



# **Hallmark Financial Services, Inc.**

*Presentation for*

## **2011 Annual Shareholder Meeting**

*June 2, 2011*

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# Forward-Looking Statements

**This presentation contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, which are intended to be covered by the safe harbors created thereby. These statements include the plans and objectives of management for future operations, including plans and objectives relating to future growth of our business activities and availability of funds. The forward-looking statements included herein are based on current expectations that involve numerous risks and uncertainties. Assumptions relating to the foregoing involve judgments with respect to, among other things, future economic, competitive and market conditions, regulatory framework, weather-related events and future business decisions, all of which are difficult or impossible to predict accurately and many of which are beyond our control. Although we believe that the assumptions underlying the forward-looking statements are reasonable, any of the assumptions could be inaccurate and, therefore, there can be no assurance that the forward-looking statements included in this presentation will prove to be accurate. In light of the significant uncertainties inherent in the forward-looking statements included herein, the inclusion of such information should not be regarded as a representation by any person that our objectives and plans will be achieved.**

**More information about forward-looking statements and the risk factors associated with our company are included in our annual, quarterly and other reports filed with the Securities and Exchange Commission.**

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# Property & Casualty Insurance Industry Update

**Mark Schwarz**

Executive Chairman

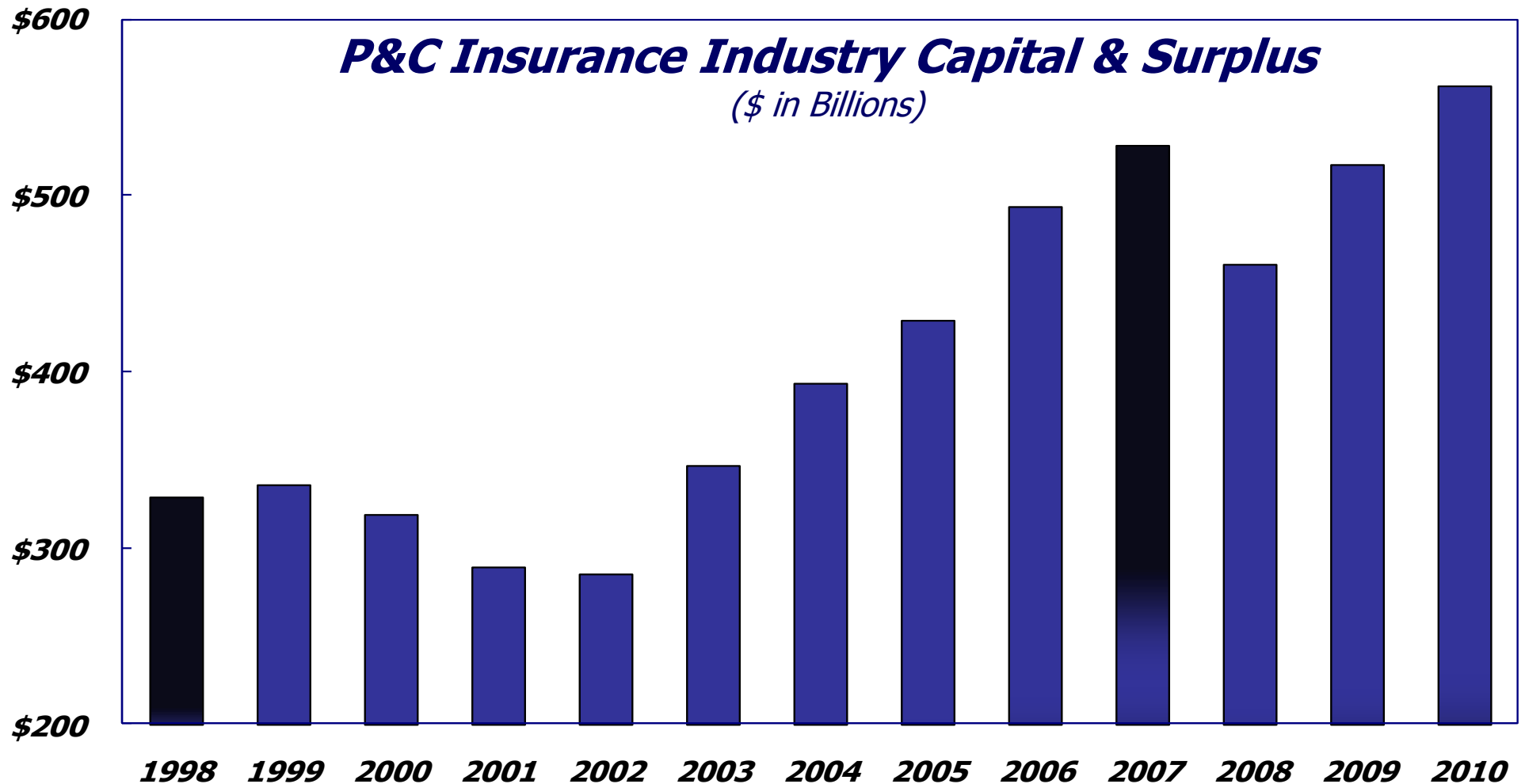


# Property & Casualty Industry Update

- Industry net premiums written grew 1.1% during 2010; the first increase the industry recorded since 2006.
- The industry combined ratio deteriorated 2.1 percentage points to 100.8% from 98.7% in 2009.
- Commercial lines net premiums written contracted 2.0% during 2010 from a prolonged soft market and sluggish recovery from the recession.
  - ✓ Commercial lines of business combined ratio deteriorated 7.1 percentage points to 106.0% in 2010 compared to 98.9% in 2009.
- Personal lines net premiums written grew 2.8% during 2010 due to more favorable rate and exposure.
  - ✓ Personal lines of business improved in 2010 with a reported calendar year combined ratio of 100.0% compared to 102.4% in 2009.
- The industry's overall net investment gains increased approximately 34% to \$56.7 billion from \$42.4 billion in 2009.

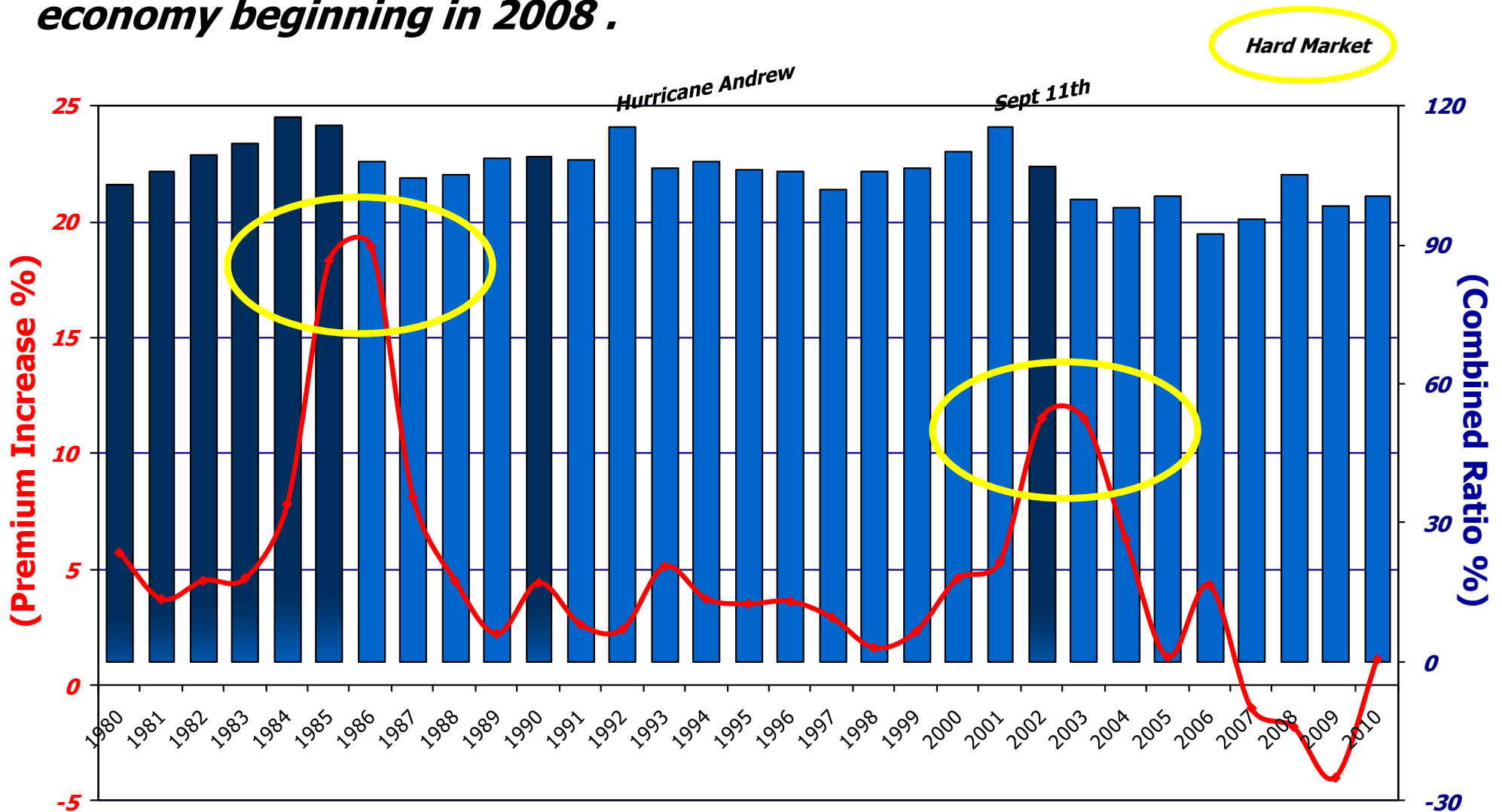
# P&C Industry Capital & Surplus

***U.S. P&C Surplus as of December 31, 2010 was a record \$563 billion, up from \$437 billion during the 2008 financial crisis.***



# P&C Industry Operating Results

**After Sept. 11th, the P&C industry premium benefited from a strong hard market cycle. However, since 2003 premium growth has been impacted by softening rates, coupled with the contraction in the economy beginning in 2008.**



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## **When Will the Market Turn?**

**“Rates of premium at last gave signs of having reached a stage at which, with careful underwriting, a reasonable margin of profit might be expected.”**

**– Post Magazine, U.K., 1914**

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# Strategic Overview

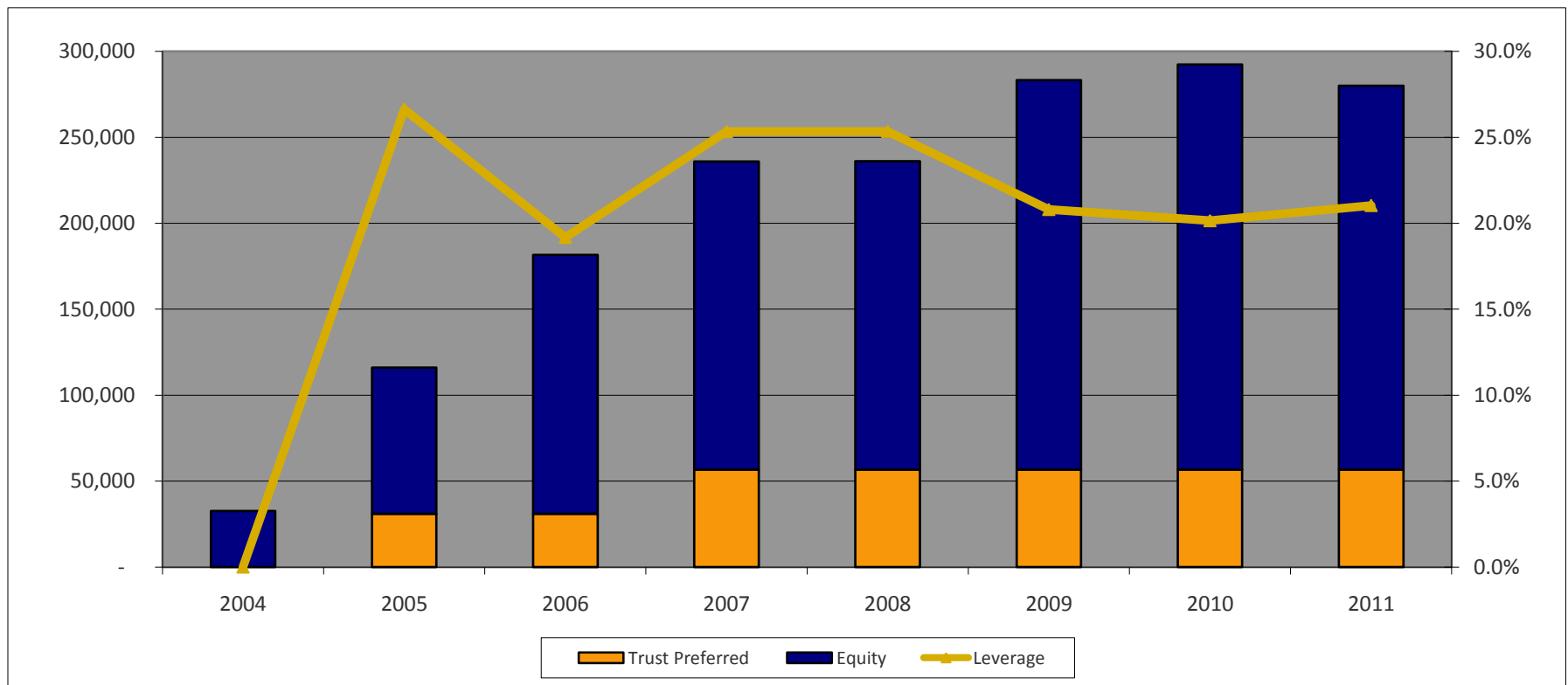


## Who We Are

- ✓ Diversified specialty property/casualty insurer with operating units in Dallas-Fort Worth and San Antonio, Texas and Basking Ridge, New Jersey
- ✓ Market, underwrite and service over \$300 million of commercial and personal insurance in selected markets
  - Focused on underserved sectors, mostly short-tailed lines
  - Operate in diversified, sustainable niche markets
- ✓ Focus on disciplined underwriting and bottom line profitability
- ✓ Proven track record of strong underwriting performance
- ✓ Demonstrated ability to identify and acquire profitable, niche businesses
- ✓ "A-" (Excellent) A.M. Best Financial Strength Rating
- ✓ Combined Statutory Surplus of \$178 million as of March 31, 2011

# Who We Are

- ✓ Market capitalization of \$143 million, with 20.1 million shares outstanding (\$7.10 market value per share) as of May 27, 2011
- ✓ Consolidated Shareholders' Equity of \$223 million as of March 31, 2011 (\$11.10 per share)
- ✓ Total capitalization of \$283 million as of March 31, 2011, including \$57 million of subordinated trust preferred debt securities that mature in 2035.



# Our Corporate Strategy

***To be a "Best in Class" Specialty Insurance Company Focused on: (1) Underwriting Profitability; and (2) Superior Investment Returns:***

- ✓ Strong management team has interests aligned with shareholders
- ✓ Focus on specialty insurance niches
- ✓ Diversification through multiple business lines
- ✓ Selectively and opportunistically acquire well positioned businesses with strong underwriting and operating management
- ✓ Balance Sheet based on strong investment, reinsurance and reserving practices
- ✓ Performance measurement based on long-term growth in book value per share

# The Hallmark Track Record

***Aggregates & Averages for the Last Seven Years Highlight Hallmark's Successful Expansion and Diversification into Specialty Lines of Business.***

	<b>Gross Premiums Produced</b>	<b>Investment Income</b>	<b>Operating Income</b>	<b>GAAP Equity</b>		<b>GAAP BVPS</b>		<b>Year End Stock Price</b>	
			(2)		ROAE	(3)	% Chg	(3)	% Chg
<b>2004</b>	\$ 119,305	\$ 1,386	\$ 8,602	\$ 32,656	20%	\$ 5.37		\$ 7.20	
<b>2005</b>	\$ 118,066	\$ 3,836	\$ 13,468	\$ 85,188	16%	\$ 5.89	10%	\$ 8.16	13%
<b>2006</b> (1)	\$ 293,304	\$ 10,461	\$ 23,950	\$ 150,731	13%	\$ 7.26	23%	\$ 9.91	21%
<b>2007</b>	\$ 297,904	\$ 13,180	\$ 41,769	\$ 179,621	17%	\$ 8.65	19%	\$ 15.86	60%
<b>2008</b>	\$ 287,081	\$ 16,049	\$ 21,124	\$ 179,412	7%	\$ 8.61	0%	\$ 8.77	-45%
<b>2009</b>	\$ 288,450	\$ 14,947	\$ 33,257	\$ 226,517	12%	\$ 11.26	31%	\$ 7.96	-9%
<b>2010</b>	\$ 314,857	\$ 14,849	\$ 8,264	\$ 235,763	3%	\$ 11.72	4%	\$ 9.10	14%
<b>Last 7 Years (2004-2010).....</b>									
<b>TOTAL</b>	\$ 1,718,967	\$ 74,708	\$ 150,434						
<b>CAGR</b>	<b>18%</b>	<b>48%</b>	<b>-1%</b>	<b>39%</b>		<b>14%</b>		<b>4%</b>	

(1) 2006 excludes the noncash interest expense from amortization of deemed discount on convertible notes. See Non-GAAP measure slide at the end of this presentation for a reconciliation to GAAP

(2) Operating income is income before noncash interest expense from amortization of deemed discount on convertible notes, income tax and non-controlling interest.

(3) Stock prices prior to 2006 have been adjusted for the one for six stock split which took place during the Q3 2006.

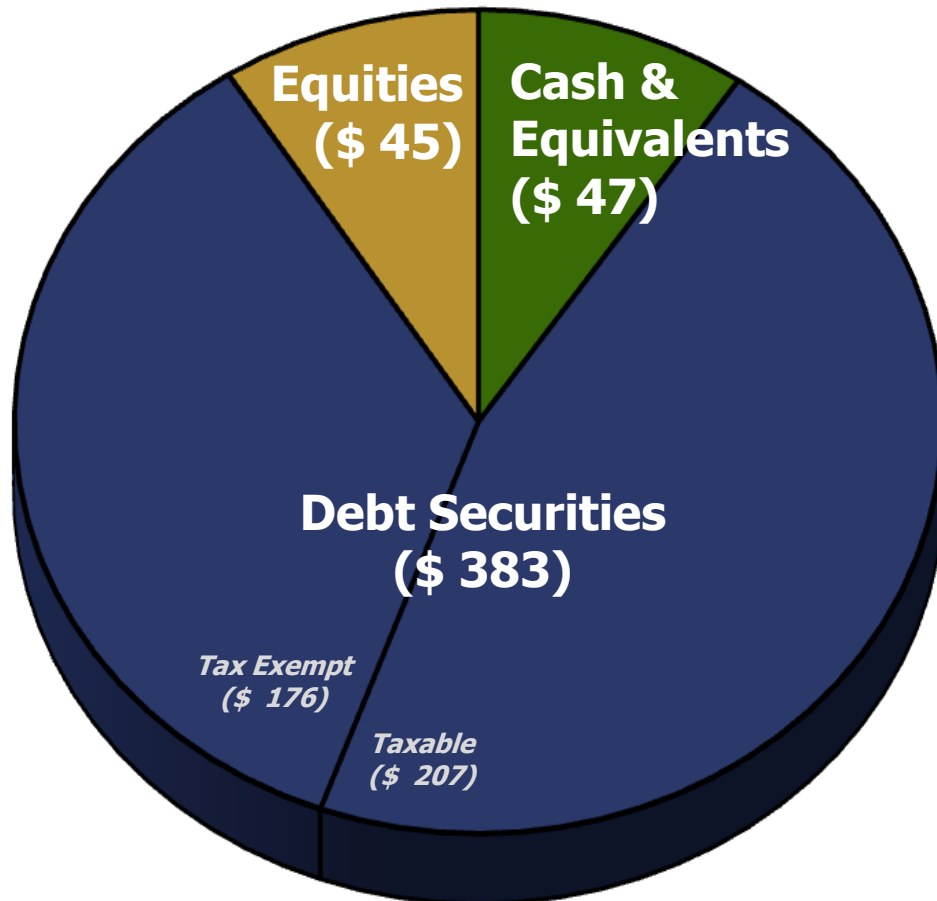
# Investment Strategy

***Hallmark views Investment Operations as a Core Competency. Hallmark has achieved above average results and expense savings through internal management of its investments.***

- ✓ Employ a disciplined, value-based investment strategy
- ✓ Investment process focuses on individual security selection
- ✓ Seek to outperform market benchmarks on average vs. consistently beating the market ever year
- ✓ Total return approach values all components of investment return equally, whether reported as interest and dividends on the income statement or recognized as comprehensive income on the balance sheet
- ✓ Seek to maximize total return on an after-tax basis through investment in tax-exempt securities and compounding of unrealized gains.

# Investment Portfolio

**As of March 31, 2011**  
(\$ in millions)



***Total Cash & Investments  
\$475 million, or  
Approximately \$24 per  
Share.***

- ✓ Cash \$47 million
- ✓ Total Investments \$427 million
- ✓ Investment grade portfolio, marketable securities
- ✓ No hedge fund or private equity investments
- ✓ 10% invested in equities
- ✓ Annualized tax equivalent yield of approx 5.5%
- ✓ Weighted-average duration of 2.9 years

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# Property & Casualty Insurance Industry Update

**Mark Morrison**

President & Chief Executive Officer



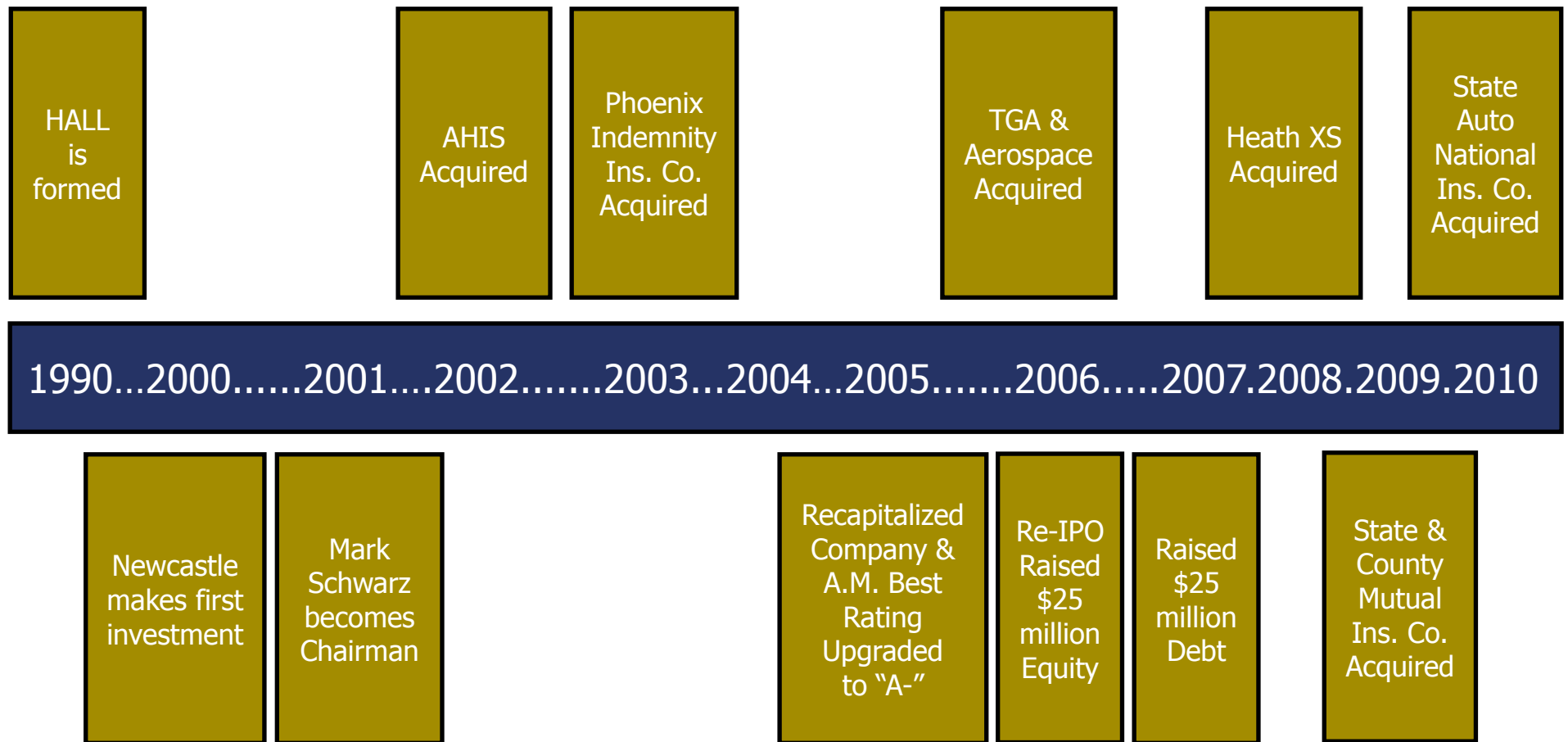
# Underwriting Strategy

## Disciplined Underwriting Strategy in Specialty Niche Market Segments:

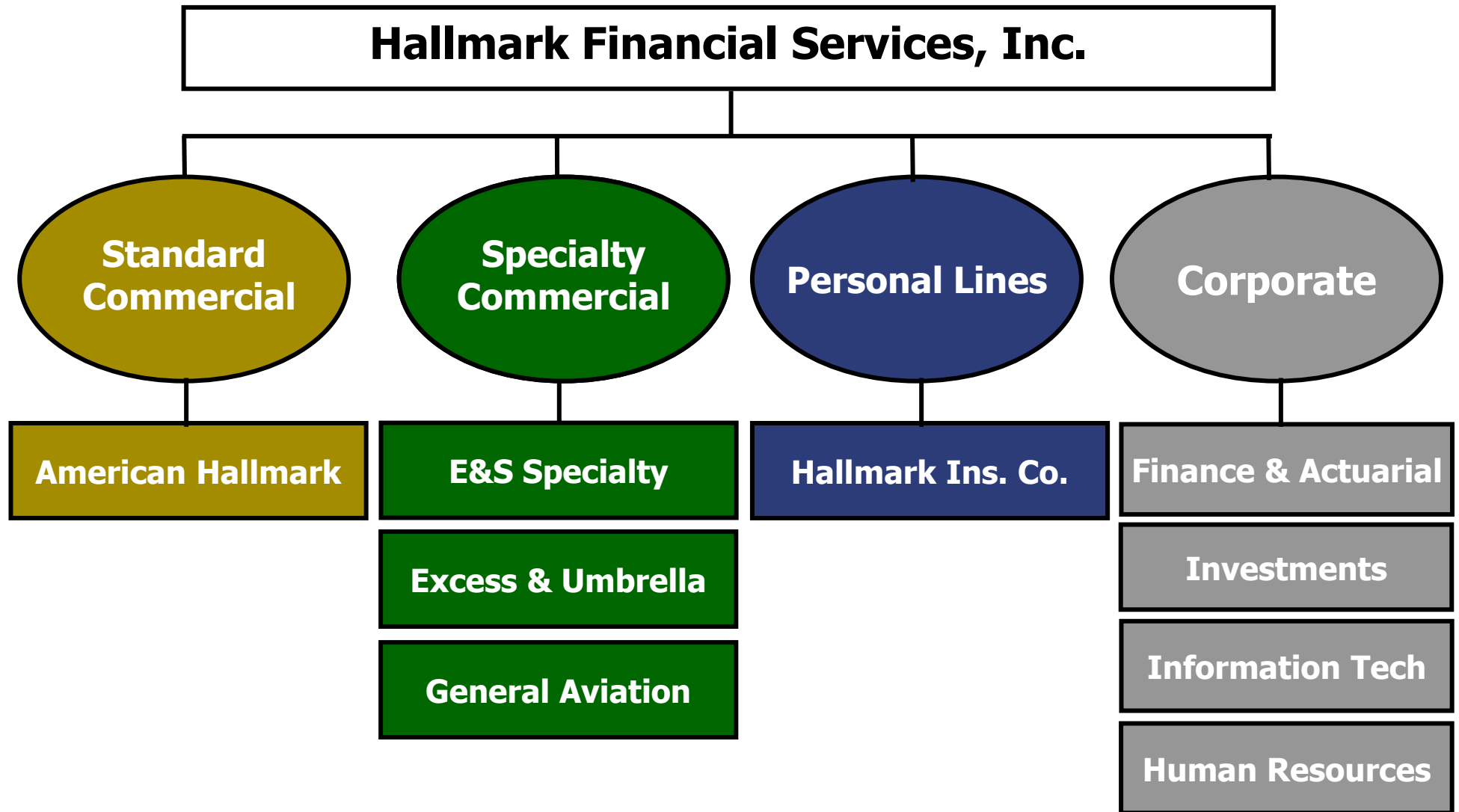
- ✓ Underserved markets – limited competition
- ✓ Highly customized products to meet unique needs of insureds
- ✓ Low price sensitivity
- ✓ Low-severity and short-tailed exposures
- ✓ Underwriting expertise critical: Underwriters have an average of 15 years of experience
- ✓ Underwriters' bonuses based on underwriting performance—emphasizes bottom-line profitability over top-line growth
- ✓ Sustain strong, consistent underwriting performance
- ✓ Reinsurance used to reduce operating volatility and to protect shareholders capital.

# How We Got to Where We Are Today

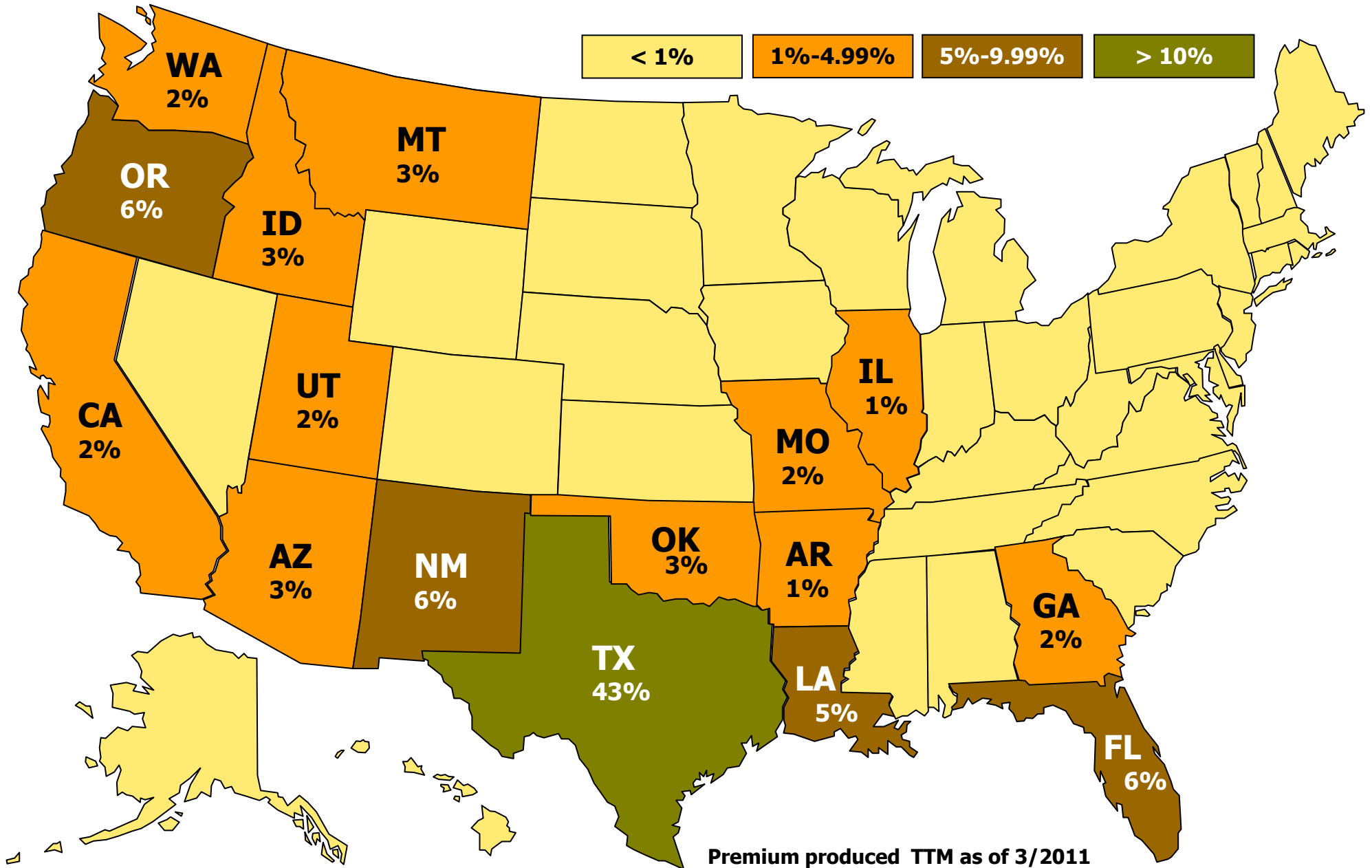
***Hallmark Began in 1990 as a Texas-only, Mono-line Company. In 2002, New Management Begins Transformation into into a Diversified, Specialty Lines Focused Property/Casualty Insurer.***



# Organizational Overview

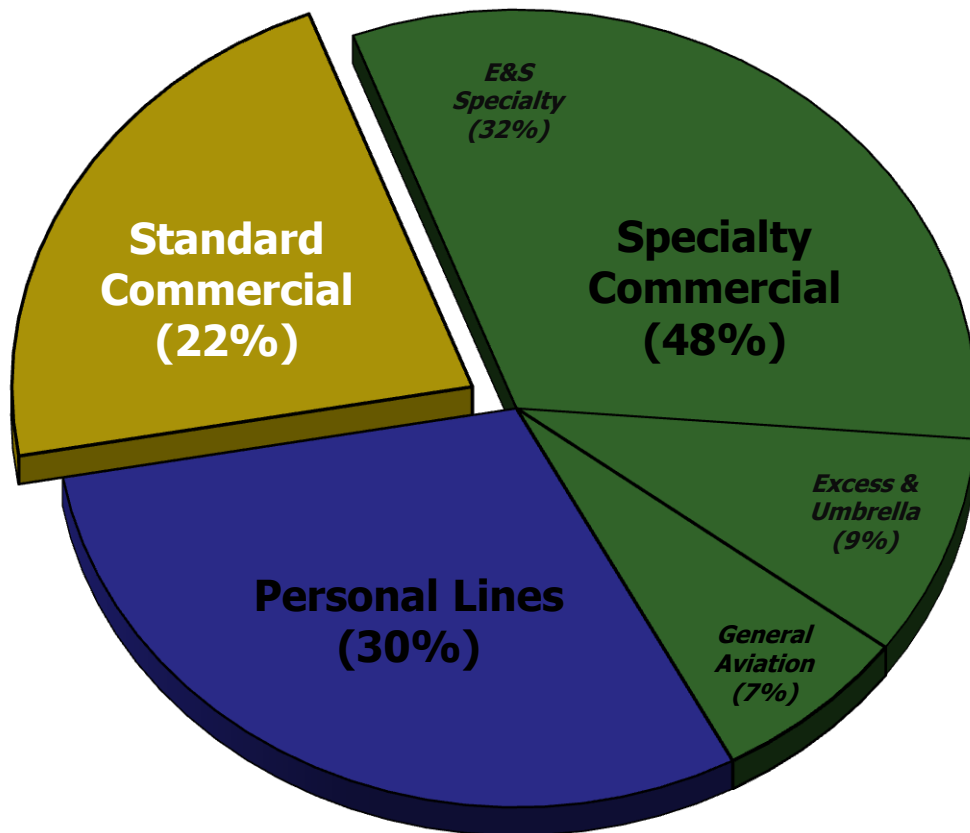


# Geographic Spread of Premiums Produced



# Standard Commercial

## Gross Premiums Produced *By Operating Unit*



*FY 2010 Gross Premium Produced of \$315 million*

### **Product/Market Focus:**

- ✓ Small account, low-hazard commercial package business
- ✓ Focused on rural and suburban markets
- ✓ Smaller, less competitive markets

### **Agency Relationships:**

- ✓ Long-standing relationships
- ✓ Selectively chosen group of 200 independent retail agencies with 325 offices in AR, HI, ID, MT, NM, OR, TX, UT, WA & WY
- ✓ Agents given market exclusivity

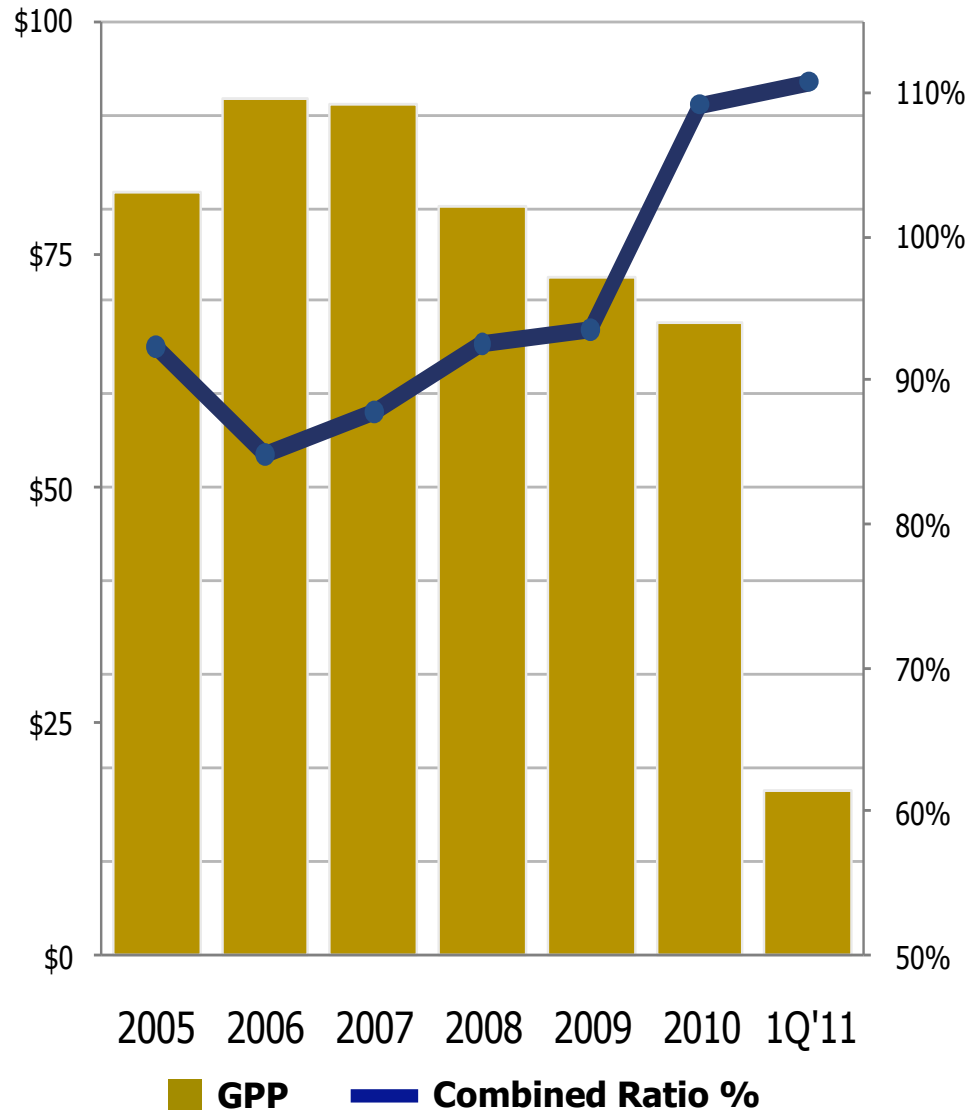
### **Growth Opportunities:**

- ✓ Expand into new geographic areas with new & existing agents
- ✓ Expand into new product lines

# Standard Commercial Operating Trends

## Gross Premiums Produced

*\$ in millions*



## **Disciplined Underwriting in a Prolonged Soft Market has Significantly Reduced Book of Business**

- ✓ Larger accounts written in hard market have migrated to national carriers

## **Cost Saving Initiatives have been Ongoing since 2008**

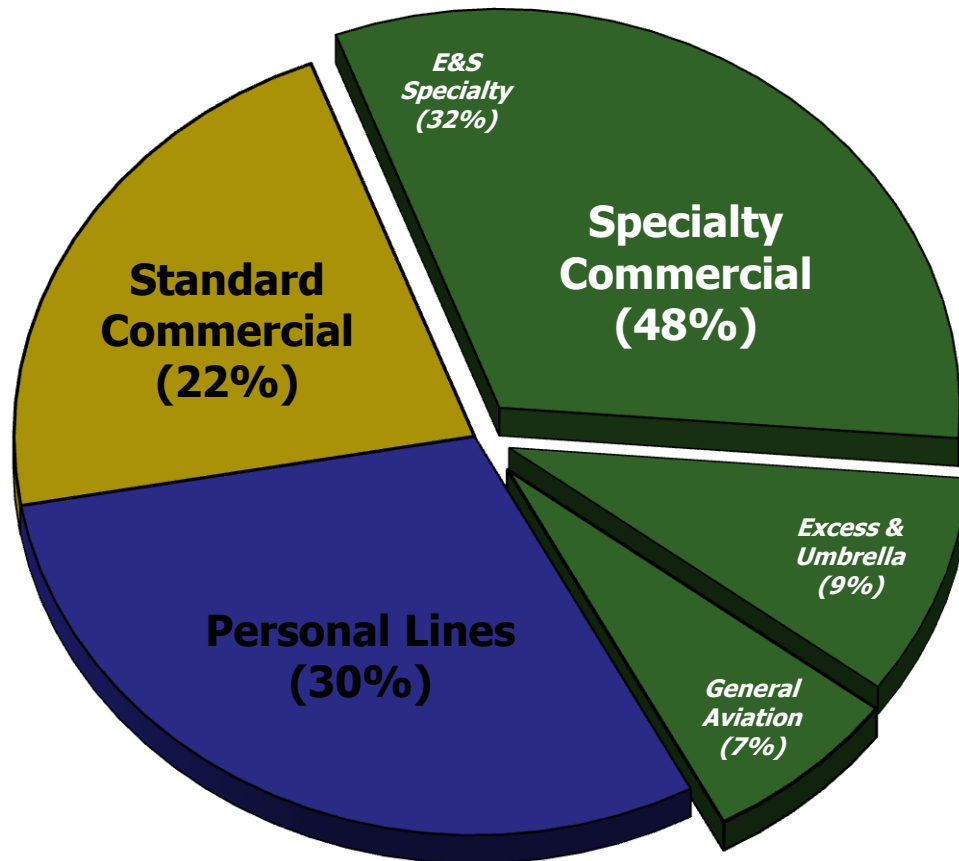
- ✓ Savings help to maintain margins

## **Loss Ratio in 2010 has been impacted by High Level of Large Property Losses**

- ✓ Despite consistent underwriting, an unprecedented level of large property losses incurred as a result of arson and natural catastrophes

# Specialty Commercial

## Gross Premiums Produced *By Operating Unit*



*FY 2010 Gross Premium Produced of \$315 million*

## **Product/Market Focus:**

- ✓ Difficult-to-place business risks
- ✓ Mostly commercial auto, surplus lines general liability, general aviation & excess/umbrella
- ✓ National footprint, but still largely concentrated in Texas

## **Agency Relationships:**

- ✓ 300 wholesale/specialty brokers representing more than 3,000 individual agents nationwide

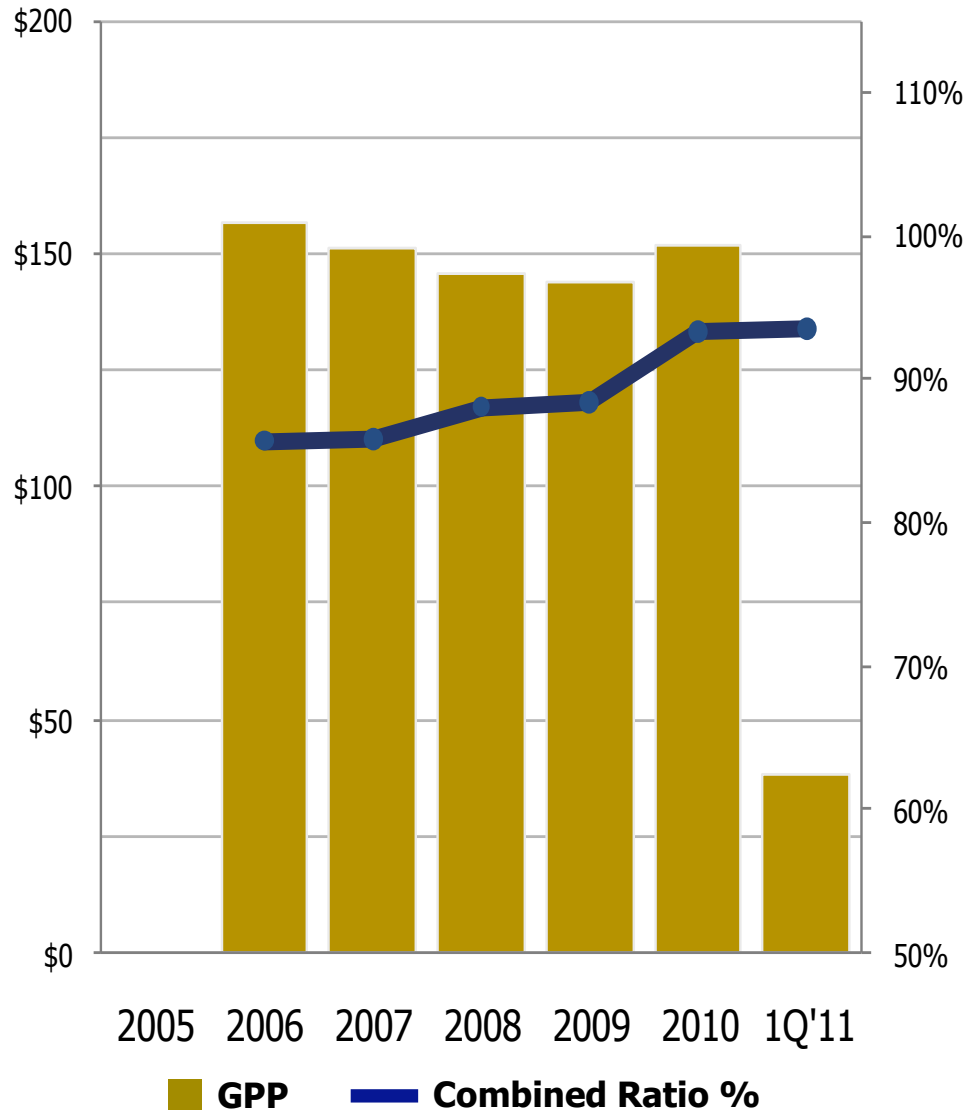
## **Growth Opportunities:**

- ✓ Expand into new geographic areas through new & existing agents
- ✓ Expand into new Specialty products

# Specialty Commercial Operating Trends

## Gross Premiums Produced

*\$ in millions*



## **Soft Market Conditions Continue to cause Premium Production to Decline**

- ✓ Standard markets look to specialty risks for top line growth
- ✓ Current economic conditions severely impact insured exposures

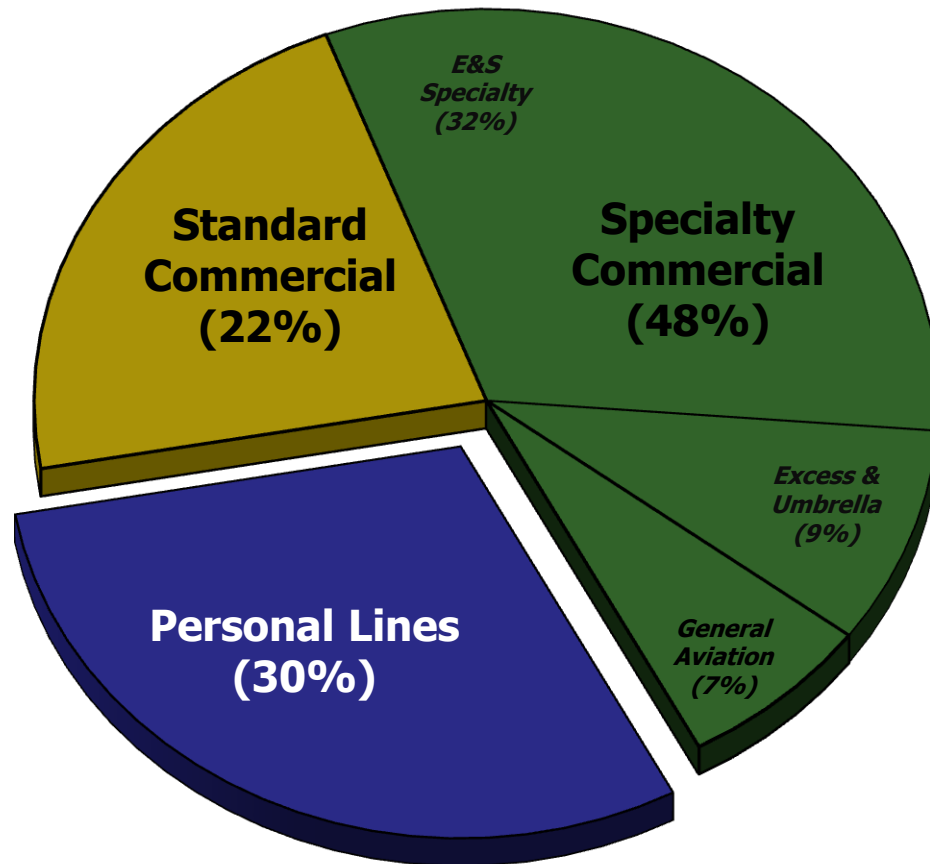
## **Recent Acquisitions help to support Top Line Growth**

- ✓ Net premium retention has increased in order to deploy available capital
- ✓ Experienced specialty lines underwriters added to support product & geographic expansion

## **Underwriting Discipline has helped to Maintain Healthy Margins**

# Personal Lines

## Gross Premiums Produced *By Operating Unit*



*FY 2010 Gross Premium Produced of \$315 million*

### **Product/Market Focus:**

- ✓ Non-standard personal auto
- ✓ Supplement NSA with other niche personal line products
- ✓ Light touch, low cost provider

### **Agency Relationships:**

- ✓ Over 8,800 independent retail agents in 31 states
- ✓ Efficiency via technology
- ✓ Tiered agency relationships

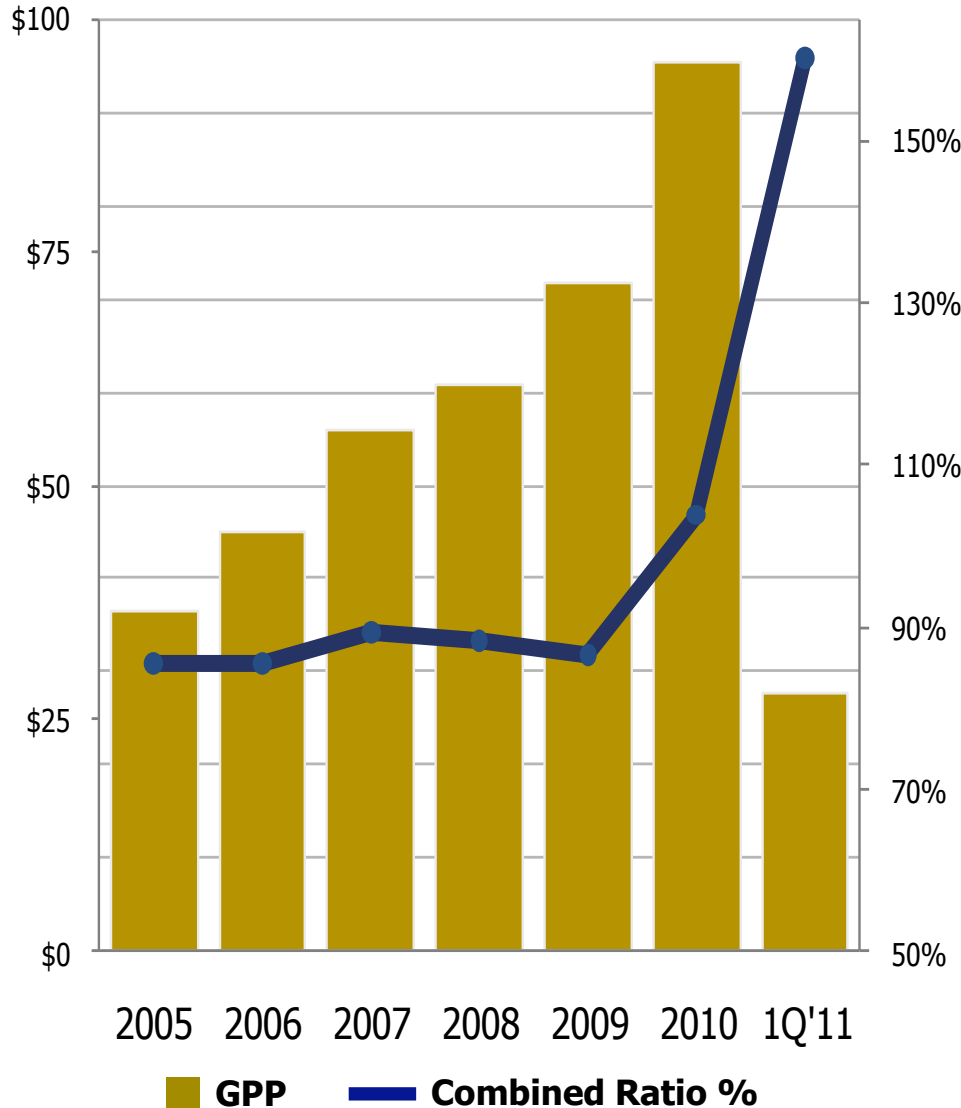
### **Growth Opportunities:**

- ✓ Continued geographic expansion
- ✓ Distribution channel expansion
- ✓ Integration of State Auto National NSA acquisition
- ✓ More product expansion (property, motorcycle, business auto)

# Personal Lines Operating Trends

## Gross Premiums Produced

*\$ in millions*



## Significant Geographic & Product Expansion Strategy

- ✓ Expansion into 4-5 new states per year since 2004
- ✓ Supplementing NSA with other niche personal line products

## Highly Efficient Operating Platform with Expense Ratio in low 20%'s

- ✓ Efficiency via technology and light touch approach

## Significant Loss Ratio Pressure beginning in 2010 as a result of Recent Expansion into Florida

- ✓ Turbulent market conditions lead to unanticipated level of production
- ✓ Widespread claim fraud continues with no legislative relief in sight

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# Financial Overview



# Hallmark's Six-Year Track Record

***ROE Calculation Utilizing Comprehensive Income is Equivalent to Change in Book Value per Share (after adjustment for changes in equity capitalization)***

- ✓ Hallmark has historically produced significant contribution to ROE from both underwriting and investments

	Underwriting	Investment	Debt	Other	Comprehensive Pre-Tax ROBE	Tax	Comprehensive After-Tax ROBE	Treasury Buyback	Stock Comp	Stock Issuances	Minority Interest	BVPS Growth
2005	22%	6%	-4%	9%	33%	31%	22%	NA	0.4%	-13%	NA	10%
2006	25%	11%	-7%	-12%	17%	36%	11%	NA	0.2%	12%	NA	23%
2007	18%	10%	-3%	3%	28%	33%	19%	NA	0.2%	NA	NA	19%
2008	11%	-7%	-3%	-1%	1%	268%	-1%	NA	0.6%	NA	-0.1%	-1%
2009	12%	32%	-3%	1%	41%	31%	29%	2%	0.8%	NA	-0.2%	31%
2010	-3%	11%	-2%	-2%	4%	14%	4%	NA	0.5%	NA	-0.1%	4%
<b>6-YR Avg</b>	<b>14%</b>	<b>11%</b>	<b>-3%</b>	<b>0%</b>	<b>21%</b>	<b>32%</b>	<b>14%</b>	<b>NM</b>	<b>0.4%</b>	<b>NM</b>	<b>NM</b>	<b>14%</b>

## Growth in BVPS Compared to “Best in Class” Peers

***Hallmark’s Three-Year and Five-Year Average Growth in Book Value per Share Meet or Exceed the Performance of “Best in Class” Peer Companies.***

- ✓ Average Growth in Book Value per Share for Hallmark and “Best in Class” Peer Companies Substantially Exceeds Performance of the S&P 500 Index.

	Select Leading Specialty Property/Casualty Insurers						S&P
	HALL	HCC	WRB	RLI	MKL	BRK	
2004	19%	18%	24%	12%	20%	11%	11%
2005	10%	18%	21%	10%	4%	6%	5%
2006	23%	20%	29%	15%	32%	18%	16%
2007	19%	16%	15%	12%	15%	11%	6%
2008	-1%	10%	-5%	-6%	-16%	-10%	-37%
2009	31%	14%	22%	19%	27%	20%	27%
2010	4%	8%	14%	-4%	16%	13%	15%
<b>3-YR Average</b>	<b>11%</b>	<b>11%</b>	<b>10%</b>	<b>3%</b>	<b>9%</b>	<b>8%</b>	<b>2%</b>
<b>5-YR Average</b>	<b>15%</b>	<b>14%</b>	<b>15%</b>	<b>7%</b>	<b>15%</b>	<b>11%</b>	<b>5%</b>

# Select Financial Highlights

***Hallmark's Track Record has been Tarnished in Recent Quarters by Poor Underwriting Results arising from its 2009 Expansion into the Florida Personal Lines Market.***

	Year Ended December 31										Three Months Ended March 31		
	2006 <sup>(1)</sup>		2007		2008		2009		2010		2010	2011	
Gross Premiums Produced	↑	\$ 293,304	↑	\$ 297,904	↓	\$ 287,081	↑	\$ 288,450	↑	\$ 314,857	\$ 80,510	↑	\$ 83,692
Gross Premiums Written	↑	213,945	↑	249,472	↓	243,849	↑	287,558	↑	320,973	81,859	↑	89,712
Net Premiums Earned	↑	152,061	↑	225,971	↑	236,320	↑	251,072	↑	278,271	67,015	↑	70,113
Total Revenues	↑	202,741	↑	275,166	↓	268,690	↑	287,039	↑	307,060	75,823	↑	77,408
Net Earnings <sup>(2)</sup>	↑	15,257	↑	27,863	↓	12,899	↑	24,575	↓	7,334	6,286	↓	(11,226)
Loss Ratio (GAAP)	↑	57.3%	↑	58.8%	↑	61.0%	↑	61.2%	↑	72.8%	64.3%	↑	91.0%
Expense Ratio (GAAP)	↓	<u>28.7%</u>	↑	<u>29.1%</u>	↑	<u>30.6%</u>	↓	<u>30.5%</u>	↓	<u>29.6%</u>	<u>28.9%</u>	↑	<u>30.6%</u>
Combined Ratio (GAAP)	↓	86.0%	↑	87.9%	↑	91.6%	↑	91.7%	↑	102.4%	93.2%	↑	121.6%
EPS - Basic	↑	\$ 0.89	↑	\$ 1.34	↓	\$ 0.62	↑	\$ 1.19	↓	\$ 0.36	\$ 0.31	↓	\$ (0.56)
EPS - Diluted	↑	\$ 0.89	↑	\$ 1.34	↓	\$ 0.62	↑	\$ 1.19	↓	\$ 0.36	\$ 0.31	↓	\$ (0.56)
Return on Average Equity	↓	13%	↑	17%	↓	7%	↑	12%	↓	3%	11%	↓	-20%
Book Value Per Share	↑	\$ 7.26	↑	\$ 8.65	↓	\$ 8.61	↑	\$ 11.26	↑	\$ 11.72	\$ 11.70	↓	\$ 11.10

*(1) 2006 adjusted to exclude the effect of the non-cash interest charge (net of tax) of \$6.1 million resulting from the convertible promissory notes issued and converted during 2006. See Non-GAAP measure slide at the end of this presentation for a reconciliation to GAAP.*

*(2) Net earnings is defined as net income attributable to Hallmark Financial Services, Inc. as reported in our consolidated statements of operations.*



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**NASDAQ: HALL**

# Non-GAAP Measure Reconciliation

The following reconciles Hallmark's 2006 annual net income, diluted earnings per share and return on average equity without interest expense from amortization attributable to the deemed discount on convertible promissory notes to its reported results (in thousands). Management believes this reconciliation provides useful supplemental information in evaluating the operating results of Hallmark's business. This disclosure should not be viewed as a substitute for net income, diluted earnings per share and return on average equity determined in accordance with U.S. generally accepted accounting principles ("GAAP"):

	Income excluding interest expense from amortization of discount, net of tax	Interest expense from amortization of discount	Tax effect	Net Income
Year ended December 31, 2006	\$ 15,257	\$ 9,625	\$ (3,559)	\$ 9,191
Weighted average shares - basic	17,181			17,181
Weighted average shares - diluted	17,194			17,194
Average shareholder's equity	117,960			117,960
Net income per share - basic	\$ 0.89			\$ 0.53
Net income per share - diluted	\$ 0.89			\$ 0.53
Return on average equity	12.9%			7.8%