

## 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. 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 marketplaces 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. We operate in both the admitted marketplace where coverage terms and prices are regulated by the states in which we conduct business, and the excess & surplus lines marketplace where we are free to set terms and prices. The excess and surplus lines marketplace provides an alternative for customers with hard-to-place risks and risks that admitted insurers specifically refuse to write. Regardless of the marketplace in which we write, 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. We rely on product vice presidents to oversee our major coverage areas. We focus on hiring leaders with decades of experience in their marketplaces and provide a compensation structure that rewards the consistent delivery of underwriting profits.

The foundation of our overall business strategy is to underwrite for profit, and we have achieved this for nine consecutive years averaging 91.7 over that period of time. This drives our ability to provide shareholder returns in three different ways: the underwriting profit itself, investment income from our fixed income portfolio, 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 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 which 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 occasional fluctuations of realized and unrealized gains or losses in the equity portfolio, our investment in stocks as part of a long-term asset allocation strategy has contributed significantly to our historic growth in book value.

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. Within our underwriting operation, we evaluate our business in terms of three segments: casualty, property and surety. Each of these segments consists of different coverages that share common risk characteristics.

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 39% of our 2004 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 statutory 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 marketplace 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.

The insurance marketplace has softened in the last year, meaning that the marketplace has become more competitive and prices are generally flat to falling, even as coverage terms become less restrictive. This softening is particularly pronounced in our property segment. Nevertheless, we believe that our business model is geared to create underwriting profits by focusing on sound underwriting discipline. Our primary focus will continue to be on underwriting profitability as opposed to premium growth or market share measurements. And although we will be challenged to deliver premium growth in 2005, we expect to continue delivering underwriting profits.

## 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 and drawing comparisons to our peers. These measures are gross revenues, gross premiums written, net premiums written 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 barometer 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. For example, a combined ratio of 95 implies that for every \$100 of premium we earn, we record \$5 of underwriting profit.

### *Net Unpaid Loss and Settlement Expenses*

“Unpaid losses and settlement expenses,” as shown in the liabilities section of our balance sheet, represents the total obligations to claimants for both estimates of known claims and estimates for incurred but not reported (IBNR) claims. The related asset item, “Reinsurance balances recoverable on unpaid losses and settlement expense,” is the estimate of known claims and estimates of IBNR that we expect to recover from reinsurers. The net of these two items is generally referred to as net unpaid loss and settlement expenses and is commonly referred to in our disclosures regarding the process of establishing these various estimated amounts.

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**

We accrue liabilities intended to represent the ultimate settlement cost of losses and loss expenses incurred but not yet settled as of the accounting date. This includes both claims whose loss circumstances have been reported to us and for which our claims personnel have established estimates of ultimate cost (case reserves), and claims which have occurred, but which have not yet been reported to us (incurred but not reported — or IBNR — reserves). The ultimate cost of both of these categories, and therefore the liability booked to represent their ultimate cost, involve estimates.

The estimates underlying the accrued liabilities are derived from generally accepted actuarial techniques, applied to our actual experience, and take into account insurance industry data to the extent judged relevant to our operations.

Our experience in a given accounting period is affected by all those factors which affect the quality of the business

written in competitive coverage marketplaces: the premiums for which the coverage can be sold, the frequency and severity of claims ultimately produced on that business, the terms at which we purchase reinsurance coverage, and our expense structure.

In the estimation of ultimate loss and loss expense liabilities, the factors which most significantly affect the ultimate results are:

- changes in claim frequency and severity, or, more generally, the underwriting quality of the business written;
- changes in the coverage sold (limits of coverage, deductibles, exclusions and extensions of coverage, reinsurance terms); and
- changes in the overall profitability of the competitive coverage marketplace.

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 incurred losses and settlement obligations that have not been reported. 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. Furthermore, we may determine that recorded reserves are more than adequate to cover expected losses as happened in 2004 when favorable experience on casualty business led us to reduce our reserves. See the Results of Operations section for further discussion.

### *Underwriting Quality of the Business Written*

In general, competitive insurance marketplaces change over time. This is particularly true of the excess and surplus lines marketplace. The principal feature of those changes is the average profitability of business in a given segment, which is principally determined by the premium charged as well as the frequency and severity of claims produced. Because the quality of business changes continuously, the ultimate profitability of the business being written in the current accounting period must be estimated. As the quality of the business changes, the reliability of recent experience as a guide to the results of current business weakens.

We therefore monitor changes in the quality of business written by the number of claims per unit of exposure, the cost per claim, and the shifts in the distribution of business by geographic region and product segment. We incorporate our understanding of those changes into our estimates of the ultimate cost of current claims for which reserves have been established.

#### *Changes in the Coverage Sold*

The excess and surplus lines marketplace is characterized by somewhat greater regulatory latitude in coverage terms and pricing. As competitive marketplace conditions change, our underwriters respond by modifying our coverage terms. While this is an appropriate response to a changing competitive environment, it also weakens the reliability of past experience as a predictor of the ultimate cost of claims arising from current business. The admitted marketplaces in which we operate provide for more stable terms and pricing because of their regulated nature. However, this regulation limits our ability to quickly adapt terms and pricing in light of changing marketplace dynamics.

Reinsurance is also important to our operations. Reinsurance is purchased in a related, but distinct competitive marketplace which also changes over time. The changes in the relative cost of reinsurance affect the ultimate cost of net loss liabilities for which we accrue reserves. In general, as we grow and increase our financial capacity to absorb fluctuations in results, our need for, and purchase of, reinsurance may decrease incrementally.

#### *Changes in Overall Profitability*

During and immediately after the period in which coverage is provided and the corresponding premiums are earned, there may be little actual claim experience from which to estimate the ultimate cost of those claims. In particular, for longer-tailed liability lines such as excess coverage, the reporting, case reserving, and settlement of those claims may take considerable time.

We therefore use generally accepted actuarial techniques which use the premiums charged for coverage as a basis for estimating the ultimate cost of losses and loss expenses for relatively immature accident periods. While this is technically appropriate, it does introduce another variable into the reserve estimate: the changing profitability of premiums for a given product over time. Since the ultimate profitability of the business written in a given period depends upon all the factors mentioned above,

highly accurate profitability estimates of the longer-tailed lines are difficult to achieve.

We have insignificant exposure to asbestos and environmental policy liabilities. We entered affected liability lines after the industry had already recognized them as a problem, and we adopted appropriate coverage exclusions. 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 and that our participation exists in the excess layers of coverage on these risks.

#### **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 improved 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. Available-for-sale securities are carried at fair value with unrealized gains/losses recorded as a component of comprehensive earnings and shareholders' equity, net of deferred income taxes. Trading securities are carried at fair value with unrealized gains/losses included in earnings.

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.

### 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 related liabilities, since reinsurance does not relieve us of our 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 of 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 premiums are earned. Judgments as to ultimate recoverability of such deferred costs are highly dependent upon estimated future loss costs associated with the premiums written.

Additional discussion of other significant accounting policies may be found in note 1 to the financial statements.

## Results of Operations

Consolidated gross revenue for 2004 totaled \$820.0 million, up 2.7% from \$798.8 million in 2003 and above the 2002 level of \$741.5 million. The largest component, gross premiums written, recorded a slight increase of 1.4% in 2004 following a 5.0% increase in 2003. After increasing by 38.2% in 2002, the growth rate of gross writings declined due to softening marketplace conditions and re-underwriting of some coverages. Net investment income grew 22.5% in 2004, to \$54.1 million, better than the 17.3% increase in 2003.

<b>Gross revenue</b> (in thousands)			
Year ended December 31,	<b>2004</b>	2003	2002
Gross premiums written	<b>\$752,588</b>	\$742,477	\$707,453
Net investment income	<b>54,087</b>	44,151	37,640
Realized investment gains (losses)	<b>13,365</b>	12,138	(3,552)
<b>Total gross revenue</b>	<b>\$820,040</b>	\$798,766	\$741,541

Consolidated net revenue for 2004 was \$578.8 million, up from \$519.9 million in 2003 and \$382.2 million in 2002. Revenue growth outpaced the top line as a result of increased retentions in certain coverages and the earning of premiums written in prior years.

Increases in both underwriting profit and investment income drove the upward trend in net earnings each of the last two years. Some of those gains were offset by increases in debt interest and general corporate expenses.

<b>Net earnings</b> (in thousands)	<b>2004</b>	2003	2002
Underwriting income	<b>\$ 39,891</b>	\$37,337	\$15,608
Investment income	<b>54,087</b>	44,151	37,640
Realized investment gains (losses)	<b>13,365</b>	12,138	(3,552)
Debt interest	<b>(6,894)</b>	(1,010)	(1,860)
Corporate expenses	<b>(5,536)</b>	(3,886)	(3,505)
Investee earnings	<b>5,429</b>	5,548	4,397
Pretax earnings	<b>\$100,342</b>	\$94,278	\$48,728
Income tax	<b>(27,306)</b>	(22,987)	(12,876)
<b>Net earnings</b>	<b>\$ 73,036</b>	\$71,291	\$35,852

Comprehensive earnings for 2004 were \$81.4 million, compared to \$97.7 million the prior year and only \$13.7 million in 2002. This was a consequence of unrealized gains on the investment portfolio being \$18.1 million lower in 2004 than those in 2003. Unrealized losses of \$22.2 million were recorded in 2002. We continue our commitment to a long-term investment strategy. We believe this will maximize value for shareholders in the future, as it has done historically.

## RLI Insurance Group

As indicated earlier, the hard marketplace conditions of 2002 have declined steadily during the last two years. This trend has affected all coverages to varying degrees. Some lines have declined significantly, particularly in our property business. The decline in property revenue, combined with the impact of four hurricanes in the third quarter, resulted in reduced profits for that segment. We believe that our ability to generate underwriting profit in our property segment despite softening marketplace conditions and unusual hurricane activity demonstrates our disciplined approach to risk selection and understanding of our marketplaces. Underwriting profits for both the surety and casualty segments improved. The following table and narrative provide a more detailed look at individual segment performance.

<b>Gross premiums written</b> (in thousands)	<b>2004</b>	2003	2002
Casualty	<b>\$519,817</b>	\$497,692	\$434,075
Property	<b>178,625</b>	193,359	210,310
Surety	<b>54,146</b>	51,426	63,068
<b>Total</b>	<b>\$752,588</b>	\$742,477	\$707,453
<b>Underwriting profits (losses)</b> (in thousands)	<b>2004</b>	2003	2002
Casualty	<b>\$ 19,560</b>	\$ 4,968	\$ (768)
Property	<b>20,400</b>	38,959	24,472
Surety	<b>(69)</b>	(6,590)	(8,096)
<b>Total</b>	<b>\$ 39,891</b>	\$ 37,337	\$ 15,608
<b>Combined ratio</b>	<b>2004</b>	2003	2002
Casualty	<b>94.7</b>	98.4	100.4
Property	<b>79.2</b>	63.8	72.6
Surety	<b>100.2</b>	114.2	116.0
<b>Total</b>	<b>92.2</b>	92.0	95.6

The following table further summarizes revenues (net premiums earned) by major coverage type within each segment:

(in thousands)	<b>2004</b>	2003	2002
<b>Casualty</b>			
General liability	<b>\$174,954</b>	\$131,896	\$ 75,906
Commercial and personal umbrella	<b>53,478</b>	42,842	33,796
Executive products	<b>13,074</b>	13,876	8,444
Specialty program business	<b>47,072</b>	50,840	28,458
Commercial transportation	<b>55,994</b>	50,566	44,199
Other	<b>21,045</b>	19,528	17,310
<b>Total</b>	<b>\$365,617</b>	\$309,548	\$208,113
<b>Property</b>			
Commercial property	<b>\$ 90,802</b>	\$100,579	\$ 82,231
Homeowners/residential property	<b>7,241</b>	7,099	6,997
<b>Total</b>	<b>\$ 98,043</b>	\$107,678	\$ 89,228
<b>Surety</b>	<b>\$ 47,688</b>	\$ 46,371	\$ 50,724
<b>Grand total</b>	<b>\$511,348</b>	\$463,597	\$348,065

Casualty gross premiums grew 4.4%, or \$22.1 million, after a 14.7% increase in 2003. This was the outcome from mixed results across coverages as increases in general liability, umbrella, and transportation were offset by declines in executive products and specialty program business. Even in the lines experiencing increases, the rate of growth slowed. Despite competitive pressures, we remained disciplined in writing only those accounts which we believe will provide adequate returns. This soft marketplace is likely to continue suppressing premium production growth in this segment in 2005.

The 94.7 combined ratio for the casualty segment was below 100.0 for the second consecutive year, compared to 98.4 in 2003 and 100.4 in 2002. The segment was consistently profitable throughout the year. In the fourth quarter, actuarial studies indicated that cumulative experience attributable to many casualty coverages for mature accident years was considerably lower than the reserves booked. Therefore, we released reserves totaling \$9.7 million. While we had been experiencing robust price improvements in this segment the last several years, we also produced significant new business with new exposures. Our reserving evaluation process requires adequate time periods to elapse to assess the impact of such changes in marketplace conditions on our book of casualty business.

Gross premiums written in the property segment fell 7.6% in 2004, marking the second consecutive year of declines. All coverages in the segment were either flat or down for each of the past two years reflecting a

more dramatic impact of the continued softening of this marketplace. Revenues had increased in 2003 on the strength of strong top line growth in 2002, but consecutive years of declines in gross premiums written set against some fixed catastrophe reinsurance costs caused 2004 revenues to diminish.

Underwriting profits for the property segment were \$20.4 million in 2004 with a 79.2 combined ratio. These results were affected by four hurricanes in the third quarter that cost us \$17.0 million pretax. Aside from the hurricanes, property segment profitability was comparable to 2003 in terms of underwriting income and combined ratio. Despite a decline in 2004, property revenue still exceeded the 2002 result, particularly in the most profitable coverages such as commercial earthquake and fire.

Surety gross premiums written increased \$2.7 million, or 5.3%, in 2004. This turnaround followed a decline in 2003 premiums of 18.5% as we re-underwrote our contract coverage following poor loss experience. While contract premiums were down again in 2004, all other coverages more than made up the difference. Total segment revenue followed suit as it declined in 2003 and recorded a slight increase of 2.8% in 2004.

The surety segment's combined ratio of 100.2 in 2004 was an important achievement after posting ratios in excess of 110 in each of the last two years. The results for 2003 and 2002 came as a consequence of poor experience on our contract bonds. Beginning in 2003 and continuing throughout 2004, we recorded a decline in the number of new contract surety claims. This, coupled with increased volume in profitable coverages, provided the basis for the 2004 turnaround.

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 for further discussion.

### Investment Income and Realized Investment Gains

During 2004, net investment income increased by 22.5%, due to continued operating cash flow and investment of the proceeds from our 2002 equity offering and 2003 debt offering. On an after-tax basis, investment income increased by 21.8%. Operating cash flows were \$189.0 million in 2004, down slightly from \$191.0 million

in 2003, but up from \$162.0 million in 2002. Cash flows in excess of current needs were primarily 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 2004, 2003 and 2002:

<b>Pretax yield</b>	<b>2004</b>	2003	2002
Taxable (on book value)	<b>4.92%</b>	5.11%	6.00%
Tax-exempt (on book value)	<b>4.10%</b>	4.41%	4.80%
Equities (on market value)	<b>3.26%</b>	3.10%	2.91%
<b>After-tax yield</b>	<b>2004</b>	2003	2002
Taxable (on book value)	<b>3.20%</b>	3.32%	3.90%
Tax-exempt (on book value)	<b>3.88%</b>	4.18%	4.55%
Equities (on market value)	<b>2.79%</b>	2.66%	2.49%

The after-tax yield reflects the different tax rates applicable to each category of investment. Our taxable bonds are subject to our corporate tax rate of 35.0%, our tax-exempt municipal bonds are subject to a tax rate of 5.3% and our dividend income is generally subject to a tax rate of 14.2%. During 2004, the average after-tax yield of the fixed income portfolio decreased 0.21% (3.47% vs. 3.68%) 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 operating cash flow and the investment of the proceeds from our December 2003 debt 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 \$153.3 million during the year. This portfolio had realized gains of \$0.3 million and a tax-adjusted total return on a mark-to-market basis of 4.7%. Our equity portfolio increased by \$39.9 million during 2004, to \$315.9 million. For the year, this portfolio had pretax appreciation of \$14.9 million and realized gains of \$12.8 million. The total return for the year on this portfolio was 13.1%.

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

(in thousands)	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>	Annualized Return on Avg. Invested Assets	Tax Equivalent Annualized Return on Avg. Invested Assets
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%
<b>2004</b>	<b>1,451,539</b>	<b>54,087</b>	<b>13,365</b>	<b>13,200</b>	<b>5.6%</b>	<b>6.3%</b>
5-yr Avg.	\$1,002,704	\$39,420	\$5,793	\$1,895	4.4%	5.2%

<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 recorded \$0.1 million in net investment income during 2004 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 \$1.7 million recognized in 2003 and \$1.8 million in 2002. These warrants relate to Taylor, Bean & Whitaker Mortgage Corp., a private mortgage lender. We employed 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. On October 11, 2004, we converted our warrants into common stock, bringing our total ownership to 21%. These common shares are accounted for as an investment in unconsolidated investees. For the period after conversion, the change in value of these shares of \$462,000 was recognized in the income statement as equity in earnings of unconsolidated investees, rather than as investment income.

We realized \$13.4 million in capital gains in 2004, compared to capital gains of \$12.1 million in 2003 and capital losses of \$3.6 million in 2002. 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. There were no losses associated with the other-than-temporary impairment of securities in 2004 or 2003. In 2002, our analysis identified \$6.5 million of such declines, which were recognized.

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, 2004, including market value, cost basis, and unrealized gains and losses.

(in thousands)	Cost Basis	12/31/04 Mkt Value	Gross Unrealized Gains	Unrealized Losses	Net	Unrealized Gain/Loss% <sup>(1)</sup>
Consumer discretionary	\$ 15,665	\$ 20,544	\$ 4,879	\$ -	\$ 4,879	31.1%
Consumer staples	17,922	39,149	21,227	-	21,227	118.4%
Energy	8,357	21,007	12,650	-	12,650	151.4%
Financials	32,311	67,131	34,820	-	34,820	107.8%
Healthcare	7,814	23,381	15,567	-	15,567	199.2%
Industrials	14,848	34,746	19,898	-	19,898	134.0%
Materials	12,641	20,024	7,422	(39)	7,383	58.4%
Information technology	10,785	14,722	3,988	(51)	3,937	36.5%
Telecommunications	8,935	15,126	6,191	-	6,191	69.3%
Utilities	40,201	60,045	19,844	-	19,844	49.4%
Total	\$169,479	\$315,875	\$146,486	\$(90)	\$146,396	86.4%

<sup>(1)</sup> Calculated as the percentage of net unrealized gain (loss) to cost basis

As of December 31, 2004, we held four common stocks that were in unrealized loss positions. The total unrealized loss on these securities was \$90,000. All of these securities have been in an unrealized loss position for less than six months.

The fixed income portfolio contained 136 positions at a loss as of December 31, 2004. Of these 136 securities, 19 have been in an unrealized loss position for more than 12 consecutive months and these collectively represent \$2.0 million in unrealized losses, or 0.2% of the fixed income portfolio's value. 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. 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, 2004, 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, 2004.

The amortized cost and estimated fair value of fixed-maturity securities at December 31, 2004, by contractual maturity, are shown as follows:

(in thousands)	Amortized Cost	Estimated Fair Value
<b>Total fixed income</b>		
Due in one year or less	\$ 16,212	\$ 16,416
Due after one year through five years	257,689	264,784
Due after five years through 10 years	517,117	533,417
Due after 10 years	370,175	372,564
Total	\$1,161,193	\$1,187,181

Expected maturities may differ from contractual maturities due to call provisions present on some existing securities. Management believes the impact of any calls should be slight and intends to follow its asset-liability management policy.

### Interest and General Corporate Expense

The 2004 rise in interest expense on debt was directly attributable to the issuance of \$100 million in 10-year maturity senior notes in December 2003. Substantially all of our other 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. 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 our capital. Additionally, director fees, travel and compensation rose in 2004 relative to 2003, due to increased activities and liability for directors resulting from Sarbanes-Oxley compliance.

### Income Taxes

Our effective tax rates were 27.2%, 24.4% and 26.4% for 2004, 2003 and 2002, respectively. The decline in 2003 was due to the tax benefit associated with the sale of an insurance shell. Effective rates are dependent upon components of pretax earnings and the related tax effects. Our pretax earnings in 2004 included \$25.2 million of investment income that is wholly or partially exempt from federal income tax, compared to \$21.5 million and \$17.2 million in 2003 and 2002, 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 2004, we recorded \$5.0 million in earnings from this investment, compared to nearly \$5.5 million in 2003 and \$4.4 in 2002. Also included in this caption were \$463,000 in earnings from our investment in Taylor, Bean, and Whitaker Mortgage Corp. During the fourth quarter of 2004, we converted warrants to common stock in this private mortgage origination company.

### Net Unpaid Losses and Settlement Expenses

The primary liability on our balance sheet relates to unpaid losses and settlement expenses, which represents our estimated liability for losses and related settlement expenses before considering offsetting reinsurance recoverable balances. This liability can be further deconstructed into two parts: (1) case reserves representing estimates of losses and settlement expenses on known claims and (2) IBNR — incurred but not reported — reserves representing estimates of losses and settlement expenses on claims that have occurred but have not yet been reported to us. Our gross liability for both case and IBNR reserves is reduced by reinsurance balances recoverable on unpaid losses and settlement expenses to calculate our net reserve balance. This net reserve balance increased from \$531.4 million at December 31, 2003 to \$668.4 million as of December 31, 2004. This reflects incurred loss of \$306.4 million in 2004 offset by paid losses of \$169.1 million, compared to incurred losses of \$279.0 million offset by \$139.5 million paid in 2003. As of December 31, 2004, our net IBNR reserves represented 61.1% of total net reserves while the remainder was for case reserves. As of December 31, 2003 IBNR net reserves represented 62.3% of total net reserves.

## Other Liabilities

We participate in a securities lending program where we exchange fixed income instruments for collateral from a borrower for temporary use. For use of the security, the borrower provides collateral to secure the promise to return the instrument. Generally, the collateral requirement is 102% of the value of the loaned securities to mitigate credit risk. As of December 31, 2004, fixed income securities with a fair value of \$42.0 million were on loan pursuant to the security lending program. A short-term investment asset and a corresponding other liability have been recognized for the cash collateral amount. No amounts were outstanding under our security lending program as of December 31, 2003.

## 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.

## 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. To give this the proper perspective, our short-term debt was \$46.8 million at the end of 2004 and \$47.6 million the prior year while operating cash flow has averaged \$180.7 million over the last three years. 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, 2004, our equity portfolio had a beta of 0.68 in comparison to the S&P 500. Our equity investment returns have been similar to the S&P 500 with much less volatility. 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.

## Sensitivity Analysis

The tables on pages 11-12 detail information on the market risk exposure for our financial investments as of December 31, 2004. Listed on each table is the December 31, 2004, 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. For example, our ability to hold non-trading securities to maturity mitigates fluctuation. 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, 2004, our fixed income portfolio had a market value of \$1.2 billion. The sensitivity analysis uses scenarios of interest rates increasing 100 and 200 basis points from their December 31, 2004, levels with all other variables held constant. Such scenarios would result in decreases in the market value of the fixed income portfolio of \$56.9 million and \$112.2 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 lower. Furthermore, while trading securities are subject to market-driven fluctuations in our financial statements, we still maintain the ability to hold these securities to maturity, thereby reducing our risk of having to realize a loss. As of December 31, 2003, our fixed income portfolio had a market value of \$1.0 billion. Given the same scenarios, the corresponding decreases in the market value of the fixed income portfolio as of the year-end 2003 were \$46.0 million and \$90.5 million, respectively. The potential decrease for 2004 is larger than for 2003, due to continuing purchases of fixed income investments during 2004.

As of December 31, 2004, our equity portfolio had a market value of \$315.9 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 \$21.5 million and \$43.0 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, 2003, our equity portfolio had a market value of \$276.0 million. Given the same scenarios, the market value decreases as of year-end 2003 were \$18.8 million and \$37.5 million, respectively. The change between years is attributable to the increase in the equity portfolio during 2004.

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, 2004, we had \$46.8 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 \$0.9 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, 2003, we had \$47.6 million of short-term debt outstanding. Because the amount of short-term debt outstanding at December 31, 2004, was lower than at the prior year end, the hypothetical impact of the stated scenarios would be decreased.

**Table 1** (in thousands)

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

	12/31/04 Market Value	Interest Rate Risk	Equity Risk
Held for trading purposes			
Fixed maturity securities	\$ 11,939	\$ (447)	\$ -
Total trading	11,939	(447)	-
Held for nontrading purposes			
Fixed maturity securities	1,175,242	(56,472)	-
Equity securities	315,875	-	(21,479)
Total nontrading	1,491,117	(56,472)	(21,479)
Total trading & nontrading	\$1,503,057	\$ (56,919)	\$(21,479)

**Table 2** (in thousands)

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

	12/31/04 Market Value	Interest Rate Risk	Equity Risk
Held for trading purposes			
Fixed maturity securities	\$ 11,939	\$ (876)	\$ -
Total trading	11,939	(876)	-
Held for nontrading purposes			
Fixed maturity securities	1,175,242	(111,337)	-
Equity securities	315,875	-	(42,958)
Total nontrading	1,491,117	(111,337)	(42,958)
Total trading & nontrading	\$1,503,057	\$(112,213)	\$(42,958)

**Table 3** (in thousands)

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

	12/31/04 Market Value	Interest Rate Risk	Equity Risk
Held for trading purposes			
Fixed maturity securities	\$ 11,939	\$ 444	\$ -
Total trading	11,939	444	-
Held for nontrading purposes			
Fixed maturity securities	1,175,242	54,685	-
Equity securities	315,875	-	21,479
Total nontrading	1,491,117	54,685	21,479
Total trading & nontrading	\$1,503,057	\$ 55,129	\$ 21,479

**Table 4** (in thousands)

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

	12/31/04 Market Value	Interest Rate Risk	Equity Risk
Held for trading purposes			
Fixed maturity securities	\$ 11,939	\$ 912	\$ –
Total trading	11,939	912	–
Held for nontrading purposes			
Fixed maturity securities	1,175,242	112,903	–
Equity securities	315,875	–	42,958
Total nontrading	1,491,117	112,903	42,958
Total trading & nontrading	\$1,503,057	\$113,815	\$42,958

## Liquidity and Capital Resources

### Overview

We have three primary types of cash flows: (1) operating cash flows, which consist mainly of cash generated by our underwriting operations and income earned on our investment portfolio; (2) investing cash flows related to the purchase, sale and maturity of investments; and (3) financing cash flows 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)	2004	2003	2002
Operating cash flows	\$ 188,962	\$ 191,019	\$ 161,971
Investing cash flows	(177,189)	(283,911)	(248,123)
Financing cash flows	(11,773)	92,892	86,152
	\$ –	\$ –	\$ –

Our balance sheet does not reflect any cash balance because all of our funds are invested in short-term investments; primarily highly rated money market funds.

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, 2004.

(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>					
Loss and settlement expense	\$1,132,599	\$365,919	\$416,475	\$175,091	\$175,114
Long-term debt	100,000	–	–	–	100,000
Short-term debt	46,839	46,839	–	–	–
Capital lease	744	324	420	–	–
Operating lease	11,602	2,154	3,780	2,781	2,887
Total	\$1,291,784	\$415,236	\$420,675	\$177,872	\$278,001

Loss and settlement expense reserves represent management's best estimate of the ultimate cost of settling reported and unreported claims and related expenses. As discussed previously, the estimation of loss and loss expense reserves is based on various complex and subjective judgments. Actual losses and settlement expenses paid may deviate, perhaps substantially, from the reserve estimates reflected in our financial statements. Similarly, the timing for payment of our estimated losses is not fixed and is not determinable on an individual or aggregate basis. The assumptions used in estimating the payments due by periods are based on our historical claims payment experience. Due to the uncertainty inherent in the process of estimating the timing of such payments, there is a risk that the amounts paid in any period can be significantly different than the amounts disclosed above. Amounts disclosed above are gross of anticipated amounts recoverable from reinsurers. Reinsurance balances recoverable on unpaid loss and settlement reserves are reported separately as assets, instead of being netted with the related liabilities, since reinsurance does not discharge us of our liability to policyholders. Amounts recoverable from reinsurers on unpaid loss and settlement reserves totaled \$464.2 million at December 31, 2004.

The next 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, 2004, we were party to seven reverse repurchase agreements (short-term debt) totaling \$46.8 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, 2004, we had short-term investments and other investments maturing within one year, of approximately \$92.4 million and additional investments of \$260.2 million maturing within five years. We maintain a \$40.0 million revolving line of credit with two financial institutions. The line of credit has a three-year term that expires on May 31, 2005. As of December 31, 2004, 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. We have generated positive operating cash flow for the last ten years. In the most recent three years ended December 31, 2004, 2003 and 2002 our operating cash flow was \$189.0 million, \$191.0 million, and \$162.0 million, respectively. The primary factor in our ability to generate positive operating cash flow is underwriting profitability. If we are not able to continue generating positive operating cash flow, we may have to sell investment securities, some of which might be sold at a loss.

### 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, taxes, 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 reinsurers, and collect cash back when losses subject to our reinsurance coverage are incurred.

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, both natural and man-made, such as earthquakes, hurricanes and terrorism. 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, 2004, our portfolio had a book value of \$1.6 billion. Invested assets at December 31, 2004, increased by \$236.4 million, or 18%, from December 31, 2003. Contributing to this increase was the investment of cash flows from operations.

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 our 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, 2004, 50.6% of our shareholders' equity was invested in common stocks, as compared to 49.8% at both December 31, 2003 and 2002.

We currently classify 13% 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 (86%)

or trading (1%) and are carried at fair market value. As of December 31, 2004, we maintained \$1.02 billion 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, a significant portion of available cash flow has been invested into fixed income investments. Our bond portfolio comprised 75.0% of our total 2004 portfolio, where it represented 76.8% of the total at December 31, 2003, and 72.5% of the total as of December 31, 2002. Our fixed income portfolio consists almost entirely of bonds rated investment grade by Standard & Poor's and Moody's. As of December 31, 2004, our fixed income portfolio contained 64.2% AAA/treasury/agency bonds, 14.8% AA-rated bonds, 15.1% A-rated bonds and 5.9% BBB-rated bonds.

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, 2004, our duration was 4.91 years. Our fixed income portfolio remained well diversified, with 649 individual issues as of December 31, 2004. During 2004, the total return on our bond portfolio on a tax-equivalent, mark-to-market basis was 4.7%.

In addition, at December 31, 2004, our equity portfolio had a value of \$315.9 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 with our bond portfolio, we maintain a well-diversified group of 106 equity securities. During 2004, the total return on our equity portfolio on a mark-to-market basis was 13.1%.

## 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, 2004, our capital structure consisted of \$100.0 million in 10-year maturity senior notes (long-term debt), \$46.8 million in reverse repurchase debt agreements (short-term debt), and \$623.7 million of shareholders' equity. Debt outstanding comprised 19% of total capital as of December 31, 2004.

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.

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 115th consecutive dividend payment was declared in the first quarter of 2005 and will be paid on April 15, 2005, in the amount of \$0.14 per share. Since the inception of cash dividends in 1976, we have increased our annual dividend every year.

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 2005 without prior approval is \$60.6 million. The actual amount paid in 2004 was \$19.6 million.

In July 1997, we implemented a 4.5 million-share common stock repurchase program. Although 560,000 shares remained authorized no repurchases have been made since 2001 and we are not currently pursuing any share repurchases.

## Outlook for 2005

The insurance marketplace, and in particular the excess and surplus segment, is subject to cycles involving alternating periods of price increases and decreases. Beginning in 2001, conditions in the insurance marketplace have been extremely favorable as evidenced by increasing pricing, favorable terms and conditions, and improved underwriting profitability. The years 2001 and 2002 represented the fastest growth rates in pricing and premiums in the current marketplace cycle. However, 2003 and 2004 have seen continued but decelerating growth rates. In 2005, the insurance marketplace is expected to continue to experience declining premium growth rates that were in evidence during 2004. Certainly, this will vary greatly between our various coverages, and we do expect to experience marginal organic growth in 2005. It is also generally predicted that favorable loss trends will drive combined ratios lower, absent any specific catastrophe. We believe we are well positioned to continue to deliver strong underwriting profit in our casualty segment. Absent catastrophes, the property segment is expected to generate healthy returns as well. Our surety segment is poised to deliver underwriting profit after three years of losses. Specific details regarding events in our business segments follow.

### Casualty

We expect generally stable premium volume in 2005, relative to 2004, as we will not pursue risks outside our required return guidelines for the sake of growth. We believe that pricing in the overall casualty insurance marketplace will remain generally stable, as companies continue sound underwriting practices in a low interest rate environment. There is, however, the risk that pricing will deteriorate if the level of capital in the industry continues to grow and if interest rates increase, allowing for investment returns to offset declines in some organizations' underwriting discipline. This outlook varies slightly by

coverage as we find competitive pressures across the board. We anticipate continued profitability in 2005 as a result of our ability to select quality risks. As volume levels off, some pressure to the expense ratio may occur without a significant impact on expected underwriting profit. Our 2004 underwriting results were positively influenced by a reduction in reserves related to prior years — a \$9.7 million pretax impact — that can not be expected to reoccur.

### Property

While this segment has experienced sharp declines in premiums the last two years, it is expected that the rate of decline will slow during 2005, leaving premiums flat to slightly down by comparison to 2004. Despite the 2004 hurricane impact, which depressed underwriting profits by \$17 million pretax, property loss experience has been exemplary over the last three years and it would be imprudent to expect considerable improvement.

### Surety

Having addressed the loss experience issues related to our contract surety coverage over the last three years, additional underwriting staff and improving marketplace conditions should contribute to some growth in 2005. It is further expected that the surety segment will make a return to profitability in 2005 after a break-even 2004, as corrective underwriting actions taken in the last two years prove effective.

### Investments

Within our investment portfolio, we expect to continue to increase investment income as the balance of our portfolio grows from operating and investing cash flow. Interest rates for bonds with maturities of greater than five years, where a majority of our fixed income portfolio is concentrated, have remained relatively stable in the last couple of years, although they are below the historical average. If interest rates increase, we will be able to invest our cash flow into higher-yielding investments which would improve investment income. However, rising interest rates will depress the value of our bond portfolio which will negatively impact comprehensive earnings and book value. Twenty percent of our portfolio is invested in common stocks. While we expect the dividend income on these stocks to remain stable, the value of this portfolio will be dictated by the performance of the general stock market, which is difficult to predict. We do not expect to make any significant changes to the risk profile of our investment portfolio in 2005.

## Accounting Standards

In December 2002, the Financial Accounting Standards Board (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 December 2004, the FASB revised Statement No. 123 (SFAS 123R), "Share-Based Payment," which requires companies to expense the estimated fair value of employee stock options and similar awards. The accounting provisions of SFAS 123R will be effective for interim periods beginning after June 15, 2005. We are in the process of determining how the new method of valuing stock-based compensation as prescribed in SFAS 123R will be applied to valuing stock-based awards granted, modified or vested after the effective date and the impact the recognition of compensation expense related to such awards will have on our financial statements.

In January 2003, the FASB issued FASB Interpretation No. 46 (FIN 46), "Consolidation of Variable Interest Entities." In December 2003, a revised interpretation of FIN 46 (FIN 46-R) was issued. FIN 46-R requires that certain variable interest entities be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. We do not currently have any investments in entities that we believe are variable interest entities for which we are the primary beneficiary.

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. We have no affected contracts.

In March 2004, the FASB issued Emerging Issues Task Force (EITF) Issue No. 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments" which provides new guidance for assessing impairment losses on debt and equity investments. Additionally, EITF Issue No. 03-1 includes new disclosure requirements for investments that are deemed to be temporarily impaired. In September 2004, the FASB delayed the accounting provisions of EITF Issue No. 03-1; however, the disclosure requirements remain effective and have been adopted for our year ended December 31, 2004. We will evaluate the effect, if any, of EITF 03-1 when final guidance is released.

In June 2004, the FASB issued EITF Issue No. 02-14, "Whether an Investor Should Apply the Equity Method of Accounting to Investments Other Than Common Stock." EITF Issue No. 02-14 addresses whether the equity method of accounting applies when an investor does not have an investment in voting common stock of an investee but exercises significant influence through other means. EITF Issue No. 02-14 states that an investor should only apply the equity method of accounting when it has investments in either common stock or in-substance common stock of a corporation, provided that the investor has the ability to exercise significant influence over the operating and financial policies of the investee. The accounting provisions of EITF Issue No. 02-14 are effective for the first quarter of fiscal 2005. We have determined that this will not impact us as we are not party to any such agreements.

## 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 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. Marketplace 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.

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, 2004, \$1.2 million 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 marketplace 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 marketplaces.

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 to determine the potential effect on our business and prepare for our legal compliance:

### **Broker Contingent Commission**

In 2004, the New York attorney general began an investigation into insurance broker activities connected with contingent commission agreements. The investigation led to lawsuits and prompted other attorneys general and state insurance departments to conduct further investigations. We have responded to all inquiries from state attorneys general and insurance departments. We also conducted an internal investigation of our contingent commission arrangements and related underwriting practices and found no improper actions. We have also established a corporate policy regarding the proper use and authorization of contingent commission agreements. The National Association of Insurance Commissioners (NAIC) has proposed a model act on these agreements for agents and brokers, and several states have indicated they will adopt the model act or some variation of the proposed act. We continue to closely monitor all proposals.

### **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 (ISO). The ISO endorsement included certain coverage limitations. Many states allowed the endorsements for commercial lines, but rejected such exclusions for personal exposures.

On November 26, 2002, the Terrorism Risk Insurance Act of 2002 (TRIA) 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. Under TRIA, coverage provided for losses caused by acts of terrorism is partially reimbursed by the United States under a formula whereby the government pays 90% of covered terrorism losses exceeding a prescribed deductible to the

insurance company providing the coverage. The deductible is calculated as 15% of gross earned premium net of a few excludable lines. Coverage under the act must be made available, with certain limited exceptions, in all commercial property and casualty policies. 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. 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. In 2004, the House Financial Services Committee approved an extension of TRIA to December 31, 2007. It is expected that Congress will vote on the extension in mid-2005, or the act will expire on December 31, 2005. We would support extension of TRIA.

### **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 this 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 act's related privacy requirements. During 2004, states continued to pass legislation on privacy notice measurements and sharing information between affiliates. We continue to monitor our procedures for compliance.

### **OFAC**

The treasury department's Office of Foreign Asset Control (OFAC) maintains a list of "Specifically Designated Nationals and Blocked Persons" (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. As required by Section 404 of the act and under the supervision from and participation of management, including executive management, we have completed an initial evaluation of our internal control system including all design, assessment, documentation, and testing phases. This evaluation produced improvements in documentation, access controls, and segregation of duties. We identified deficiencies and completed an evaluation, which resulted in the identification of no material weaknesses. We have also implemented a process to further investigate and, where necessary, remediate deficiencies.

The proliferation of changing laws, regulations and standards relating to corporate governance and public disclosure create uncertainty for public companies including ours. The lack of specificity in this area results in varying interpretations of practical application that hamper implementation efforts. The compliance effort regarding the Sarbanes-Oxley Act required significant involvement of managerial time as well as increased general and administrative costs in making our assessment of our internal controls over financial reporting and our external auditors' audit of that assessment. Incremental costs in 2004

associated with this effort totaled \$1.9 million. Virtually all of these costs will continue and could increase depending on evolving compliance issues. The continued promulgation of such laws, regulations, and standards poses a risk regarding the diversion of management resources from core revenue-generating activities.

### **Asbestos Litigation Reform**

Congress is contemplating a bill to require manufacturers and insurers to fund liabilities for asbestos exposure to provide for a remedy for all asbestos-related claims, pending and future. The proposal calls for funding in the amount of \$140 billion. The bill further provides that in the event the fund is exhausted, those individuals not fully compensated would be allowed to pursue claims through the court system. 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 us 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. We anticipate there will be further legislative activity during 2005.

---

## Corporate Compliance

We have a code of conduct, corporate governance guidelines, and compliance manual, which provide directors, officers and employees with guidance on complying with a variety of federal and state laws. Electronic versions of these documents, as well as the following documents, are available on our website (www.rlicorp.com): 2004 summary annual report; 2004 financial report; 2005 proxy statement; annual report to securities and exchange commission (form 10-K); and charters of the executive resources, audit, finance and investment, and nominating/corporate governance committees. Printed copies of these documents are available upon request without charge to any shareholder.

## 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 processing, premium accounting, file maintenance, financial/management reporting, reinsurance processing 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, “eRLI” and “RLINK”

in 2000 and “EFIDUCIARY” in 2002, and “Surety America” and “Underwriters Indemnity” in 2004 in the U.S. Patent and Trademark Office. Such registrations protect the marks nationwide from deceptively similar use. The duration of these registrations is ten 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.