

MERCURY GENERAL CORP

Form 10-Q

November 04, 2014

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

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FORM 10-Q

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QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF  
THE SECURITIES EXCHANGE ACT OF 1934

For the Quarter Ended September 30, 2014

Commission File No. 001-12257

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MERCURY GENERAL CORPORATION

(Exact name of registrant as specified in its charter)

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California

(State or other jurisdiction of  
incorporation or organization)

95-2211612

(I.R.S. Employer  
Identification No.)

4484 Wilshire Boulevard, Los Angeles, California

(Address of principal executive offices)

90010

(Zip Code)

Registrant's telephone number, including area code: (323) 937-1060

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Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark whether the Registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☒ No ☐

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ☒

Accelerated filer ☐

Non-accelerated filer ☐ (Do not check if a smaller reporting  
company)

Smaller reporting company ☐

Indicate by check mark whether the Registrant is a shell company (as defined in the Rule 12b-2 of the Exchange Act). Yes ☐ No ☒

At October 31, 2014, the Registrant had issued and outstanding an aggregate of 55,036,367 shares of its Common Stock.



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## PART I - FINANCIAL INFORMATION

## Item 1. Financial Statements

MERCURY GENERAL CORPORATION AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS  
(in thousands)

|                                                                        | September 30, 2014<br>(unaudited) | December 31, 2013 |
|------------------------------------------------------------------------|-----------------------------------|-------------------|
| <b>ASSETS</b>                                                          |                                   |                   |
| Investments, at fair value:                                            |                                   |                   |
| Fixed maturity securities (amortized cost \$2,509,057; \$2,523,042)    | \$2,619,867                       | \$2,560,653       |
| Equity securities (cost \$444,915; \$223,933)                          | 496,511                           | 281,883           |
| Short-term investments (cost \$291,646; \$315,886)                     | 291,325                           | 315,776           |
| Total investments                                                      | 3,407,703                         | 3,158,312         |
| Cash                                                                   | 279,681                           | 266,508           |
| Receivables:                                                           |                                   |                   |
| Premiums                                                               | 395,688                           | 366,075           |
| Accrued investment income                                              | 38,171                            | 36,120            |
| Other                                                                  | 22,212                            | 23,029            |
| Total receivables                                                      | 456,071                           | 425,224           |
| Deferred policy acquisition costs                                      | 201,438                           | 194,466           |
| Fixed assets, net                                                      | 160,134                           | 156,716           |
| Deferred income taxes                                                  | 0                                 | 15,220            |
| Goodwill                                                               | 42,796                            | 42,796            |
| Other intangible assets, net                                           | 37,118                            | 41,603            |
| Other assets                                                           | 24,065                            | 14,336            |
| Total assets                                                           | \$4,609,006                       | \$4,315,181       |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>                            |                                   |                   |
| Losses and loss adjustment expenses                                    | \$1,062,913                       | \$1,038,984       |
| Unearned premiums                                                      | 1,012,619                         | 953,527           |
| Notes payable                                                          | 290,000                           | 190,000           |
| Accounts payable and accrued expenses                                  | 141,897                           | 127,663           |
| Current income taxes                                                   | 7,792                             | 11,856            |
| Deferred income taxes                                                  | 5,306                             | 0                 |
| Other liabilities                                                      | 163,839                           | 170,665           |
| Total liabilities                                                      | 2,684,366                         | 2,492,695         |
| Commitments and contingencies                                          |                                   |                   |
| Shareholders' equity:                                                  |                                   |                   |
| Common stock without par value or stated value:                        |                                   |                   |
| Authorized 70,000 shares; issued and outstanding 55,021; 54,975        | 83,666                            | 81,591            |
| Additional paid-in capital                                             | 3,046                             | 411               |
| Retained earnings                                                      | 1,837,928                         | 1,740,484         |
| Total shareholders' equity                                             | 1,924,640                         | 1,822,486         |
| Total liabilities and shareholders' equity                             | \$4,609,006                       | \$4,315,181       |
| See accompanying Condensed Notes to Consolidated Financial Statements. |                                   |                   |



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CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

(unaudited)

|                                        | Three Months Ended September 30, |           |
|----------------------------------------|----------------------------------|-----------|
|                                        | 2014                             | 2013      |
| Revenues:                              |                                  |           |
| Net premiums earned                    | \$705,237                        | \$678,913 |
| Net investment income                  | 32,564                           | 30,857    |
| Net realized investment (losses) gains | (20,089                          | ) 16,212  |
| Other                                  | 2,275                            | 2,685     |
| Total revenues                         | 719,987                          | 728,667   |
| Expenses:                              |                                  |           |
| Losses and loss adjustment expenses    | 492,525                          | 492,558   |
| Policy acquisition costs               | 131,090                          | 126,891   |
| Other operating expenses               | 58,545                           | 54,087    |
| Interest                               | 707                              | 338       |
| Total expenses                         | 682,867                          | 673,874   |
| Income before income taxes             | 37,120                           | 54,793    |
| Income tax expense                     | 5,824                            | 15,223    |
| Net income                             | \$31,296                         | \$39,570  |
| Net income per share:                  |                                  |           |
| Basic                                  | \$0.57                           | \$0.72    |
| Diluted                                | \$0.57                           | \$0.72    |
| Weighted average shares outstanding:   |                                  |           |
| Basic                                  | 55,002                           | 54,959    |
| Diluted                                | 55,014                           | 54,973    |
| Dividends paid per share               | \$0.6150                         | \$0.6125  |

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in thousands)

(unaudited)

|                                                           | Three Months Ended September 30, |          |
|-----------------------------------------------------------|----------------------------------|----------|
|                                                           | 2014                             | 2013     |
| Net income                                                | \$31,296                         | \$39,570 |
| Other comprehensive income, before tax:                   |                                  |          |
| Gains on hedging instrument                               | 0                                | 0        |
| Other comprehensive income, before tax:                   | 0                                | 0        |
| Income tax expense related to gains on hedging instrument | 0                                | 0        |
| Other comprehensive income, net of tax:                   | 0                                | 0        |
| Comprehensive income                                      | \$31,296                         | \$39,570 |

See accompanying Condensed Notes to Consolidated Financial Statements.

Table of ContentsMERCURY GENERAL CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

(unaudited)

|                                        | Nine Months Ended September 30, |             |
|----------------------------------------|---------------------------------|-------------|
|                                        | 2014                            | 2013        |
| Revenues:                              |                                 |             |
| Net premiums earned                    | \$2,086,827                     | \$2,017,295 |
| Net investment income                  | 93,656                          | 93,706      |
| Net realized investment gains (losses) | 102,813                         | (7,153)     |
| Other                                  | 6,666                           | 7,539       |
| Total revenues                         | 2,289,962                       | 2,111,387   |
| Expenses:                              |                                 |             |
| Losses and loss adjustment expenses    | 1,452,171                       | 1,446,524   |
| Policy acquisition costs               | 393,964                         | 377,006     |
| Other operating expenses               | 166,341                         | 166,165     |
| Interest                               | 1,900                           | 864         |
| Total expenses                         | 2,014,376                       | 1,990,559   |
| Income before income taxes             | 275,586                         | 120,828     |
| Income tax expense                     | 76,681                          | 24,061      |
| Net income                             | \$198,905                       | \$96,767    |
| Net income per share:                  |                                 |             |
| Basic                                  | \$3.62                          | \$1.76      |
| Diluted                                | \$3.62                          | \$1.76      |
| Weighted average shares outstanding:   |                                 |             |
| Basic                                  | 54,986                          | 54,941      |
| Diluted                                | 54,995                          | 54,957      |
| Dividends paid per share               | \$1.8450                        | \$1.8375    |

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in thousands)

(unaudited)

|                                                           | Nine Months Ended September 30, |          |
|-----------------------------------------------------------|---------------------------------|----------|
|                                                           | 2014                            | 2013     |
| Net income                                                | \$198,905                       | \$96,767 |
| Other comprehensive income, before tax:                   |                                 |          |
| Gains on hedging instrument                               | 0                               | 0        |
| Other comprehensive income, before tax:                   | 0                               | 0        |
| Income tax expense related to gains on hedging instrument | 0                               | 0        |
| Other comprehensive income, net of tax:                   | 0                               | 0        |
| Comprehensive income                                      | \$198,905                       | \$96,767 |

See accompanying Condensed Notes to Consolidated Financial Statements.

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**MERCURY GENERAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

(in thousands)

(unaudited)

|                                                                                   | Nine Months Ended September 30, |            |   |
|-----------------------------------------------------------------------------------|---------------------------------|------------|---|
|                                                                                   | 2014                            | 2013       |   |
| CASH FLOWS FROM OPERATING ACTIVITIES                                              |                                 |            |   |
| Net income                                                                        | \$ 198,905                      | \$ 96,767  |   |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                 |            |   |
| Depreciation and amortization                                                     | 20,145                          | 23,715     |   |
| Net realized investment (gains) losses                                            | (102,813                        | ) 7,153    |   |
| Bond amortization, net                                                            | 14,650                          | 8,659      |   |
| Excess tax benefit from exercise of stock options                                 | (169                            | ) (258     | ) |
| Increase in premiums receivables                                                  | (29,613                         | ) (27,431  | ) |
| Change in current and deferred income taxes                                       | 16,632                          | 6,758      |   |
| Increase in deferred policy acquisition costs                                     | (6,972                          | ) (10,374  | ) |
| Increase (decrease) in unpaid losses and loss adjustment expenses                 | 23,929                          | (25,589    | ) |
| Increase in unearned premiums                                                     | 59,092                          | 46,891     |   |
| Increase in accounts payable and accrued expenses                                 | 15,968                          | 38,749     |   |
| Share-based compensation                                                          | 2,741                           | 216        |   |
| Changes in other payables                                                         | (14,643                         | ) 9,142    |   |
| Other, net                                                                        | 1,645                           | (4,681     | ) |
| Net cash provided by operating activities                                         | 199,497                         | 169,717    |   |
| CASH FLOWS FROM INVESTING ACTIVITIES                                              |                                 |            |   |
| Fixed maturities available-for-sale in nature:                                    |                                 |            |   |
| Purchases                                                                         | (393,208                        | ) (625,326 | ) |
| Sales                                                                             | 175,919                         | 172,557    |   |
| Calls or maturities                                                               | 213,865                         | 232,426    |   |
| Equity securities available-for-sale in nature:                                   |                                 |            |   |
| Purchases                                                                         | (706,461                        | ) (463,056 | ) |
| Sales                                                                             | 522,662                         | 677,017    |   |
| Changes in securities payable and receivable                                      | (5,622                          | ) (43,918  | ) |
| Net decrease in short-term investments and purchased options                      | 23,788                          | 42,614     |   |
| Purchase of fixed assets                                                          | (20,880                         | ) (12,983  | ) |
| Sale of fixed assets                                                              | 209                             | 610        |   |
| Other, net                                                                        | 2,896                           | 1,547      |   |
| Net cash used in investing activities                                             | (186,832                        | ) (18,512  | ) |
| CASH FLOWS FROM FINANCING ACTIVITIES                                              |                                 |            |   |
| Dividends paid to shareholders                                                    | (101,461                        | ) (100,967 | ) |
| Excess tax benefit from exercise of stock options                                 | 169                             | 258        |   |
| Proceeds from stock options exercised                                             | 1,800                           | 1,382      |   |
| Proceeds from bank loan                                                           | 100,000                         | 40,000     |   |
| Net cash provided by (used in) financing activities                               | 508                             | (59,327    | ) |
| Net increase in cash                                                              | 13,173                          | 91,878     |   |
| Cash:                                                                             |                                 |            |   |
| Beginning of the year                                                             | 266,508                         | 158,183    |   |
| End of period                                                                     | \$ 279,681                      | \$ 250,061 |   |
| SUPPLEMENTAL CASH FLOW DISCLOSURE                                                 |                                 |            |   |



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|                   |          |          |
|-------------------|----------|----------|
| Interest paid     | \$1,840  | \$796    |
| Income taxes paid | \$60,049 | \$17,303 |

See accompanying Condensed Notes to Consolidated Financial Statements.

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MERCURY GENERAL CORPORATION AND SUBSIDIARIES  
CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(unaudited)

1. General

Consolidation and Basis of Presentation

The condensed consolidated financial statements include the accounts of Mercury General Corporation and its subsidiaries (referred to herein collectively as the “Company”). For the list of the Company’s subsidiaries, see Note 1 “Summary of Significant Accounting Policies” of the Notes to Consolidated Financial Statements in the Company’s Annual Report on Form 10-K for the year ended December 31, 2013.

The condensed consolidated financial statements have been prepared in conformity with U.S. generally accepted accounting principles (“GAAP”), which differ in some respects from those filed in reports to insurance regulatory authorities. All intercompany transactions and balances have been eliminated.

The financial data of the Company included herein are unaudited. In the opinion of management, all material adjustments of a normal recurring nature have been made to present fairly the Company’s financial position at September 30, 2014 and the results of operations, comprehensive income, and cash flows for the periods presented. These statements were prepared in accordance with the instructions for interim reporting and do not contain certain information that was included in the annual financial statements included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2013. Readers are urged to review the Company’s Annual Report on Form 10-K for the year ended December 31, 2013 for more complete descriptions and discussions. Operating results and cash flows for the nine months ended September 30, 2014 are not necessarily indicative of the results that may be expected for the year ending December 31, 2014.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosures of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. These estimates require the Company to apply complex assumptions and judgments, and often the Company must make estimates about effects of matters that are inherently uncertain and will likely change in subsequent periods. The most significant assumptions in the preparation of these condensed consolidated financial statements relate to reserves for losses and loss adjustment expenses. Actual results could differ from those estimates (See Note 1 “Summary of Significant Accounting Policies” of the Notes to Consolidated Financial Statements in the Company’s Annual Report on Form 10-K for the year ended December 31, 2013).

Earnings per Share

Potentially dilutive securities representing approximately 18,000 and 53,000 shares of common stock for the three months ended September 30, 2014 and 2013, respectively, and 31,000 and 76,000 shares of common stock for the nine months ended September 30, 2014 and 2013, respectively, were excluded from the computation of diluted earnings per common share for these periods because their effect would have been anti-dilutive.

Deferred Policy Acquisition Costs

Deferred policy acquisition costs consist of commissions paid to outside agents, premium taxes, salaries, and certain other underwriting costs that are incremental or directly related to the successful acquisition of new and renewal insurance contracts and are amortized over the life of the related policy in proportion to premiums earned. Deferred policy acquisition costs are limited to the amount that will remain after deducting from unearned premiums and anticipated investment income, the estimated losses and loss adjustment expenses, and the servicing costs that will be incurred as premiums are earned. The Company’s deferred policy acquisition costs are further limited by excluding those costs not directly related to the successful acquisition of insurance contracts. Deferred policy acquisition cost amortization was \$131.1 million and \$126.9 million for the three months ended September 30, 2014 and 2013, respectively, and \$394.0 million and \$377.0 million for the nine months ended September 30, 2014 and 2013, respectively. The Company does not defer advertising expenditures but expenses them as incurred. The Company recorded net advertising expenses of approximately \$17 million and \$16 million for the nine months ended September 30, 2014 and 2013, respectively.

Total Return Swap

During the first quarter of 2014, the Company formed and consolidated a special purpose investment vehicle, Fannette Funding LLC (“FFL”). The Company is the sole managing member of FFL. On February 13, 2014, FFL entered into a three-year

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total return swap agreement with Citibank, N.A. ("Citibank"). Under the total return swap agreement, FFL receives the income equivalent on underlying obligations due to Citibank and pays to Citibank interest equal to LIBOR plus 140 basis points on the outstanding notional amount of the underlying obligations, which was approximately \$113 million as of September 30, 2014. The total return swap agreement is secured by approximately \$30 million of U.S. Treasuries as collateral, which are included in short-term investments on the consolidated balance sheets. In the event of significant erosion in market value, FFL's position in the loan portfolio will be reduced and the Company has the option to add additional capital or terminate the total return swap agreement.

## 2. Recently Issued Accounting Standards

In May 2014, the Financial Accounting Standards Board ("FASB") issued a new standard that requires entities to apply a five-step model to determine the amount and timing of revenue recognition. The model specifies, among other criteria, that revenue should be recognized when an entity transfers control of goods or services to a customer at the amount at which the entity expects to be entitled. The new standard will be effective for fiscal years and interim periods within those years that begin after December 15, 2016. Early adoption is not permitted. The adoption of the new standard is not expected to have a material impact on the Company's consolidated financial statements.

In July 2013, the FASB issued a new standard that requires entities to present an unrecognized tax benefit as a reduction of a deferred tax asset for a net operating loss carryforward, or similar tax loss or tax credit carryforward, rather than as a liability when the uncertain tax position would reduce the net operating loss or other carryforward under the tax law of the applicable jurisdiction and when the entity intends to use the deferred tax asset for that purpose. The Company adopted the new standard which became effective for the interim period ended March 31, 2014. The adoption of the new standard did not have a material impact on the Company's consolidated financial statements.

## 3. Fair Value of Financial Instruments

The financial instruments recorded in the consolidated balance sheets include investments, receivables, total return swaps, accounts payable, equity contracts, and secured and unsecured notes payable. Due to their short-term maturity, the carrying values of receivables and accounts payable approximate their fair market values. The following table presents the estimated fair values of financial instruments at September 30, 2014 and December 31, 2013.

|                    | September 30, 2014     | December 31, 2013 |
|--------------------|------------------------|-------------------|
|                    | (Amounts in thousands) |                   |
| Assets             |                        |                   |
| Investments        | \$3,407,703            | \$3,158,312       |
| Total return swaps | \$—                    | \$1,650           |
| Liabilities        |                        |                   |
| Equity contracts   | \$348                  | \$140             |
| Total return swaps | \$1,287                | \$—               |
| Secured notes      | \$140,000              | \$140,000         |
| Unsecured note     | \$150,000              | \$50,000          |

Methods and assumptions used in estimating fair values are as follows:

### Investments

The Company applies the fair value option to all fixed maturity and equity securities and short-term investments at the time an eligible item is first recognized. The cost of investments sold is determined on a first-in and first-out method and realized gains and losses are included in net realized investment (losses) gains. For additional disclosures regarding methods and assumptions used in estimating fair values of these securities, see Note 5.

### Total return swaps

The fair values of the total return swaps reflect the estimated amounts that, upon termination of the contracts, would be received for selling an asset or paid to transfer a liability in an orderly transaction at September 30, 2014 and December 31, 2013 based on models using inputs, such as interest rate yield curves and credit spreads, observable for substantially the full term of the contract. For additional disclosures regarding methods and assumptions used in

estimating fair values, see Note 5.

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## Equity contracts

The fair value of equity contracts is based on quoted prices for identical instruments in active markets. For additional disclosures regarding methods and assumptions used in estimating fair values of equity contracts, see Note 5.

## Secured notes payable

The fair value of the Company's \$120 million secured note and \$20 million secured note, classified as Level 2 in the fair value hierarchy described in Note 5, is estimated based on assumptions and inputs, such as the market value of underlying collateral and reset rates, for similarly termed notes that are observable in the market.

## Unsecured note payable

The fair value of the Company's \$150 million unsecured note, classified as Level 2 in the fair value hierarchy described in Note 5, is based on the unadjusted quoted price for similar notes in active markets.

## 4. Fair Value Option

Gains and losses due to changes in fair value for items measured at fair value pursuant to application of the fair value option are included in net realized investment (losses) gains in the Company's consolidated statements of operations, while interest and dividend income on investment holdings are recognized on an accrual basis on each measurement date and are included in net investment income in the Company's consolidated statements of operations. The primary reasons for electing the fair value option were simplification and cost-benefit considerations as well as the expansion of the use of the Company's fair value measurement consistent with the long-term measurement objectives of the FASB for accounting for financial instruments.

The following table presents gains (losses) due to changes in fair value of investments that are measured at fair value pursuant to application of the fair value option:

|                           | Three Months Ended September<br>30,<br>2014 |             | Nine Months Ended September<br>30,<br>2014 |             |
|---------------------------|---------------------------------------------|-------------|--------------------------------------------|-------------|
|                           | 2013                                        |             | 2013                                       |             |
|                           | (Amounts in thousands)                      |             |                                            |             |
| Fixed maturity securities | \$3,536                                     | \$(11,295 ) | \$73,149                                   | \$(81,268 ) |
| Equity securities         | (23,995 )                                   | 32,602      | (6,355 )                                   | 67,625      |
| Short-term investments    | (69 )                                       | 508         | (211 )                                     | 199         |
| Total                     | \$(20,528 )                                 | \$21,815    | \$66,583                                   | \$(13,444 ) |

## 5. Fair Value Measurement

The Company employs a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The fair value of a financial instrument is the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date using the exit price.

Accordingly, when market observable data are not readily available, the Company's own assumptions are used to reflect those that market participants would be presumed to use in pricing the asset or liability at the measurement date. Assets and liabilities recorded on the consolidated balance sheets at fair value are categorized based on the level of judgment associated with inputs used to measure their fair value and the level of market price observability, as follows:

Level 1 Unadjusted quoted prices are available in active markets for identical assets or liabilities as of the reporting date.

Pricing inputs are other than quoted prices in active markets, which are based on the following:

- Quoted prices for similar assets or liabilities in active markets;

Level 2

- Quoted prices for identical or similar assets or liabilities in non-active markets; or

- Either directly or indirectly observable inputs as of the reporting date.

Level 3

Pricing inputs are unobservable and significant to the overall fair value measurement, and the determination of fair value requires significant management judgment or estimation.

In certain cases, inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, the level in the fair value hierarchy within which the fair value measurement in its entirety falls has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. Thus, a Level 3 fair value measurement may include inputs that are observable (Level 1 or Level 2) and unobservable (Level 3). The Company's assessment of the significance

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of a particular input to the fair value measurement in its entirety requires judgment and consideration of factors specific to the asset or liability.

The Company uses prices and inputs that are current as of the measurement date, including during periods of market disruption. In periods of market disruption, the ability to observe prices and inputs may be reduced for many instruments. This condition could cause an instrument to be reclassified from Level 1 to Level 2, or from Level 2 to Level 3. The Company recognizes transfers between levels at either the actual date of the event or a change in circumstances that caused the transfer.

Summary of Significant Valuation Techniques for Financial Assets and Financial Liabilities

The Company's fair value measurements are based on the market approach, which utilizes market transaction data for the same or similar instruments.

The Company obtained unadjusted fair values on 99.6% of its portfolio from an independent pricing service. For 0.4% of its portfolio, classified as Level 3, the Company obtained specific unadjusted broker quotes based on net fund value and, to a lesser extent, unobservable inputs from at least one knowledgeable outside security broker to determine the fair value as of September 30, 2014.

Level 1 Measurements - Fair values of financial assets and financial liabilities are obtained from an independent pricing service, and are based on unadjusted quoted prices for identical assets or liabilities in active markets. Additional pricing services and closing exchange values are used as a comparison to ensure that reasonable fair values are used in pricing the investment portfolio.

U.S. government bonds and agencies/Short-term bonds: Valued using unadjusted quoted market prices for identical assets in active markets.

Common stock: Comprised of actively traded, exchange listed U.S. and international equity securities and valued based on unadjusted quoted prices for identical assets in active markets.

Money market instruments: Valued based on unadjusted quoted prices for identical assets.

Equity contracts: Comprised of free-standing exchange listed derivatives that are actively traded and valued based on quoted prices for identical instruments in active markets.

Level 2 Measurements - Fair values of financial assets and financial liabilities are obtained from an independent pricing service or outside brokers, and are based on prices for similar assets or liabilities in active markets or valuation models whose inputs are observable, directly or indirectly, for substantially the full term of the asset or liability. Additional pricing services are used as a comparison to ensure reliable fair values are used in pricing the investment portfolio.

Municipal securities: Valued based on models or matrices using inputs such as quoted prices for identical or similar assets in active markets.

Mortgage-backed securities: Comprised of securities that are collateralized by mortgage loans and valued based on models or matrices using multiple observable inputs, such as benchmark yields, reported trades and broker/dealer quotes, for identical or similar assets in active markets. The Company had holdings of \$22.0 million and \$21.9 million at September 30, 2014 and December 31, 2013, respectively, in commercial mortgage-backed securities.

Corporate securities/Short-term bonds: Valued based on a multi-dimensional model using multiple observable inputs, such as benchmark yields, reported trades, broker/dealer quotes and issue spreads, for identical or similar assets in active markets.

Non-redeemable preferred stock: Valued based on observable inputs, such as underlying and common stock of same issuer and appropriate spread over a comparable U.S. Treasury security, for identical or similar assets in active markets.

Total return swaps: Valued based on models using inputs such as interest rate yield curves, underlying debt/credit instruments and the appropriate benchmark spread for similar assets in active markets, observable for substantially the full term of the contract.

Level 3 Measurements - Fair values of financial assets are based on inputs that are both unobservable and significant to the overall fair value measurement, including any items in which the evaluated prices obtained elsewhere were deemed to be of a distressed trading level.



Collateralized debt obligations/Partnership interest in a private credit fund: Valued based on underlying debt/credit instruments and the appropriate benchmark spread for similar assets in active markets; taking into consideration unobservable inputs related to liquidity assumptions.

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The Company's financial instruments at fair value are reflected in the consolidated balance sheets on a trade-date basis. Related unrealized gains or losses are recognized in net realized investment (losses) gains in the consolidated statements of operations. Fair value measurements are not adjusted for transaction costs.

The following tables present information about the Company's assets and liabilities measured at fair value on a recurring basis as of September 30, 2014 and December 31, 2013, and indicate the fair value hierarchy of the valuation techniques utilized by the Company to determine such fair value:

|                                               | September 30, 2014     |              |           |              |
|-----------------------------------------------|------------------------|--------------|-----------|--------------|
|                                               | Level 1                | Level 2      | Level 3   | Total        |
|                                               | (Amounts in thousands) |              |           |              |
| Assets                                        |                        |              |           |              |
| Fixed maturity securities:                    |                        |              |           |              |
| U.S. government bonds and agencies            | \$ 16,116              | \$ 0         | \$ 0      | \$ 16,116    |
| Municipal securities                          | 0                      | 2,280,217    | 0         | 2,280,217    |
| Mortgage-backed securities                    | 0                      | 38,156       | 0         | 38,156       |
| Corporate securities                          | 0                      | 285,378      | 0         | 285,378      |
| Equity securities:                            |                        |              |           |              |
| Common stock:                                 |                        |              |           |              |
| Public utilities                              | 129,325                | 0            | 0         | 129,325      |
| Banks, trusts and insurance companies         | 8,566                  | 0            | 0         | 8,566        |
| Energy and other                              | 316,472                | 0            | 0         | 316,472      |
| Non-redeemable preferred stock                | 0                      | 29,478       | 0         | 29,478       |
| Partnership interest in a private credit fund | 0                      | 0            | 12,670    | 12,670       |
| Short-term bonds                              | 69,994                 | 18,679       | 0         | 88,673       |
| Money market instruments                      | 202,652                | 0            | 0         | 202,652      |
| Total assets at fair value                    | \$ 743,125             | \$ 2,651,908 | \$ 12,670 | \$ 3,407,703 |
| Liabilities                                   |                        |              |           |              |
| Equity contracts                              | \$ 348                 | \$ 0         | \$ 0      | \$ 348       |
| Total return swaps                            | 0                      | 1,287        | 0         | 1,287        |
| Total liabilities at fair value               | \$ 348                 | \$ 1,287     | \$ 0      | \$ 1,635     |

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|                                               | December 31, 2013      |             |          |             |
|-----------------------------------------------|------------------------|-------------|----------|-------------|
|                                               | Level 1                | Level 2     | Level 3  | Total       |
|                                               | (Amounts in thousands) |             |          |             |
| Assets                                        |                        |             |          |             |
| Fixed maturity securities:                    |                        |             |          |             |
| U.S. government bonds and agencies            | \$ 16,096              | \$ 0        | \$ 0     | \$ 16,096   |
| Municipal securities                          | 0                      | 2,235,323   | 0        | 2,235,323   |
| Mortgage-backed securities                    | 0                      | 40,247      | 0        | 40,247      |
| Corporate securities                          | 0                      | 264,685     | 0        | 264,685     |
| Collateralized debt obligations               | 0                      | 0           | 4,302    | 4,302       |
| Equity securities:                            |                        |             |          |             |
| Common stock:                                 |                        |             |          |             |
| Public utilities                              | 85,287                 | 0           | 0        | 85,287      |
| Banks, trusts and insurance companies         | 2,927                  | 0           | 0        | 2,927       |
| Energy and other                              | 151,554                | 0           | 0        | 151,554     |
| Non-redeemable preferred stock                | 0                      | 29,567      | 0        | 29,567      |
| Partnership interest in a private credit fund | 0                      | 0           | 12,548   | 12,548      |
| Short-term bonds                              | 39,998                 | 12,890      | 0        | 52,888      |
| Money market instruments                      | 262,888                | 0           | 0        | 262,888     |
| Total return swap                             | 0                      | 1,650       | 0        | 1,650       |
| Total assets at fair value                    | \$558,750              | \$2,584,362 | \$16,850 | \$3,159,962 |
| Liabilities                                   |                        |             |          |             |
| Equity contracts                              | \$ 140                 | \$ 0        | \$ 0     | \$ 140      |
| Total liabilities at fair value               | \$ 140                 | \$ 0        | \$ 0     | \$ 140      |

The following tables present a summary of changes in fair value of Level 3 financial assets and financial liabilities held at fair value.

|                                                                                                                          | Three Months Ended September 30, |                | 2013             |                |
|--------------------------------------------------------------------------------------------------------------------------|----------------------------------|----------------|------------------|----------------|
|                                                                                                                          | 2014                             |                |                  |                |
|                                                                                                                          | Collateralized                   | Partnership    | Collateralized   | Partnership    |
|                                                                                                                          | Debt Obligations                 | Interest in a  | Debt Obligations | Interest in a  |
|                                                                                                                          |                                  | Private Credit |                  | Private Credit |
|                                                                                                                          |                                  | Fund           |                  | Fund           |
|                                                                                                                          | (Amounts in thousands)           |                |                  |                |
| Beginning Balance                                                                                                        | \$0                              | \$12,966       | \$38,992         | \$11,990       |
| Realized (losses) gains included in earnings                                                                             | 0                                | (296           | ) 5,616          | 134            |
| Settlements                                                                                                              | 0                                | 0              | (8,264           | ) 0            |
| Ending Balance                                                                                                           | \$0                              | \$12,670       | \$36,344         | \$12,124       |
| The amount of total (losses) gains for the period included in earnings attributable to assets still held at September 30 | \$0                              | \$(296         | ) \$5,616        | \$134          |

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|                                                                                                                 | Nine Months Ended September 30,<br>2014 |                                                        | 2013                               |                                                        |
|-----------------------------------------------------------------------------------------------------------------|-----------------------------------------|--------------------------------------------------------|------------------------------------|--------------------------------------------------------|
|                                                                                                                 | Collateralized<br>Debt Obligations      | Partnership<br>Interest in a<br>Private Credit<br>Fund | Collateralized<br>Debt Obligations | Partnership<br>Interest in a<br>Private Credit<br>Fund |
|                                                                                                                 | (Amounts in thousands)                  |                                                        |                                    |                                                        |
| Beginning Balance                                                                                               | \$4,302                                 | \$12,548                                               | \$42,801                           | \$11,306                                               |
| Realized (losses) gains included in earnings                                                                    | (755)                                   | ) 122                                                  | 5,993                              | 818                                                    |
| Sales                                                                                                           | (3,547)                                 | ) 0                                                    | (4,186)                            | ) 0                                                    |
| Settlements                                                                                                     | 0                                       | 0                                                      | (8,264)                            | ) 0                                                    |
| Ending Balance                                                                                                  | \$0                                     | \$12,670                                               | \$36,344                           | \$12,124                                               |
| The amount of total gains for the period included in earnings attributable to assets still held at September 30 | \$0                                     | \$122                                                  | \$6,510                            | \$818                                                  |

There were no transfers between Levels 1, 2, and 3 of the fair value hierarchy during the nine months ended September 30, 2014 and 2013.

At September 30, 2014, the Company did not have any nonrecurring fair value measurements of nonfinancial assets or nonfinancial liabilities.

#### 6. Derivative Financial Instruments

The Company is exposed to certain risks relating to its ongoing business operations. The primary risks managed by using derivative instruments are equity price risk and interest rate risk. Equity contracts on various equity securities are intended to manage the price risk associated with forecasted purchases or sales of such securities. Interest rate swaps are intended to manage the interest rate risk associated with the Company's debts with fixed or floating rates. On March 3, 2008, the Company entered into an interest rate swap of its floating LIBOR rate on a Bank of America \$18 million LIBOR plus 50 basis points loan for a fixed rate of 4.25% that matured on March 1, 2013. On October 4, 2011, the Company refinanced the \$18 million loan that was scheduled to mature on March 1, 2013 with a Union Bank \$20 million LIBOR plus 40 basis points loan that matures on January 2, 2015. The related swap expired on March 1, 2013.

The Company also enters into derivative contracts to enhance returns on its investment portfolio.

On February 13, 2014, FFL entered into a three-year total return swap agreement with Citibank. Under the total return swap agreement, FFL receives the income equivalent on underlying obligations due to Citibank and pays to Citibank interest equal to LIBOR plus 140 basis points on the outstanding notional amount of the underlying obligations, which was approximately \$113 million as of September 30, 2014. The total return swap is secured by approximately \$30 million of U.S. Treasuries as collateral, which are included in short-term investments on the consolidated balance sheets.

On August 9, 2013, Animas Funding LLC ("AFL"), a special purpose investment vehicle, entered into a three-year total return swap agreement with Citibank. Under the total return swap agreement, AFL receives the income equivalent on underlying obligations due to Citibank and pays to Citibank interest equal to LIBOR plus 120 basis points on the outstanding notional amount of the underlying obligations, which was approximately \$148 million as of September 30, 2014. The total return swap is secured by approximately \$40 million of U.S. Treasuries as collateral, which are included in short-term investments on the consolidated balance sheets.

Fair value amounts, and gains and losses on derivative instruments

The following tables present the location and amounts of derivative fair values in the consolidated balance sheets and derivative gains in the consolidated statements of operations:



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|                                                 | Asset Derivatives     |                      | Liability Derivatives |                      |
|-------------------------------------------------|-----------------------|----------------------|-----------------------|----------------------|
|                                                 | September 30,<br>2014 | December 31,<br>2013 | September 30,<br>2014 | December 31,<br>2013 |
|                                                 | (Amount in thousands) |                      |                       |                      |
| Total return swaps - Other assets (liabilities) | \$0                   | \$1,650              | \$(1,287              | ) \$0                |
| Equity contracts - Other liabilities            | 0                     | 0                    | (348                  | ) (140               |
| Total derivatives                               | \$0                   | \$1,650              | \$(1,635              | ) \$(140             |

|                                                             | (Loss) Gain Recognized in Income |         |                             |         |
|-------------------------------------------------------------|----------------------------------|---------|-----------------------------|---------|
|                                                             | Three Months Ended               |         | Nine Months Ended September |         |
|                                                             | September 30,<br>2014            | 2013    | 30,<br>2014                 | 2013    |
|                                                             | (Amounts in thousands)           |         |                             |         |
| Total return swaps - Net realized investment (losses) gains | \$(3,090                         | ) \$381 | \$(482                      | ) \$381 |
| Equity contracts - Net realized investment (losses) gains   | 1,627                            | 543     | 2,681                       | 1,722   |
| Interest rate swap - Other revenue                          | 0                                | 0       | 0                           | 103     |
| Total                                                       | \$(1,463                         | ) \$924 | \$2,199                     | \$2,206 |

Most equity contracts consist of covered calls. The Company writes covered calls on underlying equity positions held as an enhanced income strategy that is permitted for the Company's insurance subsidiaries under statutory regulations. The Company manages the risk associated with covered calls through strict capital limitations and asset diversification throughout various industries. For additional disclosures regarding equity contracts, see Note 5.

#### 7. Goodwill and Other Intangible Assets

##### Goodwill

There were no changes in the carrying amount of goodwill for the nine months ended September 30, 2014. Goodwill is reviewed annually for impairment and more frequently if potential impairment indicators exist. No impairment indications were identified during any of the periods presented.

##### Other Intangible Assets

The following table presents the components of other intangible assets as of September 30, 2014 and December 31, 2013.

|                              | Gross Carrying<br>Amount | Accumulated<br>Amortization | Net Carrying<br>Amount | Useful Lives |
|------------------------------|--------------------------|-----------------------------|------------------------|--------------|
|                              | (Amounts in thousands)   |                             |                        | (in years)   |
| As of September 30, 2014:    |                          |                             |                        |              |
| Customer relationships       | \$51,755                 | \$(28,175                   | ) \$23,580             | 11           |
| Trade names                  | 15,400                   | (3,690                      | ) 11,710               | 24           |
| Technology                   | 4,300                    | (2,472                      | ) 1,828                | 10           |
| Favorable leases             | 1,725                    | (1,725                      | ) 0                    | 3            |
| Software                     | 550                      | (550                        | ) 0                    | 2            |
| Total intangible assets, net | \$73,730                 | \$(36,612                   | ) \$37,118             |              |
| As of December 31, 2013:     |                          |                             |                        |              |
| Customer relationships       | \$51,755                 | \$(24,494                   | ) \$27,261             | 11           |
| Trade names                  | 15,400                   | (3,208                      | ) 12,192               | 24           |
| Technology                   | 4,300                    | (2,150                      | ) 2,150                | 10           |
| Favorable leases             | 1,725                    | (1,725                      | ) 0                    | 3            |
| Software                     | 550                      | (550                        | ) 0                    | 2            |
| Total intangible assets, net | \$73,730                 | \$(32,127                   | ) \$41,603             |              |

Intangible assets are amortized on a straight-line basis over their useful lives. Intangible assets amortization expense was \$1.5 million for the three months ended September 30, 2014 and 2013, respectively, and \$4.5 million for the nine months ended September 30, 2014 and 2013, respectively. The following table presents the estimated future amortization expenses related to intangible assets as of September 30, 2014:

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| Year Ending       | Amortization Expense<br>(Amounts in thousands) |
|-------------------|------------------------------------------------|
| Remainder of 2014 | \$ 1,495                                       |
| 2015              | 5,980                                          |
| 2016              | 5,980                                          |
| 2017              | 5,253                                          |
| 2018              | 5,239                                          |
| Thereafter        | 13,171                                         |
| Total             | \$ 37,118                                      |

**8. Share-Based Compensation**

Share-based compensation expense for all share-based payment awards granted or modified is based on the estimated grant-date fair value. The Company recognizes these compensation costs on a straight-line basis over the requisite service period of the award, which is the option vesting term of four or five years for options granted prior to 2008 and four years for options granted subsequent to January 1, 2008, for only those shares expected to vest. The fair value of stock option awards is estimated using the Black-Scholes option pricing model with the grant-date assumptions and weighted-average fair values.

Under the Company's 2005 Incentive Award Plan (the "Plan"), the Compensation Committee of the Company's Board of Directors granted performance vesting restricted stock units to the Company's senior management and key employees as follows:

|                                                   | Grant Year |         |         |
|---------------------------------------------------|------------|---------|---------|
|                                                   | 2014       | 2013    | 2012    |
| Three-year performance period ending December 31, | 2016       | 2015    | 2014    |
| Vesting shares, target (net of forfeited)         | 85,000     | 81,000  | 81,000  |
| Vesting shares, maximum (net of forfeited)        | 159,375    | 182,250 | 182,250 |

The restricted stock units vest at the end of a three-year performance period beginning with the year of the grant, and then only if, and to the extent that, the Company's performance during the performance period achieves the threshold established by the Compensation Committee of the Company's Board of Directors. For 2012 grants, vesting will be based on the Company's cumulative underwriting income and net premium written growth. For 2013 and 2014 grants, vesting will be based on the Company's cumulative underwriting income, annual underwriting income, and net earned premium growth. As of September 30, 2014, 6,500, 3,500, and 11,000 target restricted stock units granted in 2014, 2013, and 2012, respectively, have been forfeited because the recipients are no longer employed by the Company. The fair value of each restricted share grant was determined based on the market price on the grant date.

Compensation cost is recognized based on management's best estimate that performance goals will be achieved. If such goals are not met, no compensation cost is recognized and any recognized compensation cost would be reversed. For 2012 grants, the achievement of the performance condition set by the Compensation Committee was no longer considered probable, and previously recognized compensation costs were reversed.

**9. Income Taxes**

For financial statement purposes, the Company recognizes tax benefits related to positions taken, or expected to be taken, on a tax return only if, "more-likely-than-not," the positions are sustainable. Once this threshold has been met, the Company's measurement of its expected tax benefits is recognized in its financial statements.

There was a \$1.3 million increase to the total amount of unrecognized tax benefit related to tax uncertainties during the nine months ended September 30, 2014. The increase was the result of tax positions taken regarding state tax apportionment issues based on management's best judgment given the facts, circumstances, and information available at the reporting date. The Company does not expect any changes in such unrecognized tax benefits to have a significant impact on its consolidated financial statements within the next 12 months.

The Company and its subsidiaries file income tax returns in the U.S. federal jurisdiction and various states. Tax years that remain subject to examination by major taxing jurisdictions are 2011 through 2013 for federal taxes and 2003 through 2013 for California state taxes. The Company is currently under examination by the California Franchise Tax



Board (“FTB”) for tax years 2003 through 2010. The FTB issued Notices of Proposed Assessments to the Company for tax years 2003 through 2006, which

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were affirmed following an administrative protest process with the FTB examination. The Company is considering its options for resolving the case. No assessments have been received for tax years 2007 through 2010. Management believes that the resolution of these examinations and assessments will not have a material impact on the consolidated financial statements.

Deferred tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the financial reporting basis and the respective tax basis of the Company's assets and liabilities, and expected benefits of utilizing net operating loss, capital loss, and tax-credit carryforwards. The Company assesses the likelihood that its deferred tax assets will be realized and, to the extent management does not believe these assets are more likely than not to be realized, a valuation allowance is established.

At September 30, 2014, the Company's deferred income taxes were in a net liability position which included a combination of ordinary and capital deferred tax benefits. In assessing the realizability of this component of the total deferred tax balance which consists of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon generating sufficient taxable income of the appropriate character within the carryback and carryforward periods available under the tax law. Management considers the reversal of deferred tax liabilities, projected future taxable income of an appropriate nature, and tax-planning strategies in making this assessment. The Company believes that through the use of prudent tax planning strategies and the generation of capital gains, sufficient income will be realized in order to maximize the full benefits of its deferred tax assets. Although realization is not assured, management believes that it is more likely than not that the Company's deferred tax assets will be realized.

### 10. Subsequent Event

On October 22, 2014, Mercury General Corporation entered into a Stock Purchase Agreement (the "Purchase Agreement") with C&D Shammas Realty, LP, a California limited partnership, Workmen's Holding Company, a California corporation, and Workmen's Auto Insurance Company, a California domestic property and casualty insurance company ("Workmen's"). Pursuant to the terms of the Purchase Agreement, in the first quarter of 2015, the Company anticipates to acquire all of the issued and outstanding capital stock of Workmen's for an aggregate purchase price of \$8 million.

### 11. Contingencies

The Company is, from time to time, named as a defendant in various lawsuits or regulatory actions incidental to its insurance business. The majority of lawsuits brought against the Company relate to insurance claims that arise in the normal course of business and are reserved for through the reserving process. For a discussion of the Company's reserving methods, see the Company's Annual Report on Form 10-K for the year ended December 31, 2013.

The Company also establishes reserves for non-insurance claims related lawsuits, regulatory actions, and other contingencies when the Company believes a loss is probable and is able to estimate its potential exposure. For material loss contingencies believed to be reasonably possible, the Company also discloses the nature of the loss contingency and an estimate of the possible loss, range of loss, or a statement that such an estimate cannot be made. While actual losses may differ from the amounts recorded and the ultimate outcome of the Company's pending actions is generally not yet determinable, the Company does not believe that the ultimate resolution of currently pending legal or regulatory proceedings, either individually or in the aggregate, will have a material adverse effect on its financial condition, results of operations, or cash flows.

In all cases, the Company vigorously defends itself unless a reasonable settlement appears appropriate. For a discussion of legal matters, see the Company's Annual Report on Form 10-K for the year ended December 31, 2013.

## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

### Cautionary Statements

Certain statements in this Quarterly Report on Form 10-Q or in other materials the Company has filed or will file with the Securities and Exchange Commission ("SEC") (as well as information included in oral statements or other written statements made or to be made by the Company) contain or may contain "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of

1934, as amended. These forward-looking statements may address, among other things, the Company's strategy for growth, business development, regulatory approvals, market position, expenditures, financial results, and reserves. Forward-looking statements are not guarantees of performance and are subject to important factors and events that could cause the Company's actual business, prospects, and results of operations to differ materially from the historical information contained in this Quarterly Report on Form 10-Q and from those

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that may be expressed or implied by the forward-looking statements contained in this Quarterly Report on Form 10-Q and in other reports or public statements made by the Company.

Factors that could cause or contribute to such differences include, among others: the competition currently existing in the automobile insurance markets in California and the other states in which the Company operates; the cyclical and generally competitive nature of the property and casualty insurance industry and general uncertainties regarding loss reserves or other estimates; the accuracy and adequacy of the Company's pricing methodologies; the Company's success in managing its business in non-California states; the impact of potential third party "bad-faith" legislation, changes in laws, regulations or new interpretations of existing laws and regulations, tax position challenges by the FTB, and decisions of courts, regulators and governmental bodies, particularly in California; the Company's ability to obtain and the timing of required regulatory approvals of premium rate changes for insurance policies issued in states where the Company operates; the Company's reliance on independent agents to market and distribute its insurance policies; the investment yields the Company is able to obtain on its investments and the market risks associated with the Company's investment portfolio; the effect government policies may have on market interest rates; uncertainties related to assumptions and projections generally, inflation and changes in economic conditions; changes in driving patterns and loss trends; acts of war and terrorist activities; court decisions, trends in litigation, and health care and auto repair costs; adverse weather conditions or natural disasters, including those which may be related to climate change, in the markets served by the Company; the stability of the Company's information technology systems and the ability of the Company to execute on its information technology initiatives; the Company's ability to realize deferred tax assets or to hold certain securities with current loss positions to recovery or maturity; and other uncertainties, all of which are difficult to predict and many of which are beyond the Company's control. GAAP prescribes when the Company may reserve for particular risks including litigation exposures. Accordingly, results for a given reporting period could be significantly affected if and when a reserve is established for a major contingency. Reported results may therefore appear to be volatile in certain periods.

The Company undertakes no obligation to publicly update any forward-looking statements, whether as a result of new information or future events or otherwise. Investors are cautioned not to place undue reliance on any forward-looking statements, which speak only as of the date of this Quarterly Report on Form 10-Q or, in the case of any document the Company incorporates by reference, any other report filed with the SEC or any other public statement made by the Company, the date of the document, report, or statement. Investors should also understand that it is not possible to predict or identify all factors and should not consider the risks set forth above to be a complete statement of all potential risks and uncertainties. If the expectations or assumptions underlying the Company's forward-looking statements prove inaccurate or if risks or uncertainties arise, actual results could differ materially from those predicted in any forward-looking statements. The factors identified above are believed to be some, but not all, of the important factors that could cause actual events and results to be significantly different from those that may be expressed or implied in any forward-looking statements. Any forward-looking statements should also be considered in light of the information provided in "Item 1A. Risk Factors" in the Company's Annual Report on Form 10-K for the year ended December 31, 2013 and in Item 1A. Risk Factors in Part II - Other Information of this Quarterly Report on Form 10-Q.

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## OVERVIEW

## A. General

The operating results of property and casualty insurance companies are subject to significant quarter-to-quarter and year-to-year fluctuations due to the effect of competition on pricing, the frequency and severity of losses, the effect of weather and natural disasters on losses, general economic conditions, the general regulatory environment in states in which an insurer operates, state regulation of insurance including premium rates, changes in fair value of investments, and other factors such as changes in tax laws. The property and casualty insurance industry has been highly cyclical, with periods of high premium rates and shortages of underwriting capacity followed by periods of severe price competition and excess capacity. These cycles can have a large impact on the Company's ability to grow and retain business.

This section discusses some of the relevant factors that management considers in evaluating the Company's performance, prospects, and risks. It is not all-inclusive and is meant to be read in conjunction with the entirety of management's discussion and analysis, the Company's condensed consolidated financial statements and notes thereto, and all other items contained within this Quarterly Report on Form 10-Q.

## B. Business

The Company is primarily engaged in writing personal automobile insurance through 13 insurance subsidiaries ("Insurance Companies") in 13 states, principally California. The Company also writes homeowners, commercial automobile, commercial property, mechanical breakdown, and umbrella insurance. These policies are mostly sold through independent agents who receive a commission for selling policies. The Company believes that it has thorough underwriting and claims handling processes that, together with its agent relationships, provide the Company with competitive advantages because they allow the Company to charge lower prices while realizing better margins than many competitors.

The direct premiums written during the nine months ended September 30, 2014 and 2013 by state and line of business were:

## Nine Months Ended September 30, 2014

(Amounts in thousands)

|                             | Private<br>Passenger Auto | Homeowners | Commercial<br>Auto | Other Lines | Total       |       |   |
|-----------------------------|---------------------------|------------|--------------------|-------------|-------------|-------|---|
| California                  | \$1,395,236               | \$226,833  | \$50,645           | \$61,249    | \$1,733,963 | 80.5  | % |
| Florida                     | 100,706                   | 7          | 19,717             | 4,798       | 125,228     | 5.8   | % |
| Other states <sup>(1)</sup> | 182,127                   | 55,405     | 30,956             | 25,905      | 294,393     | 13.7  | % |
| Total                       | \$1,678,069               | \$282,245  | \$101,318          | \$91,952    | \$2,153,584 | 100.0 | % |
|                             | 77.9                      | % 13.1     | % 4.7              | % 4.3       | % 100.0     | %     |   |

## Nine Months Ended September 30, 2013

(Amounts in thousands)

|                             | Private<br>Passenger Auto | Homeowners | Commercial<br>Auto | Other Lines | Total       |       |   |
|-----------------------------|---------------------------|------------|--------------------|-------------|-------------|-------|---|
| California                  | \$1,322,137               | \$203,015  | \$39,405           | \$53,660    | \$1,618,217 | 78.2  | % |
| Florida                     | 104,996                   | 0          | 16,145             | 5,676       | 126,817     | 6.1   | % |
| Other states <sup>(1)</sup> | 211,250                   | 55,604     | 20,922             | 35,773      | 323,549     | 15.7  | % |
| Total                       | \$1,638,383               | \$258,619  | \$76,472           | \$95,109    | \$2,068,583 | 100.0 | % |
|                             | 79.2                      | % 12.5     | % 3.7              | % 4.6       | % 100.0     | %     |   |

(1) No individual state accounts for more than 5% of total direct premiums written.



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## C. Regulatory and Litigation Matters

The Department of Insurance (“DOI”) in each state in which the Company operates is responsible for conducting periodic financial and market conduct examinations of the Insurance Companies in their states. Market conduct examinations typically review compliance with insurance statutes and regulations with respect to rating, underwriting, claims handling, billing, and other practices. The following table presents a summary of current financial and market conduct examinations:

| State | Exam Type      | Period Under Review | Status                             |
|-------|----------------|---------------------|------------------------------------|
| CA    | Financial      | 2011 to 2013        | Fieldwork began in April 2014.     |
| GA    | Financial      | 2011 to 2013        | Fieldwork began in April 2014.     |
| FL    | Financial      | 2010 to 2013        | Fieldwork began in April 2014.     |
| IL    | Financial      | 2010 to 2013        | Fieldwork began in April 2014.     |
| TX    | Financial      | 2010 to 2013        | Fieldwork began in April 2014.     |
| TX    | Market Conduct | 2013 to 2014        | Fieldwork began in August 2014.    |
| CA    | Market Conduct | 2013 to 2014        | Fieldwork began in September 2014. |

During the course of and at the conclusion of these examinations, the examining DOI generally reports findings to the Company. None of the findings reported to date is expected to be material to the Company’s financial position.

During 2014, the Company implemented rate changes in twelve states, including rate decreases for private passenger auto in several states outside of California. In California, the following rate increases were implemented:

In January, a 6.0% rate increase on its preferred private passenger automobile line of business, which represents approximately 51% of the total Company net premiums earned.

In January, a 8.26% rate increase on its homeowners line of business, which represents approximately 10% of the total Company net premiums earned.

In October, a 6.9% rate increase on its standard private passenger automobile line of business, which represents approximately 15% of the total Company net premiums earned.

In April 2010, the California DOI issued a Notice of Non-Compliance (“2010 NNC”) to Mercury Insurance Company (“MIC”), Mercury Casualty Company (“MCC”), and California Automobile Insurance Company (“CAIC”) based on a Report of Examination of the Rating and Underwriting Practices of these companies issued by the California DOI in February 2010. The 2010 NNC includes allegations of 35 instances of noncompliance with applicable California insurance law and seeks to require that each of MIC, MCC, and CAIC change its rating and underwriting practices to rectify the alleged noncompliance and may also seek monetary penalties. In April 2010, the Company submitted a Statement of Compliance and Notice of Defense to the 2010 NNC, in which it denied the allegations contained in the 2010 NNC and provided specific defenses to each allegation. The Company also requested a hearing in the event that the Statement of Compliance and Notice of Defense does not establish to the satisfaction of the California DOI that the alleged noncompliance does not exist, and the matters described in the 2010 NNC are not otherwise able to be resolved informally with the California DOI. However, no assurance can be given that efforts to resolve the 2010 NNC informally will be successful.

In March 2006, the California DOI issued an Amended Notice of Non-Compliance to a Notice of Non-Compliance originally issued in February 2004 (as amended, “2004 NNC”) alleging that the Company charged rates in violation of the California Insurance Code, willfully permitted its agents to charge broker fees in violation of California law, and willfully misrepresented the actual price insurance consumers could expect to pay for insurance by the amount of a fee charged by the consumer’s insurance broker. The California DOI seeks to impose a fine for each policy in which the Company allegedly permitted an agent to charge a broker fee and a penalty for each policy on which the Company allegedly used a misleading advertisement and to suspend certificates of authority for a period of one year. In January 2012, an Administrative Law Judge (“ALJ”) bifurcated the 2004 NNC between (a) the California DOI’s order to show cause, in which the California DOI asserts the false advertising allegations and accusation, and (b) the California DOI’s notice of noncompliance, in which the California DOI asserts the unlawful rate allegations. In February 2012, the ALJ submitted a proposed decision dismissing the California DOI’s 2004 NNC. In March 2012, the California Insurance

Commissioner rejected the ALJ's proposed decision. The Company challenged the rejection in Los Angeles Superior Court ("Superior Court") in April 2012. Following a hearing, the Superior Court sustained the California Insurance Commissioner's demurrer without leave to amend because it found the Company must first exhaust its administrative remedies. In January 2013, the Superior Court's decision was affirmed on appeal. In January 2013, the ALJ heard various pending motions that had been filed by the Company in June 2011. The ALJ granted certain portions of the California DOI's motion for collateral estoppel to prevent the Company from litigating certain findings of fact reached in a prior litigation action and denied the Company's motion for governmental estoppel and laches, without prejudice, on the ground that a resolution of the motion requires specific factual findings in the context of the evidentiary hearing. The ALJ held an evidentiary hearing on the noncompliance portion of the 2004 NNC in April 2013. A mediation was held in September 2013, but the parties were unable to reach a settlement of the matter. The Company,



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the California DOI, and a consumer group filed post-hearing briefs following the April 2013 evidentiary hearing and the ALJ closed the evidentiary record on April 30, 2014. The Company is awaiting notice of the ALJ's decision. Following receipt of the ALJ's decision, the California Insurance Commissioner will issue his final order adopting, rejecting or modifying the ALJ's decision.

The Company denies the allegations in the 2004 and 2010 NNC matters, and believes that no monetary penalties are warranted, and the Company intends to defend itself against the allegations vigorously, unless a reasonable settlement can be reached. The Company has been subject to fines and penalties by the California DOI in the past due to alleged violations of the California Insurance Code. The largest and most recent of these was settled in 2008 for \$300,000. However, prior settlement amounts are not necessarily indicative of the potential results in the current notice of non-compliance matters and recent fines levied against other insurers by the current California Insurance Commissioner have been much higher. Based upon its understanding of the facts and the California Insurance Code, the Company does not expect that the ultimate resolution of the 2004 and 2010 NNC matters will be material to the Company's financial position. The Company has accrued a liability for the estimated cost to defend itself in the notice of non-compliance matters.

The Company is, from time to time, named as a defendant in various lawsuits or regulatory actions incidental to its insurance business. The majority of lawsuits brought against the Company relate to insurance claims that arise in the normal course of business and are reserved for through the reserving process. For a discussion of the Company's reserving methods, see the Company's Annual Report on Form 10-K for the year ended December 31, 2013.

The Company also establishes reserves for non-insurance claims related lawsuits, regulatory actions, and other contingencies when the Company believes a loss is probable and is able to estimate its potential exposure. For material loss contingencies believed to be reasonably possible, the Company also discloses the nature of the loss contingency and an estimate of the possible loss, range of loss, or a statement that such an estimate cannot be made. While actual losses may differ from the amounts recorded and the ultimate outcome of the Company's pending actions is generally not yet determinable, the Company does not believe that the ultimate resolution of currently pending legal or regulatory proceedings, either individually or in the aggregate, will have a material adverse effect on its financial condition, results of operations, or cash flows.

In all cases, the Company vigorously defends itself unless a reasonable settlement appears appropriate. For a discussion of legal matters, see the Company's Annual Report on Form 10-K for the year ended December 31, 2013.

### D. Critical Accounting Policies and Estimates

#### Reserves

Preparation of the Company's consolidated financial statements requires management's judgment and estimates. The most significant is the estimate of loss reserves. Estimating loss reserves is a difficult process as many factors can ultimately affect the final settlement of a claim and, therefore, the reserve that is required. Changes in the regulatory and legal environment, results of litigation, medical costs, the cost of repair materials, and labor rates, among other factors, can impact ultimate claim costs. In addition, time can be a critical part of reserving determinations since the longer the span between the incidence of a loss and the payment or settlement of a claim, the more variable the ultimate settlement amount could be. Accordingly, short-tail claims, such as property damage claims, tend to be more reasonably predictable than long-tail liability claims.

The Company also engages independent actuarial consultants to review the Company's reserves and to provide the annual actuarial opinions required under state statutory accounting requirements. The Company does not rely on the actuarial consultants for GAAP reporting or periodic disclosure purposes. The Company analyzes loss reserves quarterly primarily using the incurred loss, claim count development, and average severity methods described below. The Company also uses the paid loss development method as part of its reserve analysis. When deciding among methods to use, the Company evaluates the credibility of each method based on the maturity of the data available and the claims settlement practices for each particular line of business or coverage within a line of business. When establishing the reserve, the Company will generally analyze the results from all of the methods used rather than relying on a single method. While these methods are designed to determine the ultimate losses on claims under the Company's policies, there is inherent uncertainty in all actuarial models since they use historical data to project outcomes. The Company believes that the techniques it uses provide a reasonable basis in estimating loss reserves.

The incurred loss development method analyzes historical incurred case loss (case reserves plus paid losses) development to estimate ultimate losses. The Company applies development factors against current case incurred losses by accident period to calculate ultimate expected losses. The Company believes that the incurred loss development method provides a reasonable basis for evaluating ultimate losses, particularly in the Company's larger, more established lines of business which have a long operating history.

The average severity method analyzes historical loss payments and/or incurred losses divided by closed claims and/or total claims to calculate an estimated average cost per claim. From this, the expected ultimate average cost per claim can

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be estimated. The average severity method coupled with the claim count development method provides meaningful information regarding inflation and frequency trends that the Company believes is useful in establishing reserves. The claim count development method analyzes historical claim count development to estimate future incurred claim count development for current claims. The Company applies these development factors against current claim counts by accident period to calculate ultimate expected claim counts.

The paid loss development method analyzes historical payment patterns to estimate the amount of losses yet to be paid. The Company uses this method for losses and loss adjustment expenses.

At September 30, 2014 and December 31, 2013, the Company recorded its point estimate of approximately \$1.06 billion and \$1.04 billion, respectively, in losses and loss adjustment expenses liabilities, which include approximately \$429 million and \$409 million, respectively, of incurred but not reported loss reserves ("IBNR"). IBNR includes estimates, based upon past experience, of ultimate developed costs, which may differ from case estimates, unreported claims that occurred on or prior to September 30, 2014, and estimated future payments for reopened claims. Management believes that the liability for losses and loss adjustment expenses is adequate to cover the ultimate net cost of losses and loss adjustment expenses incurred to date; however, since the provisions are necessarily based upon estimates, the ultimate liability may be more or less than such provisions.

The Company evaluates its reserves quarterly. When management determines that the estimated ultimate claim cost requires a decrease for previously reported accident years, favorable development occurs and a reduction in losses and loss adjustment expenses is reported in the current period. If the estimated ultimate claim cost requires an increase for previously reported accident years, unfavorable development occurs and an increase in losses and loss adjustment expenses is reported in the current period. For the nine months ended September 30, 2014, the Company reported favorable development of approximately \$10 million on the 2013 and prior accident years' losses and loss adjustment expenses reserves, which at December 31, 2013 totaled approximately \$1.04 billion. The favorable development in 2014 came primarily from California personal auto lines of business, which was partially offset by adverse development in other states.

For the nine months ended September 30, 2014, the Company recorded catastrophe losses of approximately \$7 million which were primarily related to winter freeze events on the East Coast.

For a further discussion of the Company's reserving methods, see the Company's Annual Report on Form 10-K for the year ended December 31, 2013.

### Investments

The Company's fixed maturity and equity investments are classified as "trading" and carried at fair value as required when applying the fair value option, with changes in fair value reflected in net realized investment gains or losses in the consolidated statements of operations. The majority of equity holdings, including non-redeemable fund preferred stocks, is actively traded on national exchanges or trading markets, and is valued at the last transaction price on the balance sheet dates.

### Fair Value of Financial Instruments

Financial instruments recorded in the consolidated balance sheets include investments, receivables, total return swaps, accounts payable, equity contracts, and secured and unsecured notes payable. The fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Due to their short-term maturity, the carrying values of receivables and accounts payable approximate their fair market values. All investments are carried on the consolidated balance sheets at fair value, as described in Note 3 of Condensed Notes to Consolidated Financial Statements.

The Company's financial instruments include securities issued by the U.S. government and its agencies, securities issued by states and municipal governments and agencies, certain corporate and other debt securities, equity securities, and exchange traded funds. 99.6% of the fair value of financial instruments held at September 30, 2014 is based on observable market prices, observable market parameters, or is derived from such prices or parameters. The availability of observable market prices and pricing parameters can vary by financial instrument. Observable market prices and pricing parameters of a financial instrument, or a related financial instrument, are used to derive a price without requiring significant judgment.

The Company may hold or acquire financial instruments that lack observable market prices or market parameters because they are less actively traded currently or in future periods. The fair value of such instruments is determined using techniques appropriate for each particular financial instrument. These techniques may involve some degree of judgment. The price transparency of the particular financial instrument will determine the degree of judgment involved in determining the fair value of the Company's financial instruments. Price transparency is affected by a wide variety of factors, including, for example, the type of financial instrument, whether it is a new financial instrument and not yet established in the marketplace, and the characteristics particular to the transaction. Financial instruments for which actively quoted prices or pricing parameters are available or for which fair

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value is derived from actively quoted prices or pricing parameters will generally have a higher degree of price transparency. By contrast, financial instruments that are thinly traded or not quoted will generally have diminished price transparency. Even in normally active markets, the price transparency for actively quoted instruments may be reduced during periods of market dislocation. Alternatively, in thinly quoted markets, the participation of market makers willing to purchase and sell a financial instrument provides a source of transparency for products that otherwise are not actively quoted.

### Income Taxes

At September 30, 2014, the Company's deferred income taxes were in a net liability position materially due to deferred tax liabilities generated by deferred acquisition costs and unrealized gains on securities held. These deferred tax liabilities were substantially offset by deferred tax assets resulting from unearned premiums, expense accruals, loss reserve discounting, and alternative minimum tax and other tax credit carryforwards. The Company assesses the likelihood that its deferred tax assets will be realized and, to the extent management does not believe these assets are more likely than not to be realized, a valuation allowance is established. Management's recoverability assessment of the Company's deferred tax assets which are ordinary in character takes into consideration the Company's strong history of generating ordinary taxable income and a reasonable expectation that it will continue to generate ordinary taxable income in the future. Further, the Company has the capacity to recoup its ordinary deferred tax assets through tax loss carryback claims for taxes paid in prior years. Finally, the Company has various deferred tax liabilities that represent sources of future ordinary taxable income.

Management's recoverability assessment with regard to its capital deferred tax assets is based on estimates of anticipated capital gains and tax-planning strategies available to generate future taxable capital gains, each of which would contribute to the realization of deferred tax benefits. The Company expects to hold certain debt securities, which are currently in loss positions, to recovery or maturity. Management believes unrealized losses related to these debt securities, which represent a significant portion of the unrealized loss positions at period-end, are fully realizable at maturity. Management believes its long-term time horizon for holding these securities allows it to avoid any forced sales prior to maturity. The Company also has unrealized gains in its investment portfolio that could be realized through asset dispositions, at management's discretion. Further, the Company has the capability to generate additional realized capital gains by entering into sale-leaseback transactions using one or more of its appreciated real estate holdings.

The Company has the capability to implement tax planning strategies as it has a steady history of generating positive cash flow from operations and believes that its cash flow needs can be met in future periods without the forced sale of its investments. This capability assists management in controlling the timing and amount of realized losses generated during future periods. By prudent utilization of some or all of these strategies, management has the intent and believes that it has the ability to generate capital gains and minimize tax losses in a manner sufficient to avoid losing the benefits of its deferred tax assets. Management will continue to assess the need for a valuation allowance on a quarterly basis. Although realization is not assured, management believes it is more likely than not that the Company's deferred tax assets will be realized.

The Company's effective income tax rate for the year could be different from the effective tax rate for the nine months ended September 30, 2014 and will be dependent on the Company's profitability for the remainder of the year. The Company's effective income tax rate can be affected by several factors. These generally include tax exempt investment income, other non-deductible expenses, and periodically, non-routine tax items such as adjustments to unrecognized tax benefits related to tax uncertainties. The effective tax rate for the nine months ended September 30, 2014 was 27.8%, compared to 19.9% for the same period in 2013. The increase in the effective tax rate is mainly due to an increase in taxable income relative to tax exempt investment income. The Company's effective tax rate for the nine months ended September 30, 2014 was lower than the statutory tax rate primarily as a result of tax exempt investment income earned. However, the effective tax rate for the entire year could differ from the rate for the nine months ended September 30, 2014.

### Contingent Liabilities

The Company has known, and may have unknown, potential liabilities which include claims, assessments, lawsuits, or regulatory fines and penalties relating to the Company's business. The Company continually evaluates these potential

liabilities and accrues for them and/or discloses them in the condensed notes to the consolidated financial statements where required. The Company does not believe that the ultimate resolution of currently pending legal or regulatory proceedings, either individually or in the aggregate, will have a material adverse effect on its financial condition, results of operations, or cash flows.

#### Premiums

The Company's insurance premiums are recognized as income ratably over the term of the policies and in proportion to the amount of insurance protection provided. Unearned premiums are carried as a liability on the consolidated balance sheets and are computed monthly on a pro-rata basis. The Company evaluates its unearned premiums periodically for premium deficiencies by comparing the sum of expected claim costs, unamortized acquisition costs, and maintenance costs partially offset by investment

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income to related unearned premiums. To the extent that any of the Company's lines of business become unprofitable, a premium deficiency reserve may be required.

### RESULTS OF OPERATIONS

Three Months Ended September 30, 2014 compared to Three Months Ended September 30, 2013

#### Revenue

Net premiums written and net premiums earned for the three months ended September 30, 2014 increased 2.2% and 3.9%, respectively, from the corresponding period in 2013. The increase in net premiums written was primarily due to higher average premiums per policy arising from rate increases in the California private passenger automobile and homeowners lines of business.

Net premiums written is a non-GAAP financial measure which represents the premiums charged on policies issued during a fiscal period less any applicable reinsurance. Net premiums written is a statutory measure designed to determine production levels. Net premiums earned, the most directly comparable GAAP measure, represents the portion of net premiums written that is recognized as revenue in the financial statements for the period presented and earned on a pro-rata basis over the term of the policies. The following is a reconciliation of total net premiums written to net premiums earned:

|                                | Three Months Ended September 30, |           |
|--------------------------------|----------------------------------|-----------|
|                                | 2014                             | 2013      |
|                                | (Amounts in thousands)           |           |
| Net premiums written           | \$720,153                        | \$704,895 |
| Change in net unearned premium | (14,916)                         | (25,982)  |
| Net premiums earned            | \$705,237                        | \$678,913 |

#### Expenses

Loss and expense ratios are used to interpret the underwriting experience of property and casualty insurance companies. The following table presents the Insurance Companies' loss ratio, expense ratio, and combined ratio determined in accordance with GAAP:

|                               | Three Months Ended September 30, |        |   |
|-------------------------------|----------------------------------|--------|---|
|                               | 2014                             | 2013   |   |
| Loss ratio                    | 69.8                             | % 72.6 | % |
| Expense ratio                 | 26.9                             | % 26.7 | % |
| Combined ratio <sup>(1)</sup> | 96.7                             | % 99.2 | % |

(1) Combined ratio for the three months ended September 30, 2013 does not sum due to rounding.

Loss ratio is calculated by dividing losses and loss adjustment expenses by net premiums earned. The 2014 loss ratio includes approximately \$1 million of catastrophe losses and approximately \$2 million of favorable development on prior accident year reserves. The 2013 loss ratio includes approximately \$2 million of catastrophe losses and \$1 million of unfavorable development on prior accident year reserves. Excluding the impact of these items, the loss ratio would have been 70.0% and 72.1% for the three months ended September 30, 2014 and 2013, respectively.

Expense ratio is calculated by dividing the sum of policy acquisition costs plus other operating expenses by net premiums earned. The increase in expense ratio resulted primarily from an increase in profit based compensation for the three months ended September 30, 2014 compared to the same period in 2013.

Combined ratio is equal to loss ratio plus expense ratio and is the key measure of underwriting performance traditionally used in the property and casualty insurance industry. A combined ratio under 100% generally reflects profitable underwriting results; and a combined ratio over 100% generally reflects unprofitable underwriting results. Income tax expense was \$5.8 million and \$15.2 million for the three months ended September 30, 2014 and 2013, respectively. The decrease in income tax expense resulted primarily from net realized investment losses for the three months ended September 30, 2014 compared to net realized investment gains in the corresponding period in 2013.





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## Investments

The following table presents the investment results of the Company:

|                                                    | Three Months Ended September 30, |             |
|----------------------------------------------------|----------------------------------|-------------|
|                                                    | 2014                             | 2013        |
|                                                    | (Amounts in thousands)           |             |
| Average invested assets at cost <sup>(1)</sup>     | \$3,237,993                      | \$3,025,614 |
| Net investment income <sup>(2)</sup>               |                                  |             |
| Before income taxes                                | \$32,564                         | \$30,857    |
| After income taxes                                 | \$28,677                         | \$27,214    |
| Average annual yield on investments <sup>(2)</sup> |                                  |             |
| Before income taxes                                | 4.0                              | % 4.1       |
| After income taxes                                 | 3.5                              | % 3.6       |
| Net realized investment (losses) gains             | \$(20,089                        | ) \$16,212  |

Fixed maturities and short-term bonds at amortized cost; and equities and other short-term investments at cost.

(1) Average invested assets at cost are based on the monthly amortized cost of the invested assets for each respective period.

Net investment income increased due to higher average invested asset balances; and average annual yield

(2) decreased slightly primarily due to the maturity and replacement of higher yielding investments purchased when market interest rates were higher, with lower yielding investments purchased during low interest rate environments.

Included in net income are net realized investment losses of \$20.1 million and gains of \$16.2 million for the three months ended September 30, 2014 and 2013, respectively. Net realized investment (losses) gains include losses of \$20.5 million and gains of \$21.8 million for the three months ended September 30, 2014 and 2013, respectively, due to changes in the fair value of total investments pursuant to the application of the fair value accounting option. Net losses for the three months ended September 30, 2014 arose primarily from market value decreases in the Company's equity securities of \$24.0 million, partially offset by market value increases of \$3.5 million in its fixed maturity securities. The Company's municipal bond holdings represent the majority of the fixed maturity portfolio and were positively affected by improvement in the municipal bond market during the three months ended September 30, 2014. The primary cause of the decrease in the value of the Company's equity securities was the decline in the equity markets during the three months ended September 30, 2014. Net gains for the three months ended September 30, 2013 arose primarily from market value increases in the Company's equity securities of \$32.6 million, offset by market value decreases of \$11.3 million in its fixed maturity portfolio. The primary cause of the increase in the value of the Company's equity securities was the improvement in the equity markets during the three months ended September 30, 2013. The Company's municipal bond holdings represent the majority of the fixed maturity portfolio and were adversely affected by the increase in market interest rates during the three months ended September 30, 2013.

## Net Income

Net income was \$31.3 million, or \$0.57 per share (basic and diluted), and \$39.6 million, or \$0.72 per share (basic and diluted), for the three months ended September 30, 2014 and 2013, respectively. Diluted per share results were based on a weighted average of 55.0 million shares both for the three months ended September 30, 2014 and 2013. Included in net income per share were net realized investment (losses) gains, net of income taxes, \$(0.24) and \$0.19 per share (basic and diluted) for the three months ended September 30, 2014 and 2013, respectively.

Nine Months Ended September 30, 2014 compared to Nine Months Ended September 30, 2013

## Revenue

Net premiums written and net premiums earned for the nine months ended September 30, 2014 increased 4.0% and 3.4%, respectively, from the corresponding period in 2013. The increase in net premiums written was primarily due to higher average premiums per policy arising from rate increases in the California private passenger automobile and homeowners lines of business.

The following is a reconciliation of total net premiums written to net premiums earned:



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|                                | Nine Months Ended September 30, |             |
|--------------------------------|---------------------------------|-------------|
|                                | 2014                            | 2013        |
|                                | (Amounts in thousands)          |             |
| Net premiums written           | \$2,143,605                     | \$2,060,878 |
| Change in net unearned premium | (56,778)                        | ) (43,583   |
| Net premiums earned            | \$2,086,827                     | \$2,017,295 |

## Expenses

Loss and expense ratios are used to interpret the underwriting experience of property and casualty insurance companies. The following table presents the Insurance Companies' loss ratio, expense ratio, and combined ratio determined in accordance with GAAP:

|                | Nine Months Ended September 30, |        |   |
|----------------|---------------------------------|--------|---|
|                | 2014                            | 2013   |   |
| Loss ratio     | 69.6                            | % 71.7 | % |
| Expense ratio  | 26.8                            | % 26.9 | % |
| Combined ratio | 96.4                            | % 98.6 | % |

The loss ratio was affected by favorable development of approximately \$10 million and \$2 million on prior accident years' losses and loss adjustment expenses reserves for the nine months ended September 30, 2014 and 2013, respectively. The favorable development in 2014 is primarily from California personal auto lines of business. The favorable development in 2013 is primarily from non-California states. The Company also recognized approximately \$7 million of catastrophic losses for the nine months ended September 30, 2014 primarily related to winter freeze events on the East Coast, and approximately \$16 million of catastrophic losses for the nine months ended September 30, 2013 primarily as a result of tornadoes in Oklahoma and severe storms in the Midwest and the Southeast region. Excluding the effect of estimated prior period's loss development and catastrophic losses, the loss ratio would have been 69.7% and 71.0%, for the nine months ended September 30, 2014 and 2013, respectively.

The expense ratio did not materially change for the nine months ended September 30, 2014 compared to the same period in 2013.

Income tax expense was \$76.7 million and \$24.1 million for the nine months ended September 30, 2014 and 2013, respectively. The increase in income tax expense resulted from greater pre-tax income, primarily arising from greater net realized investment gains and underwriting income for the nine months ended September 30, 2014 compared to the corresponding period in 2013.

## Investments

The following table presents the investment results of the Company:

|                                                    | Nine Months Ended September 30, |             |
|----------------------------------------------------|---------------------------------|-------------|
|                                                    | 2014                            | 2013        |
|                                                    | (Amounts in thousands)          |             |
| Average invested assets at cost <sup>(1)</sup>     | \$3,185,457                     | \$3,038,281 |
| Net investment income <sup>(2)</sup>               |                                 |             |
| Before income taxes                                | \$93,656                        | \$93,706    |
| After income taxes                                 | \$83,227                        | \$82,272    |
| Average annual yield on investments <sup>(2)</sup> |                                 |             |
| Before income taxes                                | 3.9                             | % 4.1       |
| After income taxes                                 | 3.5                             | % 3.6       |
| Net realized investment gains (losses)             | \$102,813                       | \$(7,153)   |

Fixed maturities and short-term bonds at amortized cost; and equities and other short-term investments at cost.

(1) Average invested assets at cost are based on the monthly amortized cost of the invested assets for each respective period.

Net investment income after taxes increased due to higher average investment balances in tax exempt securities.  
(2) Net investment income before income taxes and average annual yield decreased slightly primarily due to the maturity and

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replacement of higher yielding investments purchased when market interest rates were higher, with lower yielding investments purchased during low interest rate environments.

Included in net income are net realized investment gains of \$102.8 million and losses of \$7.2 million for the nine months ended September 30, 2014 and 2013, respectively. Net realized investment gains (losses) include gains of \$66.6 million and losses of \$13.4 million for the nine months ended September 30, 2014 and 2013, respectively, due to changes in the fair value of total investments pursuant to the application of the fair value accounting option. Net gains for the nine months ended September 30, 2014 arose primarily from market value increases in the Company's fixed maturity securities of \$73.1 million, partially offset by market value decreases in its equity securities of \$6.4 million. The Company's municipal bond holdings represent the majority of the fixed maturity portfolio and were positively affected by improvements in the municipal bond market during the nine months ended September 30, 2014. The primary cause of the decrease in the value of the Company's equity securities was the overall decline in the energy and utilities sectors during the three months ended September 30, 2014. The net losses for the nine months ended September 30, 2013 arose primarily from market value decreases in the Company's fixed maturity securities of \$81.3 million, partially offset by market value increases in its equity securities of \$67.6 million. The Company's municipal bond holdings represent the majority of the fixed maturity portfolio, which were adversely affected by the increase in interest rates during the nine months ended September 30, 2013. The primary cause of the increase in the value of the Company's equity securities was the improvement in the equity markets during the nine months ended September 30, 2013.

### Net Income

Net income was \$198.9 million, or \$3.62 per share (basic and diluted), and \$96.8 million, or \$1.76 per share (basic and diluted), in the nine months ended September 30, 2014 and 2013, respectively. Diluted per share results were based on a weighted average of 55.0 million shares both for the nine months ended September 30, 2014 and 2013. Included in net income per share were net realized investment gains (losses), net of income taxes, \$1.22 and \$(0.08) per share (basic and diluted) in the nine months ended September 30, 2014 and 2013, respectively.

## LIQUIDITY AND CAPITAL RESOURCES

### A. Cash Flows

The Company has generated positive cash flow from operations for more than twenty consecutive years and does not attempt to match the duration and timing of asset maturities with those of liabilities. Rather, the Company manages its portfolio with a view towards maximizing total return with an emphasis on after-tax income. With combined cash and short-term investments of \$571.0 million at September 30, 2014 as well as \$50 million of credit available on a \$200 million revolving credit facility, the Company believes its cash flow from operations is adequate to satisfy its liquidity requirements without the forced sale of investments. Investment maturities are also available to meet the Company's liquidity needs. However, the Company operates in a rapidly evolving and often unpredictable business environment that may change the timing or amount of expected future cash receipts and expenditures. Accordingly, there can be no assurance that the Company's sources of funds will be sufficient to meet its liquidity needs or that the Company will not be required to raise additional funds to meet those needs or for future business expansion, through the sale of equity or debt securities or from credit facilities with lending institutions.

Net cash provided by operating activities in the nine months ended September 30, 2014 was \$199.5 million, an increase of \$29.8 million compared to the corresponding period in 2013. The increase was primarily due to the increase in collected premiums and decrease in paid losses and loss adjustment expenses; partially offset by the increase in paid expenses and income taxes. The Company utilized the cash provided by operating activities primarily for the payment of dividends to its shareholders and for making investments.

The following table presents the estimated fair value of the Company's fixed maturity securities at September 30, 2014 by contractual maturity in the next five years:

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|                                          | Fixed Maturities<br>(Amounts in thousands) |
|------------------------------------------|--------------------------------------------|
| Due in one year or less                  | \$ 64,651                                  |
| Due after one year through two years     | 89,533                                     |
| Due after two years through three years  | 104,099                                    |
| Due after three years through four years | 77,810                                     |
| Due after four years through five years  | 68,859                                     |
| Total due within five years              | \$ 404,952                                 |

## B. Reinsurance

The Company's Catastrophe Reinsurance Treaty ("Treaty") was renewed for one year beginning July 1, 2014. The Treaty provides for \$100 million coverage on a per occurrence basis after covered catastrophe losses exceed a \$100 million Company retention limit; excludes coverage in Florida; and limits certain coverages to 37% of catastrophe losses resulting from earthquakes and fire following earthquakes. The annual premium is \$4.8 million.

## C. Invested Assets

## Portfolio Composition

An important component of the Company's financial results is the return on its investment portfolio. The Company's investment strategy emphasizes safety of principal and consistent income generation, within a total return framework. The investment strategy has historically focused on maximizing after-tax yield with a primary emphasis on maintaining a well-diversified, investment grade, fixed income portfolio to support the underlying liabilities and achieve return on capital and profitable growth. The Company believes that investment yield is maximized by selecting assets that perform favorably on a long-term basis and by disposing of certain assets to enhance after-tax yield and minimize the potential effect of downgrades and defaults. The Company continues to believe that this strategy enables the optimal investment performance necessary to sustain investment income over time. The Company's portfolio management approach utilizes a market risk and consistent asset allocation strategy as the primary basis for the allocation of interest sensitive, liquid and credit assets as well as for determining overall below investment grade exposure and diversification requirements. Within the ranges set by the asset allocation strategy, tactical investment decisions are made in consideration of prevailing market conditions.

The following table presents the composition of the total investment portfolio of the Company at September 30, 2014:

|                                               | Cost <sup>(1)</sup><br>(Amounts in thousands) | Fair Value   |
|-----------------------------------------------|-----------------------------------------------|--------------|
| Fixed maturity securities:                    |                                               |              |
| U.S. government bonds and agencies            | \$ 16,036                                     | \$ 16,116    |
| Municipal securities                          | 2,174,407                                     | 2,280,217    |
| Mortgage-backed securities                    | 35,834                                        | 38,156       |
| Corporate securities                          | 282,780                                       | 285,378      |
|                                               | 2,509,057                                     | 2,619,867    |
| Equity securities:                            |                                               |              |
| Common stock:                                 |                                               |              |
| Public utilities                              | 125,841                                       | 129,325      |
| Banks, trusts and insurance companies         | 7,215                                         | 8,566        |
| Energy and other                              | 272,803                                       | 316,472      |
| Non-redeemable preferred stock                | 29,056                                        | 29,478       |
| Partnership interest in a private credit fund | 10,000                                        | 12,670       |
|                                               | 444,915                                       | 496,511      |
| Short-term investments                        | 291,646                                       | 291,325      |
| Total investments                             | \$ 3,245,618                                  | \$ 3,407,703 |

(1) Fixed maturities and short-term bonds at amortized cost; and equities and other short-term investments at cost.



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At September 30, 2014, 66.7% of the Company's total investment portfolio at fair value and 86.7% of its total fixed maturity investments at fair value were invested in tax-exempt state and municipal bonds. Equity holdings consist of non-redeemable preferred stocks, dividend-bearing common stocks on which dividend income is partially tax-sheltered by the 70% corporate dividend received deduction, and a partnership interest in a private credit fund. At September 30, 2014, 69.6% of short-term investments consisted of highly rated short-duration securities redeemable on a daily or weekly basis. The Company does not have any direct equity investment in sub-prime lenders.

During the nine months ended September 30, 2014, the Company recognized \$102.8 million in net realized investment gains, which included gains of \$70.4 million related to fixed maturity securities and \$30.8 million related to equity securities. Included in the gains were \$73.1 million in gains due to changes in the fair value of the Company's fixed maturity security portfolio and \$6.4 million in losses due to changes in the fair value of the Company's equity security portfolios as a result of applying the fair value accounting option.

During the nine months ended September 30, 2013, the Company recognized \$7.2 million in net realized investment losses, which included gains of \$73.2 million related to equity securities and losses of \$81.5 million related to fixed maturity securities. Included in the gains and losses were \$67.6 million in gains due to changes in the fair value of the Company's equity security portfolio and \$81.3 million in losses due to changes in the fair value of the Company's fixed maturity security portfolio as a result of applying the fair value option.

### Fixed maturity securities and short-term investments

Fixed maturity securities include debt securities, which may have fixed or variable principal payment schedules, may be held for indefinite periods of time, and may be used as a part of the Company's asset/liability strategy or sold in response to changes in interest rates, anticipated prepayments, risk/reward characteristics, liquidity needs, tax planning considerations, or other economic factors. Short-term investments include money market accounts, options, and short-term bonds that are highly rated short duration securities and redeemable within one year.

A primary exposure for the fixed maturity securities is interest rate risk. The longer the duration, the more sensitive the asset is to market interest rate fluctuations. As assets with longer maturity dates tend to produce higher current yields, the Company's historical investment philosophy has resulted in a portfolio with a moderate duration. The nominal average maturities of the overall bond portfolio were 12.6 years and 13.3 years (11.8 years and 12.1 years when including short-term instruments) at September 30, 2014 and December 31, 2013, respectively. The portfolio is heavily weighted in investment grade tax-exempt municipal bonds. Fixed maturity investments purchased by the Company typically have call options attached, which further reduce the duration of the asset as interest rates decline. The call-adjusted average maturities of the overall bond portfolio were 3.5 years and 5.2 years (3.3 years and 4.7 years when including short-term instruments) at September 30, 2014 and December 31, 2013, respectively, related to holdings which are heavily weighted with high coupon issues that are expected to be called prior to maturity. The modified durations of the overall bond portfolio reflecting anticipated early calls were 2.9 years and 3.9 years (2.7 years and 3.6 years when including short-term instruments) at September 30, 2014 and December 31, 2013, respectively, including collateralized mortgage obligations with a modified duration of 2.2 years and 2.3 years at September 30, 2014 and December 31, 2013, respectively, and short-term bonds that carry no duration. Modified duration measures the length of time it takes, on average, to receive the present value of all the cash flows produced by a bond, including reinvestment of interest. As it measures four factors (maturity, coupon rate, yield and call terms) which determine sensitivity to changes in interest rate, modified duration is considered a better indicator of price volatility than simple maturity alone.

Another exposure related to the fixed maturity securities is credit risk, which is managed by maintaining a weighted-average portfolio credit quality rating of A+, at fair value, at September 30, 2014, compared to AA-, at fair value, at December 31, 2013. The small decrease in the weighted-average rating of the Company's fixed maturity portfolio was a result of the maturation of certain AAA rated bonds that were replaced with lower rated investment grade bonds. To calculate the weighted-average credit quality ratings as disclosed throughout this Quarterly Report on Form 10-Q, individual securities were weighted based on fair value and a credit quality numeric score that was assigned to each rating grade. Tax-exempt bond holdings are broadly diversified geographically. Taxable holdings consist principally of investment grade issues. At September 30, 2014, fixed maturity holdings rated below investment grade and non-rated bonds totaled \$37.2 million and \$11.0 million, respectively, at fair value, and represented 1.4%



and 0.4%, respectively, of total fixed maturity securities. At December 31, 2013, fixed maturity holdings rated below investment grade and non-rated bonds totaled \$35.0 million and \$13.1 million, respectively, at fair value, and represented 1.4% and 0.5%, respectively, of total fixed maturity securities.

The following table presents the credit quality ratings of the Company's fixed maturity portfolio by security type at September 30, 2014 at fair value. The Company's estimated credit quality ratings are based on the average of ratings assigned by nationally recognized securities rating organizations. Credit ratings for the Company's fixed maturity portfolio were stable during the nine months ended September 30, 2014, with 97.9% of fixed maturity securities at fair value experiencing no change in their

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overall rating. 0.8% of fixed maturity securities at fair value experienced upgrades during the period, partially offset by 1.2% in credit downgrades. A majority of the downgrades were slight and still within the investment grade portfolio.

| September 30, 2014<br>(Amounts in thousands) |            |                   |                  |                    |                 |                        |
|----------------------------------------------|------------|-------------------|------------------|--------------------|-----------------|------------------------|
|                                              | AAA        | AA <sup>(1)</sup> | A <sup>(1)</sup> | BBB <sup>(1)</sup> | Non-Rated/Other | Total<br>Fair<br>Value |
| U.S. government bonds and agencies:          |            |                   |                  |                    |                 |                        |
| Treasuries                                   | \$ 14,836  | \$ 0              | \$ 0             | \$ 0               | \$ 0            | \$ 14,836              |
| Government agency                            | 1,280      | 0                 | 0                | 0                  | 0               | 1,280                  |
| Total                                        | 16,116     | 0                 | 0                | 0                  | 0               | 16,116                 |
|                                              | 100.0      | %                 |                  |                    |                 | 100.0 %                |
| Municipal securities:                        |            |                   |                  |                    |                 |                        |
| Insured                                      | 10,768     | 440,830           | 546,576          | 14,458             | 14,449          | 1,027,081              |
| Uninsured                                    | 229,298    | 361,079           | 487,174          | 171,769            | 3,816           | 1,253,136              |
| Total                                        | 240,066    | 801,909           | 1,033,750        | 186,227            | 18,265          | 2,280,217              |
|                                              | 10.5       | % 35.2            | % 45.3           | % 8.2              | % 0.8           | % 100.0 %              |
| Mortgage-backed securities:                  |            |                   |                  |                    |                 |                        |
| Commercial                                   | 0          | 0                 | 11,360           | 10,609             | 0               | 21,969                 |
| Agencies                                     | 5,846      | 0                 | 0                | 0                  | 0               | 5,846                  |
| Non-agencies:                                |            |                   |                  |                    |                 |                        |
| Prime                                        | 13         | 404               | 617              | 0                  | 2,836           | 3,870                  |
| Alt-A                                        | 0          | 17                | 1,352            | 0                  | 5,102           | 6,471                  |
| Total                                        | 5,859      | 421               | 13,329           | 10,609             | 7,938           | 38,156                 |
|                                              | 15.4       | % 1.1             | % 34.9           | % 27.8             | % 20.8          | % 100.0 %              |
| Corporate securities:                        |            |                   |                  |                    |                 |                        |
| Communications                               | 0          | 0                 | 5,874            | 0                  | 0               | 5,874                  |
| Consumer-cyclical                            | 0          | 0                 | 8,646            | 5,549              | 0               | 14,195                 |
| Consumer-non-cyclical                        | 0          | 0                 | 0                | 16,951             | 0               | 16,951                 |
| Industrial                                   | 0          | 0                 | 0                | 9,859              | 5,814           | 15,673                 |
| Energy                                       | 0          | 0                 | 0                | 75,036             | 4,972           | 80,008                 |
| Basic materials                              | 0          | 0                 | 0                | 16,452             | 0               | 16,452                 |
| Financial                                    | 0          | 13,320            | 35,307           | 61,313             | 7,838           | 117,778                |
| Technology                                   | 0          | 0                 | 0                | 10,893             | 3,369           | 14,262                 |
| Utilities                                    | 0          | 0                 | 2,027            | 2,158              | 0               | 4,185                  |
| Total                                        | 0          | 13,320            | 51,854           | 198,211            | 21,993          | 285,378                |
|                                              | 0.0        | % 4.6             | % 18.2           | % 69.5             | % 7.7           | % 100.0 %              |
| Total                                        | \$ 262,041 | \$ 815,650        | \$ 1,098,933     | \$ 395,047         | \$ 48,196       | \$ 2,619,867           |
|                                              | 10.0       | % 31.1            | % 41.9           | % 15.1             | % 1.9           | % 100.0 %              |

(1) Intermediate ratings are offered at each level (e.g., AA includes AA+, AA and AA-).

At September 30, 2014, the Company had \$22.0 million, or 0.8% of its fixed maturity portfolio, at fair value, in U.S. government bonds and agencies and mortgage-backed securities (Agencies). In August 2011, Standard and Poor's downgraded the U.S. government's long-term sovereign credit rating from AAA to AA+. This downgrade triggered significant volatility in prices for a variety of investments. While Moody's and Fitch affirmed their AAA ratings, they placed a negative outlook in November 2011 and warned of a potential downgrade if no long-term deficit agreement was reached over the next two years. In 2013, while Moody's and S&P affirmed AAA and AA+ ratings, respectively,

with a stable outlook, Fitch warned of a potential downgrade from AAA if the debt limit was not raised in time. In March 2014, Fitch affirmed its AAA rating with a stable outlook after the February suspension of the U.S. federal debt limit in a timely manner. These rating agencies' concerns indicate declining confidence that timely fiscal measures will be forthcoming to place U.S. public finances on a sustainable path and secure the AAA ratings. Standard and Poor's affirmed the U.S. Treasury's short-term credit rating of AAA indicating that the short-term capacity of the U.S. to meet its financial commitment on its outstanding obligations is strong. The Company understands that market

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participants continue to use rates of return on U.S. government debt as a risk-free rate and have continued to invest in U.S. Treasury securities.

### (1) Municipal Securities

The Company had \$2.3 billion at fair value (\$2.2 billion at amortized cost) in municipal bonds at September 30, 2014, of which \$1.0 billion were insured by bond insurers. For insured municipal bonds that have underlying ratings, the average underlying rating was A+ at September 30, 2014.

At September 30, 2014, the bond insurers providing credit enhancement were Assured Guaranty Corporation, Berkshire Hathaway Assurance Corporation, and National Public Finance Guarantee Corporation, which covered approximately 49.8% of the insured municipal securities. The average rating of the Company's municipal bonds insured by these bond insurers was A+, with an underlying rating of A. Most of the insured bonds' ratings were investment grade and reflected the credit of the underlying issuers. 9.0% of the remaining insured bonds are non-rated or below investment grade, and the Company does not believe that these insurers provide credit enhancement to the municipal bonds that they insure.

The Company considers the strength of the underlying credit as a buffer against potential market value declines which may result from future rating downgrades of the bond insurers. In addition, the Company has a long-term time horizon for its municipal bond holdings which generally allows it to recover the full principal amounts upon maturity and avoid forced sales prior to maturity of bonds that have declined in market value due to the bond insurers' rating downgrades. Based on the uncertainty surrounding the financial condition of these insurers, it is possible that there will be additional downgrades to below investment grade ratings by the rating agencies in the future, and such downgrades could impact the estimated fair value of municipal bonds.

### (2) Mortgage-Backed Securities

The mortgage-backed securities portfolio is categorized as loans to "prime" borrowers except for \$6.5 million and \$7.0 million (\$5.7 million and \$6.3 million at amortized cost) of Alt-A mortgages at September 30, 2014 and December 31, 2013, respectively. Alt-A mortgage backed securities are at fixed or variable rates and include certain securities that are collateralized by residential mortgage loans issued to borrowers with credit profiles stronger than those of sub-prime borrowers, but do not qualify for prime financing terms due to high loan-to-value ratios or limited supporting documentation. The Company had holdings of \$22.0 million and \$21.9 million (\$21.8 million and \$21.8 million at amortized cost) in commercial mortgage-backed securities at September 30, 2014 and December 31, 2013, respectively.

The weighted-average rating of the Company's Alt-A mortgage-backed securities was B and the weighted-average rating of the entire mortgage-backed securities portfolio was BBB at September 30, 2014.

### (3) Corporate Securities

Included in fixed maturity securities are \$285.4 million and \$264.7 million of corporate securities, which had durations of 2.3 years and 3.4 years, at September 30, 2014 and December 31, 2013, respectively. The weighted-average rating was BBB as of September 30, 2014 and December 31, 2013.

### Equity securities

Equity holdings consist of non-redeemable preferred stocks, common stocks on which dividend income is partially tax-sheltered by the 70% corporate dividend received deduction, and a partnership interest in a private credit fund. The net losses due to changes in fair value of the Company's equity portfolio during the nine months ended September 30, 2014 were \$6.4 million. The primary cause of the decrease in the value of the Company's equity securities was the overall decline in the energy and utilities sectors during the three months ended September 30, 2014.

The Company's common stock allocation is intended to enhance the return of and provide diversification for the total portfolio. At September 30, 2014, 14.6% of the total investment portfolio at fair value was held in equity securities, compared to 8.9% at December 31, 2013.



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Notes payable consists of the following:

|                           | Lender                         | Interest Rate              | Expiration      | September 30,<br>2014<br>(Amounts in thousands) | December 31,<br>2013 |
|---------------------------|--------------------------------|----------------------------|-----------------|-------------------------------------------------|----------------------|
| Secured credit facility   | Bank of America                | LIBOR plus 40 basis points | July 31, 2016   | \$ 120,000                                      | \$ 120,000           |
| Secured loan              | Union Bank                     | LIBOR plus 40 basis points | January 2, 2015 | 20,000                                          | 20,000               |
| Unsecured credit facility | Bank of America and Union Bank | (1)                        | June 30, 2018   | 150,000                                         | 50,000               |
| Total                     |                                |                            |                 | \$ 290,000                                      | \$ 190,000           |

(1) On July 2, 2013, the Company entered into an unsecured \$200 million five-year revolving credit facility. The interest rate on borrowings under the credit facility is based on the Company's debt to total capital ratio and ranges from LIBOR plus 112.5 basis points when the ratio is under 15% to LIBOR plus 162.5 basis points when the ratio is above 25%. Commitment fees for the undrawn portion of the credit facility range from 12.5 basis points when the ratio is under 15% to 22.5 basis points when the ratio is above 25%. During the nine months ended September 30, 2014, the interest rate was LIBOR plus 112.5 basis points on the \$150 million of borrowings and 12.5 basis points on the undrawn portion of the credit facility.

The bank loan and credit facilities contain financial covenants pertaining to minimum statutory surplus, debt to capital ratio, and risk based capital ratio. The Company was in compliance with all of its loan covenants at September 30, 2014.

**E. Regulatory Capital Requirement**

Among other considerations, industry and regulatory guidelines suggest that the ratio of a property and casualty insurer's annual net premiums written to statutory policyholders' surplus should not exceed 3.0 to 1. Based on the combined surplus of all the Insurance Companies of \$1.5 billion at September 30, 2014, and net premiums written for the twelve months ended on that date of \$2.8 billion, the ratio of premiums written to surplus was 1.9 to 1.

**Item 3. Quantitative and Qualitative Disclosures About Market Risks**

The Company is subject to various market risk exposures primarily due to its investing and borrowing activities. Primary market risk exposures are changes in interest rates, equity prices, and credit risk. Adverse changes to these rates and prices may occur due to changes in the liquidity of a market, or to changes in market perceptions of creditworthiness and risk tolerance. The following disclosure reflects estimates of future performance and economic conditions. Actual results may differ.

**Overview**

The Company's investment policies define the overall framework for managing market and investment risks, including accountability and controls over risk management activities, and specify the investment limits and strategies that are appropriate given the liquidity, surplus, product profile, and regulatory requirements of the subsidiaries. Executive oversight of investment activities is conducted primarily through the Company's investment committee. The Company's investment committee focuses on strategies to enhance after-tax yields, mitigate market risks, and optimize capital to improve profitability and returns.

The Company manages exposures to market risk through the use of asset allocation, duration, and credit ratings. Asset allocation limits place restrictions on the total funds that may be invested within an asset class. Duration limits on the fixed maturities portfolio place restrictions on the amount of interest rate risk that may be taken. Comprehensive day-to-day management of market risk within defined tolerance ranges occurs as portfolio managers buy and sell within their respective markets based upon the acceptable boundaries established by investment policies.

Credit risk

Credit risk results from uncertainty in a counterparty's ability to meet its obligations. Credit risk is managed by maintaining a high credit quality fixed maturities portfolio. As of September 30, 2014, the estimated weighted-average credit quality rating of the fixed maturities portfolio was A+, at fair value, compared to AA-, at fair value, at December 31, 2013. The small decrease in the weighted-average rating of the Company's fixed maturity portfolio was a result of the maturation of certain AAA rated bonds that were replaced with lower rated investment grade bonds. Historically, the ten-year default rate for municipal bonds rated A or higher by Moody's has been less than 1%. The Company's municipal bond holdings, which represent 87.0% of its fixed maturity

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portfolio at September 30, 2014, at fair value, are broadly diversified geographically. 99.7% of municipal bond holdings are tax-exempt. The following table presents municipal bond holdings by state in descending order of holdings at fair value at September 30, 2014:

| States       | Fair Value             | Average Rating |
|--------------|------------------------|----------------|
|              | (Amounts in thousands) |                |
| California   | \$ 364,053             | A+             |
| Texas        | 340,798                | AA             |
| Florida      | 219,217                | A+             |
| Illinois     | 167,869                | A+             |
| Washington   | 118,605                | AA-            |
| Other states | 1,069,675              | A+             |
| Total        | \$ 2,280,217           |                |

The portfolio is broadly diversified among the states and the largest holdings are in populous states such as California and Texas. These holdings are further diversified primarily among cities, counties, schools, public works, hospitals, and state general obligations. The Company seeks to minimize overall credit risk and ensure diversification by limiting exposure to any particular issuer.

Taxable fixed maturity securities represented 13.3% of the Company's fixed maturity portfolio at September 30, 2014. 6.3% of the Company's taxable fixed maturity securities were comprised of U.S. government bonds and agencies and mortgage-backed securities (Agencies), which were rated AAA at September 30, 2014. 7.5% of the Company's taxable fixed maturity securities, representing 1.0% of its total fixed maturity portfolio, were rated below investment grade. Below investment grade issues are considered "watch list" items by the Company, and their status is evaluated within the context of the Company's overall portfolio and its investment policy on an aggregate risk management basis, as well as their ability to recover their investment on an individual issue basis.

Equity price risk

Equity price risk is the risk that the Company will incur losses due to adverse changes in the equity markets.

At September 30, 2014, the Company's primary objective for common equity investments was current income. The fair value of the equity investments consisted of \$454.3 million in common stocks, \$29.5 million in non-redeemable preferred stocks, and \$12.7 million in a partnership interest in a private credit fund. Common stock equity assets are typically valued for future economic prospects as perceived by the market. The Company invests more in the energy and utility sector relative to the S&P 500 Index.

Common stocks represented 13.3% of total investments at fair value at September 30, 2014. Beta is a measure of a security's systematic (non-diversifiable) risk, which is measured by the percentage change in an individual security's return for a 1% change in the return of the market. Based on a hypothetical reductions in the overall value of the stock market, the following table illustrates estimated reductions in the overall value of the Company's common stock portfolio at September 30, 2014 and December 31, 2013:

|                                                                        | September 30, 2014                          | December 31, 2013 |
|------------------------------------------------------------------------|---------------------------------------------|-------------------|
|                                                                        | (Amounts in thousands, except average Beta) |                   |
| Average Beta                                                           | 1.00                                        | 0.93              |
| Hypothetical reduction in the overall value of the stock market of 25% | \$113,591                                   | \$55,746          |
| Hypothetical reduction in the overall value of the stock market of 50% | \$227,182                                   | \$111,492         |

Interest rate risk

Interest rate risk is the risk that the Company will incur a loss due to adverse changes in interest rates relative to the interest rate characteristics of interest bearing assets and liabilities. The Company faces interest rate risk, as it invests substantial funds in interest sensitive assets and issues interest sensitive liabilities. Interest rate risk includes risks related to changes in U.S. Treasury yields and other key benchmarks, as well as changes in interest rates resulting from widening credit spreads and credit exposure to collateralized securities.





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The value of the fixed maturity portfolio at September 30, 2014, which represented 76.9% of total investments at fair value, is subject to interest rate risk. As market interest rates decrease, the value of the portfolio increases and vice versa. A common measure of the interest sensitivity of fixed maturity assets is modified duration, a calculation that utilizes maturity, coupon rate, yield and call terms to calculate an average age of the expected cash flows generated by such assets. The longer the duration, the more sensitive the asset is to market interest rate fluctuations.

The Company has historically invested in fixed maturity investments with a goal of maximizing after-tax yields and holding assets to the maturity or call date. Since assets with longer maturities tend to produce higher current yields, the Company's historical investment philosophy resulted in a portfolio with a moderate duration. Bond investments made by the Company typically have call options attached, which further reduce the duration of the asset as interest rates decline. The modified duration of the overall bond portfolio reflecting anticipated early calls was 2.9 years at September 30, 2014 compared to 3.9 years at December 31, 2013.

Given a hypothetical increase of 100 or 200 basis points in interest rates, the Company estimates that the fair value of its bond portfolio at September 30, 2014 would decrease by \$78.5 million or \$157.1 million, respectively. Conversely, if interest rates were to decrease, the fair value of the Company's bond portfolio would rise, and it may cause a higher number of the Company's bonds to be called away. The proceeds from the called bonds would likely be reinvested at lower yields which would result in lower overall investment income for the Company.

### Item 4. Controls and Procedures

#### Evaluation of Disclosure Controls and Procedures

The Company maintains disclosure controls and procedures designed to ensure that information required to be disclosed in the Company's reports filed under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the SEC rules and forms, and that such information is accumulated and communicated to the Company's management, including its Chief Executive Officer and Chief Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost benefit relationship of possible controls and procedures.

As required by Securities and Exchange Commission Rule 13a-15(b), the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of the end of the quarter covered by this Quarterly Report on Form 10-Q. Based on the foregoing, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective at the reasonable assurance level.

#### Changes in Internal Control over Financial Reporting

There has been no change in the Company's internal control over financial reporting during the Company's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting. The Company's process for evaluating controls and procedures is continuous and encompasses constant improvement of the design and effectiveness of established controls and procedures and the remediation of any deficiencies which may be identified during this process.

## PART II - OTHER INFORMATION

### Item 1. Legal Proceedings

The Company is, from time to time, named as a defendant in various lawsuits or regulatory actions incidental to its insurance business. The majority of lawsuits brought against the Company relate to insurance claims that arise in the normal course of business and are reserved for through the reserving process. For a discussion of the Company's reserving methods, see the Company's Annual Report on Form 10-K for the year ended December 31, 2013.

The Company also establishes reserves for non-insurance claims related lawsuits, regulatory actions, and other contingencies when the Company believes a loss is probable and is able to estimate its potential exposure. For material loss contingencies believed to be reasonably possible, the Company also discloses the nature of the loss contingency and an estimate of the possible loss, range of loss, or a statement that such an estimate cannot be made. While actual losses may differ from the amounts recorded and the ultimate outcome of the Company's pending actions is generally not yet determinable, the Company does not believe that the

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ultimate resolution of currently pending legal or regulatory proceedings, either individually or in the aggregate, will have a material adverse effect on its financial condition, results of operations, or cash flows.

In all cases, the Company vigorously defends itself unless a reasonable settlement appears appropriate. For a discussion of legal matters, see the Company's Annual Report on Form 10-K for the year ended December 31, 2013. See also "Overview-C. Regulatory and Litigation Matters" in Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations of this Quarterly Report on Form 10-Q.

There are no environmental proceedings arising under federal, state, or local laws or regulations to be discussed.

Item 1A. Risk Factors

The Company's business, results of operations, and financial condition are subject to various risks. These risks are described elsewhere in this Quarterly Report on Form 10-Q and in the Company's other filings with the United States Securities and Exchange Commission, including the Company's Annual Report on Form 10-K for the year ended December 31, 2013. The risk factors identified in the Company's Annual Report on Form 10-K for the year ended December 31, 2013 have not changed in any material respect.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosure

Not applicable.

Item 5. Other Information

None.

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Item 6. Exhibits

|         |                                                                                                                                                                                                                                                                                                                                                                                                                                      |
|---------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 15.1    | Report of Independent Registered Public Accounting Firm.                                                                                                                                                                                                                                                                                                                                                                             |
| 15.2    | Awareness Letter of Independent Registered Public Accounting Firm.                                                                                                                                                                                                                                                                                                                                                                   |
| 31.1    | Certification of Registrant's Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.                                                                                                                                                                                                                                                                                                                     |
| 31.2    | Certification of Registrant's Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.                                                                                                                                                                                                                                                                                                                     |
| 32.1    | Certification of Registrant's Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as created by Section 906 of the Sarbanes-Oxley Act of 2002. This certification is being furnished solely to accompany this Quarterly Report on Form 10-Q and is not being filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and is not to be incorporated by reference into any filing of the Company. |
| 32.2    | Certification of Registrant's Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as created by Section 906 of the Sarbanes-Oxley Act of 2002. This certification is being furnished solely to accompany this Quarterly Report on Form 10-Q and is not being filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and is not to be incorporated by reference into any filing of the Company. |
| 101.INS | XBRL Instance Document                                                                                                                                                                                                                                                                                                                                                                                                               |
| 101.SCH | XBRL Taxonomy Extension Schema Document                                                                                                                                                                                                                                                                                                                                                                                              |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document                                                                                                                                                                                                                                                                                                                                                                                |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document                                                                                                                                                                                                                                                                                                                                                                                      |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document                                                                                                                                                                                                                                                                                                                                                                               |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document                                                                                                                                                                                                                                                                                                                                                                                 |

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

MERCURY GENERAL CORPORATION

Date: November 4, 2014

By: /s/ Gabriel Tirador  
Gabriel Tirador  
President and Chief Executive Officer

Date: November 4, 2014

By: /s/ Theodore R. Stalick  
Theodore R. Stalick  
Senior Vice President and Chief Financial Officer