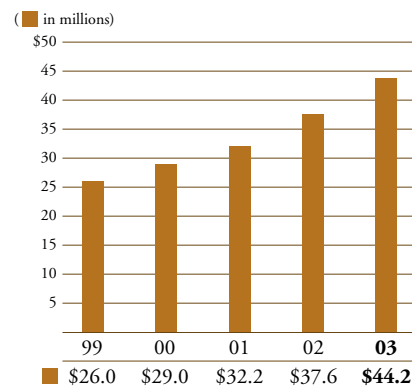
We maintain an equity investment in a private mortgage banking company. As of December 31, 2003, our equity investment, which consisted of common shares and warrants to acquire common shares, had a carrying value and estimated market value of \$6.9 million. We recorded \$1.7 million in net investment income during 2003 in accordance with Statement of Financial Accounting Standards (SFAS) 133, "Accounting for Derivative Instruments and Hedging Activities" (SFAS 133). SFAS 133 requires that we recognize the change in fair value of stock warrants received with the purchase of a note receivable. This compares to \$1.8 million recognized in 2002 and \$1.6 million in 2001. We employ a consistent valuation formula to recognize investment income or loss each quarter and to adjust the carrying value of our investment. This formula is based on the investee's book value, the volume of mortgages originated and profitability.

We realized \$12.1 million in capital gains in 2003, compared to capital losses of \$3.6 million in 2002 and capital gains of \$4.2 million in 2001. Included in the 2003 realized gain is a \$3.4 million gain related to the sale of an insurance company shell, Lexon Holding Company (formerly known as UIH, Inc.), and its insurance subsidiary, Lexon Insurance Company (formerly known as Underwriters Indemnity Company, or UIC), that was sold on July 1, 2003. The remaining \$8.7 million realized gain was due to the sale of certain equity and fixed income securities during 2003. The increase in net realized gains is due in part to the timing of the sale of individual securities.

We regularly evaluate the quality of our investment portfolio. When we believe that a specific security has suffered an other-than-temporary decline in value, the investment's value is adjusted by reclassifying the decline from unrealized to realized losses. This has no impact on shareholders' equity. During 2003, there were no losses associated with the other-than-temporary impairment of securities, while in 2002 our analysis identified \$6.5 million of such declines, which were recognized.

## Investment income

*Strong cash flow and proceeds from 2002's equity offering helped set a new investment income record.*



The following table is used as part of our impairment analysis and illustrates certain industry-level measurements relative to our equity portfolio as of December 31, 2003, including market value, cost basis, and unrealized gains and losses.

(in thousands)	Cost Basis	12/31/03 Mkt Value	Gains	Gross Unrealized Losses	Net	Unrealized Gain/Loss%
Consumer discretionary	\$ 9,470	\$ 14,157	\$ 4,687	\$ -	\$ 4,687	49.5%
Consumer staples	17,816	37,671	19,855	-	19,855	111.4%
Energy	7,434	15,833	8,399	-	8,399	113.0%
Financials	12,266	41,123	28,857	-	28,857	235.3%
Healthcare	7,504	25,834	18,330	-	18,330	244.3%
Industrials	17,416	36,343	18,927	-	18,927	108.7%
Materials	9,180	13,768	4,588	-	4,588	50.0%
Information technology	9,505	15,231	5,726	-	5,726	60.2%
Telecommunications	8,392	13,285	4,893	-	4,893	58.3%
Utilities	38,636	55,844	17,280	(71)	17,209	44.5%
Private investments	6,932	6,932	-	-	-	0.0%
	\$144,550	\$276,021	\$131,542	\$(71)	\$131,471	91.0%

The following table is also used as part of our impairment analysis and illustrates the total value of securities that were in an unrealized loss position as of December 31, 2003. It segregates the securities based on type, noting the fair value, cost (or amortized cost), and unrealized loss on each category of investment as well as in total. The table further classifies the securities based on the length of time they have been in an unrealized loss position.

<b>Investment Positions with Unrealized Losses Segmented by Type and Period of Continuous Unrealized Loss at December 31, 2003</b>			
(in thousands)	0-12 Mos.	>12 Mos.	Total
<b>U.S. Government debt securities</b>			
Fair value	\$ 95,539	\$ -	\$ 95,539
Cost or amortized cost	96,455	-	96,455
Unrealized loss	\$ (915)	\$ -	\$ (915)
<b>Corporate debt securities</b>			
Fair value	\$ 86,653	\$ -	\$ 86,653
Cost or amortized cost	89,502	-	89,502
Unrealized loss	\$ (2,850)	\$ -	\$ (2,850)
<b>States, political subdivisions, revenues &amp; debt securities</b>			
Fair value	\$ 28,411	\$ -	\$ 28,411
Cost or amortized cost	28,599	-	28,599
Unrealized loss	\$ (188)	\$ -	\$ (188)
<b>Subtotal, debt securities</b>			
Fair value	\$210,603	\$ -	\$210,603
Cost or amortized cost	214,556	-	214,556
Unrealized loss	\$ (3,953)	\$ -	\$ (3,953)
<b>Common stock</b>			
Fair value	\$ 1,576	\$ -	\$ 1,576
Cost or amortized cost	1,647	-	1,647
Unrealized loss	\$ (71)	\$ -	\$ (71)
<b>Total</b>			
Fair value	\$212,179	\$ -	\$212,179
Cost or amortized cost	216,203	-	216,203
Unrealized loss	\$ (4,024)	\$ -	\$ (4,024)

As of December 31, 2003, we held one common stock that was in an unrealized loss position. The total unrealized loss on this security was \$71,000 and it had been in an unrealized loss position for less than six months.

The fixed income portfolio contained 72 positions at a loss as of December 31, 2003. All of the fixed income positions were at a loss for less than 12 months. The fixed income unrealized losses can primarily be attributed to an increase in medium and long-term interest rates since the purchase of many of these fixed income securities. After a lengthy period of downward pressure on medium and long-term interest rates, this trend started to reverse in June 2003. This upward trend in interest rates created unrealized losses

for many fixed income investors. As interest rates rise, the prices of many of the fixed income securities in our portfolio will decline, generating increasing levels of unrealized losses. We continually monitor the credit quality of our fixed income investments to gauge our ability to be repaid principal and interest. We consider price declines of securities in our other-than-temporary-impairment analysis where such price declines provide evidence of declining credit quality, and we distinguish between price changes caused by credit deterioration, as opposed to rising interest rates.

As of December 31, 2003, we held no equity or fixed income securities that individually had an unrealized loss greater than 10%. Based on our evaluation of equity securities held within specific industry sectors, as well as the duration and magnitude of unrealized losses in our equity and bond portfolios, we do not believe any securities suffered an other-than-temporary decline in value as of December 31, 2003.

The amortized cost and estimated fair value of fixed-maturity securities at December 31, 2003, by contractual maturity, are shown as follows.

(in thousands)	Amortized Cost	Estimated Fair Value
<b>Available-for-sale</b>		
Due in one year or less	\$ 2,307	\$ 2,321
Due after one year through five years	228,451	231,759
Due after five years through 10 years	313,329	326,333
Due after 10 years	273,118	274,816
	\$ 817,205	\$ 835,229
<b>Held-to-maturity</b>		
Due in one year or less	\$ 10,784	\$ 11,073
Due after one year through five years	69,923	75,085
Due after five years through 10 years	93,024	101,102
Due after 10 years	6,969	7,787
	\$ 180,700	\$ 195,047
<b>Trading</b>		
Due in one year or less	\$ –	\$ –
Due after one year through five years	5,006	5,282
Due after five years through 10 years	2,472	2,643
Due after 10 years	468	481
	\$ 7,946	\$ 8,406
<b>Total fixed-income</b>		
Due in one year or less	\$ 13,091	\$ 13,394
Due after one year through five years	303,380	312,126
Due after five years through 10 years	408,825	430,078
Due after 10 years	280,555	283,084
	\$1,005,851	\$1,038,682

Expected maturities may differ from contractual maturities due to call provisions present on some existing securities. Manage-

ment believes the impact of any calls should be slight and intends to follow its policy of matching assets against anticipated liabilities.

### Interest and General Corporate Expense

Interest expense on debt fell to \$1.0 million in 2003, down from \$1.9 million in 2002, and \$3.2 million in 2001. Substantially all of our interest expense in the last three years was on short-term debt with maturities of less than one year. As a result, our interest expense was heavily influenced by changes in short-term interest rates. The decline in interest expense on debt in 2002 was due to the lower short-term debt balances outstanding as well as reduced interest rates on our debt that resulted from a general decline in interest rates. The further decline in interest expense in 2003 is primarily the result of further reductions in our short-term debt balances. We issued \$100.0 million of senior notes with a coupon rate of 5.95% on December 12, 2003, but because these notes were only outstanding for the last two weeks of the year, we did not recognize significant interest expense on these notes in 2003. In 2004, and through the bond maturity in 2014, we expect to incur interest expense on these senior notes of approximately \$6.0 million per year. General corporate expenses generally fluctuate relative to our executive compensation plan called Market Value Potential (MVP). This model measures comprehensive earnings against a minimum required return on company capital. These general corporate expenses were \$3.9 million, \$3.5 million and \$2.6 million for 2003, 2002 and 2001, respectively.

### Income Taxes

Our effective tax rates for 2003, 2002 and 2001 were 24.4%, 26.4% and 26.3%, respectively. The decline in the rate during 2003 is largely due to the tax benefit associated with the sale of an insurance shell during the third quarter. Effective rates are dependent upon components of pretax earnings and the related tax effects. Our pretax earnings in 2003 included \$21.5 million of investment income that is wholly or partially exempt from federal income tax, compared to \$17.2 million and \$16.3 million in 2002 and 2001, respectively.

### Investee Earnings

We maintain a 42% interest in the earnings of Maui Jim, Inc., primarily a manufacturer of high-quality polarized sunglasses. Maui Jim's chief executive officer owns the majority of the remaining outstanding shares of Maui Jim, Inc. In 2003, we recorded nearly \$5.5 million in earnings compared to \$4.4 million in 2002 and \$2.8 million in 2001. In 2003, Maui Jim net sales increased by 26% despite continued weakness in the retail sector and overall market for premium sunglasses. Explanations for the growth were

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a 47% increase in international sales, strong growth with existing key accounts, and the continued addition of new optical, golf and corporate accounts. Net sales grew 22% in 2002 and 8% in 2001. Gross margins grew 26% in 2003, compared to an increase of 25% in 2002 and a 12% increase in 2001. The margin percentage was relatively flat in 2003 as the dollar weakened against the Euro and Yen, making the cost of production higher, which was offset by the introduction of a new line with improved margins. Operating expenses grew by 22% in 2003 as a result of continued development of a new prescription facility and product to be introduced in 2004. Operating expenses grew by 18% in 2002 and 16% in 2001.

## Market Risk Disclosure

Market risk is a general term describing the potential economic loss associated with adverse changes in the fair market value of financial instruments. Management of market risk is a critical component of our investment decisions and objectives. We manage our exposure to market risk by using the following tools:

1. Monitoring the fair market value of all financial assets on a constant basis;
2. Changing the character of future investment purchases as needed; and
3. Maintaining a balance between existing asset and liability portfolios.

Our primary risk exposures are to changes in interest rates and equity prices, as we had no foreign exchange risk and only one derivative — warrants related to a private equity investment valued at \$6.8 million, as of December 31, 2003.

### Interest Rate Risk

Our primary exposure to interest rate risk is with our fixed-income investment portfolio and outstanding short-term debt instruments.

Modified duration analysis is used to measure the sensitivity of the fixed-income portfolio to changes in interest rates, providing a measure of price percentage volatility. We attempt to minimize interest rate risk by matching the duration of assets to that of liabilities.

Interest rate risk will also affect our income statement due to its impact on interest expense. We maintain debt obligations that are both short term and long term in nature. Our short-term debt generally has maturities ranging from one to nine months. As a result, we assume interest rate risk in our ability to refinance these short-term debt obligations. Any rise in interest rates will cause interest expense to increase if debt levels are maintained at current levels. We will continue to monitor this outstanding short-term debt and may use operating cash flow, the available-for-sale

fixed-income portfolio, or proceeds from any potential issuance of additional capital to pay it down — all or in part — as market conditions warrant. Our long-term debt carries a fixed interest rate. As such, our interest expense on this obligation is not subject to changes in interest rates. As this debt is not due until 2014, we will not assume risk in our ability to refinance this debt for many years.

### Equity Price Risk

Equity price risk is the potential that we will incur economic loss due to the decline of common stock prices. Beta analysis is used to measure the sensitivity of our equity portfolio to changes in the value of the S&P 500 Index (an index representative of the broad equity market). As measured from December 31, 1981, to December 31, 2003, our equity portfolio had a beta of 0.68 in comparison to the S&P 500, which has a beta of 1.00. This low beta statistic reflects our long-term emphasis on maintaining a conservative, value oriented, dividend-driven investment philosophy for our equity portfolio. Historically, dividend paying common stocks have demonstrated superior down-market performance characteristics.

Additional risk management techniques include:

1. Restricting individual security weightings to no more than 5% of the equity portfolio's market value, and
2. Reducing the exposure to sector risk by limiting the market value that can be invested in any one particular industry sector to 25% of the equity portfolio.

Equity securities are classified as available-for-sale, with unrealized gains and losses excluded from net earnings but recorded as a component of comprehensive earnings and shareholders' equity, net of deferred income taxes.

### Sensitivity Analysis

The tables on page 32 detail information on the market risk exposure for our financial investments as of December 31, 2003. Listed on each table is the December 31, 2003, market value for our assets and the expected pretax reduction in market value given the stated hypothetical events. This sensitivity analysis assumes the composition of our assets remains constant over the period being measured and also assumes interest rate changes are reflected uniformly across the yield curve. The analysis does not consider any action we would undertake in response to the various changes in market conditions. For purposes of this disclosure, market-risk-sensitive instruments are divided into two categories: instruments held for trading purposes and those held for nontrading purposes. The examples given are not predictions of future market events, but rather illustrations of the effect such events may have on the market value of our investment portfolio.

As of December 31, 2003, our fixed-income portfolio had a market value of \$1.04 billion. The sensitivity analysis uses scenarios of interest rates increasing 100 and 200 basis points from their December 31, 2003, levels with all other variables held constant. Such scenarios would result in decreases in the market value of the fixed-income portfolio of \$46.0 million and \$90.5 million, respectively. Due to our use of the held-to-maturity designation for a portion of the fixed-income portfolio, the balance sheet impact of these scenarios would be much lower. As of December 31, 2002, our fixed-income portfolio had a market value of \$742.8 million. Given the same scenarios, the corresponding decreases in the market value of the fixed-income portfolio as of the year-end 2002 were \$29.3 million and \$59.2 million, respectively. The potential decrease for 2003 is larger than for 2002, due to continuing purchases of fixed-income investments during 2003.

As of December 31, 2003, our equity portfolio had a market value of \$276.0 million. The base sensitivity analysis uses market scenarios of the S&P 500 Index declining both 10% and 20%. These scenarios would result in approximate decreases in the equity market value of \$18.8 million and \$37.5 million, respectively. As we designate all common stocks as available-for-sale, these market value declines would impact our balance sheet. As of December 31, 2002, our equity portfolio had a market value of \$227.3 million. Given the same scenarios, the market value decreases as of year-end 2002 were \$15.5 million and \$30.9 million, respectively. The change between years is attributable to the increase in the equity portfolio during 2003.

Counter to the base scenarios shown in Tables 1 and 2, Tables 3 and 4 quantify the opposite impact. Under the assumptions of falling interest rates and an increasing S&P 500 Index, the market value of our assets will increase from their present levels by the indicated amounts.

The income statement will also be impacted by interest expense. As of December 31, 2003, we had \$47.6 million in short-term debt obligations. Assuming this debt level remains constant, a hypothetical 100-basis-point increase in interest rates would increase our annual interest expense by \$0.5 million, and a 200-basis-point increase would increase annual interest expense by \$1.0 million. Conversely, falling interest rates would result in equivalent reductions in interest expense. These numbers are not included in the following tables. As of December 31, 2002, we had \$54.4 million of short-term debt outstanding. Because the amount of short-term debt outstanding at December 31, 2003, was lower than at the prior year end, the hypothetical impact of the stated scenarios would be reduced.

**Table 1** (in thousands)

Effect of a 100-basis-point increase in interest rates and a 10% decline in the S&P 500:

	12/31/03 Market Value	Interest Rate Risk	Equity Risk
Held for trading purposes			
Fixed maturity securities	\$ 8,406	\$ (292)	\$ -
Total trading	8,406	(292)	-
Held for nontrading purposes			
Fixed maturity securities	1,030,276	(45,669)	-
Equity securities	276,021	-	(18,769)
Total nontrading	1,306,298	(45,669)	(18,769)
Total trading & nontrading	\$1,314,703	\$(45,961)	\$(18,769)

**Table 2** (in thousands)

Effect of a 200-basis-point increase in interest rates and a 20% decline in the S&P 500:

	12/31/03 Market Value	Interest Rate Risk	Equity Risk
Held for trading purposes			
Fixed maturity securities	\$ 8,406	\$ (571)	\$ -
Total trading	8,406	(571)	-
Held for nontrading purposes			
Fixed maturity securities	1,030,276	(89,885)	-
Equity securities	276,021	-	(37,539)
Total nontrading	1,306,298	(89,885)	(37,539)
Total trading & nontrading	\$1,314,703	\$(90,456)	\$(37,539)

**Table 3** (in thousands)

Effect of a 100-basis-point decrease in interest rates and a 10% decline in the S&P 500:

	12/31/03 Market Value	Interest Rate Risk	Equity Risk
Held for trading purposes			
Fixed maturity securities	\$ 8,406	\$ 303	\$ -
Total trading	8,406	303	-
Held for nontrading purposes			
Fixed maturity securities	1,030,276	46,188	-
Equity securities	276,021	-	18,769
Total nontrading	1,306,298	46,188	18,769
Total trading & nontrading	\$1,314,703	\$46,491	\$18,769

**Table 4** (in thousands)

Effect of a 200-basis-point decrease in interest rates and a 20% increase in the S&P 500:

	12/31/03 Market Value	Interest Rate Risk	Equity Risk
Held for trading purposes			
Fixed maturity securities	\$ 8,406	\$ 623	\$ -
Total trading	8,406	623	-
Held for nontrading purposes			
Fixed maturity securities	1,030,276	95,479	-
Equity securities	276,021	-	37,539
Total nontrading	1,306,298	95,479	37,539
Total trading & nontrading	\$1,314,703	\$96,102	\$37,539

## Liquidity and Capital Resources

### Overview

We have three primary types of cash flows; (1) cash flows from operating activities, which consist mainly of cash generated by our underwriting operations and income earned on our investment portfolio, (2) cash flows from financing activities related to the purchase, sale and maturity of investments, and (3) cash flows from financing activities that impact our capital structure, such as changes in debt and shares outstanding. The following table summarizes these three cash flows over the last three years.

(in thousands)	2003	2002	2001
Cash flows from operating activities	\$191,019	\$161,971	\$77,874
Cash flows from investing activities	(283,911)	(248,123)	(74,821)
Cash flows from financing activities	92,892	86,152	(3,053)
	\$ -	\$ -	\$ -

We have entered into certain contractual obligations that require us to make recurring payments. The following table summarizes our contractual obligations as of December 31, 2003.

(in thousands)	Total	Payments due by period			
		Less than 1 yr.	1-3 yrs.	3-5 yrs.	More than 5 yrs.
<b>Contractual Obligations</b>					
Long-term debt	\$100,000	\$ -	\$ -	\$ -	\$100,000
Short-term debt	47,560	47,560	-	-	-
Capital lease	588	406	182	-	-
Operating lease	12,308	1,997	3,817	2,815	3,679
Total	\$160,456	\$49,963	\$3,999	\$2,815	\$103,679

Our largest contractual obligation relates to long-term debt outstanding. On December 12, 2003, we completed a public debt offering, issuing \$100 million in senior notes maturing January 15, 2014 (a 10-year maturity), and paying interest semi-annually at the rate of 5.95%. The notes were issued at a discount resulting in proceeds, net of discount and commission, of \$98.9 million. As of December 31, 2003, we were party to seven reverse repurchase agreements (short-term debt) totaling \$47.6 million. We are not party to any off-balance sheet arrangements.

Our primary objective in managing our capital is to preserve and grow shareholders' equity and statutory surplus to improve our competitive position and allow for expansion of our insurance operations. Our insurance subsidiaries must maintain certain minimum capital levels in order to meet the requirements of the states in which we are regulated. Our insurance companies are also evaluated by rating agencies that assign financial strength ratings that measure our ability to meet our obligations to policyholders over an extended period of time.

We have grown our shareholders' equity and policyholders' surplus in each of the last two years as a result of three sources/uses of funds: (1) earnings on underwriting and investing activities, (2) appreciation or depreciation in the value of our invested assets, and (3) financing activities such as the issuance of common stock and debt.

At December 31, 2003, we had short-term investments, cash and other investments maturing within one year, of approximately \$46.4 million and additional investments of \$312.1 maturing within five years. We maintain a \$40.0 million revolving line of credit with two financial institutions. The facility has a three-year term that expires on May 31, 2005. As of December 31, 2003, no amounts were outstanding on this facility.

We believe that cash generated by operations, cash generated by investments and cash available from financing activities will provide sufficient sources of liquidity to meet our anticipated needs over the next 12 to 24 months.

### Operating Activities

The following table highlights some of the major sources and uses of cash flow from operating activities:

Sources	Uses
Premiums received	Claims
Reinsurance losses and settlement expenses	Ceded premium to reinsurers
Investment income (interest & dividends)	Commissions paid
	Operating expenses
	Interest expense
	Income taxes

Our largest source of cash is from premiums received from our customers, which we receive at the beginning of the coverage period. Our largest cash outflow is for claims that arise when a customer incurs an insured loss. Because the payment of claims occurs after the receipt of the premium, often years later, we invest the cash in various investment securities that earn interest and dividends — another source of cash. We use cash to pay commissions to brokers and agents, as well as to pay for ongoing operating expenses such as salaries, rent, interest expense and other operating expenses. We also utilize reinsurance to manage the risk that we take on our policies. We cede, or pay out, part of the premiums we receive from our customers to our reinsurance partners, and collect cash back when losses are incurred subject to our reinsurance coverage.

The timing of our cash flows from operating activities can vary among periods due to the timing by which payments are made or received. Some of our payments and receipts, including loss settlements and subsequent reinsurance receipts, can be significant, so their timing can influence cash flows from operating activities in

any given period. We are subject to the risk of incurring significant losses on catastrophes such as earthquakes. If we were to incur such losses, we would have to make significant claims payments in a relatively concentrated period of time.

### Investing Activities

The following table highlights some of the major sources and uses of cash flow from investing activities:

Sources	Uses
Proceeds from bonds sold, called or matured	Purchase of bonds
Proceeds from stocks sold	Purchase of stocks

We maintain a well-diversified investment portfolio representing policyholder funds that have not yet been paid out as claims, as well as the capital we hold for our shareholders. As of December 31, 2003, our portfolio had a book value of \$1.3 billion. Invested assets at December 31, 2003, increased by \$333.3 million, or 33%, from December 31, 2002. Contributing to this increase was the investment of cash flows from operations, \$98.9 million in proceeds from our senior notes offering, and \$10.1 million in proceeds from the over-allotment option exercised in connection with our December 2002 equity offering.

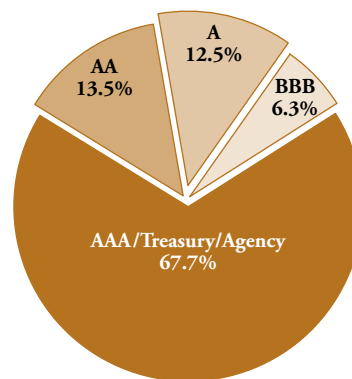
Our overall investment philosophy is designed to first protect policyholders by maintaining sufficient funds to meet corporate and policyholder obligations, then generate long term growth in shareholders' equity. Because the company's existing and projected liabilities are sufficiently funded by the fixed-income portfolio, we can improve returns by investing a portion of the surplus (within limits) in a conservative equity portfolio. As of December 31, 2003, 49.8% of our shareholders' equity was invested in common stocks, as compared to 49.8% and 82.8% at December 31, 2002 and 2001, respectively.

We currently classify 18% of the securities in our fixed-income portfolio as held-to-maturity, meaning they are carried at amortized cost and are intended to be held until their contractual maturity. Other portions of the fixed-income portfolio are classified as available-for-sale (81%) or trading (1%) and are carried at fair market value. As of December 31, 2003, we maintained \$843.6 million in fixed-income securities within the available-for-sale and trading classifications. The available-for-sale portfolio provides an additional source of liquidity and can be used to address potential future changes in our asset/liability structure.

Our fixed-income portfolio is managed for safety, focusing on securities of the highest ratings and liquidity. Yield is of secondary importance behind the preservation of capital. The equity portfolio is managed for long-term growth, maintaining a conservative, value-oriented approach. This philosophy of portfolio

diversification, management style, and asset allocation allows us to maximize overall returns with the least amount of risk.

In each of the last three years, all available cash flow has been invested into fixed income investments as opposed to stocks. As a result, our bond portfolio now comprises 76.8% of our total portfolio, where it represented 72.5% of the total at December 31, 2002, and 58.2% of the total as of December 31, 2001. We regularly evaluate our asset allocation among stocks and bonds, and may choose to invest new cash into stocks in the future. Our fixed income portfolio consists almost entirely of bonds rated investment grade by Standard & Poor's and Moody's. As of December 31, 2003, our fixed-income portfolio had the following rating distribution:



In selecting the maturity of securities in which we invest, we consider the relationship between the duration of our fixed-income investments and the duration of our liabilities, including the expected ultimate payout patterns of our reserves. We believe that both liquidity and interest rate risk can be minimized by such asset/liability management. As of December 31, 2003, our duration was 4.5 years. Our fixed-income portfolio remained well diversified, with 592 individual issues as of December 31, 2003. During 2003, the total return on our bond portfolio on a tax-equivalent, mark-to-market basis was 5.2%.

In addition, at December 31, 2003, our equity portfolio had a value of \$276.0 million, all of which is classified as available-for-sale and is also a source of liquidity. The securities within the equity portfolio remain primarily invested in large-cap issues with strong dividend performance. The strategy remains one of value investing, with security selection taking precedence over market timing. A buy-and-hold strategy is used, minimizing both transactional costs and taxes.

As of December 31, 2003, our portfolio had a dividend yield of 2.8% compared to 1.6% for the S&P 500 index. Because of the corporate-dividend-received deduction applicable to our dividend income, we pay an effective tax rate of only 14.2% on dividends, compared to 35.0% on taxable interest income and 5.3% on municipal bond interest income. As with our bond portfolio, we

maintain a well-diversified group of 112 equity securities. During 2003, the total return on our equity portfolio on a mark-to-market basis was 25.0%.

### Financing Activities

In addition to the previously discussed operating and investing activities, we also engage in financing activities to manage our capital structure. The following table highlights some of the major sources and uses of cash flow from financing activities:

Sources	Uses
Proceeds from stock offerings	Shareholder dividends
Proceeds from debt offerings	Debt repayment
Short-term borrowing	Share buy-backs
Treasury shares issued	Treasury shares purchased
Shares issued under stock option plans	

Our capital structure is comprised of equity and debt outstanding. As of December 31, 2003, our capital structure consisted of \$100.0 million in 10-year maturity senior notes (long-term debt), \$47.6 million in reverse repurchase debt agreements (short-term debt), and \$554.1 million of shareholders' equity. Debt outstanding comprised 21% of total capital as of December 31, 2003.

On December 12, 2003, we completed a public debt offering, issuing \$100 million in senior notes maturing January 15, 2014, and paying interest semi-annually at the rate of 5.95%. The notes were issued at a discount resulting in proceeds, net of discount and commission, of \$98.9 million. Of the proceeds, \$50.0 million was contributed to our insurance subsidiaries to increase their statutory surplus with the balance retained at the holding company.

On December 26, 2002, we completed the sale of 4.8 million shares of common stock in an underwritten public offering at a price of \$25.25 per share. After considering the 5.0% underwriting discount, we received \$115.1 million in net proceeds, before expenses. On January 9, 2003, we sold an additional 420,000 shares pursuant to an over-allotment option granted to the underwriters, receiving an additional \$10.1 million in net proceeds. The proceeds from the offering were used to pay indebtedness under our line of credit and to increase surplus at our insurance companies.

Our 110th consecutive dividend payment was declared in the fourth quarter of 2003 and paid on January 15, 2004, in the amount of \$0.11 per share. Our 111th consecutive dividend payment was declared in the first quarter of 2004 and is payable on April 15, 2004, in the amount of \$0.11 per share. Since the inception of cash dividends in 1976, we have increased our annual dividend every year. In its annual "Handbook of Dividend Achievers," Mergent FIS (formerly a division of Moody's) ranked us 186th of more than 11,000 U.S. public companies in dividend growth over the last decade.

Dividend payments to us from our principal insurance subsidiary are restricted by state insurance laws as to the amount that may be paid without prior approval of the regulatory authority of Illinois. The maximum dividend distribution is limited by Illinois law to the greater of 10% of RLI Insurance Company's policyholder surplus as of December 31 of the preceding year or its net income for the 12-month period ending December 31 of the preceding year. Therefore, the maximum dividend distribution that can be paid by RLI Insurance Company during 2004 without prior approval is \$54.7 million. The actual amount paid in 2003 was \$5.5 million.

In July 1997, we implemented a 4.5 million-share common stock repurchase program. In early 2001, we repurchased 5,544 shares at a total cost of \$122,895. Although 560,000 shares remained authorized for repurchase at year-end 2003, we are not currently pursuing any share repurchases.

### Outlook for 2004

The insurance marketplace is expected to support continued growth in 2004 although opinions vary greatly as to the degree. There is consensus that any growth will continue to slow, compared to the last two years. It is also generally predicted that combined ratios will decline absent any specific occurrences of catastrophes. This bodes well for us, as we have consistently exceeded industry profitability measures over the years. As always, we will work hard to secure favorable reinsurance coverages, leverage our underwriting expertise and exploit any opportunities that complement our collection of products and services. We are attentive to the cyclical nature of this industry and will look beyond 2004 to position ourselves for inevitable changes in the market. Specific details regarding events in our business segments follow.

### Casualty

The 2004 blueprint for our casualty segment is no different than in recent years. Continued growth is expected in varying degrees across all active product lines, supported by continued, if somewhat reduced, rate improvements. This segment's combined ratio is expected to remain below 100 as a result of writing quality business at superior prices.

### Property

Despite an increasingly competitive environment, we believe growth in premiums may be achieved in our property book. While our earthquake business production is subject to more constraints related to our overall exposure to loss, there is still room to grow in the commercial fire and construction lines. The trend in our property loss ratio over the last two years has been outstanding, and

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it would be imprudent to project significant improvement in that area. However, absent any major catastrophic events, this segment is expected to continue to realize substantial profit margins.

### **Surety**

Premium production in this segment is projected to be flat for all product lines except our miscellaneous business, where modest growth is projected. The profitability picture did improve in 2003, but not to a satisfactory level. We believe the necessary changes have been made to set this segment on the path to improvements in 2004.

### **Accounting Standards**

In March 2001, the FASB adopted the guidance set forth in Derivatives Implementation Group (DIG) Issue A17, "Contracts That Provide for Net Share Settlement." Based on this guidance, we determined that stock warrants received in conjunction with the purchase of a note receivable qualify as derivatives under SFAS 133. Therefore, in accordance with the transition provisions of SFAS 133, we accounted for these warrants as derivatives effective April 1, 2001. The warrants were marked to fair value, as of April 1, 2001, with a cumulative-effect adjustment of \$800,415, net of tax. The change in fair value of this instrument from April 1 to December 31, 2001 totaled \$1.6 million and was recorded through the statement of earnings as net investment income. During 2002 and 2003, we recorded \$1.8 million and \$1.7 million, respectively, in net investment income to recognize the current period change in the fair value of these stock warrants.

In July 2001, the FASB issued SFAS 141 "Business Combinations," effective for all business combinations initiated after June 30, 2001, and SFAS 142 "Accounting for Goodwill and Other Intangible Assets," effective for fiscal years beginning after December 15, 2001. We adopted the provisions of these statements. SFAS 141 requires the purchase method of accounting be used for all business combinations. Goodwill and indefinite-lived intangible assets will remain on the balance sheet and not be amortized. Intangible assets with a definite life will continue to be amortized over their estimated useful lives. SFAS 142 establishes a new method of testing goodwill for impairment. On an annual basis, and when there is reason to suspect that their values may have been diminished or impaired, these assets must be tested for impairment. The amount of goodwill determined to be impaired will be expensed to current operations. A reconciliation of the pro forma effects of eliminating the amortization of goodwill for the year ended December 31, 2001 can be found in note 1 to our audited consolidated financial statements.

In August 2001, the FASB issued SFAS 143, "Accounting for Asset Retirement Obligations," which becomes effective for fiscal years beginning after June 15, 2002. SFAS 143 addresses the financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs.

In October 2001, the FASB issued SFAS 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," which supersedes SFAS 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of" and the accounting and reporting provisions of APB 30, "Reporting the Results of Operations — Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions" for the disposal of a segment of a business. SFAS 144 retains many of the fundamental provisions of SFAS 121, but resolves certain implementation issues associated with that statement. SFAS 144 is effective for fiscal years beginning after December 15, 2001.

In April 2002, the FASB issued SFAS 145, "Rescission of FASB Statements No. 4, 44, 64, Amendment of FASB Statement 13, Technical Corrections." This statement rescinds FASB Statements 4, 44, and 64, amends FASB Statement 13, and makes certain technical corrections. The rescission of Statements 4 and 64 affects income statement classification of gains and losses from extinguishment of debt. SFAS 145 is effective for financial statements issued on or after May 15, 2002.

In April 2002, the FASB issued SFAS 146, "Accounting For Costs Associated With Exit or Disposal Activities." This statement nullifies EITF Issue 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)." Under SFAS 146, a commitment to an exit or disposal plan no longer will be a sufficient basis for recording a liability for those activities. SFAS 146 is effective for exit or disposal activities that are initiated after December 15, 2002.

The provisions of SFAS 143, 144, 145 and 146 have not had a material impact on our consolidated financial statements.

In November 2002, the FASB issued FASB Interpretation No. 45 (FIN 45), "Guarantor's Accounting and Disclosure Requirements for Guarantees." FIN 45 requires that disclosures be made by a guarantor in its interim and annual financial statements about its obligation under certain guarantees that it has issued. It also clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. FIN 45 does not apply to certain guarantee contracts such as those issued by insurance and reinsurance companies and accounted for under accounting principles for those companies. The disclosure

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requirements are effective for financial statements for periods ending after December 15, 2002. Recognition and measurement provisions are applicable on a prospective basis to guarantees issued or modified after December 31, 2002. We are not currently in any such transactions subject to FIN 45.

In December 2002, the FASB published SFAS 148, "Accounting for Stock-Based Compensation — Transition and Disclosure." SFAS 148 amends SFAS 123, "Accounting for Stock-Based Compensation" and provides alternative methods of transition for a voluntary change to the fair-value-based method of accounting for stock-based employee compensation. Because we have not elected to adopt the fair-value-based method of accounting for stock compensation, the transitional provisions of this statement did not impact us. In addition, SFAS 148 amends the disclosure requirements of SFAS 123 to require more prominent and more frequent disclosures in financial statements about the effects of stock-based compensation, including disclosures in interim financial statements. The transition guidance and annual disclosure provisions of SFAS 148 were effective for fiscal years ending after December 15, 2002. The disclosure provisions became effective for annual reporting in 2002 and interim reporting in 2003.

In January 2003, the FASB issued FASB Interpretation No. 46 (FIN 46), "Consolidation of Variable Interest Entities." FIN 46 requires that companies absorbing the majority of another entity's expected losses, receiving a majority of its expected residual returns, or both, as a result of holding variable interests that are ownership, contractual, or other economic interests, consolidate that entity (variable interest entity (VIE)). Companies meeting this definition are considered primary beneficiaries. The consolidation requirements apply to all VIEs created after January 31, 2003. For pre-existing VIEs, if it is reasonably possible that a company will have a significant variable interest in a VIE on the date FIN 46's requirements become effective, the company must disclose the nature, purpose, size and activities of the VIE as well as the company's maximum exposure to loss resulting from the VIE in all financial statements issued after January 31, 2003. This disclosure is required even if the company would not become the primary beneficiary. We are not currently involved in any transactions subject to this guidance.

In April 2003, the FASB issued SFAS 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities." SFAS 149 amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities under SFAS 133, "Accounting for Derivative Instruments and Hedging Activities." SFAS 149 was designed to improve financial reporting by requiring that contracts with comparable characteristics be accounted for similarly. With some exception, this statement

is effective on a prospective basis for contracts entered into or modified after June 30, 2003.

In May 2003, the FASB issued SFAS 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity." SFAS 150 establishes standards for the classification in the statement of financial position of certain financial instruments that have characteristics of both liabilities and equity but may have previously been presented either entirely as equity or between the liabilities section and the equity section of the statement of financial position. SFAS 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period after June 15, 2003. It is to be implemented by reporting a cumulative effect of a change in accounting principle for financial instruments created before the issuance date of the statement and still existing at the beginning of the interim period of adoption.

The provisions of SFAS 149 and 150 are not anticipated to have a material impact on our consolidated financial statements.

## State and Federal Legislation

As an insurance holding company, we, as well as our insurance subsidiaries are subject to regulation by the states in which the insurance subsidiaries are domiciled or transact business. Holding company registration in each insurer's state of domicile requires periodic reporting to the state regulatory authority of the financial, operational and management data of the insurers within the holding company system. All transactions within a holding company system affecting insurers must have fair and reasonable terms, and the insurer's policyholder surplus following any transaction must be both reasonable in relation to its outstanding liabilities and adequate for its needs. Notice to regulators is required prior to the consummation of certain transactions affecting insurance company subsidiaries of the holding company system.

The insurance holding company laws also require that ordinary dividends be reported to the insurer's domiciliary regulator prior to payment of the dividend and that extraordinary dividends may not be paid without such regulator's prior approval. An extraordinary dividend is generally defined as a dividend that, together with all other dividends made within the past 12 months, exceeds the greater of 100% of the insurer's statutory net income for the most recent calendar year, or 10% of its statutory policyholders' surplus as of the preceding year end. Insurance regulators have broad powers to prevent the reduction of statutory surplus to inadequate levels, and there is no assurance that extraordinary dividend payments would be permitted.

In addition, the insurance holding company laws require advance approval by state insurance commissioners of any change

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in control of an insurance company that is domiciled (or, in some cases, having such substantial business that it is deemed to be commercially domiciled) in that state. "Control" is generally presumed to exist through the ownership of 10% or more of the voting securities of a domestic insurance company or of any company that controls a domestic insurance company. In addition, insurance laws in many states contain provisions that require prenotification to the insurance commissioners of a change in control of a non-domestic insurance company licensed in those states. Any future transactions that would constitute a change in control of our insurance company subsidiaries, including a change of control of us, would generally require the party acquiring control to obtain the prior approval by the insurance departments of the insurance company subsidiaries' states of domicile or commercial domicile, if any, and may require pre-acquisition notification in applicable states that have adopted pre-acquisition notification provisions. Obtaining these approvals could result in material delay of, or deter, any such transaction.

Other regulations impose restrictions on the amount and type of investments our insurance company subsidiaries may have. Regulations designed to ensure financial solvency of insurers and to require fair and adequate treatment and service for policyholders are enforced by filing, reporting and examination requirements. Market oversight is conducted by monitoring and periodically examining trade practices, approving policy forms, licensing of agents and brokers, and requiring the filing and in some cases, approval, of premiums and commission rates to ensure they are fair and equitable. Such restrictions may limit the ability of our insurance company subsidiaries to introduce new products or implement desired changes to current premium rates or policy forms. Financial solvency is monitored by minimum reserve and capital requirements (including risk-based capital requirements), periodic reporting procedures (annually, quarterly, or more frequently if necessary), and periodic examinations.

The quarterly and annual financial reports to the states utilize statutory accounting principles that are different from GAAP, which show the business as a going concern. The statutory accounting principles used by regulators, in keeping with the intent to assure policyholder protection, are generally based on a solvency concept. The NAIC recently developed a codified version of these statutory accounting principles, designed to foster more consistency among the states for accounting guidelines and reporting. The industry adopted this codified standard beginning January 1, 2001. This adoption required our insurance company subsidiaries to recognize a cumulative effect adjustment to statutory surplus for the difference between the amount of surplus at the beginning of the year and the amount of surplus that would have been

reported at that date if the new codified standard had been applied retroactively for all prior periods.

This cumulative effect adjustment decreased consolidated statutory surplus by \$23.9 million as of January 1, 2001, primarily due to the recognition of deferred tax liabilities. This statutory adjustment had no impact on our GAAP financial statements as presented in this report.

Under state insurance laws, our insurance company subsidiaries cannot treat reinsurance ceded to an unlicensed or non-accredited reinsurer as an asset or as a deduction from its liabilities in their statutory financial statements, except to the extent that the reinsurer has provided collateral security in an approved form, such as a letter of credit. As of December 31, 2003, \$689,000 of our reinsurance recoverables were due from unlicensed or non-accredited reinsurers that had not provided us with approved collateral.

Many jurisdictions have laws and regulations that limit an insurer's ability to withdraw from a particular market. For example, states may limit an insurer's ability to cancel or not renew policies. Furthermore, certain states prohibit an insurer from withdrawing one or more lines of business from the state, except pursuant to a plan that is approved by the state insurance department. The state insurance department may disapprove a plan that may lead to market disruption. Laws and regulations that limit cancellation and non-renewal and that subject program withdrawals to prior approval requirements may restrict our ability to exit unprofitable markets.

Virtually all states require licensed insurers to participate in various forms of guaranty associations in order to bear a portion of the loss suffered by the policyholders of insurance companies that become insolvent. Depending upon state law, licensed insurers can be assessed an amount that is generally equal to between 1% and 2% of the annual premiums written for the relevant lines of insurance in that state to pay the claims of an insolvent insurer. These assessments may increase or decrease in the future, depending upon the rate of insolvencies of insurance companies. In some states, these assessments may be wholly or partially recovered through policy fees paid by insureds.

In addition to monitoring our existing regulatory obligations, we are also monitoring developments in the following areas:

#### *Terrorism Exclusion Regulatory Activity*

After the events of September 11, 2001, the NAIC urged states to grant conditional approval to commercial lines endorsements that excluded coverage for acts of terrorism consistent with language developed by the Insurance Services Office, Inc. The ISO endorsement included certain coverage limitations. Many states

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allowed the endorsements for commercial lines, but rejected such exclusions for personal exposures.

On November 26, 2002, the Terrorism Risk Insurance Act of 2002 became law. The act provides for a federal backstop for terrorism losses as defined by the act and certified by the Secretary of the Treasury in concurrence with the Secretary of State and the U.S. Attorney General. The immediate effect, as regards state regulation, was to nullify terrorism exclusions to the extent they exclude losses that would otherwise be covered under the act. The act further states that rates and forms for terrorism risk insurance covered by the act are not subject to prior approval or a waiting period under any applicable state law. Rates and forms of terrorism exclusions and endorsements are subject to subsequent review. We continue to monitor state regulations regarding the use of terrorism exclusions, particularly with respect to the applicability of the standard fire policy. We are in compliance with the requirements of TRIA and have made terrorism coverage available to policyholders. Given the challenges associated with attempting to assess the potentiality of future acts of terror exposures and assign an appropriate price to the risk, we have taken a conservative underwriting position on most of our products.

#### *Mold Contamination*

The property-casualty insurance industry experienced an increase in claim activity in the last few years pertaining to mold contamination. Significant plaintiffs' verdicts and increased media attention to the subject have caused insurers to develop and/or refine relevant insurance policy language that excludes mold coverage. The insurance industry foresees increased state legislative activity pertaining to mold contamination in 2004. We will closely monitor litigation trends in 2004, and continue to review relevant insurance policy exclusion language. There were few insurance laws or regulations enacted in 2003 regarding mold coverages. The regulatory emphasis appears to focus on personal lines rather than commercial lines. We have had an immaterial impact from mold claims and attach a mold exclusion to policies where applicable.

#### *Privacy*

As mandated by the federal Gramm-Leach-Bliley Act, enacted in 1999, the individual states continue to promulgate and refine regulations that require financial institutions, including insurance licensees, to take certain steps to protect the privacy of certain consumer and customer information relating to products or services primarily for personal, family or household purposes. A recent NAIC initiative that impacted the insurance industry in 2001 was the adoption in 2000 of the Privacy of Consumer Financial and Health Information Model Regulation, which assisted states in

promulgating regulations to comply with the Gramm-Leach-Bliley Act. In 2002, to further facilitate the implementation of the Gramm-Leach-Bliley Act, the NAIC adopted the Standards for Safeguarding Customer Information Model Regulation. Several states have now adopted similar provisions regarding the safeguarding of customer information. Our insurance subsidiaries have implemented procedures to comply with the Gramm-Leach-Bliley related privacy requirements. During 2003, states continued to pass legislation on privacy notice measurements and sharing information between affiliates. We continue to monitor our procedures for compliance.

Although the federal government generally does not directly regulate the insurance business, federal initiatives often have an impact on the business in a variety of ways. We are monitoring the following initiatives.

#### *OFAC*

The Treasury Department's Office of Foreign Asset Control ("OFAC") maintains a list of "Specifically Designated Nationals and Blocked Persons" (the "SDN List"). The SDN List identifies persons and entities that the government believes are associated with terrorists, rogue nations and/or drug traffickers. OFAC's regulations prohibit insurers, among others, from doing business with persons or entities on the SDN List. If the insurer finds and confirms a match, the insurer must take steps to block or reject the transaction, notify the affected person and file a report with OFAC. The focus on insurers' responsibilities with respect to the SDN List has increased significantly since September 11. Our insurance subsidiaries have implemented procedures to comply with OFAC's SDN List regulations.

#### *Sarbanes-Oxley Act of 2002*

The Sarbanes-Oxley Act of 2002, enacted on July 30, 2002, presents a significant expansion of securities law regulation of corporate governance, accounting practices, reporting and disclosure that affects publicly traded companies. The act, in part, sets forth requirements for certification by company CEOs and CFOs of certain reports filed with the SEC, disclosures pertaining to the adoption of a code of ethics applicable to certain management personnel, and safeguards against actions to fraudulently influence, manipulate or mislead independent public or certified accountants of the issuer's financial statements. It also requires stronger guidance for development and evaluation of internal control procedures, as well as provisions pertaining to a company's audit committee of the board of directors. We continue our efforts toward compliance with the act, particularly related to Section 404 dealing with our system of internal controls.

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### *Asbestos Litigation Reform*

The insurance industry is contemplating a proposal to fund its liabilities for asbestos exposure to provide for the exclusive remedy for all asbestos-related claims, pending and future. The proposal calls for funding over a 27-year period, based upon a company's exposure to asbestos litigation. We continue to monitor our expected exposure and do not perceive a significant risk.

### *Class Action Reform*

We are monitoring proposed legislation that would curtail forum shopping and allow defendants to move large national class action cases to federal courts. The legislation also includes provisions to protect consumer class members on matters such as non-cash settlements and written settlement information. We view this as favorable legislation to our company and the industry.

### *Health Insurance Portability and Accessibility Act*

Regulations under the Health Insurance Portability and Accessibility Act of 1996 (HIPAA) were adopted on April 14, 2003 to protect the privacy of individual health information. While property/casualty insurers are not required to comply with the various administrative requirements of the act, the regulations have an impact on obtaining information within the context of claims information. We continue to monitor regulatory developments under HIPAA.

### *Federal Insurance Charter*

The Senate Commerce Committee recently has held hearings on federal involvement in the regulation of the insurance industry. The hearings included a discussion of a proposed federal charter that would allow companies to operate under federal, rather than state, regulation. Any proposed legislation would have a significant impact on the insurance industry, and we continue to monitor all proposals.

### **Corporate Compliance**

We have developed a code of conduct and compliance manual, which provides directors, officers and employees with guidance on complying with a variety of federal and state laws. Both documents may be found on the company's website.

### **Licenses and Trademarks**

RLI Insurance Company has a software license and services agreement with Risk Management Solutions, Inc. for the modeling of natural hazard catastrophes. The license is renewed on an annual basis. RLI Insurance Company has a perpetual license with AIG Technology Enterprises, Inc. for policy management, claims pro-

cessing, premium accounting, file maintenance, financial/management reporting and statistical reporting. We also enter into other software licensing agreements in the ordinary course of business.

RLI Insurance Company obtained service mark registration of the letters "RLI" in 1998, as well as "eRLI" and "RLINK" in 2000, in the U.S. Patent and Trademark Office. Such registrations protect the marks nationwide from deceptively similar use. The duration of these registrations is 10 years unless renewed.

### **Forward Looking Statements**

Forward looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 appear throughout this report. These statements relate to our expectations, hopes, beliefs, intentions, goals or strategies regarding the future and are based on certain underlying assumptions by us. Such assumptions are, in turn, based on information available and internal estimates and analyses of general economic conditions, competitive factors, conditions specific to the property and casualty insurance industry, claims development and the impact thereof on our loss reserves, the adequacy of our reinsurance programs, developments in the securities market and the impact on our investment portfolio, regulatory changes and conditions, and other factors. Actual results could differ materially from those in forward looking statements. We assume no obligation to update any such statements. You should review the various risks, uncertainties and other factors listed from time to time in our Securities and Exchange Commission filings.