working together

ICI MUTUAL 2008 ANNUAL REPORT

For more than 20 years, ICI Mutual has offered investment companies consistent coverage at risk-related prices, expert claims handling, and risk management services. The Company is able to serve the mutual fund industry in these ways because of the unique relationship it has with fund advisers, directors, and officers. As the industry's only captive insurer, the Company's interests are aligned with those of its insureds—a structure that naturally results in all parties

working together.

ICI MUTUAL
2008 Annual Report

MESSAGE
from the President and Chairman

2008 was a good year for ICI Mutual financially and strategically, as we made progress on a number of important initiatives; however, a review of any company's 2008 operating results must begin with a discussion of how the economic difficulties of the past 18 months affected the enterprise. What began in 2007 as the sub-prime mortgage crisis, worsened into a worldwide credit crisis as 2008 unfolded. There has been no shortage of media reports explaining that financial institutions of all types have been one of the most severely affected sectors of the economy. As both investors of capital and underwriters of risk, financial institutions—commercial banks, investment banks, broker dealers, insurance companies, etc.—are exposed to loss of capital from both activities. In 2008, the insurance industry was hit hard as investment losses resulting from declining bond and equity values were compounded by underwriting losses from both traditional property and casualty risks and from less traditional financial risks, such as credit default swaps, investment guarantees supporting variable annuities, and mortgage bond insurance.

Operating Results

We are pleased to report that against this difficult economic environment, ICI Mutual posted both net underwriting and net investment profits (i.e., net investment income plus net realized losses) in 2008. In addition, the Company's surplus declined only 2.3%, as unrealized losses on investment securities offset the positive contributions from underwriting and investment activities. Net income for 2008 was $12.1 million compared to $19.3 million in 2007, while the ending surplus was $156.7 million, just under the $160.4 million of surplus at the end of 2007. 2008 marked the fourth consecutive year that ICI Mutual realized an underwriting profit following market timing and associated losses earlier this decade. Normally, operating results such as these would

result in the Company declaring a dividend, as it did in 2007. However, as 2008 closed, the Company's Board of Directors decided not to declare a dividend in the face of the uncertain economic outlook for 2009. The Board's decision reflects the Company's continuing conservative financial approach.

More specifically, as an investor of capital, ICI Mutual's portfolio has always been managed to a conservative mandate, emphasizing short or intermediate exposure to interest-rate risk and high credit quality. As 2008 began, the duration of the portfolio was 1.51 years and the average credit quality was AA. This profile performed well through the first eight months of the year, but the events after Lehman Brothers filed for bankruptcy on September 15 took their toll. At the end of the year, the portfolio had approximately 9% unrealized depreciation, which has been reflected in the financial statements net of tax benefits and is the primary cause of the small reduction in surplus for 2008. Looking ahead, a combination of positive cash flow from portfolio maturities and operations provides ICI Mutual with the ability to hold the depreciated securities until they are expected to recover. For a more complete discussion of the year's investment results, please see page 19 of this report.

As an insurer of risks, ICI Mutual's 2008 underwriting results reflect both positive developments on claims related to market timing and associated events earlier this decade and the generally benign claims environment that mutual funds and their directors, officers, and advisers have experienced since 2004. Although market timing and associated issues were very expensive for the industry and by extension ICI Mutual, the several hundred million dollars that the Company and its reinsurance partners invested to defend insureds have resulted in numerous legal decisions that have both reaffirmed the legal protections

provided by mutual fund regulation and contributed to the relatively benign claims environment up through 2007. As the mutual fund industry's captive insurer, ICI Mutual provides liability insurance—D&O/E&O coverage and fidelity bonds—to mutual funds and their directors, officers, and advisers. The Company does not write any of the non-traditional financial risks that affected a number of major liability insurers this past year. As a result of these factors, the Company experienced an underwriting profit for the fourth year in a row, while maintaining stable premium rates and consistently available coverage limits for its insureds.

The Credit Markets

The credit market events of 2007 and 2008 have presented litigation challenges to virtually all financial institutions, including mutual funds. From the beginning of the subprime mortgage problems, ICI Mutual has held the view that the fundamental regulatory requirements governing funds—diversification, liquidity, restricted leverage, and daily valuation—combined with prospectus disclosure requirements, would minimize mutual funds' exposure to many of the conditions that have led to civil litigation against other financial institutions. In the Company's view, those funds that demonstrated significant negative performance relative to their peer group (i.e., "outlier" performance) would be the funds most exposed to litigation. Events to date support this view, as mutual funds and their advisers have been involved in only

a relatively small number of the scores of credit crisis securities class action lawsuits that have been filed against financial institutions, and those involved have been performance "outliers."

Credit market events have caused world insurance markets, especially the market for financial institution D&O/E&O insurance, to begin to harden in general and in some segments significantly, as some commercial insurers seek double-digit premium increases. Reminiscent of the events that led to the creation of ICI Mutual over 20 years ago, commercial insurers often still include mutual funds in the same rating category as all other financial institutions, without consideration of the unique risk protections provided by fund regulation. In order to help insureds benefit from the regulatory protections, ICI Mutual has invested substantial time meeting with insurers and reinsurers that support the insurance programs we offer to distinguish the exposures mutual funds have to credit market litigation from the exposures presented by other financial institutions. These efforts enabled ICI Mutual to offer greater stability of premiums and coverage limits to insureds during 2008. We will continue this communication campaign and expect it will yield benefits in the coming years.

In 2008, claim frequency returned to its historic annual run-rate, after a relatively benign three-year period. In addition to credit market claims, 2008 witnessed a spate of portfolio trading errors, implicating the "costs of correction" coverage that ICI Mutual pioneered in the 1980s. The Company also saw creative attempts by the plaintiffs' bar to bring litigation against funds and advisers on new issues, including investments in gambling securities and disclosure related to "A" share versus "B" share pricing. Looking ahead, ICI Mutual expects to see more claims from the plaintiffs' bar as it continues to search for new theories to attack mutual fund fees and files actions to test the strength of prospectus disclosures.

Strategic Initiatives

ICI Mutual undertook several strategic initiatives in 2008 to strengthen the services we offer insureds and to evaluate the strength of the Company's capital.

First, in order to respond more effectively to the needs of insureds and to actively promote ICI Mutual's value as a captive insurer, the Board of Directors and the member-owners of the Company approved a conversion from a Vermont-domiciled association captive insurer to a Vermont-domiciled captive risk retention group (RRG), effective January 1, 2009. The RRG business form was created by federal law to ensure that liability insurers organized under the law are subject to traditional insurance regulation only by the insurer's state of domicile, notwithstanding multi-state business activities.

This conversion does not affect the insurance coverages the Company offers, but will permit the Company's staff to more actively serve insureds in their places of business and to implement technologies to facilitate communication with insureds, including development of an ICI Mutual website. ICI Mutual will continue to pursue the same mission on behalf of mutual funds, their directors, officers, and advisers; will continue to be subject to oversight by Vermont regulators; and will continue to be governed by the same Board of Directors. Although ICI Mutual is not a publicly traded company, it has always sought to pattern its corporate governance practices after the "best practices" of its insureds and other publicly traded companies. A section of this annual report describes the governance practices ICI Mutual follows to ensure alignment between the Company's mission and the needs of its owners.

Second, in response to comments from insureds and to changes in fund regulation, ICI Mutual revised its insurance application from the ground up during 2008. The new application is much shorter and places greater emphasis on fund and adviser risk management processes. Rather than expand the core application, the Company introduced supplemental underwriting questionnaires to address topical risk exposures, such as asset-backed securities, market timing, and credit default swaps. The questionnaires can be eliminated after the particular issue is no longer relevant. This approach reduces the effort it takes for insureds to complete the application.

Third, although published in early 2009, the ICI Mutual staff spent many months preparing a risk management study on mutual fund insurance issues. Entitled *Mutual Fund D&O/E&O Insurance: A Guide for Insureds*, the study is designed as a resource for fund directors and advisers on the unique aspects of mutual fund D&O/E&O insurance and on how such coverage differs from similar coverage for operating companies. The study has been reviewed by outside counsel to funds, directors and advisers, in-house mutual fund general counsel, and an insurance intermediary to ensure it covers the important issues from the various perspectives that are part of the insurance buying decision. The study joins about a dozen publications in our risk management library and helps to fulfill a key portion of our mission, to educate the industry about risks.

Fourth, in order to evaluate the Company's capital adequacy, management engaged Aon Global Risk Consulting, ICI Mutual's independent actuary, to perform a Dynamic Financial Analysis (DFA) of capital adequacy under various scenarios. Consistent with the Company's long history of being highly rated by A.M. Best, the DFA indicated that ICI Mutual's capital could withstand most stressful claim environments. The results were presented to the Investment Committee and to the Board of Directors for their ongoing evaluation of ICI Mutual's asset allocation strategy and capital policies.

Outlook for 2009

Given the depth and breadth of the current global economic issues and the uncertainty created by the many government initiatives to address the problems, world markets for liability insurance will remain unsettled and may harden further throughout 2009 as insurers seek to minimize risk (by reducing limits and tightening coverage terms) in the face of an uncertain claims environment and to restore capital (by raising premium rates) that has been lost in bond and stock markets.

As for ICI Mutual, we will continue to pursue our core mission of providing mutual funds and their directors, officers, and advisers with stable coverage limits at risk-related prices. The Company is well capitalized and enjoys the ongoing strong support of its insureds and reinsurers. We believe that our singular focus and the knowledge advantage that results from that focus will benefit our insureds.

In closing, we want to thank our insureds for your continued support of ICI Mutual. The Board of Directors and staff look forward to continuing to provide your organizations with high-quality insurance services for many years to come.

Lawrence R. Maffia, *President*

Ralph K. Packard, *Chairman of the Board of Directors*

Regardless of which direction the economic winds are blowing, investment companies need an insurance partner that provides consistent coverage limits, terms, and premiums over the long-term. ICI Mutual has the financial strength, stable capacity, and consistent coverages to fulfill the risk-financing needs of investment companies in all insurance and economic cycles. For over 21 years, insureds have depended on ICI Mutual to always

be there for them.

Benefiting
from conservative financial management

With a strong financial position and tailored, specialized coverages, ICI Mutual has long been the predominant provider of insurance coverage for the U.S. mutual fund industry. Its insureds represent over 60% of the industry's managed assets.

The Company's financial strength stems in large part from its historically conservative financial management. In every facet of the Company's operations—underwriting, risk retention, reinsurance affiliations, portfolio management, and administration—the Company has sought to use resources wisely, invest prudently, and manage risk diligently in order to build capital to meet the needs of insureds, and to pay dividends to the Company's owners when prudent to do so.

Providing
consistent coverage in all markets

As a captive insurer, the Company's only mandate is to serve the needs of its insureds. Unlike commercial insurers, the Company's future is not dependent on maintaining high earnings or continual growth. In fact, ICI Mutual's captive structure is an asset, as it permits the Company to thoroughly understand the industry it serves and insulates it from the losses that commercial insurers incur from risks unrelated to the mutual fund industry. ICI Mutual is well positioned to adjust to the changing needs of its insureds and to finance investment company risks in all economic markets. In the current market, some commercial insurers are disrupting insureds' coverage by choosing to enter or exit the investment company market, reduce limits, tighten the terms of coverage, or change prices opportunistically. By contrast, ICI Mutual is committed to meeting the full insurance needs of investment companies at risk-related prices in all markets.

In the current mutual fund insurance market, as in the past, ICI Mutual remains a stabilizing force. Indeed, it was the critical need for consistent coverage limits and prices that led to the creation of

ICI Mutual in 1987. Businesses were then in the grips of a major liability insurance crisis, which resulted in a shortage of quality coverage at reasonable rates. In response, the Investment Company Institute and its members banded together to create ICI Mutual, in order to provide coverage in all markets and to address the specialized liability insurance needs of the mutual fund industry. ICI Mutual carries on that mission today.

Working
with a strong, diversified group of reinsurance partners

ICI Mutual, together with its long-term reinsurance partners, is positioned to provide the full limits of coverage sought by investment companies. The ability to insure with one carrier offers investment companies and advisers a variety of benefits, including the ability to resolve claims with a single carrier, rather than multiple carriers.

In early 2008, the Company again obtained renewed support for its core reinsurance treaty from a diversified group of highly rated reinsurers. Due to the sub-prime mortgage crisis, the Company was unable to achieve a reduction in the treaty rate, but the Company's renewal at the expiring rate supported the Company's objective of maintaining stable premium rates for its insureds. Overall, based on their latest available information, the Company's treaty participants have combined capital and surplus of over $12 billion and are rated highly by A.M. Best. ICI Mutual is careful to maintain the treaty's strength by selecting a group of partners that are diversified across industries and geographically.

ICI Mutual monitors the effect of the economic turmoil on the various reinsurance markets it utilizes. Facultative reinsurance partners are selected based on their financial strength and measures are in place to avoid concentrations on an underlying insurance program. Of note, certain AIG affiliates are reinsurance partners of the Company; the Company believes that to the extent reinsurance amounts were to become recoverable from these entities, they would be able to pay.

Informed by deep industry knowledge and expertise, ICI Mutual offers tailored coverages at sustainable prices that reflect the risks involved.

Of course, minimizing claims is in the best interests of funds, advisers, and the insurer. With this ideal in mind, the Company seeks to identify and share industry knowledge and practices for limiting risk. Looking at these advantages together, it is clear ICI Mutual is

built for you.

Offering
coverages that investment companies need

Mutual funds and their directors, officers, and advisers have exposure to the financial impact of defense costs incurred in civil litigation and regulatory investigations, settlements, judgments, and costs of correcting operational errors. Civil litigation and regulatory investigations and proceedings often involve either alleged conflicts of interest or alleged inadequacies in disclosure. The Company's core products—the Directors and Officers/Errors and Omissions Liability Policy, the Investment Company Blanket Bond, and the Independent Directors Liability Policy—are written specifically to address the unique risks of funds, fund directors and officers, and advisers. In addition, the Company frequently tailors coverage for an investment company or investment adviser having specific needs that may not be addressed by the standard form of the Company's core policies.

Understanding
issues investment companies face

One key advantage of ICI Mutual is its intimate knowledge of mutual fund processes and exposures. Few, if any, commercial insurers can compete with this advantage. In addition to the Company's employees, many of whom have significant tenure addressing investment company and investment adviser issues, the Company is able to call upon the expertise of its Board of Directors, who include mutual fund independent directors and investment adviser executives. A free exchange of information and insight into current risk issues takes place between Company management and Board members. The Risk Prevention and Underwriting Committees of the Board meet in person twice a year to identify current risk issues and offer guidance to management regarding coverage of the new and emerging risks.

The Company's management also interacts with other leading fund industry professionals, including those at the Investment Company Institute, at the Independent Directors Council, and at various groups of industry lawyers around the country. Through these relationships, the Company gains insights that permit the Company to develop appropriate insurance coverages and to provide educational materials that focus on the specialized risk management and insurance issues faced by investment companies and advisers.

The Company delivers these capabilities to each insured through ICI Mutual's experienced team of underwriters and lawyers. Each insured is assigned a specific underwriter to work with

throughout the insured's relationship with the Company. This enables the underwriter to develop a thorough understanding of the insured's processes and procedures to ensure that the insured's policy coverages and pricing appropriately reflect the insured's business and risk profile.

Anticipating emerging risks

ICI Mutual has a long history of anticipating new and emerging fund industry risks, and developing coverages to address these risks. Insights gained from the Company's Board and claims experience enables ICI Mutual to identify new and emerging risks and to communicate with insureds regarding steps that can be taken to mitigate risk exposures. Helping insureds to control losses serves the interest of both ICI Mutual and its insureds, by reducing costs and stabilizing the insurance market over the long-term.

ICI Mutual helps the industry to better understand new and emerging risks through its sponsorship of annual Risk Management Conferences, and through its library of risk management studies. The annual conferences offer insureds an opportunity to exchange views with their peers about effective risk management techniques. As the 2008 Annual Report goes to press, the Company has just released another risk management study, *Mutual Fund D&O/E&O Insurance: A Guide for Insureds*.

Last year offered a number of opportunities for ICI Mutual staff to evaluate emerging risks. Of note, special underwriting questionnaires were prepared to address fund exposures to asset-backed securities and credit default swaps. Looking to the future, ICI Mutual expects to devote substantial attention to ERISA exposures and to issues that may arise from a decision anticipated from the U.S. Supreme Court in late 2009 or early 2010 in *Jones v. Harris,* a case involving mutual fund fees.

A History of Our Risk Management Publications

Managing Risk in Processing Corporate Actions, 2001

Investment Management Compliance Risks, 2002

Understanding Bond Fund Risks, 2002

Computer Security Lite, 2003

Managing Defense Costs, 2004

Fair Valuation Study—An Introduction, 2005 (co-authored with ICI and IDC)

Fair Valuation Study—The Role of the Board, 2006 (co-authored with ICI and IDC)

The Two Faces of Identity Theft, 2006

Independent Director Litigation Risk, 2006

Preparing for a Pandemic, 2007

What to Expect in the Claims Process, 2007

2008 ICI Mutual Risk Management Publications

- ***Managing Risks in Trade Allocation*** reviews the basic fiduciary principles underlying an adviser's allocation responsibilities and the associated legal risks advisers may face. The publication includes case studies illustrating how individual advisers have chosen to address particular trade allocation issues.
- ***Outsourcing by Advisers and Affiliated Service Providers*** discusses the increased outsourcing of specialized functions by advisers and affiliated service providers to unaffiliated third-party vendors, particularly the potential liabilities that such advisers and providers may face for a third-party vendor's errors and the potential availability of insurance for losses resulting from such errors.
- ***Mutual Fund D&O/E&O Insurance: A Guide for Insureds*** provides a general introduction to mutual fund D&O/E&O insurance coverage as well as commentary on specific insurance issues that may be of interest to fund boards, senior management, risk managers, and others involved in the insurance selection process. Among other things, the Guide describes insurance issues associated with regulatory investigations, prospectus liability claims, fee litigation, fraud, and the costs of correcting operations-based errors. The Company designed this Guide to assist all decision-makers involved in the insurance selection process.
- ***Claims Trends*** is an annual newsletter that provides an overview of the fund industry claims environment, and includes discussion of litigation developments and court decisions that affect the funds, fund directors, and advisers

Through its unique business structure, ICI Mutual works with its clients toward the same goals. As a captive, insureds play an integral role in how the Company is run, which products it offers, and what emerging issues to focus on. Inherent in that formula is the reality that ICI Mutual is managed for its insureds.

Operating
the Company for its insureds

ICI Mutual is the only insurance company created by the mutual fund industry for the mutual fund industry. As a "captive," the Company is governed by senior fund industry leaders of owner insureds who serve on the Company's Board of Directors, thus directly aligning ICI Mutual's interests with those of the clients it serves.

As lawyers, doctors, colleges, universities, and mutual funds have found, forming and continuing to be insured by a captive offers a number of advantages, including stable long-term protection, tailored coverage designed by like-minded insureds, long-term control over insurance costs, specialized risk management services, and the potential for dividends. Especially in a financially uncertain time, the captive model is an excellent long-term value for investment companies seeking consistent coverage and stable pricing.

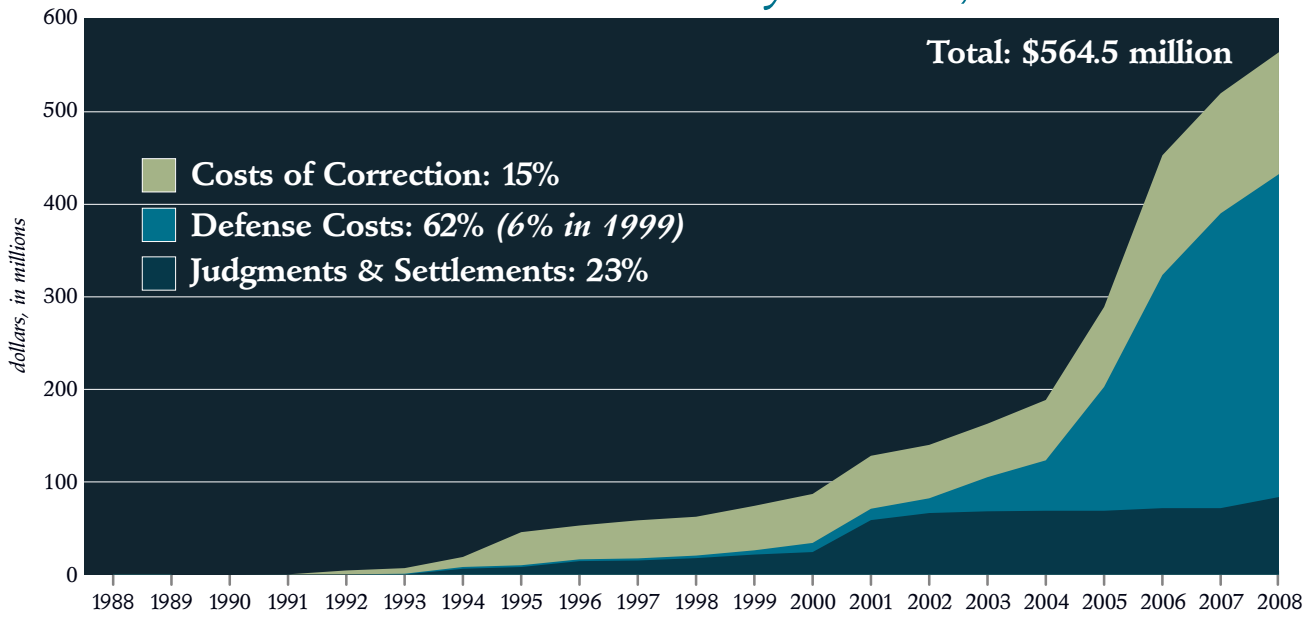
Handling
claims with expertise

Regardless of how well managed a fund group may be, mistakes are made and lawsuits are filed that result in claims. Since its establishment in 1987, ICI Mutual has paid more than $565 million in claims. The Company's lawyers combine an in-depth knowledge of both the mutual fund industry and insurance to ensure that claims are settled in a fair, efficient, and cooperative manner.

Insureds frequently ask what drives the cost of D&O/E&O insurance. As the chart on page 14 shows, more than 60% of the amounts paid by ICI Mutual have gone to reimburse insureds for their legal fees and other costs of defending claims, and such defense cost payments have grown significantly over the past 10 years. Although some of these defense cost payments are attributable to market timing/late trading issues, a substantial portion results from litigation related to mutual fund advisory fees, various distribution practices, and other non-market timing matters. Although

very expensive, the defense costs incurred by insureds—and paid by ICI Mutual—have helped to secure a number of favorable results in the courts. ICI Mutual believes these results bode well for reducing liability losses in the future.

D&O/E&O Insurance Payments, 1988–2008



ICI Mutual understands that insureds have a keen interest in directing and controlling their own defense in regulatory investigations and litigation; the Company's policy thus permits insureds to select their own counsel (subject to the Company's consent). It is in the interest of both ICI Mutual and its insureds to work together to achieve successful outcomes to investigations and litigation, and—because defense expenses are ultimately reflected in the cost of insurance—to do so at a reasonable cost. ICI Mutual works closely with its insureds to help coordinate defense efforts in matters involving more than one insured, and brings the specialized expertise of '40 Act counsel to assist the defense bar with achieving successful results. Company publications—including the *Claims Trends* annual newsletter and the periodic *Litigation Notebook*—help insureds and their counsel to better understand new and emerging areas of potential regulatory and litigation exposure.

As the mutual fund industry's only captive insurer, ICI Mutual maintains a unique relationship with the companies it serves. Principals from insureds' firms are nominated to serve on the Company's Board of Directors and its committees, where they play a significant role in shaping Company policies and projects. The committee members' work adds priceless value to the Company as they share their

deep well of knowledge.

Company bylaws specify that the Board of Directors shall have at least 15 and no more than 25 directors, 75% of whom shall be affiliated with capital contributing member insureds. The remaining 25% of the directors include individuals from non-capital contributing insureds, a resident of the State of Vermont, the Company's President, and representatives of the Investment Company Institute. The composition of the Board helps to ensure a key advantage of ICI Mutual as a captive insurer—a close alignment of the Company's strategic direction and insurance products with its owners' interests and with the needs of mutual funds and their directors, officers, and advisers—is always maintained.

Directors are recommended for service by the Nominating Committee of the Company's Board and are elected by a vote of the members. Directors generally serve a three-year term at which time they step off the Board for a period of one year and are then eligible for reelection. The nominating and rotation process ensures that the Board is representative of the Company's client base and provides an opportunity for service from all organizations interested in being represented on the Board. A complete list of Directors can be found at the end of this Annual Report.

Insureds occasionally ask whether individual Directors are involved in or are able to influence premium rates and claims settlements for individual insureds. Management is fully accountable to the Board for the Company's overall results of operation and for implementation of the Board's actions. However, neither client-specific underwriting nor client-specific claim settlement issues are brought to or reviewed with the Board. In order to ensure that senior management settles claims in a manner consistent with the Company's philosophy, large claims and claims involving unique matters are reviewed, after their resolution, by the Board's Claims Committee.

Similar to many fund complexes, ICI Mutual's Directors have found that assigning responsibility for strategy and oversight to discrete committees, each with a defined mission, is an effective way to govern. On the next page, the Chairman of each committee provides an overview of his committee's work.

Audit Committee


Brian T. Zino

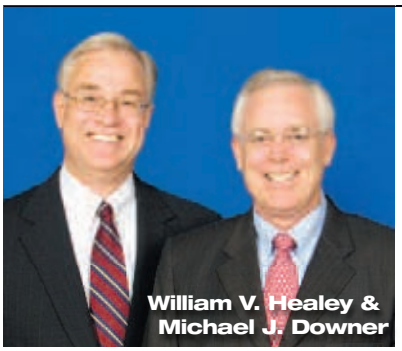
The Audit Committee performs a vital role overseeing the financial reporting process of the Company. This oversight function helps ensure that the Company's management and external auditors remain objective, and that the financial reporting of the Company is accurate. The committee makes recommendations to the Company's full Board regarding selection and retention of the external auditor, and evaluates the auditor's independence. The committee meets with the audit professionals and ICI Mutual's independent actuary at regularly scheduled intervals, it has unlimited access to them, and may meet with them with or without management's knowledge. Six Directors serve on the Audit Committee, none of whom are officers or employees of ICI Mutual or the ICI.

Investment Committee


Ronald H. Fielding

ICI Mutual's substantial investment portfolio is the financial resource available to pay claims. Careful stewardship of these assets is necessary for maintaining the Company's strong financial position. The Investment Committee thus serves a critical oversight function, hiring and monitoring the performance of the professional advisers who manage the Company's investment portfolio. In addition, the committee evaluates the Investment Guidelines for the Company's portfolio in light of market conditions and developments, and recommends to the full Board changes that may be appropriate from time to time. Six Directors serve on the Investment Committee, all of whom have investment experience from their work with their investment management companies.

Joint Underwriting/Risk Prevention Committee


William V. Healey &
Michael J. Downer

In many ways, underwriting and risk prevention form the heart of the insurance business and, in this regard, ICI Mutual's insureds have long benefited from the participation of industry experts on these committees. Bringing their deep industry knowledge to the table, members of these committees establish and approve specific underwriting criteria, determine which issues to address in the Company's risk management publications, and monitor the ongoing and emerging liability risks faced by ICI Mutual insureds. The majority of the thirteen Directors on the Joint Underwriting/Risk Prevention Committee have a background in law and a particular interest in the legal, compliance, and other risks facing mutual fund organizations.

Executive and Claims Committees


Ralph K. Packard

These two committees represent the Company's core leadership. The Executive Committee—comprised of the Chairman and Vice Chairman of the Board of Directors, the chairman of each Committee of the Board, the President of the ICI, and the President of ICI Mutual—manages the affairs of the Company. The Claims Committee—comprised of the Chairman, Vice Chairman, and immediate past Chairman of the Board of Directors—reviews ex-post management's adjustment of large claims and claims involving unusual issues to ensure claims are settled in a rational, even-handed manner.

2008 financial INFORMATION

CONTENTS

FINANCIAL discussion and analysis

Results of Operations

Income before dividends and taxes equaled $18.4 million in 2008 as compared to $34.1 million in 2007. The $15.7 million decline is primarily the result of increases in net loss and loss adjustment expenses, net realized losses on securities, and a decrease in net premiums earned.

2008 marked the fourth consecutive year that the Company produced an underwriting profit. While claims frequency returned to a more normal level from the unusually low level of reported claims in 2007, favorable developments on prior year claims helped to offset the higher claims costs attributable to the 2008 policy year, resulting in a net loss and loss adjustment expense ratio of approximately 37%. The expenses incurred to write the 2008 business resulted in a ratio of expenses to net premium written of approximately 28%, resulting in a combined ratio of 65%. The Company's combined ratio for 2008 compares very favorably to the average for the property and casualty insurance industry which experienced a combined ratio of 105% in 2008. The combined ratio is an industry accepted measure of underwriting profitability. Ratios under 100% indicate underwriting profitability while ratios greater than 100% indicate underwriting losses.

Premiums Written

Gross premiums written equaled $102.5 million in 2008 ($105.1 million in 2007) of which $69.3 million ($71.2 million in 2007) was ceded to reinsurers, resulting in net premiums written of $33.2 million ($33.9 million in 2007). The small decline in both direct and ceded premiums is the result of the Company's decision to adjust the rates it charges on fidelity bonds coupled with a general weakness in the market for the products the Company sells.

The Company continues to employ a very conservative ratio of net premiums written to surplus of 0.2 to 1 as compared to an industry average of 0.8 to 1.

Net premiums earned equaled $33.2 million in 2008 as compared to $35.1 million in 2007.

Investment Results

Net investment income equaled $12.0 million in 2008 as compared to $12.4 million in 2007. The decrease in net investment income is primarily attributable to lower interest rates on short term investments in 2008, partially mitigated by an increase in average investment assets.

Net realized losses on securities equaled $5.8 million in 2008 as compared to $0.3 million in 2007. These amounts include gains and losses from the sales of fixed income, equity, and derivative securities (principally U.S. Treasury Note and Eurodollar futures). The majority of the Company's investment assets are in fixed income securities. An independent investment specialist manages the Company's portfolio to seek to maximize total return, consistent with prudent investment management and regulatory constraints. As a result of this strategy, the Company purchases and sells securities throughout the year to take advantage of opportunities in various sectors of the market. These transactions can result in the Company realizing investment gains and losses. Net realized gains on investment securities equaled $6.1 million and $0.2 million in 2008 and 2007, respectively. Also included in net realized losses on securities are pre-tax losses of $11.9 million and $0.5 million for 2008 and 2007, respectively, from other-than-temporary impairments in value of certain securities.

The factors considered by management in determining whether a security's decline in value is other than temporary is discussed in Note 1B to the Consolidated Financial Statements.

Net Loss and Loss Adjustment Expense

Net loss and loss adjustment expenses equaled $12.2 million in 2008 as compared to $4.6 million in 2007, as both the frequency and severity of claims increased to levels more traditionally experienced by the Company from the unusually low levels experienced in 2007. Despite the turmoil experienced in the financial markets in 2008, the impact on the Company's claims experience in 2008 was minimal due to the strong compliance measures employed by its insureds, the stringent regulatory environment in which its insureds operate, and the Company's rigorous underwriting guidelines that mitigated the Company's exposure to losses that occurred in other segments of the financial services industry.

Reinsurance

The Company, like many of its competitors, utilizes reinsurance to spread the risks it insures and to provide the limits of coverage requested by its insureds. The reinsurance provided under the Company's treaty program, which covers risks insured for policy limits above $3 million up to $15 million, is capped at $120 million (a sub-limit of $91 million is further imposed on the $7 million in excess of $3 million layer) for each of the treaty years ending March 31, 2003 (02 Treaty), and March 31, 2004 (03 Treaty). A cap of $100 million is in effect for all subsequent treaty years. The treaties are issued on a risk-attaching basis, meaning that any policy written during the period of the treaty is covered until that policy expires (usually twelve months).

During 2006, total claims incurred (paid, case, and incurred but not reported) on the 03 Treaty reached $130 million, which exceeded the Treaty's cap by $10 million. A charge for this amount was reflected in the Company's 2006 results of operations. There was no additional adverse development on the 03 Treaty in either 2007 or 2008. However, it is possible that there could be further deterioration on the 03 Treaty, or that the cap on one of the other treaty years could be exceeded, if there are sufficient future claims made under policies that attach to those treaties or if there is further deterioration in claims already noticed under policies that attach to those treaties. If one of these events were to occur, the Company would be required to pay losses in excess of the treaty caps out of its earnings and surplus. There can be no assurance that, in this event, the Company's earnings and surplus would be sufficient to meet all of its obligations. At December 31, 2008, no treaty, other than the 03 Treaty, is near the cap applicable to that year and management believes that none of the other treaties will exceed their respective caps.

Several years can elapse between the time the Company is first notified of a claim and the time it actually pays the claim. At the time of payment, the amounts representing the reinsurers' portion of the claim payment would be due from reinsurers. Should a reinsurer be unable or unwilling to meet its obligations to the Company, the Company would remain primarily liable for payment of the full amount due to its insureds. The Company's policy is to do business only with reinsurers it deems financially stable (generally, having an A.M. Best rating of at least "A" [Excellent] or its equivalent). In addition, the Company has procedures to monitor the financial stability of its reinsurance partners and has no reason to believe that any amounts currently due from reinsurers will ultimately be uncollectible. Should the Company become aware of any reinsurance amounts that it believes are reasonably likely to be uncollectible, management would establish an appropriate provision for uncollectible reinsurance at that time. Such provision would be a charge against operations in the year established.

Dividend to Policyholders

The Board of Directors has the responsibility of determining if and in what amount a dividend to policyholders will be declared and paid. In making this decision, the Board reviews the current operating results of the Company, its

current capital levels, and the capital surplus levels required to support the Company's future operations. After a review of all of these factors, the Board of Directors elected not to declare a dividend to member policyholders in 2008. While both the current year operating results and the current level of surplus would have supported the payment of a dividend, given the uncertainty surrounding the current financial conditions in the U.S. economy, the Board determined that it would be prudent to defer the payment of a dividend until such time as the economic uncertainties that existed at the end of 2008 were resolved. The Board of Directors declared a $4.5 million dividend to policyholders in 2007.

Policyholders' Capital Contributions

In 2008, the Company had two classes of insureds: members and non-members. Member insureds made a capital contribution (consisting of a cash payment and a letter of credit). Members participated in corporate governance matters, were eligible for receipt of policyholder dividends, and had an interest in the undistributed net worth of the Company. Conversely, non-members made no capital contribution, did not participate on corporate governance matters, were not eligible for policyholder dividends, and had no interest in the undistributed net worth of the Company. As of December 31, 2008 and 2007, the capital contributed by members in the form of cash and letters of credit was $42.2 million and $43.0 million, respectively. The letters of credit, in the amounts of $19.7 million and $19.3 million, respectively, represent a contingent form of capital which the Company can call upon based on the existence of certain conditions. As such, the letters of credit are not reflected in the Company's Consolidated Balance Sheets or Statements of Changes in Equity.

In order to better serve its insureds, and pursuant to the prior approval of its member organizations and the Vermont Department of Banking, Insurance, Securities & Health Care Administration, ICI Mutual converted its organization form from a Vermont association captive insurance company to a Vermont risk retention group (RRG), effective January 1, 2009. An RRG is a captive insurance company organized pursuant to the Liability Risk Retention Act of 1986, a federal statute. The conversion to the RRG form allows the Company to transact insurance business in jurisdictions other than Vermont, without subjecting the Company to the requirements of traditional insurance regulation by such other states. The conversion to an RRG, other than permitting the Company to better serve its insureds, will not change the Company's mission or the insurance coverages it offers, and is not expected to have a material impact on the Company's financial results.

Capital Strength

Total capital equaled $156.7 million at December 31, 2008, a $3.7 million decrease from December 31, 2007 and was primarily the result of declines in the fair value of the Company's investment assets. It is the Company's policy to maintain capital at relatively high levels compared to the net risks it retains. Accordingly, the Company's surplus is far in excess of amounts required by Vermont regulations. The Company believes that its current level of equity is sufficient to meet its claim obligations and to fund its ongoing operations.

Critical Accounting Estimates and Judgments

The consolidated financial statements include amounts based on informed estimates and judgments of management for those transactions that are not yet complete. Such estimates and judgments affect the reported amounts in the financial statements. The estimates and judgments that management believes were most critical to the preparation of the financial statements involved the adequacy of the loss reserves and the ultimate recoverability of the related reinsurance. The establishment of loss reserves is a complex process that involves making judgments based on assumptions about many variables, some of which may change over time. While management believes that the judgments and assumptions utilized in establishing the

year-end reserves are reasonable, legal or factual developments in underlying claim matters (adverse or positive), or other changes in the assumptions relied upon by management, could have a material impact on the level of reserves established. As many of the Company's current claims have legal and factual elements in common, developments in one claim could influence other claims thus magnifying the impact on reserves.

In determining whether to establish a reserve for uncollectible reinsurance at year-end, management based its decision on an assessment of the validity of the claims against the reinsurance as well as management's assessment of reinsurers' current financial condition. Should reinsurers raise coverage objections in the future, or if their financial condition were to deteriorate before all of the reinsurance recoverable was collected, some or all of these balances could prove to be uncollectible.

If different estimates and judgments had been applied, materially different amounts might have been reported in the consolidated financial statements.

Outlook

The Company's main mission is the same today as it was 21 years ago when it was formed—to be the insurer of choice for the investment management industry by providing superior insurance coverages at risk-related prices and to ensure its ability to meet all legitimate claims obligations through conservative and prudent financial management.

2008 saw the deterioration of financial conditions in the United States and around the world, including the unprecedented disruption in financial markets. If these conditions continue in 2009, or worsen, they could adversely impact the Company's future operations. Many of the Company's insureds have experienced significant declines in their assets under management that have resulted in declines in their primary sources of revenue. These declines in assets under management and revenues could result in a decrease in the demand for the Company's products as well as place pressure on the Company's premium rates as insureds look to decrease their costs. In addition, while past experience does not indicate a direct connection, there is the possibility that the Company will experience an increase in claims against insureds, including claims resulting from investors seeking to recover some of the losses they have experienced. Such an increase in claims, or at a minimum, the expectation of increased claims activity, could negatively impact the Company's reinsurers' willingness to offer reinsurance limits on the current terms. Any reduction in reinsurance capacity or increase in the cost of reinsurance could negatively impact the Company's revenues in 2009.

The unprecedented disruptions in world financial markets have caused a significant lack of liquidity in the fixed income investment markets that has resulted in a decline in the market value of many of the Company's investments. Should these conditions continue or worsen in 2009, a further decline in the value of the Company's investments and a resulting decline in the Company's surplus could occur.

In an attempt to unlock the credit markets and return liquidity to the marketplace the Federal Reserve Bank has aggressively acted to reduce interest rates. These reductions in interest rates will have a negative impact on the Company's investment earnings, as new cash flows will be invested at these lower rates.

While the current economic environment certainly presents many challenges, the Company believes that the measures it has taken over the years to sharpen its underwriting and risk assessment skills, combined with an in-depth knowledge of the industry it insures and a long history of conservative financial management, will allow the Company to weather the current financial conditions and remain positioned to provide the investment management industry with the insurance coverage it wants and needs. This opinion was recognized by A.M. Best which once again affirmed the Company's "A" (Excellent) rating with a stable outlook.

REPORT of independent auditors

TO THE BOARD OF DIRECTORS AND
MEMBERS OF ICI MUTUAL INSURANCE COMPANY:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations and changes in equity and consolidated statements of cash flows present fairly, in all material respects, the financial position of ICI Mutual Insurance Company and its subsidiaries (together, the "Company") at December 31, 2008 and 2007, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

PricewaterhouseCoopers LLP

March 27, 2009

consolidated financial STATEMENTS

Consolidated Balance Sheets

December 31,	*2008*	*2007*
ASSETS		
Cash and cash equivalents (Note 1H)	$ 5,973,323	$ 8,619,332
Investments (Notes 1B, 2, and 3)		
Debt securities, at fair value (amortized cost of $201,672,295 and $184,507,802, respectively)	182,435,561	183,589,589
Equity securities, at fair value (cost of $6,572,148 and $8,284,591, respectively)	6,896,700	11,821,827
Money market funds	21,130,104	40,046,730
Total cash and investments	216,435,688	244,077,478
Prepaid expenses	711,491	737,074
Prepaid federal income taxes	—	537,677
Deferred policy acquisition costs (Notes 1D and 4)	2,734,896	2,735,466
Premiums receivable	12,036,846	12,728,056
Interest receivable	2,060,742	1,443,708
Reinsurance recoverables (Notes 1G and 10)	163,889,025	185,726,373
Prepaid reinsurance premiums (Notes 1C and 10)	45,369,826	45,501,551
Other amounts receivable under reinsurance contracts	4,603,629	8,295,659
Furniture and fixtures, net (Note 1I)	593,795	509,354
Deferred income taxes (Notes 1F and 7)	13,963,702	2,897,873
Investment securities and other receivables	474,989	4,732,105
Total assets	$462,874,629	$509,992,374
LIABILITIES AND EQUITY		
Reserve for losses and loss adjustment expenses (Notes 1E, 10, and 11)	$233,849,582	$271,027,400
Unearned premiums (Notes 1C and 10)	58,878,252	59,056,863
Reinsurance premium payable (Note 1G)	8,128,947	6,199,943
Premium taxes payable	201,486	200,427
Federal income taxes payable	898,189	—
Accounts payable and other liabilities	1,400,005	1,926,904
Investment securities payable	—	4,529,718
Benefits payable (Note 14)	2,416,416	2,072,177
Dividends payable (Note 13)	406,519	4,500,000
Total liabilities	306,179,396	349,513,432
Commitments and contingencies (Notes 6 and 12)		
Contributed surplus (Note 5)	22,539,340	23,711,152
Accumulated other comprehensive (loss) income (Notes 1B and 2)	(13,174,403)	1,481,166
Accumulated earnings	147,330,296	135,216,624
Total equity	156,695,233	160,408,942
Total liabilities and equity	$462,874,629	$509,922,374

The accompanying notes are an integral part of these consolidated financial statements.

Consolidated
Statements of Operations and Changes in Equity

years ended December 31,	*2008*	*2007*
UNDERWRITING INCOME		
Net premiums written (Notes 1C and 10)	$ 33,168,704	$ 33,869,368
Change in net unearned premiums (Note 1C)	46,886	1,241,855
Net premiums earned	33,215,590	35,111,223
Reinsurance profit-sharing income (Note 1G)	153,950	437,576
Total underwriting income	33,369,540	35,548,799
UNDERWRITING EXPENSES		
Net loss and loss adjustment expenses (Notes 1E, 10, and 11)	12,247,441	4,646,175
Premium tax expense	200,000	200,000
Underwriting expenses	4,067,035	3,862,592
Royalty expense (Note 9)	1,000,000	1,000,000
General and administrative expenses (Note 9)	4,026,485	4,213,257
Total underwriting expenses	21,540,961	13,922,024
Net underwriting income	11,828,579	21,626,775
Net investment income (Notes 1B, 2, and 3)	11,974,743	12,362,964
Other income	357,810	415,874
Net realized losses on securities (Notes 1B, 2, and 3)	(5,770,832)	(268,086)
Income before dividends to policyholders and provision for income taxes	18,390,300	34,137,527
Dividends to policyholders (Note 13)	—	4,500,000
Income before provision for income taxes	18,390,300	29,637,527
Provision for income taxes (Notes 1F and 7)	6,276,628	10,383,917
Net income	12,113,672	19,253,610
Other comprehensive loss, net of tax, net of reclassification adjustments		
Net unrealized losses on investments (Notes 1B and 15)	(13,995,283)	(1,856,400)
Net actuarial loss on employee benefit plans (Notes 14 and 15)	(660,286)	—
Comprehensive (loss) income	$ (2,541,897)	$ 17,397,210
CHANGES IN EQUITY		
Balance at beginning of year	$ 160,408,942	$ 143,547,714
Net income	12,113,672	19,253,610
Other comprehensive loss, net of tax, net of reclassification adjustments		
Net unrealized losses on investments (Notes 1B and 15)	(13,995,283)	(1,856,400)
Adjustment to initially apply FASB Statement No. 158, net of tax	—	(221,198)
Net actuarial loss on employee benefit plans (Notes 14 and 15)	(660,286)	—
Distributions of contributed surplus (Note 5)	(1,171,812)	(314,784)
Balance at end of year	$ 156,695,233	$ 160,408,942

The accompanying notes are an integral part of these consolidated financial statements.

Consolidated
Statements of Cash Flows

years ended December 31,	*2008*	*2007*
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$ 12,113,672	$ 19,253,610
Adjustments to reconcile net income to net cash provided by operating activities		
Accretion of discount	(616,179)	(280,008)
Deferred income taxes	(3,174,367)	1,232,491
Depreciation of furniture and fixtures	89,976	81,945
Net realized losses on sale of securities	5,770,832	268,086
Employee benefits	(671,586)	(453,314)
Changes in operating assets and liabilities		
Prepaid expenses	25,583	(4,231)
Prepaid federal income taxes	537,677	(537,677)
Deferred policy acquisition costs	570	(348,344)
Premiums receivable	691,210	1,737,603
Interest receivable	(617,034)	195,258
Reinsurance recoverables	21,837,348	86,527,700
Prepaid reinsurance premiums	131,725	4,732,755
Other amounts receivable under reinsurance contracts	3,692,030	(3,192,941)
Investment securities and other receivables	4,257,116	(4,061,757)
Reserve for losses and loss adjustment expenses	(37,177,818)	(71,917,179)
Unearned premiums	(178,611)	(5,974,610)
Reinsurance premium payable	1,929,004	(585,411)
Premium taxes payable	1,059	(2,529)
Federal income taxes payable	898,189	(543,721)
Accounts payable and other liabilities	(526,899)	636,513
Investment securities payable	(4,529,718)	4,529,718
Dividends payable	(4,093,481)	4,500,000
Net cash provided by operating activities	390,298	35,793,957
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from sales of investments available for sale	813,523,044	169,358,096
Proceeds from maturities of investments available for sale	11,196,000	4,910,000
Purchases of furniture and fixtures, net	(199,780)	(75,765)
Payments for purchases of investments available for sale	(852,969,968)	(173,810,203)
Net payments from derivative activity	7,669,583	(1,906,139)
Change in money market funds	18,916,626	(36,000,490)
Net cash used in investing activities	(1,864,495)	(37,524,501)
CASH FLOWS FROM FINANCING ACTIVITIES		
Distributions of contributed surplus	(1,171,812)	(314,784)
Net cash used in financing activities	(1,171,812)	(314,784)
Net decrease in cash and cash equivalents	(2,646,009)	(2,045,328)
Cash and cash equivalents at beginning of year	8,619,332	10,664,660
Cash and cash equivalents at end of year	$ 5,973,323	$ 8,619,332

The accompanying notes are an integral part of these consolidated financial statements.

Notes
to Consolidated Financial Statements

1 Significant Accounting Policies
A. BASIS OF PRESENTATION

At December 31, 2008, ICI Mutual Insurance Company (Mutual) was an association captive insurance company domiciled in the State of Vermont. Mutual was incorporated on August 26, 1987 and commenced accepting insurance risks on March 1, 1988. Mutual, together with its wholly-owned subsidiaries described below, are collectively referred to as "the Company." The Company primarily writes fidelity bonds, NASD bonds, and directors and officers and errors and omissions insurance for members and associate members of the Investment Company Institute (ICI) and their affiliated companies on a claims-made basis. These members primarily provide services to the regulated investment company industry.

On December 15, 2008 the members of Mutual voted to convert Mutual from a Vermont association captive insurance company to a Vermont risk retention group (RRG), under the federal Liability Risk Retention Act of 1987 (Act), subject to the approval of the Vermont Department of Banking, Insurance, Securities and Health Care Administration (BISHCA). Mutual received the approval of BISHCA and the change became effective on January 1, 2009. Among other things, the Act preempts certain state registration requirements and will allow Mutual to solicit business and service clients in those states where it applies for admission as an RRG. The conversion to an RRG is not expected to have a material impact on Mutual's operations or financial condition.

In 1990, ICI Mutual Insurance Brokers, Inc. (Brokers) was formed as a wholly-owned subsidiary of Mutual. Brokers was formed to allow the Company to provide insurance brokerage services to members of the ICI.

In 1992, ICIM Services, Inc. (Services) was formed as a wholly-owned subsidiary of Mutual. Services provides the underwriting function for the Company under a written agreement. This agreement provides that Mutual will reimburse Services for all reasonable expenses associated with performing the underwriting function plus a 5% fee.

In 1999, ICIM Reinsurance Company (ICIM Re) was capitalized with $20 million as a wholly-owned subsidiary of Mutual. ICIM Re commenced writing insurance to cover certain money market events of default. In December of 2002, ICIM Re ceased writing new business. In December 2003, ICIM Re transferred substantially all of its net assets to Mutual, maintaining only sufficient assets to retain its license in Vermont. In December 2008, ICIM Re surrendered its license to do business in Vermont, transferred all of its remaining net assets to Mutual and was formally liquidated.

The consolidated financial statements include the consolidated accounts of the Company with all significant intercompany amounts eliminated in consolidation. The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP), which are also in accordance with practices prescribed for captive insurance companies by

BISHCA. Certain reclassifications have been made to conform prior periods to the current year's presentation. GAAP requires management to make certain estimates and assumptions in the preparation of the financial statements. Therefore, actual results could differ from those estimates and assumptions.

B. INVESTMENTS

The Company's debt and equity securities are classified as available-for-sale and reported at fair value as defined in Note 3 below. Short-term securities and money market funds are stated at amortized cost which approximates fair value.

Where declines in securities' values are deemed other than temporary, the securities are reported at fair value and the loss is reported as a component of net realized gains (losses) on securities, establishing a new cost basis for the security. The factors considered by management in determining whether a security's decline in value is other than temporary include, but are not limited to: the length of time and extent to which the fair value has been less than cost; the financial condition and near-term prospects of the issuer; adverse changes in ratings announced by one or more rating agencies; whether the issuer of a debt security has remained current on principal and interest payments; whether the decline in fair value appears to be issuer specific or, alternatively, a reflection of general market or industry conditions (including, in the case of fixed maturities, the effect of changes in market interest rates); and the Company's intent and ability to hold the security for a period of time sufficient to allow for a recovery in fair value. Based on management's review of the portfolio, which considered these factors, the Company recorded a loss for other-than-temporary impairments of $11,937,250 and $459,396 in 2008 and 2007, respectively.

The Company utilizes, to a limited extent, derivatives such as U.S. Government Treasury Note and Eurodollar futures and options to hedge certain risks within the portfolio of debt securities that are considered to be held for other than trading purposes. The return received or paid on these contracts varies in relationship to the movement in the U.S. Government Treasury Bond and Note markets. Such instruments are characterized for financial statement purposes as available-for-sale. Outstanding futures and options positions are adjusted to market and settled daily. The Company recognizes the daily mark-to-market for futures and options as a component of net realized gains (losses) on securities. Fair value of derivatives is based on a quoted market price. The Company recognizes any unrealized gains (losses) on open forward contracts as realized gains (losses) in the consolidated statement of operations.

All debt investment transactions have credit exposure to the extent that a counterparty may default on an obligation to the Company. Credit risk is a consequence of carrying trading and investing positions. To manage credit risk, the Company focuses on higher quality fixed income securities, limits its exposure in any one investment, and monitors the portfolio quality, taking into account credit ratings assigned by recognized statistical rating organizations.

Interest income on debt securities is recorded on the accrual basis. Dividend income on equity securities is recorded on the ex-dividend date. Unrealized gains and losses from changes in the fair value of the Company's holdings, net of applicable federal income taxes, are reported as a separate component of equity. Realized gains and losses on the sale of the Company's securities are determined based on specific identification and are included as a separate component of operations.

C. PREMIUMS

Net earned premiums have been computed on a semi-monthly pro rata basis over the term of the underlying insurance policies. Ceded reinsurance premiums are charged

against premiums earned on the same basis. Unearned premiums represent the portion of the gross premium written which is applicable to the unexpired terms of policies in force. Prepaid reinsurance premiums represent the portion of unearned premiums ceded to reinsurers. Commissions on reinsurance premiums ceded are considered earned when due and serve to reduce ceded reinsurance premiums.

D. DEFERRED POLICY ACQUISITION COSTS

Acquisition costs consist primarily of fees and premium taxes associated with the acquisition and underwriting of new and renewal insurance business. These acquisition costs are being amortized over the estimated premium-paying period of related policies in proportion to the ratio of the annual earned premiums to the total premium revenue anticipated. Anticipated premium revenue was estimated using the same assumptions as those used for computing the reserve for losses and loss adjustment expenses. Expected losses, related expenses, and investment income are considered in measuring the recoverability of this asset.

E. RESERVE FOR LOSSES AND LOSS ADJUSTMENT EXPENSES

The reserve for losses and loss adjustment expenses is based on management's individual case estimates of the ultimate cost of reported losses and estimates for incurred but not reported losses (IBNR) determined in consultation with independent professional actuaries. A provision for losses and loss adjustment expenses is charged to operations by management. The method of making IBNR estimates and for establishing the resulting reserves is based on actuarial assumptions as to future contingencies and as to the applicability of other data sources which the Company's independent actuaries deem to be reasonable and appropriate in the circumstances. However, given the nature of the Company's business, the ultimate amount of losses and loss adjustment expenses may vary significantly from the estimated amounts. Due to this uncertainty, the appropriateness of the current level of such estimated liability can only be determined with the passage of time.

F. PROVISION FOR INCOME TAXES

The Company accounts for income taxes in accordance with Statement of Financial Accounting Standards (SFAS) No. 109, *Accounting for Income Taxes*, which requires the use of the liability method of accounting for deferred income taxes. SFAS No. 109 requires recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been recognized in the financial statements or tax returns.

Deferred income taxes arise principally from differences between the timing of expense or income recognition of deferred policy acquisition costs, loss reserve discounting, bond accretion, unrealized gains and losses, and the revenue offset for unearned premium reserves. Valuation allowances are established when necessary to reduce deferred tax assets to the amounts expected to be realized. No valuation allowance was deemed necessary at December 31, 2008 and 2007.

G. REINSURANCE

The Company utilizes both treaty and facultative reinsurance to provide protection for claims in excess of the Company's normal retention limits ($3 million). Under the Company's annual treaty reinsurance program (which runs from April 1 to March 31), limits up to $15 million, less the Company's normal retention, are automatically assumed by the treaty participants. Maximum recoveries under the reinsurance treaties are capped at $100 million for the treaty years ending March 31, 2009 (08 Treaty), March 31, 2008 (07 Treaty), March 31, 2007 (06 Treaty), March 31, 2006 (05 Treaty), March 31, 2005 (04 Treaty) and at $120 million for the treaty years ending March 31, 2004 (03 Treaty), and March 31, 2003 (02 Treaty). A sub-limit

of $91 million is further imposed on the $7 million excess of $3 million layer for the 03 Treaty and the 02 Treaty.

As of December 31, 2008, the Company had ceded losses (paid losses, case reserves and IBNR reserves) of which $3.0 million, $10.4 million, $9.5 million, $9.5 million, $4.0 million, $120.0 million and $62.3 million impacted the caps under the 08, 07, 06, 05, 04, 03, and 02 Treaties, respectively. Total losses incurred related to the 2003 treaty year exceeded the cap for that year and the excess ($10 million) has been expensed in the 2006 consolidated statement of operations. As the 2003 treaty year cap is exhausted, any potential future adverse development in results for this treaty year will have to be paid out of the Company's earnings and surplus. Future adverse development on any of the other treaty years could result in the respective caps for such treaty years being exceeded and such excess amounts, if any, would have to be paid out of the Company's earnings and surplus. While management believes that the Company is adequately capitalized to meet its ongoing claims obligations, there can be no assurance that in the event a cap on a reinsurance treaty is exceeded, the Company's resources would be sufficient to meet all of its claims liabilities.

The treaties are issued on a "risk-attaching" basis, meaning that any policy written during the term of the respective treaty is covered under that treaty until the policy expires, normally twelve months after its issuance. Thus, as of December 31, 2008, new claims could still impact the 08 and 07 Treaties for at least an additional fifteen and three months, respectively.

For those insureds that require limits in excess of $15 million on fidelity bonds, the Company issues additional limits of up to $5 million. For limits above $20 million on fidelity bonds or $15 million on D&O/E&O policies, the Company purchases facultative (case-by-case) reinsurance from various other reinsurers. There is no cap on facultative reinsurance except for the actual limits reinsured. In addition, from time to time, the Company may elect to retain up to $5 million in additional limits in the excess layers.

Although reinsurance agreements contractually obligate the Company's reinsurers to reimburse it for their proportionate shares of losses, they do not discharge the primary responsibility of the Company. Thus, in the event a reinsurer did not meet its obligation under its agreement with the Company, the Company would be responsible for such amount.

The Company monitors the credit worthiness of its reinsurers and only conducts business with reinsurers that are highly rated by appropriate rating agencies. As of December 31, 2008, the Company had no reason to believe that any amounts currently due from reinsurers will prove uncollectible. Accordingly, the Company has not made a separate provision for any amounts that might ultimately prove to be uncollectible from reinsurers in the future.

The 04 and 05 Treaties contain a profit-sharing feature by which the Company may recover up to 20% of the profits recognized by reinsurers on the Treaties after they have recovered any losses they may have incurred on prior treaties with the Company. The Company recognized $153,950 and $437,576 of profit commission income as a result of these features in 2008 and 2007, respectively.

H. CASH AND CASH EQUIVALENTS

The Company considers all cash on hand and deposits in banks as cash and cash equivalents for purposes of the consolidated statement of cash flows.

I. FURNITURE AND FIXTURES

Furniture and fixtures are stated at cost net of accumulated depreciation. The costs of additions and improvements are capitalized while expenditures for maintenance, repairs, and minor renewals are charged to expense as incurred. When assets are retired or otherwise disposed of, the assets and related accumulated depreciation and amortization are eliminated from the accounts and any resulting gain or loss is reflected in income. Provisions for depreciation are computed using the straight-line method based on useful lives ranging from three to twelve years. Depreciation expense was $89,976 and $81,945 for 2008 and 2007, respectively. Accumulated depreciation totaled $477,641 and $396,382 at December 31, 2008 and 2007, respectively.

J. RECENT ACCOUNTING PRONOUNCEMENTS

In December 2008, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) FIN 48-3, *Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises* (FIN 48). The FSP defers the effective date of FIN 48, for certain nonpublic enterprises, including nonpublic not-for-profit organizations, for fiscal years beginning after December 15, 2008. FIN 48 clarifies how a company should recognize, measure, present, and disclose uncertain tax positions that it has taken or expects to take on a tax return. The implementation of FIN 48 is not expected to have a material effect on the Company's consolidated financial statements.

In May 2008 the FASB issued Statement of Financial Accounting Standards (SFAS) No. 162, *The Hierarchy of Generally Accepted Accounting Principles* (SFAS 162). SFAS 162 identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles in the United States. It is effective 60 days following the Securites and Exchange Commission's approval of the Public Company Accounting Oversight Board amendments to AU Section 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*. The adoption of SFAS 162 is not expected to have a material effect on the Company's consolidated financial statements.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133* (SFAS 161). SFAS 161 expands the current disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under SFAS No. 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. In addition, SFAS 161 requires disclosure of fair values of derivative instruments and their gains and losses in a tabular format as well as cross-referencing within the footnotes to allow users of financial statements to locate important information about derivative instruments. SFAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. SFAS 161 encourages, but does not require, comparative disclosures for earlier periods at initial adoption. The adoption of SFAS 161 is not expected to have a material effect on the Company's consolidated financial statements.

Recently Adopted Accounting Standards

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157), which defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. This Statement applies under

other accounting pronouncements that require or permit fair value measurements. FSP FAS 157-2, *Effective Date of FASB Statement No. 157*, amends SFAS 157 to defer its effective date to fiscal years beginning after November 15, 2008, and for interim periods within those fiscal years. The delayed effective date applies to all non-financial assets and non-financial liabilities except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). FSP FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active* clarifies the application of SFAS 157 in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. Revisions resulting from a change in the valuation technique or its application shall be accounted for as a change in accounting estimate. The adoption of SFAS 157 for financial assets and liabilities did not have a material impact on the Company's consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an Amendment of FASB Statement No. 115* (SFAS 159). SFAS 159 would create a fair value option of accounting for qualifying financial assets and liabilities under which an irrevocable election could be made at inception to measure such assets and liabilities initially and subsequently at fair value, with all changes in fair value reported in earnings. SFAS 159 is effective as of the beginning of the first fiscal year beginning after November 15, 2007. The adoption of SFAS 159 did not impact the Company's consolidated financial statements, as no items were initially elected for fair value measurement. For financial assets and liabilities acquired in subsequent periods, the Company will determine whether to use the fair value election at the time of acquisition.

2 Investments

A summary comparison of amortized cost and fair value of debt securities is as follows:

December 31, 2008	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Debt securities available for sale				
U.S. Government, agencies and authorities securities	$ 20,556,488	$ 2,004,406	$ —	$ 22,570,894
Mortgage-backed	87,849,682	1,893,215	(10,942,644)	78,800,253
All other corporate bonds	93,256,125	748,681	(12,940,392)	81,064,414
Total debt securities	$ 201,672,295	$ 4,646,302	$ (23,883,036)	$ 182,435,561

December 31, 2007	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Debt securities available for sale				
U.S. Government, agencies and authorities securities	$ 7,904,868	$ 100,007	$ —	$ 8,004,875
Mortgage-backed	96,337,236	1,483,437	(474,474)	97,346,199
All other corporate bonds	80,265,698	811,508	(2,838,691)	78,238,515
Total debt securities	$ 184,507,802	$ 2,394,952	$ (3,313,165)	$ 183,589,589

Included in the above amounts at December 31, 2008 and 2007 is approximately $31,557,202 and $53,877,346, respectively, invested in securities such as U.S. Treasury strips, collateralized mortgage obligations, and other corporate asset-backed securities.

Futures and options contracts have been included in the U.S. Government, agencies, authorities, and mortgage-backed debt securities for financial statement purposes. The notional amounts for futures and options contracts at December 31, 2008 and 2007 were $162,613,849 and $1,313,746,766, respectively; however, the value at risk for such contracts was approximately $426,500 and $969,031 at December 31, 2008 and 2007, respectively.

The amortized cost and fair value of debt securities at December 31, 2008, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized Cost	Fair Value
Due in one year or less	$ 6,805,530	$ 6,881,774
Due after one year through five years	25,112,887	23,067,818
Due after five years through ten years	27,999,706	25,676,486
Due after ten years	141,754,172	126,809,483
Total debt securities	$ 201,672,295	$ 182,435,561

A summary comparison of cost and fair value of equity securities is as follows:

December 31, 2008	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Preferred stock	$ 68,868	$ —	$ (19,591)	$ 49,277
Common stock	6,503,280	344,143	—	6,847,423
Total equity securities	$ 6,572,148	$ 344,143	$ (19,591)	$ 6,896,700

December 31, 2007	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Preferred stock	$ 212,242	$ 9,304	$ (1,374)	$ 220,172
Common stock	8,072,349	3,529,306	—	11,601,655
Total equity securities	$ 8,284,591	$ 3,538,610	$ (1,374)	$ 11,821,827

At December 31, 2008 and 2007, the net unrealized (losses) gains on investments in debt and equity securities of $(12,292,918) and $1,702,364, respectively, have been reflected in the consolidated balance sheets as a component of accumulated other comprehensive income, net of deferred taxes of $(6,619,263), and $916,658, respectively. At December 31, 2008, the unrealized losses on debt securities that had been in an unrealized loss position for twelve months or longer were $13,910,351. The Company has the ability and intent to hold these securities until they recover in value. At December 31, 2007, there were no material unrealized losses on securities that had been in an unrealized loss position for twelve months or longer.

Proceeds from sales of debt securities and the associated gross realized gains and gross realized losses are as follows:

	Proceeds from Sales	Gross Realized Gains	Gross Realized Losses
For the year ended December 31, 2008	$ 813,381,044	$ 4,768,910	$ (6,270,701)
For the year ended December 31, 2007	$ 166,358,096	$ 982,198	$ (182,785)

Proceeds from sales of equity securities and the associated gross realized gains and gross realized losses are as follows:

	Proceeds from Sales	Gross Realized Gains	Gross Realized Losses
For the year ended December 31, 2008	$ 142,000	$ —	$ (1,374)
For the year ended December 31, 2007	$ 3,000,000	$ 1,298,036	$ —

Net gains (losses) on futures and options activity included in net realized gains (losses) on securities in the consolidated statements of operations and changes in equity were $7,669,583 and $(1,906,139), as of December 31, 2008 and 2007, respectively.

Other-than-temporary impairments included in net realized losses on securities in the consolidated statements of operations and changes in equity were $(11,937,250) and $(459,396) in 2008 and 2007, respectively.

The Company recorded $0 and $1,297,408 of gross realized capital gains from the sale of shares in a mutual fund held as part of its equity portfolio during 2008 and 2007, respectively.

Net investment income is calculated as follows:

2008	Gross Investment Income	Investment Expenses	Net Investment Income
Debt securities available for sale			
U.S. Government, agencies and authorities securities	$ 519,007	$ (26,214)	$ 492,793
Mortgage-backed	4,651,212	(234,920)	4,416,292
All other corporate bonds	7,084,019	(357,795)	6,726,224
Equity securities	359,157	(19,723)	339,434
Total	$ 12,613,395	$ (638,652)	$ 11,974,743

2007	Gross Investment Income	Investment Expenses	Net Investment Income
Debt securities available for sale			
U.S. Government, agencies and authorities securities	$ 1,203,281	$ (55,694)	$ 1,147,587
Mortgage-backed	5,035,287	(233,057)	4,802,230
All other corporate bonds	6,429,656	(297,595)	6,132,061
Equity securities	294,727	(13,641)	281,086
Total	$ 12,962,951	$ (599,987)	$ 12,362,964

3 Fair Value

Effective January 1, 2008, the Company adopted SFAS 157, *Fair Value Measurements,* for all financial instruments and non-financial instruments accounted for at fair value on a recurring basis. The adoption of SFAS 157 did not have a material impact on the financial statements. SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 applies whenever other standards require or permit assets or liabilities to be measured at fair value but does not expand the use of fair value in any new circumstances. In this standard, the FASB clarifies the principle that fair value should be based on the assumptions market participants would use when pricing the asset or liability. In support of this principle, SFAS 157 establishes a fair value hierarchy that prioritizes the information used to develop those assumptions.

The valuation techniques required by SFAS 157 are based upon observable and unobservable inputs. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect our market expectations. These two types of inputs create the following fair value hierarchy:

LEVEL 1: Quoted prices for identical instruments in active markets.

LEVEL 2: Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations whose inputs are observable or whose significant value drivers are observable.

LEVEL 3: Instruments where significant value drivers are unobservable.

When available, the Company utilizes quoted market prices to determine fair value and classifies such items in Level 1. In some cases, quoted market prices are used for similar instruments in active markets and/or model-derived valuations where inputs are observable in active markets; such items are classified in Level 2. When there are limited or inactive trading markets, the Company utilizes industry-standard pricing methodologies, including discounted cash flow models, whose inputs are based on management assumptions and available current market information. These items are classified in Level 3. Further, the Company relies upon independent pricing vendors to assist in valuing certain instruments.

The following section describes the valuation methodologies used by management to measure different financial instruments at fair value.

Investments in fixed maturities and equity securities:

Investments included in Level 1 are equities with quoted market prices. Level 2 is primarily comprised of corporate fixed income securities, residential and commercial mortgage obligations, asset-backed securities, and municipals. Level 3 securities consist primarily of corporate fixed income securities, residential mortgage obligations, and preferred securities.

The following is a summary of the inputs used in valuing the Company's assets at fair value:

	December 31, 2008	Quoted Prices (Level 1)	Other Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Investment in Debt securities	$ 182,435,561	$ —	$ 180,200,876	$ 2,234,685
Investment in Equity securities	6,896,700	6,847,423	—	49,277
Total	$ 189,332,261	$ 6,847,423	$180,200,876	$ 2,283,962

The following is a reconciliation of investments in which significant unobservable inputs (Level 3) were used in determining fair value:

	Asset-backed securities	Corporate bonds	Preferred stocks	Total Level 3 Investment
Balances as of December 31, 2007	$ 2,439,981	$ 800,694	$ 49,277	$ 3,289,952
Change in unrealized losses	(1,575,513)	(54,520)	—	(1,630,033)
Net purchases (sales)	624,043	—	—	624,043
Balances as of December 31, 2008	$ 1,488,511	$ 746,174	$ 49,277	$ 2,283,962

4 Deferred Policy Acquisition Costs

The deferred policy acquisition costs at December 31, 2008 and 2007 are comprised of the following:

	2008	*2007*
Beginning balance	$ 2,735,466	$ 2,387,122
Additional costs capitalized		
Underwriting expenses	3,553,093	3,660,076
Royalty fees (Note 9)	1,000,000	1,000,000
Premium taxes	200,000	200,000
	4,753,093	4,860,076
Less current year amortization		
Underwriting expenses	3,553,663	3,311,732
Royalty expense (Note 9)	1,000,000	1,000,000
Premium taxes	200,000	200,000
	4,753,663	4,511,732
Ending balance	$ 2,734,896	$ 2,735,466

5 Contributed Surplus (Mutual only)

Prior to October 11, 1996, Mutual required that each of its insureds, or "members," in addition to paying annual premiums for its insurance policies, pay Mutual a reserve premium equal to 125% of its initial annual premium or 100% if membership was applied for before July 31, 1987 or subsequently as the member joins the ICI. Reserve premiums represent one-time contributions by the members to provide capital to Mutual. The reserve premium with respect to a policy is required to be repaid to the member within 60 days if Mutual terminates the policy without the fault of the member; in all other cases the reserve premiums generally are not required to be repaid for five years after cancellation, termination, or failure to renew a policy. At December 31, 2008 and 2007, $1,545,152 and $1,910,685, respectively, related to reserve premiums for terminated policies which were included in contributed surplus.

Effective with a member vote on October 11, 1996, Mutual can issue insurance policies to a second group of insureds who are not required to contribute capital. These insureds, or "non-members," do not have any rights to receive dividends, to share in the Company's net worth, or to vote on corporate governance matters. Of the premiums written 27.4% and 17.0%, were attributable to non-members during the years ended December 31, 2008 and 2007, respectively.

6 Commitments (Mutual only)

Prior to October 11, 1996, Mutual also required that each of its members commit to pay Mutual amounts equal to 300% of its initial annual premiums, if, when, and to the extent required by the Board of Directors to provide for unanticipated expenses or losses of the Company. Two-thirds of each member's commitments were required to be secured by an irrevocable letter of credit (LOC). Effective with a member vote on October 11, 1996, Mutual modified its commitment practices through the elimination of the unsecured portion of the commitments as well as eliminating, over a period of ten years, subject to annual Board review, the remaining portions of the members' commitments (i.e., the portions secured by the LOC). These provisions were implemented effective January 1, 1997. Each year thereafter through 2001, the Board of Directors voted to reduce a portion of remaining members' commitment. With a view of ensuring that the Company maintains a strong capital base, effective with the 2002 scheduled reduction, the Board of Directors has annually voted to suspend further reductions in the LOCs.

As of December 31, 2008 and 2007, the Company had available $19,688,658 and $19,242,419, respectively, in secured LOCs, none of which have been drawn against to date, and $24,197 cash in lieu of LOCs. Commitments by members terminate when the policy terminates, unless the Board of Directors determines the continuation of the commitment is necessary to cover losses, to avoid jeopardizing the Company's capital, or to comply with insurance regulatory requirements.

7 Provision for Income Taxes

The provision for income taxes consists of the following:

	2008	2007
Current provision	$ 9,450,995	$ 9,151,426
Deferred provision	(3,174,367)	1,232,491
Provision for income taxes	$ 6,276,628	$ 10,383,917

Set forth below is a reconciliation of the expected income tax provision and the actual tax provision:

	2008	2007
Expected tax provision at 35%	$ 6,436,605	$ 10,373,134
Tax exempt income from municipal bonds	(181,365)	—
Dividend received deduction	(86,530)	(44,670)
Provision to return adjustments	36,480	29,048
All other, net	71,438	26,405
Actual provision for income taxes	$ 6,276,628	$ 10,383,917

The Company files a consolidated federal income tax return. Income tax provisions are allocated to the Company's wholly-owned subsidiaries as if they had been calculated on a separate company basis. State income taxes are paid by Brokers and Services. Net payments for federal income taxes were $8,015,129 and $10,222,522 in 2008 and 2007, respectively.

The deferred income tax amounts reflected in the consolidated balance sheets at December 31, 2008 and 2007 are comprised of the following items:

	2008	2007
Net unearned premiums	$ 945,597	$ 948,879
Discounting of loss reserves	3,217,911	3,840,148
Deferred policy acquisition costs	(994,274)	(995,019)
Net unrealized losses (gains) on investments	6,619,263	(916,658)
Post-retirement employee benefits	1,102,362	654,101
Bond discount accretion	(1,536,300)	(1,234,779)
Other than temporarily impaired securities	4,774,041	667,045
Other	(164,898)	(65,844)
	$ 13,963,702	$ 2,897,873

8 Unaudited Statutory Basis Information (Mutual only)

Mutual is required to file an annual statement with the Vermont Department of Banking, Insurance, Securities and Health Care Administration (BISHCA). Under this filing for 2008 and 2007, Mutual reflected LOCs and cash in lieu of LOCs of $19,712,855 and $19,266,616, respectively, described in Note 6 above, as an asset and paid-in capital in accordance with accounting practices prescribed or permitted by BISHCA.

The following is a reconciliation of GAAP to the statutory basis of accounting used in the annual statement:

	2008	2007
Net income in accordance with GAAP	$ 12,132,472	$ 19,109,527
Deferred policy acquisition costs	1,350	(364,867)
Federal income tax	(3,119,218)	1,154,530
Investment securities valuation adjustments	(206,728)	(826,330)
Net income, statutory basis	$ 8,807,876	$ 19,072,860
Deferred federal income tax adjustment	1,929,028	—
Net income, as reported in the annual statement	$ 10,736,904	$ 19,072,860
Equity in accordance with GAAP	$ 156,495,944	$ 159,530,567
Nonadmitted assets	(341,192)	(356,397)
Deferred policy acquisition costs	(2,837,117)	(2,838,465)
Deferred federal income taxes	(2,158,616)	994,792
Unrealized losses on investments	11,322,642	591,683
Write-up investment in subsidiaries	138,391	225,489
Letters of credit and cash in lieu	19,712,855	19,266,616
Low-grade bond adjustment	(1,703,179)	(949,456)
Other, net	(24,197)	(558,928)
Equity, statutory basis	$ 180,605,531	$ 175,905,901

9 Related Party Transactions

Mutual is party to a royalty agreement and a services and facilities agreement with the ICI. Under the royalty agreement, Mutual is required to pay 1% of gross annual premium as a royalty fee to the ICI, limited to a total maximum of $1,000,000 in any calendar year. Royalty fees paid for both 2008 and 2007 were $1,000,000.

The services and facilities agreement requires the Company to reimburse the ICI for actual direct and indirect expenses incurred on behalf of the Company. Service and facility fees amounted to approximately $752,000 and $630,000 for 2008 and 2007, respectively.

Amounts payable at December 31, 2008 and 2007 under these agreements were approximately $53,000 and $51,000, respectively.

10 Reinsurance Agreements

The Company utilizes reinsurance agreements to provide protection for claims in excess of the Company's normal retention limits. In addition, the Company may utilize reinsurance agreements to provide increased limits of liability on a case-by-case basis.

The Company follows SFAS No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts,* which requires ceded reinsurance balances to be reported on a gross basis. Accordingly, the following balance sheet accounts are grossed up by the amounts noted below:

	2008	2007
Reserve for losses and loss adjustment expenses	$153,979,151	$180,084,064
Unearned premiums	$ 45,369,826	$ 45,501,551

At December 31, 2008 and 2007, reinsurance recoverables were concentrated with two third-party reinsurance groups, Travelers Insurance Companies (approximately 36% and 32%, respectively) and Lloyds of London (approximately 20% and 23%, respectively).

Insurance risks ceded to reinsurance companies would become a liability in the event the reinsurers are unable to meet their obligations assumed under reinsurance contracts. Premiums and losses by the Company in 2008 and 2007 have been adjusted as follows as a result of voluntary reinsurance:

	2008		2007	
	Written	Earned	Written	Earned
PREMIUMS				
Direct and assumed	$ 102,490,602	$ 102,669,213	$ 105,060,237	$ 111,034,846
Ceded (net of ceding commission income)	(69,321,898)	(69,453,623)	(71,190,869)	(75,923,623)
Net	$ 33,168,704	$ 33,215,590	$ 33,869,368	$ 35,111,223

	2008	2007
LOSSES AND LOSS ADJUSTMENT EXPENSES		
Direct	$ 7,932,508	$ (2,818,825)
Ceded	4,314,933	7,465,000
Net	$ 12,247,441	$ 4,646,175

11 Reserve for Losses and Loss Adjustment Expenses

The following table sets forth a reconciliation of beginning and ending reserve for losses and loss adjustment expenses, as shown, in the Company's consolidated financial statements for the periods indicated:

	2008	2007
Balance at January 1	$ 271,027,400	$ 342,944,579
Less reinsurance recoverable, unpaid losses	(180,084,064)	(238,279,063)
Net balance at January 1	90,943,336	104,665,516
Incurred related to		
Current year	30,144,710	16,150,000
Prior years	(17,897,269)	(11,503,825)
Total incurred	12,247,441	4,646,175
Paid related to		
Current year	6,822,381	260,809
Prior years	16,497,965	18,107,546
Total paid	23,320,346	18,368,355
Net balance at December 31	79,870,431	90,943,336
Plus reinsurance recoverable, unpaid losses	153,979,151	180,084,064
Balance at December 31	$ 233,849,582	$ 271,027,400

As a result of changes in estimates of incurred losses related to insured events of prior years, the reserve for losses and loss adjustment expenses decreased $17,897,269 and $11,503,825, in 2008 and 2007, respectively, primarily as a result of favorable developments on certain claims that arose in the 2003, 2005, and 2006 calendar years. As additional historical loss experience information is obtained, the Company will update its estimate of the reserve for losses and loss adjustment expenses.

12 Contingencies

In the normal course of its business activities, the Company may be subject to various asserted and unasserted claims and lawsuits covering a wide range of matters. The Company is not aware of any events that would give rise to a claim at December 31, 2008.

13 Policyholders' Dividend

In determining the level of dividend to declare the Board of Directors (Board) reviews the financial results of the Company as well as the anticipated capital levels needed to fund the Company's future operations and to maintain the Company's sound financial condition. After a review of all of these factors the Board adopted a formula that resulted in a dividend of $4.5 million being declared in 2007. The Board elected not to declare a dividend in 2008.

The dividend has been distributed to members based equally on each members' share of the Company's net worth determined at December 31, 2007, before payment of the dividend, and the proportion of 2007 gross earned premium of the Company attributable to each member.

Under title 8, section 6005 of the Vermont Statutes, the Company must seek the approval of the Commissioner of BISHCA prior to the payment of any dividend.

14 Employee Benefit Plans

A. RETIREMENT PLANS

The Company has three retirement plans for its employees: a noncontributory defined benefit plan, a 401(k) defined contribution plan, and a supplemental employee retirement plan.

The noncontributory defined benefit plan (the Plan) covers substantially all regular full-time employees. The Company uses a December 31 measurement date for the Plan. Plan assets consist of mutual funds, including various debt and equity issues.

The Plan uses the actuarial cost method mandated by SFAS No. 87 and the following weighted-average assumptions to determine the benefit obligation and net periodic pension cost for the years ended December 31, 2008 and 2007:

	2008	2007
Discount rate for benefit obligation	6.50%	6.00%
Discount rate for pension cost	6.00%	5.75%
Expected return on plan assets	7.50%	7.50%
Rate of compensation increase	4.50%	4.50%

Plan amounts recognized in the consolidated balance sheet consist of:

	2008	2007
Noncurrent assets	$ —	$ —
Current liabilities	59,487	32,096
Noncurrent liabilities	234,280	295,603
Total	$ 293,767	$ 327,699

Plan amounts recognized in accumulated other comprehensive income consist of:

	2008	2007
Net loss	$ 718,715	$ 104,487

Other components of the Plan for the years ended December 31, 2008 and 2007, were as follows:

	2008	2007
Benefit obligation	$ 3,454,230	$ 3,044,725
Fair value of plan assets	3,160,463	2,717,026
Funded status of the plan	$ (293,767)	$ (327,699)
Employer contributions	$ 1,274,719	$ 499,290
Benefits paid	$ 30,732	$ 23,048

The Plan's accumulated benefit obligation is $2,446,579 as of December 31, 2008 and was $2,171,275 as of December 31, 2007. Pension expense for the Plan equaled $295,820 and $339,063 for the years ended December 31, 2008 and 2007, respectively, and is included in "General and administrative expenses" in the consolidated statements of operations and changes in equity.

The Company determines the long-term expected rate of return on Plan assets by examining historical returns and the Plan's asset allocation. Factors such as inflation and current interest rates are also evaluated. The result is reviewed against benchmarking data to ensure that the return is a reasonable and appropriate assumption.

The Plan's asset allocation at December 31, by asset category, is as follows:

	2008	2007
ASSET CATEGORY:		
Equities	60.0%	60.0%
Fixed income securities	40.0%	40.0%
Total	100.0%	100.0%

The Company's expected long-term rate of return and projected asset allocation are as follows:

	Expected Rate of Return	Guideline Asset Allocation	Expected Net Rate of Return
ASSET CATEGORY:			
Equities	9.0%	60.0%	5.4%
Fixed income securities	5.0%	40.0%	2.0%
Total		100.0%	7.4%

	Guideline Allocation	Permissible Range
ASSET CATEGORY:		
Equities	60.0%	60.0%
Fixed income securities	40.0%	40.0%

The Plan's assets will be invested in a prudent manner for the exclusive purpose of providing benefits to Plan participants. The Company's objective is to maximize the return on assets, over the long term, by investing a majority of assets in equities. The inclusion of additional asset classes with differing rates of return, volatility, and correlation are utilized to reduce the risk by providing diversification relative to equities. The Company's investment policy states that equities will comprise 60% of assets, and fixed income securities 40% of assets. The actual allocation will be compared to the target allocation monthly and if any fund allocation is more than one percentage point different than the target, funds will be bought or sold to bring the allocation to the target.

The Company made contributions of $1,274,719 and $499,290 to the Plan for the years ended December 31, 2008 and 2007,

respectively, which amounts were in excess of the minimum required ERISA contributions. The Company's funding policy is to contribute over time in order to fund toward 150% of the Plan's accumulated benefit obligation.

The estimated net loss and prior service cost for the Plan that will be amortized from accumulated other comprehensive income into net periodic benefit cost over the next fiscal year are $38,296 and $0, respectively.

Benefit payments expected to be paid from the Plan over the next five years and accumulated over the five years thereafter are as follows as of December 31:

Year	Expected Benefits
2009	$ 59,489
2010	$ 57,888
2011	$ 440,691
2012	$ 171,503
2013	$ 52,223
2014–2018	$ 1,735,007

The 401(k) defined contribution plan covers substantially all employees. Effective January 1, 2007, the Company contributes amounts to the plan sufficient to credit each participant's account with an amount equal to 3% of the participant's eligible compensation, subject to IRS limitations, during the plan year. In addition, the Company matches 100% of the first 1% and 50% of the next 1% of employee voluntary contributions of the participant's eligible compensation. Prior to January 1, 2007, the Company contributed amounts to the plan sufficient to credit each participant's account with an amount equal to 4% of the participant's eligible compensation. Participants are not required to contribute to the plan. Participants may voluntarily contribute up to 50% of eligible compensation paid to the participant during the plan year up to a maximum of $15,500. The Company contributed approximately $112,000 to this plan in both 2008 and 2007.

The Company has a supplemental employee retirement plan (SERP) for certain key employees. The SERP provides benefits equal to what would be available under both the qualified non-contributory defined benefit plan and the 401(k) defined contribution plan, if there were no statutory limitations on the amount of compensation that could be covered by the qualified plans.

Defined Benefit Component:

SERP amounts recognized in the consolidated balance sheet consist of:

	2008	2007
Noncurrent assets	$ —	$ —
Current liabilities	—	—
Noncurrent liabilities	648,892	609,717
Total	$ 648,892	$ 609,717

SERP amounts recognized in accumulated other comprehensive income consist of:

	2008	2007
Net gain	$ (57,840)	$ (9,203)

Other components of the SERP for the years ended December 31, 2008 and 2007 were as follows:

	2008	2007
Benefit obligation	$ 648,892	$ 609,717
Fair value of plan assets	—	—
Funded status of the plan	$ (648,892)	$ (609,717)
Employer contributions	$ —	$ 377,249
Benefits paid	$ —	$ 377,249

The SERP's accumulated benefit obligation is $404,213 as of December 31, 2008 and was $217,135 as of December 31, 2007. Included in "General and administrative expenses" in the accompanying consolidated statements of operations and changes in equity at December 31, 2008 and 2007, are amounts

attributable to this plan of approximately $114,001 and $55,505, respectively. The Company anticipates contributing amounts equal to the benefits payable during future plan years.

The estimated net gain and prior service cost for the SERP that will be amortized from accumulated other comprehensive income into net periodic benefit cost over the next fiscal year are $(1,607) and $2,597, respectively.

Benefit payments expected to be paid from the SERP over the next five years and accumulated over the five years thereafter are as follows as of December 31:

Year	Expected Benefits
2009	$ 0
2010	$ 0
2011	$ 0
2012	$ 0
2013	$ 0
2014–2018	$ 1,117,525

Defined Contribution Component:

The accrued liability included in the consolidated balance sheet for the defined contribution component of the SERP was $76,142 at December 31, 2008 and $47,669 at December 31, 2007. Amounts recognized in the consolidated statement of operations for the defined contribution component of the SERP were $28,473 at December 31, 2008 and $18,473 at December 31, 2007.

B. POSTRETIREMENT BENEFIT PLAN

The Company provides health and life insurance benefits to employees and retirees. The Company recognizes the expected cost of these benefits during the years in which employees render service. No assets are set aside for postretirement health and life insurance benefits.

On December 8, 2003, the President signed into law the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (the Act). In response to the Act, the Financial Accounting Standards Board issued Staff Position No. FAS 106-2 (FSP) on May 19, 2004, which provides accounting guidance related to the Act. This FSP was effective for the Company for the year ending December 31, 2005. At this time, the Company has determined that any benefits to be derived as a result of the Act are outweighed by the costs involved in applying for benefits under the Act. Consequently, the Company has not applied for benefits under the Act and any measures of the accumulated postretirement benefit obligation or net periodic postretirement benefit cost in the financial statements or accompanying notes do not reflect the effects of the Act on the Company's postretirement medical benefit plan.

Plan amounts recognized in the consolidated balance sheet consist of:

	2008	2007
Noncurrent assets	$ —	$ —
Current liabilities	22,058	5,000
Noncurrent liabilities	992,549	777,842
Total	$ 1,014,607	$ 782,842

Plan amounts recognized in accumulated other comprehensive income consist of:

	2008	2007
Net loss	$ 220,608	$ 125,914

Other components of the plan for the years ended December 31, 2008 and 2007, were as follows:

	2008	2007
Benefit obligation	$ 1,014,607	$ 782,842
Fair value of plan assets	—	—
Funded status of the plan	$ (1,014,607)	$ (782,842)
Employer contributions	$ 24,624	$ 19,239
Benefits paid	$ 24,624	$ 19,239

The following table shows the plan's obligation by participant as well as assumed discount rates:

	2008	2007
Retirees	$ (404,781)	$ (103,644)
Other active participants	(609,826)	(679,198)
Accumulated postretirement benefit obligation	$ (1,014,607)	$ (782,842)
Weighted average assumed discount rate used to determine:		
the benefit obligation	6.50%	6.25%
the net benefit cost	6.25%	6.00%

Included in "General and administrative expenses" in the accompanying consolidated statements of operations and changes in equity at December 31, 2008 and 2007, are amounts attributable to this plan of $110,706 and $99,749, respectively.

The Company's policy is to contribute the amount required to fund postretirement benefits as they become due to retirees. The amount expected to be required in contributions to the plan during the upcoming year is $22,058.

The estimated net loss and prior service cost for the plan that will be amortized from accumulated other comprehensive income into net periodic benefit cost over the next fiscal year are $13,996 and $0, respectively.

Benefit payments expected to be paid from the plan over the next five years and accumulated over the five years thereafter are as follows as of December 31:

Year	Expected Benefits
2009	$ 22,058
2010	$ 25,673
2011	$ 31,230
2012	$ 32,259
2013	$ 39,432
2014–2018	$ 299,958

For measurement purposes, a 9.5% increase in healthcare costs was assumed for fiscal year 2008, trending down to 5.0% in 2018 and thereafter.

15 Other Comprehensive Loss

The Company's other comprehensive loss is calculated as follows:

year ended December 31, 2008	Pretax Amount	Tax Expense or Benefit	Net of Tax Amount
Net unrealized losses on investments			
Net unrealized losses arising during the period	$(27,302,036)	$ (9,555,712)	$(17,746,324)
Reclassification adjustment for losses realized in net income	5,770,832	2,019,791	3,751,041
Net unrealized losses on employee benefit plans	(1,015,825)	(355,539)	(660,286)
Other comprehensive loss	$(22,547,029)	$ (7,891,460)	$(14,655,569)

year ended December 31, 2007	Pretax Amount	Tax Expense or Benefit	Net of Tax Amount
Net unrealized losses on investments			
Net unrealized losses arising during the period	$ (3,124,086)	$ (1,093,430)	$ (2,030,656)
Reclassification adjustment for losses realized in net income	268,086	93,830	174,256
Other comprehensive loss	$ (2,856,000)	$ (999,600)	$ (1,856,400)

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1

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PHOTO 1 *(clockwise, from left)*
Jeffrey L. Steele, Michael D. Strohm, Dawn-Marie Driscoll

PHOTO 2 *(clockwise, from left)*
David E. A. Carson, Kevin M. Carome, David Oestreicher, Diana P. Herrmann

PHOTO 3 *(listed left to right)*
Kelley A. Howes, Paul S. Kulig, James H. Bodurtha

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