

HORACE MANN EDUCATORS CORP /DE/

Form 10-Q

November 08, 2007

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**

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**FORM 10-Q**

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**x** **QUARTERLY REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
**For the quarterly period ended September 30, 2007**

**OR**

**..** **TRANSITION REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
**For the transition period from**                      **to**

**Commission file number 1-10890**

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**HORACE MANN EDUCATORS CORPORATION**

(Exact name of registrant as specified in its charter)

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**Delaware**  
(State or other jurisdiction of

**37-0911756**  
(I.R.S. Employer

incorporation or organization)

Identification No.)

**1 Horace Mann Plaza, Springfield, Illinois 62715-0001**

(Address of principal executive offices, including Zip Code)

**Registrant's Telephone Number, Including Area Code: 217-789-2500**

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

Indicate by check mark the registrant's filer status, as such terms are defined in Rule 12b-2 of the Act.

Large accelerated filer ☒ Accelerated filer ☐ Non-accelerated filer ☐

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

As of October 31, 2007, 43,342,534 shares of Common Stock, par value \$0.001 per share, were outstanding, net of 17,503,371 shares of treasury stock.

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HORACE MANN EDUCATORS CORPORATION

FORM 10-Q

FOR THE QUARTER ENDED SEPTEMBER 30, 2007

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

The Board of Directors and Shareholders

Horace Mann Educators Corporation:

We have reviewed the accompanying consolidated balance sheet of Horace Mann Educators Corporation and subsidiaries (the Company) as of September 30, 2007, the related consolidated statements of operations and comprehensive income for the three-month and nine-month periods ended September 30, 2007 and 2006, and the related consolidated statements of changes in shareholders' equity and cash flows for the nine-month periods ended September 30, 2007 and 2006. These consolidated financial statements are the responsibility of the Company's management.

We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to the consolidated financial statements referred to above for them to be in conformity with U.S. generally accepted accounting principles.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of the Company as of December 31, 2006, and the related consolidated statements of operations and comprehensive income, changes in shareholders' equity, and cash flows for the year then ended (not presented herein); and in our report dated February 28, 2007, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet as of December 31, 2006, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it was derived.

/s/ KPMG LLP

KPMG LLP

Chicago, Illinois

November 8, 2007

**Table of Contents****HORACE MANN EDUCATORS CORPORATION****CONSOLIDATED BALANCE SHEETS**

(Dollars in thousands)

|   | September 30,<br>2007<br>(Unaudited) | December 31,<br>2006 |
|---|--------------------------------------|----------------------|
| <b>ASSETS</b>   |                                      |                      |
| Investments   |                                      |                      |
| Fixed maturities, available for sale, at fair value   |                                      |                      |
| Fixed maturities (amortized cost 2007, \$3,797,028; 2006, \$3,511,034)                                    | \$ 3,763,926                         | \$ 3,530,658         |
| Fixed maturity securities on loan (amortized cost 2007, \$72,960; 2006, \$291,144)                        | 72,222                               | 289,524              |
| Total fixed maturities  | 3,836,148                            | 3,820,182            |
| Short-term and other investments  | 254,571                              | 182,312              |
| Short-term investments, loaned securities collateral  | 77,583                               | 299,722              |
| Total investments   | 4,168,302                            | 4,302,216            |
| Cash  | 8,293                                | 13,438               |
| Accrued investment income and premiums receivable   | 105,006                              | 107,590              |
| Deferred policy acquisition costs   | 263,778                              | 249,377              |
| Goodwill  | 47,396                               | 47,396               |
| Value of acquired insurance in force  | 6,768                                | 10,523               |
| Other assets  | 85,431                               | 104,533              |
| Separate Account (variable annuity) assets  | 1,610,342                            | 1,494,614            |
| Total assets  | \$ 6,295,316                         | \$ 6,329,687         |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>   |                                      |                      |
| Policy liabilities  |                                      |                      |
| Fixed annuity contract liabilities  | \$ 2,000,535                         | \$ 1,944,675         |
| Interest-sensitive life contract liabilities  | 658,199                              | 641,252              |
| Unpaid claims and claim expenses  | 324,851                              | 326,661              |
| Future policy benefits  | 187,794                              | 185,747              |
| Unearned premiums   | 206,369                              | 203,017              |
| Total policy liabilities  | 3,377,748                            | 3,301,352            |
| Other policyholder funds  | 140,208                              | 142,832              |
| Liability for securities lending agreements   | 77,642                               | 298,494              |
| Other liabilities   | 208,993                              | 203,332              |
| Short-term debt   |                                      |                      |
| Long-term debt  | 199,468                              | 231,982              |
| Separate Account (variable annuity) liabilities   | 1,610,342                            | 1,494,614            |
| Total liabilities   | 5,614,401                            | 5,672,606            |
| Preferred stock, \$0.001 par value, authorized 1,000,000 shares; none issued                              |                                      |                      |
| Common stock, \$0.001 par value, authorized 75,000,000 shares; issued, 2007, 60,798,330; 2006, 60,594,626 | 61                                   | 61                   |
| Additional paid-in capital  | 352,397                              | 347,873              |
| Retained earnings   | 685,084                              | 634,110              |
| Accumulated other comprehensive income (loss), net of taxes:  |                                      |                      |

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|   |              |              |
|---|--------------|--------------|
| Net unrealized gains and losses on fixed maturities and equity securities | (20,594)     | 11,070       |
| Net funded status of pension and other postretirement benefit obligations | (3,456)      | (3,456)      |
| Treasury stock, at cost, 17,503,371 shares                                | (332,577)    | (332,577)    |
| Total shareholders' equity  | 680,915      | 657,081      |
| Total liabilities and shareholders' equity                                | \$ 6,295,316 | \$ 6,329,687 |

See accompanying Notes to Consolidated Financial Statements.

See accompanying Report of Independent Registered Public Accounting Firm.

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**HORACE MANN EDUCATORS CORPORATION**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
**AND COMPREHENSIVE INCOME (UNAUDITED)**

(Dollars in thousands, except per share data)

|   | Three Months Ended<br>September 30, |                  | Nine Months Ended<br>September 30, |                  |
|---|-------------------------------------|------------------|------------------------------------|------------------|
|   | 2007                                | 2006             | 2007                               | 2006             |
| <b>Revenues</b>   |                                     |                  |                                    |                  |
| Insurance premiums and contract charges earned                                      | \$ 163,329                          | \$ 162,759       | \$ 487,996                         | \$ 487,314       |
| Net investment income   | 56,054                              | 53,152           | 166,330                            | 154,804          |
| Net realized investment gains (losses)  | (461)                               | 794              | 2,105                              | 5,282            |
| <b>Total revenues</b>   | <b>218,922</b>                      | <b>216,705</b>   | <b>656,431</b>                     | <b>647,400</b>   |
| <b>Benefits, losses and expenses</b>  |                                     |                  |                                    |                  |
| Benefits, claims and settlement expenses  | 108,608                             | 102,177          | 306,959                            | 292,925          |
| Interest credited   | 32,135                              | 30,964           | 94,979                             | 91,087           |
| Policy acquisition expenses amortized   | 18,418                              | 18,094           | 55,683                             | 54,719           |
| Operating expenses  | 29,030                              | 32,954           | 92,215                             | 95,273           |
| Amortization of intangible assets   | 1,267                               | 1,287            | 4,030                              | 4,195            |
| Interest expense  | 3,401                               | 3,672            | 10,632                             | 9,448            |
| <b>Total benefits, losses and expenses</b>  | <b>192,859</b>                      | <b>189,148</b>   | <b>564,498</b>                     | <b>547,647</b>   |
| <b>Income before income taxes</b>   | <b>26,063</b>                       | <b>27,557</b>    | <b>91,933</b>                      | <b>99,753</b>    |
| <b>Income tax expense</b>   | <b>7,741</b>                        | <b>8,250</b>     | <b>27,177</b>                      | <b>29,700</b>    |
| <b>Net income</b>   | <b>\$ 18,322</b>                    | <b>\$ 19,307</b> | <b>\$ 64,756</b>                   | <b>\$ 70,053</b> |
| <b>Net income per share</b>   |                                     |                  |                                    |                  |
| Basic   | \$ 0.42                             | \$ 0.45          | \$ 1.50                            | \$ 1.63          |
| Diluted   | \$ 0.41                             | \$ 0.43          | \$ 1.45                            | \$ 1.55          |
| <b>Weighted average number of shares and equivalent shares (in thousands)</b>       |                                     |                  |                                    |                  |
| Basic   | 43,288                              | 43,006           | 43,210                             | 42,997           |
| Diluted   | 44,268                              | 45,002           | 44,840                             | 46,023           |
| <b>Comprehensive income</b>   |                                     |                  |                                    |                  |
| Net income  | \$ 18,322                           | \$ 19,307        | \$ 64,756                          | \$ 70,053        |
| Other comprehensive income (loss), net of taxes:                                    |                                     |                  |                                    |                  |
| Change in net unrealized gains and losses on fixed maturities and equity securities | 14,077                              | 62,650           | (31,664)                           | (21,408)         |
| Change in net funded status of pension and other postretirement benefit obligations |                                     |                  |                                    |                  |
| <b>Other comprehensive income (loss)</b>  | <b>14,077</b>                       | <b>62,650</b>    | <b>(31,664)</b>                    | <b>(21,408)</b>  |
| <b>Total</b>  | <b>\$ 32,399</b>                    | <b>\$ 81,957</b> | <b>\$ 33,092</b>                   | <b>\$ 48,645</b> |

See accompanying Notes to Consolidated Financial Statements.

See accompanying Report of Independent Registered Public Accounting Firm.



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(Dollars in thousands, except per share data)

|  | <b>Nine Months Ended<br/>September 30,</b> |             |
|--|--|-------------|
|  | <b>2007</b>                                | <b>2006</b> |
| <b>Common stock</b>  |  |             |
| Beginning balance  | \$ 61                                      | \$ 60       |
| Options exercised, 2007, 183,227 shares; 2006, 54,050 shares                             |  | 1           |
| Conversion of Director Stock Plan units, 2007, 18,362 shares; 2006, 761 shares           |  |             |
| Conversion of restricted stock units, 2007, 2,115 shares; 2006, 0 shares                 |  |             |
| Ending balance   | 61   | 61          |
| <b>Additional paid-in capital</b>  |  |             |
| Beginning balance  | 347,873                                    | 345,251     |
| Options exercised and conversion of Director Stock Plan units and restricted stock units | 3,815                                      | 885         |
| Share-based compensation expense   | 709  |             |
| Ending balance   | 352,397                                    | 346,136     |
| <b>Retained earnings</b>   |  |             |
| Beginning balance  | 634,110                                    | 553,712     |
| Net income   | 64,756                                     | 70,053      |
| Cash dividends, \$0.315 per share  | (13,782)                                   | (13,736)    |
| Ending balance   | 685,084                                    | 610,029     |
| <b>Accumulated other comprehensive income (loss), net of taxes:</b>                      |  |             |
| Beginning balance  | 7,614                                      | 14,145      |
| Change in net unrealized gains and losses on fixed maturities and equity securities      | (31,664)                                   | (21,408)    |
| Change in net funded status of pension and other postretirement benefit obligations      |  |             |
| Ending balance   | (24,050)                                   | (7,263)     |
| <b>Treasury stock, at cost</b>   |  |             |
| Beginning and ending balance, 2007 and 2006, 17,503,371 shares                           | (332,577)                                  | (332,577)   |
| Shareholders' equity at end of period  | \$ 680,915                                 | \$ 616,386  |

See accompanying Notes to Consolidated Financial Statements.

See accompanying Report of Independent Registered Public Accounting Firm.

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**HORACE MANN EDUCATORS CORPORATION**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)**

(Dollars in thousands)

|  | Nine Months Ended<br>September 30, |            |
|--|------------------------------------|------------|
|  | 2007                               | 2006       |
| Cash flows - operating activities                          |                                    |            |
| Premiums collected   | \$ 501,120                         | \$ 497,323 |
| Policyholder benefits paid                                 | (329,141)                          | (320,315)  |
| Policy acquisition and other operating expenses paid       | (157,478)                          | (162,237)  |
| Federal income taxes paid                                  | (11,260)                           | (12,633)   |
| Investment income collected                                | 164,410                            | 155,657    |
| Interest expense paid                                      | (7,157)                            | (4,210)    |
| Contribution to defined benefit pension plan trust fund    |                                    | (6,450)    |
| Other  | 3,745                              | 4,921      |
| Net cash provided by operating activities                  | 164,239                            | 152,056    |
| Cash flows - investing activities                          |                                    |            |
| Fixed maturities   |                                    |            |
| Purchases  | (891,894)                          | (735,128)  |
| Sales  | 436,453                            | 395,115    |
| Maturities   | 397,298                            | 202,109    |
| Net cash used in short-term and other investments          | (73,464)                           | (59,525)   |
| Net cash used in investing activities                      | (131,607)                          | (197,429)  |
| Cash flows - financing activities                          |                                    |            |
| Dividends paid to shareholders                             | (13,782)                           | (13,736)   |
| Exercise of stock options                                  | 3,427                              | 866        |
| Proceeds from issuance of Senior Notes due 2016            |                                    | 123,485    |
| Repurchase of Senior Convertible Notes                     | (32,563)                           | (82,846)   |
| Annuity contracts, variable and fixed                      |                                    |            |
| Deposits   | 258,292                            | 241,122    |
| Benefits and withdrawals                                   | (147,997)                          | (110,456)  |
| Net transfer to Separate Account (variable annuity) assets | (107,563)                          | (87,731)   |
| Life policy accounts                                       |                                    |            |
| Deposits   | 850                                | 1,154      |
| Withdrawals and surrenders                                 | (4,878)                            | (5,316)    |
| Change in bank overdrafts                                  | 6,437                              | (21,169)   |
| Net cash (used in) provided by financing activities        | (37,777)                           | 45,373     |
| Net decrease in cash                                       | (5,145)                            |            |
| Cash at beginning of period                                | 13,438                             |            |
| Cash at end of period                                      | \$ 8,293                           | \$         |

See accompanying Notes to Consolidated Financial Statements.

See accompanying Report of Independent Registered Public Accounting Firm.



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**HORACE MANN EDUCATORS CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**September 30, 2007 and 2006**

**(Dollars in thousands, except per share data)**

**Note 1 - Basis of Presentation**

The accompanying unaudited consolidated financial statements of Horace Mann Educators Corporation ( HMEC ; and together with its subsidiaries, the Company or Horace Mann ) have been prepared in accordance with United States ( U.S. ) generally accepted accounting principles ( GAAP ) and with the rules and regulations of the Securities and Exchange Commission ( SEC ), specifically Regulation S-X and the instructions to Form 10-Q. Certain information and note disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted. The Company believes that these consolidated financial statements contain all adjustments (consisting of normal recurring accruals) which are, in the opinion of management, necessary to present fairly the Company's consolidated financial position as of September 30, 2007, the consolidated results of operations and comprehensive income for the three and nine months ended September 30, 2007 and 2006, and the consolidated changes in shareholders' equity and cash flows for the nine months ended September 30, 2007 and 2006. The preparation of consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the consolidated financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

The subsidiaries of HMEC market and underwrite tax-qualified retirement annuities and private passenger automobile, homeowners and life insurance products, primarily to educators and other employees of public schools and their families. The Company's principal operating subsidiaries are Horace Mann Life Insurance Company, Horace Mann Insurance Company, Teachers Insurance Company, Horace Mann Property & Casualty Insurance Company and Horace Mann Lloyds.

These consolidated financial statements should be read in conjunction with the consolidated financial statements and the related notes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

The results of operations for the three and nine months ended September 30, 2007 are not necessarily indicative of the results to be expected for the full year.

The Company has reclassified the presentation of certain prior period information to conform with the 2007 presentation.

**Table of Contents****Note 1 - Basis of Presentation-(Continued)***Adoption of SOP 05-1*

Effective January 1, 2007, the Company adopted American Institute of Certified Public Accountants ( AICPA ) Statement of Position ( SOP ) 05-1, Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts and did not utilize the alternative application guidance outlined in paragraphs 18 and 19 of SOP 05-1.

SOP 05-1 provides guidance on accounting for deferred policy acquisition costs ( DAC ) on internal replacements of insurance and investment contracts other than those specifically described in Financial Accounting Standards Board ( FASB ) Statement of Financial Accounting Standards ( SFAS ) No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments . SOP 05-1 defines an internal replacement as a modification in product benefits, features, rights or coverages that occurs by the exchange of a contract for a new contract, or by amendment, endorsement or rider to a contract, or by the election of a feature or coverage within a contract. Modifications that result in a replacement contract that is substantially unchanged from the replaced contract are accounted for as a continuation of the replaced contract. When modifications represent a substantial change compared to the replaced contract, the transaction is accounted for as an extinguishment of the replaced contract, and unamortized DAC and unearned revenue liabilities from the replaced contract are written off. For the nine months ended September 30, 2007, internal replacements of traditional non-interest-sensitive life insurance contracts which represented substantial changes compared to the replaced contracts resulted in \$169 of additional DAC amortization for the period.

**Note 2 - Debt**

Indebtedness outstanding was as follows:

|   | September 30,<br>2007 | December 31,<br>2006 |
|---|-----------------------|----------------------|
| Short-term debt:  |                       |                      |
| Bank Credit Facility  | \$                    | \$                   |
| Long-term debt:   |                       |                      |
| 1.425% Senior Convertible Notes, due May 14, 2032. Aggregate principal amount of \$68,553 less unaccrued discount of \$35,990 (3.0% imputed rate) |                       | 32,563               |
| 6.05% Senior Notes, due June 15, 2015. Aggregate principal amount of \$75,000 less unaccrued discount of \$205 and \$226 (6.1% imputed rate)      | 74,795                | 74,774               |
| 6.85% Senior Notes, due April 15, 2016. Aggregate principal amount of \$125,000 less unaccrued discount of \$327 and \$355 (6.9% imputed rate)    | 124,673               | 124,645              |
| Total   | \$ 199,468            | \$ 231,982           |

The Bank Credit Facility, 1.425% Senior Convertible Notes due 2032 ( Senior Convertible Notes ), 6.05% Senior Notes due 2015 ( Senior Notes due 2015 ) and 6.85% Senior Notes due 2016 ( Senior Notes due 2016 ) are described in Notes to Consolidated Financial Statements Note 4 Debt of the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

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### Note 2 - Debt-(Continued)

On May 14, 2007, pursuant to provisions of the indenture, HMEC redeemed its remaining outstanding Senior Convertible Notes (\$68,553 aggregate principal amount; \$32,563 carrying value) at \$475.00 per \$1,000.00 principal amount. The \$32,563 aggregate cost was funded with a portion of the remaining cash proceeds from HMEC's April 2006 issuance of 6.85% Senior Notes Due 2016. None of the Senior Convertible Notes were converted into shares of HMEC's common stock. No early termination penalties were incurred as a result of this redemption.

The \$231,947 aggregate principal amount of Senior Convertible Notes which HMEC previously held in brokerage accounts and the \$68,553 aggregate principal amount of Senior Convertible Notes redeemed on May 14, 2007 have been canceled.

### Note 3 - Investments

#### Fixed Maturity Securities

The following table presents the composition and value of the Company's fixed maturity securities portfolio by rating category. The Company has classified the entire fixed maturity securities portfolio as available for sale, which is carried at fair value.

| Rating of Fixed<br>Maturity Securities (1) | Percent of Fair Value |                      | September 30, 2007 |                   |
|--|-----------------------|----------------------|--------------------|-------------------|
|  | September 30,<br>2007 | December 31,<br>2006 | Fair<br>Value (2)  | Amortized<br>Cost |
| AAA  | 45.2%                 | 44.9%                | \$ 1,734,781       | \$ 1,746,055      |
| AA   | 11.3                  | 8.5                  | 434,314            | 441,916           |
| A  | 17.9                  | 19.6                 | 686,612            | 698,882           |
| BBB  | 20.2                  | 21.5                 | 775,391            | 775,137           |
| BB   | 1.8                   | 1.4                  | 71,511             | 71,797            |
| B  | 3.4                   | 3.9                  | 130,195            | 132,283           |
| CCC or lower                               | 0.1                   | 0.1                  | 1,951              | 2,007             |
| Not rated (3)                              | 0.1                   | 0.1                  | 1,393              | 1,911             |
| Total                                      | 100.0%                | 100.0%               | \$ 3,836,148       | \$ 3,869,988      |

- (1) Ratings are as assigned primarily by Standard & Poor's Corporation (S&P) when available, with remaining ratings as assigned on an equivalent basis by Moody's Investors Service, Inc. (Moody's). Ratings for publicly traded securities are determined when the securities are acquired and are updated monthly to reflect any changes in ratings.
- (2) Fair values are based on quoted market prices, when available. Fair values for private placements and certain other securities that are infrequently traded are estimated by the Company with the assistance of its investment advisors utilizing recognized valuation methodology, including cash flow modeling.
- (3) This category includes \$691 (fair value) of private placement securities not rated by either S&P or Moody's. The National Association of Insurance Commissioners (NAIC) has rated 95.1% of these private placement securities as investment grade. The remaining \$702 (fair value) of securities in this category were obtained in partial settlement of a default that occurred in 2002 and are not rated by S&P, Moody's or the NAIC.

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### Note 3 - Investments-(Continued)

The following table presents the distribution of the Company's fixed maturity securities portfolio by estimated expected maturity. Estimated expected maturities differ from contractual maturities, reflecting assumptions regarding borrowers' utilization of the right to call or prepay obligations with or without call or prepayment penalties. Estimated expected maturities consider broker dealer survey values and are verified for consistency with the interest rate and economic environments.

|                                     | Percent of Fair Value |                   | September 30, 2007 |                |
|-------------------------------------|-----------------------|-------------------|--------------------|----------------|
|                                     | September 30, 2007    | December 31, 2006 | Fair Value         | Amortized Cost |
| Due in 1 year or less               | 7.1%                  | 8.2%              | \$ 270,872         | \$ 273,261     |
| Due after 1 year through 5 years    | 28.8                  | 28.0              | 1,104,180          | 1,113,920      |
| Due after 5 years through 10 years  | 34.4                  | 36.1              | 1,321,058          | 1,332,712      |
| Due after 10 years through 20 years | 9.4                   | 9.2               | 362,677            | 365,877        |
| Due after 20 years                  | 20.3                  | 18.5              | 777,361            | 784,218        |
| Total                               | 100.0%                | 100.0%            | \$ 3,836,148       | \$ 3,869,988   |

The average option adjusted duration for the Company's fixed maturity securities was 5.6 years at September 30, 2007 and 5.4 years at December 31, 2006.

In the three months ended September 30, 2007, the Company recorded impairment charges of \$285 from the paper sector of its fixed maturity securities portfolio, and a portion of these securities were subsequently sold in October 2007. In the three months ended June 30, 2007, the Company recorded impairment charges of \$2,319 from the home builder sector of its fixed maturity securities portfolio, and these securities were subsequently sold in July 2007. There were no other impairment charges recorded in 2007. At September 30, 2007 and December 31, 2006, the fair value and gross unrealized losses of fixed maturity securities in an unrealized loss position were as follows:

|  | 12 months or less |                         | More than 12 months |                         | Total        |                         |
|--|-------------------|-------------------------|---------------------|-------------------------|--------------|-------------------------|
|  | Fair Value        | Gross Unrealized Losses | Fair Value          | Gross Unrealized Losses | Fair Value   | Gross Unrealized Losses |
| As of September 30, 2007                                   |                   |                         |                     |                         |              |                         |
| U.S. government and federally sponsored agency obligations |                   |                         |                     |                         |              |                         |
| Mortgage-backed securities                                 | \$ 263,522        | \$ 2,407                | \$ 453,194          | \$ 13,868               | \$ 716,716   | \$ 16,275               |
| Other  | 71,008            | 60                      | 70,081              | 514                     | 141,089      | 574                     |
| Municipal bonds  | 155,026           | 1,903                   | 80,107              | 1,526                   | 235,133      | 3,429                   |
| Foreign government bonds                                   |                   |                         | 7,126               | 194                     | 7,126        | 194                     |
| Corporate bonds  | 537,964           | 17,809                  | 693,186             | 23,588                  | 1,231,150    | 41,397                  |
| Other mortgage-backed securities                           | 95,848            | 9,084                   | 70,294              | 979                     | 166,142      | 10,063                  |
| Totals   | \$ 1,123,368      | \$ 31,263               | \$ 1,373,988        | \$ 40,669               | \$ 2,497,356 | \$ 71,932               |

As of December 31, 2006

|  |            |          |              |           |              |           |
|--|------------|----------|--------------|-----------|--------------|-----------|
| U.S. government and federally sponsored agency obligations |            |          |              |           |              |           |
| Mortgage-backed securities                                 | \$ 40,617  | \$ 281   | \$ 508,887   | \$ 12,208 | \$ 549,504   | \$ 12,489 |
| Other  | 76,575     | 41       | 139,848      | 1,884     | 216,423      | 1,925     |
| Municipal bonds  | 41,612     | 174      | 102,341      | 1,709     | 143,953      | 1,883     |
| Foreign government bonds                                   |            |          | 9,025        | 206       | 9,025        | 206       |
| Corporate bonds  | 330,826    | 4,696    | 697,987      | 20,732    | 1,028,813    | 25,428    |
| Other mortgage-backed securities                           | 28,134     | 93       | 100,443      | 1,759     | 128,577      | 1,852     |
| Totals   | \$ 517,764 | \$ 5,285 | \$ 1,558,531 | \$ 38,498 | \$ 2,076,295 | \$ 43,783 |





## **Table of Contents**

### **Note 3 - Investments-(Continued)**

The Company's investment portfolio includes no derivative financial instruments (futures, forwards, swaps, option contracts or other financial instruments with similar characteristics).

#### *Securities Lending*

The Company loans fixed income securities to third parties, primarily major brokerage firms. As of September 30, 2007 and December 31, 2006, fixed maturities with a fair value of \$72,222 and \$289,524, respectively, were on loan, and as of September 30, 2007 short-term investments of \$2,993 were on loan. Loans of securities are required at all times to be secured by collateral from borrowers at least equal to 100% of the fair value of the securities loaned. The Company maintains effective control over the loaned securities and therefore reports them as Fixed Maturity Securities and Short-term Investments, as appropriate, in the Consolidated Balance Sheets. Securities lending collateral is classified as short-term investments with a corresponding liability in the Company's Consolidated Balance Sheets.

### **Note 4 - Share Repurchase Program and Treasury Shares Held (Common Stock)**

As previously disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2006, \$96,343 remained authorized for future repurchases of Horace Mann Educators Corporation's Common Stock, par value \$0.001, under the May 1999 authorization by the Company's Board of Directors (the Board). The Company's last repurchase of its common shares was in July 2000. On September 12, 2007, the Board authorized a new share repurchase program allowing repurchases up to \$50,000 and ended the May 1999 authorization. The new share repurchase program authorizes the repurchase of common shares in open market or privately negotiated transactions, from time to time, depending on market conditions. As of September 30, 2007, no shares were repurchased under the new program.

At September 30, 2007, the Company held 17,503,371 shares in treasury.

### **Note 5 - Income Taxes**

Effective January 1, 2007, the Company adopted FASB Interpretation (FIN) No. 48, Accounting for Uncertainty in Income Taxes - an Interpretation of FASB Statement No 109. FIN 48 provides recognition of tax benefits from tax return positions only if it is more likely than not the position will be sustainable, upon examination, on its technical merits and any relevant administrative practices or precedents. As a result, the Company now applies a more-likely-than-not recognition threshold for all tax uncertainties.

As of January 1, 2007, the Company had \$3,914 of unrecognized tax benefits. The amount which would affect the effective tax rate is \$3,897 and differs from the gross unrecognized tax benefit liability due to the impact of federal and state benefits.

The Company does not anticipate any significant changes to its total unrecognized tax benefits within the next 12 months. Tax years 2002 through 2006 remain subject to examination by all major taxing authorities. The Company is currently under examination by the Internal Revenue Service for tax years 2002, 2004 and 2005.

**Table of Contents****Note 5 - Income Taxes-(Continued)**

The Company classifies all income tax-related interest and penalties as income tax expense. As of January 1, 2007, the Company had accrued \$569 in liabilities for tax-related interest and penalties on its Consolidated Balance Sheet.

**Note 6 - Pension Plans and Other Postretirement Benefits**

The Company has the following retirement plans: a defined contribution plan; a 401(k) plan; a defined benefit plan for employees hired on or before December 31, 1998; and certain employees participate in a supplemental defined contribution plan or a supplemental defined benefit plan or both. Additional information regarding the Company's retirement plans is contained in Notes to Consolidated Financial Statements Note 9 Pension Plans and Other Postretirement Benefits of the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

The following table summarizes the components of net periodic pension cost recognized for the defined benefit plan and the supplemental defined benefit plans for the three and nine months ended September 30, 2007 and 2006.

|   | Defined Benefit Plan  |                       |                       |                       |
|---|-----------------------|-----------------------|-----------------------|-----------------------|
|   | Three Months Ended    |                       | Nine Months Ended     |                       |
|   | September 30,<br>2007 | September 30,<br>2006 | September 30,<br>2007 | September 30,<br>2006 |
| Components of net periodic pension expense: |                       |                       |                       |                       |
| Service cost                                | \$                    | \$                    | \$                    | \$                    |
| Interest cost                               | 164                   | 436                   | 883                   | 1,594                 |
| Expected return on plan assets              | (171)                 | (414)                 | (922)                 | (1,512)               |
| Recognized net actuarial loss               | 104                   | 265                   | 563                   | 967                   |
| Settlement loss                             | 77                    | 288                   | 415                   | 1,050                 |
| Net periodic pension expense                | \$ 174                | \$ 575                | \$ 939                | \$ 2,099              |

|   | Supplemental Defined Benefit Plans |                       |                       |                       |
|---|------------------------------------|-----------------------|-----------------------|-----------------------|
|   | Three Months Ended                 |                       | Nine Months Ended     |                       |
|   | September 30,<br>2007              | September 30,<br>2006 | September 30,<br>2007 | September 30,<br>2006 |
| Components of net periodic pension expense: |                                    |                       |                       |                       |
| Service cost                                | \$ (11)                            | \$ (7)                | \$ (34)               | \$ (21)               |
| Interest cost                               | 244                                | 227                   | 733                   | 683                   |
| Expected return on plan assets              |                                    |                       |                       |                       |
| Recognized net actuarial loss               | 226                                | 154                   | 680                   | 460                   |
| Settlement loss                             |                                    |                       |                       |                       |
| Net periodic pension expense                | \$ 459                             | \$ 374                | \$ 1,379              | \$ 1,122              |

**Table of Contents****Note 6 - Pension Plans and Other Postretirement Benefits-(Continued)**

Consistent with disclosure in Notes to Consolidated Financial Statements Note 9 Pension Plans and Other Postretirement Benefits of the Company's Annual Report on Form 10-K for the year ended December 31, 2006, the Company expects to contribute \$1,140 to the supplemental defined benefit plans in 2007, of which \$842 was contributed during the nine months ended September 30, 2007. At the time of the Company's Annual Report on Form 10-K, the Company anticipated contributing \$250 to the defined benefit plan and has subsequently determined that no contribution will be made in 2007.

In addition to providing pension benefits, the Company also provides certain health care and life insurance benefits to retired employees, who meet the Plan's eligibility requirements, and their eligible dependents. As described in Notes to Consolidated Financial Statements Note 9 Pension Plans and Other Postretirement Benefits, effective January 1, 2007, the Company eliminated the previous health care benefits for retirees 65 years of age and over and established a Health Reimbursement Account (HRA) for each eligible participant. Also, the new plan does not provide life insurance benefits to individuals who retired in 1994 or later. As a result of the changes in the plan for other postretirement benefits, the Company anticipates a reduction in its expenses of approximately \$4,500 in 2007 and \$2,300 in 2008.

The following table summarizes the components of the net periodic benefit cost (gain) for postretirement benefits other than pension for the three and nine months ended September 30, 2007 and 2006.

|   | <b>Three Months Ended<br/>September 30,<br/>2007</b> |             | <b>Nine Months Ended<br/>September 30,<br/>2007</b> |             |
|---|--|-------------|---|-------------|
|   | <b>2007</b>  | <b>2006</b> | <b>2007</b>   | <b>2006</b> |
| Components of net periodic cost (gain): |  |             |   |             |
| Service cost                            | \$ 12  | \$ 11       | \$ 37   | \$ 25       |
| Interest cost                           | 359  | 353         | 1,076   | 645         |
| Amortization of prior service cost      | (1,163)  | (1,244)     | (3,489)   | (1,362)     |
| Recognized net actuarial gain           | (328)  | (524)       | (984)   | (446)       |
| Net periodic benefit gain               | \$ (1,120)   | \$ (1,404)  | \$ (3,360)  | \$ (1,138)  |

Consistent with disclosure in Notes to Consolidated Financial Statements Note 9 Pension Plans and Other Postretirement Benefits of the Company's Annual Report on Form 10-K for the year ended December 31, 2006, the Company expects to contribute \$1,637 to the postretirement benefit plans other than pensions in 2007, of which \$996 was contributed during the nine months ended September 30, 2007.

**Table of Contents****Note 7 - Reinsurance**

The Company recognizes the cost of reinsurance premiums over the contract periods for such premiums in proportion to the insurance protection provided. Amounts recoverable from reinsurers for unpaid claims and claim settlement expenses, including estimated amounts for unsettled claims, claims incurred but not reported and policy benefits, are estimated in a manner consistent with the insurance liability associated with the policy. The effects of reinsurance on premiums written and contract deposits; premiums and contract charges earned; and benefits, claims and settlement expenses were as follows:

|  | <b>Gross<br/>Amount</b> | <b>Ceded</b> | <b>Assumed</b> | <b>Net</b> |
|--|-------------------------|--------------|----------------|------------|
| <b>Three months ended September 30, 2007</b> |                         |              |                |            |
| Premiums written and contract deposits       | \$ 262,974              | \$ 9,768     | \$ 1,216       | \$ 254,422 |
| Premiums and contract charges earned         | 171,576                 | 9,626        | 1,379          | 163,329    |
| Benefits, claims and settlement expenses     | 109,540                 | 1,958        | 1,026          | 108,608    |
| <b>Three months ended September 30, 2006</b> |                         |              |                |            |
| Premiums written and contract deposits       | \$ 259,691              | \$ 9,428     | \$ 1,975       | \$ 252,238 |
| Premiums and contract charges earned         | 170,412                 | 9,439        | 1,786          | 162,759    |
| Benefits, claims and settlement expenses     | 105,762                 | 4,235        | 650            | 102,177    |
| <b>Nine months ended September 30, 2007</b>  |                         |              |                |            |
| Premiums written and contract deposits       | \$ 760,588              | \$ 28,791    | \$ 3,702       | \$ 735,499 |
| Premiums and contract charges earned         | 513,407                 | 29,673       | 4,262          | 487,996    |
| Benefits, claims and settlement expenses     | 311,998                 | 6,820        | 1,781          | 306,959    |
| <b>Nine months ended September 30, 2006</b>  |                         |              |                |            |
| Premiums written and contract deposits       | \$ 747,000              | \$ 28,688    | \$ 5,558       | \$ 723,870 |
| Premiums and contract charges earned         | 510,787                 | 29,248       | 5,775          | 487,314    |
| Benefits, claims and settlement expenses     | 316,968                 | 25,977       | 1,934          | 292,925    |

**Table of Contents****Note 8 - Segment Information**

The Company conducts and manages its business through four segments. The three operating segments, representing the major lines of insurance business, are: property and casualty insurance, principally personal lines automobile and homeowners products; annuity products, principally individual, tax-qualified fixed and variable deposits; and life insurance. The Company does not allocate the impact of corporate level transactions to the insurance segments, consistent with the basis for management's evaluation of the results of those segments, but classifies those items in the fourth segment, corporate and other. In addition to ongoing transactions such as debt service, realized investment gains and losses and certain public company expenses, within the past five years such items have included debt retirement costs/gains and restructuring charges. Summarized financial information for these segments is as follows:

|  | <b>Three Months Ended<br/>September 30,</b> |                   | <b>Nine Months Ended<br/>September 30,</b> |                   |
|--|---|-------------------|--|-------------------|
|  | <b>2007</b>                                 | <b>2006</b>       | <b>2007</b>                                | <b>2006</b>       |
| Insurance premiums and contract charges earned                             |   |                   |  |                   |
| Property and casualty  | \$ 133,469                                  | \$ 133,679        | \$ 399,240                                 | \$ 400,835        |
| Annuity  | 5,486                                       | 4,953             | 16,369                                     | 14,593            |
| Life   | 24,374                                      | 24,127            | 72,387                                     | 71,886            |
| <b>Total</b>   | <b>\$ 163,329</b>                           | <b>\$ 162,759</b> | <b>\$ 487,996</b>                          | <b>\$ 487,314</b> |
| Net investment income  |   |                   |  |                   |
| Property and casualty  | \$ 9,350                                    | \$ 8,879          | \$ 27,806                                  | \$ 25,806         |
| Annuity  | 32,525                                      | 30,395            | 96,066                                     | 89,078            |
| Life   | 14,357                                      | 13,592            | 42,421                                     | 39,688            |
| Corporate and other  | 96  | 565               | 863  | 1,071             |
| Intersegment eliminations  | (274)                                       | (279)             | (826)                                      | (839)             |
| <b>Total</b>   | <b>\$ 56,054</b>                            | <b>\$ 53,152</b>  | <b>\$ 166,330</b>                          | <b>\$ 154,804</b> |
| Net income (loss)  |   |                   |  |                   |
| Property and casualty  | \$ 10,319                                   | \$ 14,453         | \$ 45,070                                  | \$ 53,277         |
| Annuity  | 5,253                                       | 3,340             | 13,717                                     | 9,857             |
| Life   | 5,490                                       | 3,945             | 12,723                                     | 10,996            |
| Corporate and other  | (2,740)                                     | (2,431)           | (6,754)                                    | (4,077)           |
| <b>Total</b>   | <b>\$ 18,322</b>                            | <b>\$ 19,307</b>  | <b>\$ 64,756</b>                           | <b>\$ 70,053</b>  |
| Amortization of intangible assets, pretax (included in segment net income) |   |                   |  |                   |
| Value of acquired insurance in force                                       |   |                   |  |                   |
| Annuity  | \$ 932                                      | \$ 938            | \$ 3,017                                   | \$ 3,138          |
| Life   | 335   | 349               | 1,013                                      | 1,057             |
| <b>Total</b>   | <b>\$ 1,267</b>                             | <b>\$ 1,287</b>   | <b>\$ 4,030</b>                            | <b>\$ 4,195</b>   |

|                           | <b>September 30,<br/>2007</b> | <b>December 31,<br/>2006</b> |
|---------------------------|-------------------------------|------------------------------|
| Assets                    |                               |                              |
| Property and casualty     | \$ 930,710                    | \$ 903,015                   |
| Annuity                   | 4,113,517                     | 4,094,491                    |
| Life                      | 1,184,685                     | 1,232,722                    |
| Corporate and other       | 103,182                       | 126,166                      |
| Intersegment eliminations | (36,778)                      | (26,707)                     |

|       |              |              |
|-------|--------------|--------------|
| Total | \$ 6,295,316 | \$ 6,329,687 |
|-------|--------------|--------------|

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**MANAGEMENT'S DISCUSSION AND ANALYSIS OF  
FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

**(Dollars in millions, except per share data)**

**Forward-looking Information**

Statements made in the following discussion that state the Company's or management's intentions, hopes, beliefs, expectations or predictions of future events or the Company's future financial performance are forward-looking statements and involve known and unknown risks, uncertainties and other factors. Horace Mann is not under any obligation to (and expressly disclaims any such obligation to) update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. It is important to note that the Company's actual results could differ materially from those projected in forward-looking statements due to, among other risks and uncertainties inherent in the Company's business, the following important factors:

Changes in the composition of the Company's assets and liabilities which may result from occurrences such as acquisitions, divestitures, impairment in asset values or changes in estimates of insurance reserves.

Fluctuations in the fair value of securities in the Company's investment portfolio and the related after-tax effect on the Company's shareholders' equity and total capital through either realized or unrealized investment losses. In addition, the impact of fluctuations in the financial markets on the Company's defined benefit pension plan assets and the related after-tax effect on the Company's operating expenses, shareholders' equity and total capital.

The impact of fluctuations in the financial markets on the Company's variable annuity fee revenues, valuations of deferred policy acquisition costs and value of acquired insurance in force, and the level of guaranteed minimum death benefit reserves.

The impact of fluctuations in the capital markets on the Company's ability to refinance outstanding indebtedness or repurchase shares of the Company's common stock.

Defaults on interest or dividend payments in the Company's investment portfolio due to credit issues and the resulting impact on investment income.

Prevailing interest rate levels, including the impact of interest rates on (i) unrealized gains and losses in the Company's investment portfolio and the related after-tax effect on the Company's shareholders' equity and total capital, (ii) the book yield of the Company's investment portfolio, (iii) the Company's ability to maintain appropriate interest rate spreads over the fixed rates guaranteed in the Company's life and annuity products and (iv) valuations of deferred policy acquisition costs and value of acquired insurance in force.

The cyclicity of the insurance industry and the related effects of changes in price competition and industry-wide underwriting results.

The frequency and severity of catastrophes such as hurricanes, earthquakes, storms and wildfires and the ability of the Company to provide accurate estimates of ultimate catastrophe costs in its consolidated financial statements in light of such factors as: the proximity of the catastrophe occurrence date to the date of the consolidated financial statements; potential inflation of property repair costs in the affected area; the occurrence of multiple catastrophes in a geographic area over a relatively short period of time; the outcome of litigation which may be filed against the Company by policyholders, state attorneys general and other parties relative to loss coverage disputes and loss settlement payments; and the ability of state insurance facilities to assess participating insurers when financial deficits occur.





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The Company's risk exposure to catastrophe-prone areas. Based on 2006 property and casualty direct earned premiums, the Company's ten largest states represented 57% of the segment total. Included in this top ten group are certain states which are considered more prone to catastrophe occurrences: Florida, California, North Carolina, Texas, Louisiana and South Carolina.

The potential near-term, adverse impact of underwriting actions to mitigate the Company's risk exposure to catastrophe-prone areas on premium, policy and earnings growth.

The ability of the Company to maintain a favorable catastrophe reinsurance program considering both availability and cost; and the collectibility of reinsurance receivables.

Adverse development of property and casualty loss and loss adjustment expense reserve experience and its impact on estimated claims and claim settlement expenses for losses occurring in prior years.

Adverse changes in business persistency, policyholder mortality and morbidity rates, interest spreads and market appreciation and the resulting impact on both estimated reserves and the valuations of deferred policy acquisition costs and value of acquired insurance in force.

Changes in insurance regulations, including (i) those affecting the ability of the Company's insurance subsidiaries to distribute cash to the holding company and (ii) those impacting the Company's ability to profitably write property and casualty insurance policies in one or more states.

Changes in federal income tax laws and changes resulting from federal tax audits affecting corporate tax rates or taxable income.

Changes in federal and state laws and regulations, which affect the relative tax and other advantages of the Company's life and annuity products to customers, including, but not limited to, changes in IRS regulations governing Section 403(b) plans.

The resolution of legal proceedings and related matters including the potential adverse impact on the Company's reputation and charges against the Company's earnings resulting from legal defense costs, a settlement agreement and/or an adverse finding or findings against the Company from the proceedings.

The Company's ability to maintain favorable claims-paying ability, financial strength and debt ratings.

The Company's ability to profitably expand its property and casualty business in highly competitive environments.

The competitive impact of the new Section 403(b) tax-qualified annuity regulations, including 1) their potential to lead plan sponsors to restrict the number of providers and 2) the possible entry into the 403(b) market of larger competitors experienced in 401(k) plans.

The Company's ability to develop and expand its agency operations, including its agent force and their licensed producers and support staff, as well as the Company's ability to maintain and secure sponsorships by local, state and national education associations.

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The Company's dated and complex information systems, which are more prone to error than advanced technology systems.

Disruptions of the general business climate, investments, capital markets and consumer attitudes caused by pandemics or geopolitical acts such as terrorism, war or other similar events.

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### **Executive Summary**

Horace Mann Educators Corporation ( HMEC ; and together with its subsidiaries, the Company or Horace Mann ) is an insurance holding company. Through its subsidiaries, HMEC markets and underwrites personal lines of property and casualty and life insurance and retirement annuities in the U.S. The Company markets its products primarily to educators and other employees of public schools and their families.

For the three months ended September 30, 2007, the Company's net income of \$18.4 million decreased \$1.0 million compared to the prior year, including a \$0.8 million decrease in after tax realized investment gains. Third quarter 2007 property and casualty segment net income was \$4.1 million less than prior year, adversely affected by increased current accident year, non-catastrophe loss costs, particularly in the homeowners line, higher catastrophe losses and a lower level of favorable prior years' reserve development. Net income for the annuity and life segments exceeded prior year in the current quarter by \$1.8 million and \$1.5 million, respectively.

For the nine months ended September 30, 2007, the Company's net income decreased \$5.3 million compared to the prior year, including a \$2.0 million reduction in after tax realized investment gains. Consistent with management's expectations and industry experience, the year-to-date increase in property and casualty average loss costs per policy exceeded the increase in average premium per policy for the current accident period, which adversely impacted the combined ratio and net income. Compared to the first nine months of 2006, results in the first nine months of 2007 were also negatively impacted by a lower level of favorable development of prior years' property and casualty non-catastrophe reserves as well as the increased cost of the Company's catastrophe reinsurance program. Net income in the first nine months of 2007 benefited from a decrease in catastrophe costs compared to the prior year. Including all of these factors, the property and casualty combined ratio was 91.8% for the first nine months of 2007 compared to 88.3% for 2006. Annuity segment net income increased compared to the first nine months of 2006, driven by increases in the interest margin and contract charges earned. Life segment net income increased compared to a year earlier, reflecting growth in investment income and favorable mortality experience.

Premiums written and contract deposits increased 1% and 2% compared to the three and nine months ended September 30, 2006, respectively. As described in Results of Operations Insurance Premiums and Contract Charges, the third quarter 2007 expiration of an educator excess professional liability policy represented an \$8.6 million decrease compared to the prior year. Also, for the first nine months of 2007, the additional costs associated with the Company's property and casualty catastrophe reinsurance program represented a \$1.1 million decrease to current period premiums. Property and casualty premiums written reflected a slight decrease as a result of these two unfavorable items and a decrease in average automobile premium per policy partially offset by growth in average homeowners premium per policy and growth in policies in force for both automobile and homeowners. Including the effect of recent initiatives, new automobile sales units increased 2% in the current period compared to the first nine months of 2006. This sales growth, along with continued improvements in policy retention, resulted in increases in voluntary automobile policies in force compared to both December 31, 2006 and September 30, 2006. The automobile policies in force growth was driven primarily by an increase in educator policies. Annuity contract deposits for the three and nine months ended September 30, 2007 increased 10% and 7%, respectively, each compared to a year earlier, and life segment insurance premiums and contract deposits decreased 2% and 1% compared to the three and nine months ended September 30, 2006, respectively.

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### **Critical Accounting Policies**

The preparation of consolidated financial statements in conformity with U.S. generally accepted accounting principles ( "GAAP" ) requires the Company's management to make estimates and assumptions based on information available at the time the consolidated financial statements are prepared. These estimates and assumptions affect the reported amounts of the Company's consolidated assets, liabilities, shareholders' equity and net income. Certain accounting estimates are particularly sensitive because of their significance to the Company's consolidated financial statements and because of the possibility that subsequent events and available information may differ markedly from management's judgments at the time the consolidated financial statements were prepared. Management has discussed with the Audit Committee the quality, not just the acceptability, of the Company's accounting principles as applied in its financial reporting. The discussions generally included such matters as the consistency of the Company's accounting policies and their application, and the clarity and completeness of the Company's consolidated financial statements, which include related disclosures. For the Company, the areas most subject to significant management judgments include: liabilities for property and casualty claims and claim settlement expenses, liabilities for future policy benefits, deferred policy acquisition costs, value of acquired insurance in force for annuity and interest-sensitive life products, valuation of investments and valuation of assets and liabilities related to the defined benefit pension plan.

#### *Liabilities for Property and Casualty Claims and Claim Settlement Expenses*

Underwriting results of the property and casualty segment are significantly influenced by estimates of the Company's ultimate liability for insured events. There is a high degree of uncertainty inherent in the estimates of ultimate losses underlying the liability for unpaid claims and claim settlement expenses. This inherent uncertainty is particularly significant for liability-related exposures due to the extended period, often many years, that transpires between a loss event, receipt of related claims data from policyholders and ultimate settlement of the claim. Reserves for property and casualty claims include provisions for payments to be made on reported claims ( "case reserves" ), claims incurred but not yet reported ( "IBNR" ) and associated settlement expenses (together "loss reserves" ). The process by which these reserves are established requires reliance upon estimates based on known facts and on interpretations of circumstances, including the Company's experience with similar cases and historical trends involving claim payments and related patterns, pending levels of unpaid claims and product mix, as well as other factors including court decisions, economic conditions and public attitudes.

Reserves are reestimated quarterly. Changes to reserves are recorded in the period in which development factor changes result in reserve reestimates. Detailed discussion of the process utilized to estimate loss reserves, risk factors considered and the impact of adjustments recorded during recent years is included in "Notes to Consolidated Financial Statements - Note 3 - Property and Casualty Unpaid Claims and Claim Expenses" of the Company's Annual Report on Form 10-K for the year ended December 31, 2006. Due to the nature of the Company's personal lines business, the Company has no exposure to claims for toxic waste cleanup, other environmental remediation or asbestos-related illnesses other than claims under homeowners insurance policies for environmentally related items such as mold.

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Based on the Company's products and coverages, historical experience, and modeling of various actuarial methodologies used to develop reserve estimates, the Company estimates that the potential variability of the property and casualty loss reserves, excluding the unprecedented hurricane losses experienced in 2005 and 2004, within a reasonable probability of other possible outcomes, may be approximately plus or minus 6%, or plus or minus approximately \$12 million in net income. Although this evaluation reflects the most likely outcomes, it is possible the final outcome may fall below or above these estimates.

There are a number of assumptions involved in the determination of the Company's property and casualty loss reserves. Among the key factors affecting recorded loss reserves for both long-tail and short-tail related coverages, claim severity and claim frequency are of particular significance. Management estimates that a 2% change in claim severity or claim frequency for the most recent 36-month period is a reasonably likely scenario based on recent experience and would result in a change in the estimated loss reserves of between \$6.0 million and \$10.0 million for long-tail liability related exposures (automobile liability coverages) and between \$3.0 million and \$4.0 million for short-tail liability related exposures (homeowners and automobile physical damage coverages). Actual results may change, depending on the magnitude and direction of the deviation.

The Company's loss and loss adjustment expense actuarial analysis is discussed with management. As part of this discussion, the indicated point estimate of the IBNR loss reserve by line of business (coverage) is reviewed. The Company actuaries also discuss any indicated changes to the underlying assumptions used to calculate the indicated point estimate. Review of the variance between the indicated reserves from these changes in assumptions and the previously carried reserves takes place. After discussion of these analyses and all relevant risk factors, management determines whether the reserve balances require adjustment. The Company's best estimate of loss reserves may change depending on a revision in the underlying assumptions.

The Company's liabilities for property and casualty unpaid claims and claim settlement expenses were as follows:

|                      | September 30, 2007 |                  |                 | December 31, 2006 |                  |                 |
|----------------------|--------------------|------------------|-----------------|-------------------|------------------|-----------------|
|                      | Case<br>Reserves   | IBNR<br>Reserves | Total (1)       | Case<br>Reserves  | IBNR<br>Reserves | Total (1)       |
| Automobile liability | \$ 78.3            | \$ 140.2         | \$ 218.5        | \$ 80.9           | \$ 140.2         | \$ 221.1        |
| Automobile other     | 5.1                | 1.7              | 6.8             | 5.7               | 2.3              | 8.0             |
| Homeowners           | 12.5               | 39.8             | 52.3            | 11.3              | 41.7             | 53.0            |
| All other            | 4.0                | 33.6             | 37.6            | 3.7               | 32.0             | 35.7            |
| <b>Total</b>         | <b>\$ 99.9</b>     | <b>\$ 215.3</b>  | <b>\$ 315.2</b> | <b>\$ 101.6</b>   | <b>\$ 216.2</b>  | <b>\$ 317.8</b> |

(1) These amounts are gross, before reduction for ceded reinsurance reserves.

The facts and circumstances leading to the Company's reestimate of reserves relate to revisions of the development factors used to predict how losses are likely to develop from the end of a reporting period until all claims have been paid. Reestimates occur because actual loss amounts are different than those predicted by the estimated development factors used in prior reserve estimates. At September 30, 2007, the impact of a reserve reestimation resulting in a 1% increase in net reserves would be a decrease of approximately \$2 million in net income. A reserve reestimation resulting in a 1% decrease in net reserves would increase net income by approximately \$2 million.

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Favorable reserve reestimates increased net income for the nine months ended September 30, 2007 by approximately \$9.6 million, reflecting emerging loss severity trends more favorable than previously estimated, primarily for accident years 2006 and 2005 for both the voluntary automobile and homeowners lines of business. The lower than expected claims emergence and resultant lower expected loss ratios caused the Company to lower its reserve estimate.

Information regarding the Company's property and casualty claims and claims settlement expense reserve development table as of December 31, 2006 is located in Business Property and Casualty Segment Property and Casualty Reserves of the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

### *Liabilities for Future Policy Benefits*

Liabilities for future benefits on life and annuity policies are established in amounts adequate to meet the estimated future obligations on policies in force. Liabilities for future policy benefits on certain life insurance policies are computed using the net level premium method and are based on assumptions as to future investment yield, mortality and withdrawals. Mortality and withdrawal assumptions for all policies have been based on actuarial tables which are consistent with the Company's own experience. Liabilities for future benefits on annuity contracts and certain long-duration life insurance contracts are carried at accumulated policyholder values without reduction for potential surrender or withdrawal charges. In the event actual experience varies from the estimated liability assumptions, adjustments are charged or credited to income for the period in which the adjustments are made.

### *Deferred Policy Acquisition Costs and Value of Acquired Insurance in Force for Annuity and Interest-Sensitive Life Products*

Policy acquisition costs, consisting of commissions, policy issuance and other costs, which vary with and are primarily related to the production of business, are capitalized and amortized on a basis consistent with the type of insurance coverage. For all investment (annuity) contracts, acquisition costs, and also the value of annuity business acquired in the 1989 acquisition of the Company (Annuity VIF), are amortized over 20 years in proportion to estimated gross profits. Capitalized acquisition costs for interest-sensitive life contracts are also amortized over 20 years in proportion to estimated gross profits.

The most significant assumptions that are involved in the estimation of annuity gross profits include interest rate spreads, future financial market performance, business surrender/lapse rates, expenses and the impact of realized investment gains and losses. For the variable deposit portion of the annuity segment, the Company amortizes policy acquisition costs and the Annuity VIF utilizing a future financial market performance assumption of a 10% reversion to the mean approach with a 200 basis point corridor around the mean. At September 30, 2007, the ratio of capitalized annuity policy acquisition costs and the Annuity VIF asset to the total annuity accumulated cash value was approximately 4%.

In the event actual experience differs significantly from assumptions or assumptions are significantly revised, the Company may be required to record a material charge or credit to amortization expense for the period in which the adjustment is made. As noted above, there are key assumptions involved in the valuation of capitalized policy acquisition costs and the Annuity VIF. In terms of the sensitivity of this amortization to two of the more significant assumptions, assuming all other assumptions are met, (1) a 10 basis point deviation in the annual targeted interest rate spread assumption would currently impact amortization between \$0.25 million and

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\$0.35 million and (2) a 1% deviation from the targeted financial market performance for the underlying mutual funds of the Company's variable annuities would currently impact amortization between \$0.15 million and \$0.25 million. These results may change depending on the magnitude and direction of the deviations but represent a range of reasonably likely experience for the noted assumptions. Detailed discussion of the impact of adjustments to the amortization of capitalized acquisition costs and Annuity VIF is included in Results of Operations Amortization of Policy Acquisition Expenses and Intangible Assets .

### *Valuation of Investments*

Market valuations for the fixed maturity securities portfolio are based on prices provided by the Company's custodian bank and its investment managers. Both the custodian bank and the investment managers use a variety of pricing sources to determine market valuations. Each designate specific pricing services or indexes for each sector of the market based upon the provider's expertise. Broker-dealers are also used to price certain types of securities. The broker-dealers' valuation methodology is sometimes matrix-based, using indicative evaluation measures and adjustments for specific security characteristics and market sentiment. The Company analyzes market valuations received to verify reasonableness. The Company's fixed maturity securities portfolio is highly liquid, which allows for a high percentage of the portfolio to be priced through pricing services. Approximately 90% of the portfolio was priced through pricing services or index priced as of September 30, 2007.

The Company's methodology of assessing other-than-temporary impairments is based on security-specific facts and circumstances as of the date of the reporting period. Based on these facts, if management believes it is probable that amounts due will not be collected according to the contractual terms of a debt security not impaired at acquisition, or if the Company does not have the ability and intent to hold a debt security with an unrealized loss until it matures or recovers in value, an other-than-temporary impairment shall be considered to have occurred. As a general rule, if the fair value of a debt security has fallen below 80% of book value for more than six months, this security will be reviewed for an other-than-temporary impairment. Additionally, if events become known that call into question whether the security issuer has the ability to honor its contractual commitments, whether or not such security has been trading above an 80% fair value to book value relationship, such security holding will be evaluated to determine whether or not such security has suffered an other-than-temporary decline in value.

The Company reviews the fair value of all investments in its portfolio on a monthly basis to assess whether an other-than-temporary decline in value has occurred. These reviews, in conjunction with the Company's investment managers' monthly credit reports and relevant factors such as (1) the financial condition and near-term prospects of the issuer, (2) the Company's ability and intent to retain the investment long enough to allow for the anticipated recovery in fair value, (3) the stock price trend of the issuer, (4) the market leadership position of the issuer, (5) the debt ratings of the issuer and (6) the cash flows of the issuer, are all considered in the impairment assessment. A write-down of an investment is recorded when a decline in the fair value of that investment is deemed to be other-than-temporary, with a realized investment loss charged to income for the period.

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A decline in fair value below amortized cost is not assumed to be other-than-temporary for fixed maturity investments with unrealized losses due to market conditions or industry-related events where there exists a reasonable expectation that fair value will recover versus historical cost and the Company has the intent and ability to hold the investment until maturity or a market recovery is realized. An other-than-temporary impairment loss will be recognized based upon all relevant facts and circumstances for each investment, as appropriate.

*Valuation of Assets and Liabilities Related to the Defined Benefit Pension Plan*

Effective April 1, 2002, participants stopped accruing benefits under the defined benefit pension plan but continue to retain the benefits they had accrued to that date.

The Company's cost estimates for its defined benefit pension plan are determined annually based on assumptions which include the discount rate, expected return on plan assets, anticipated retirement rate and estimated lump sum distributions. A discount rate of 5.65% was used by the Company for estimating accumulated benefits under the plan at December 31, 2006, which was based on the average yield for long-term, high grade securities having maturities generally consistent with the defined benefit pension payout period. To set its discount rate, the Company looks to leading indicators, including Moody's Aa long-term bond index. The expected annual return on plan assets assumed by the Company at December 31, 2006 was 7.5%. The assumption for the long-term rate of return on plan assets was determined by considering actual investment experience during the lifetime of the plan, balanced with reasonable expectations of future growth considering the various classes of assets and percentage allocation for each asset class. Management believes that it has adopted reasonable assumptions for investment returns, discount rates and other key factors used in the estimation of pension costs and asset values.

To the extent that actual experience differs from the Company's assumptions, subsequent adjustments may be required, with the effects of those adjustments charged or credited to income and/or shareholders' equity for the period in which the adjustments are made. Generally, a change of 50 basis points in the discount rate would inversely impact pension expense and accumulated other comprehensive income (AOCI) by approximately \$0.1 million and \$1.5 million, respectively. In addition, for every \$1 million increase (decrease) in the value of pension plan assets, there is a comparable increase (decrease) in AOCI.

**Results of Operations***Insurance Premiums and Contract Charges***Insurance Premiums Written and Contract Deposits**

(Includes annuity and life contract deposits)

|   | <b>Nine Months Ended<br/>September 30,</b> |             | <b>Change From<br/>Prior Year</b> |               |
|---|--|-------------|-----------------------------------|---------------|
|   | <b>2007</b>                                | <b>2006</b> | <b>Percent</b>                    | <b>Amount</b> |
| Property & casualty                       |  |             |                                   |               |
| Automobile and property (voluntary)       | \$ 401.1                                   | \$ 396.7    | 1.1%                              | \$ 4.4        |
| Involuntary and other property & casualty | 2.0  | 11.0        | -81.8%                            | (9.0)         |
| Total property & casualty                 | 403.1                                      | 407.7       | -1.1%                             | (4.6)         |
| Annuity deposits                          | 258.3                                      | 241.1       | 7.1%                              | 17.2          |
| Life                                      | 74.1                                       | 75.1        | -1.3%                             | (1.0)         |
| Total                                     | \$ 735.5                                   | \$ 723.9    | 1.6%                              | \$ 11.6       |



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## Insurance Premiums and Contract Charges Earned

(Excludes annuity and life contract deposits)

|   | Nine Months Ended<br>September 30, |          | Change From<br>Prior Year |          |
|---|------------------------------------|----------|---------------------------|----------|
|   | 2007                               | 2006     | Percent                   | Amount   |
| Property & casualty                       |                                    |          |                           |          |
| Automobile and property (voluntary)       | \$ 392.6                           | \$ 393.0 | -0.1%                     | \$ (0.4) |
| Involuntary and other property & casualty | 6.6                                | 7.8      | -15.4%                    | (1.2)    |
| Total property & casualty                 | 399.2                              | 400.8    | -0.4%                     | (1.6)    |
| Annuity                                   | 16.4                               | 14.6     | 12.3%                     | 1.8      |
| Life                                      | 72.4                               | 71.9     | 0.7%                      | 0.5      |
| Total                                     | \$ 488.0                           | \$ 487.3 | 0.1%                      | \$ 0.7   |

For the three and nine months ended September 30, 2007, the Company's premiums written and contract deposits increased 0.8% and 1.6%, respectively, compared to the prior year, primarily reflecting growth in annuity deposits received partially offset by the decrease in other property and casualty premiums as described below. The additional costs associated with the Company's property and casualty catastrophe reinsurance program represented a \$1.1 million decrease to premiums for the nine months ended September 30, 2007. Voluntary property and casualty business represents policies sold through the Company's marketing organization and issued under the Company's underwriting guidelines. Involuntary property and casualty business consists of allocations of business from state mandatory insurance facilities and assigned risk business.

The Company's exclusive agent force totaled 797 at September 30, 2007, reflecting a decrease of 4.3% compared to 833 agents at September 30, 2006 and a decrease of 6.0% compared to 848 agents at December 31, 2006. For the first nine months of 2007, new hires decreased and terminations increased, each approximately 10%, compared to the same period in 2006. Of the current period-end total, 221 agents were in their first 24 months with the Company, down 9.4% compared to September 30, 2006. The number of experienced agents in the agent force, 576, decreased 2.2% compared to 12 months earlier. At the time of this Quarterly Report on Form 10-Q, management anticipates the agent count to decline somewhat over the next several quarters during the Company's transition to its new Agency Business Model, with an increase in total points of distribution resulting from the growing number of licensed producers supporting agents who adopt the new model.

In 2006, the Company began the transition from a single-person agent operation to its new Agency Business Model, with agents in outside offices with support personnel and licensed producers, designed to remove current capacity constraints and increase productivity. The first Agency Business School session was conducted in October 2006, beginning the formal roll-out of this model. From October 2006 through September 30, 2007, 118 of the agents at September 30, 2007 and all of the field managers completed this training. See additional description in Business Corporate Strategy and Marketing Exclusive Agency Force of the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

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New automobile sales units increased 2.2% compared to the nine months ended September 30, 2006. New homeowners sales units increased 1.9% compared to the first nine months of 2006. Homeowners, and consequently auto, new business growth in 2007 has been moderated by underwriting restrictions in Florida. Annuity new business declined 7.8% compared to the first nine months of 2006, primarily reflecting a lower level of rollover deposits and sales of fixed indexed partner products. In 2006, annuity sales benefited from increased opportunities for rollover deposits in six states that had initiated programs allowing educators to privatize a portion of their state retirement funds. Life new business decreased 2% compared to year-to-date 2006. For the first nine months of 2007, total new business sales decreased 5.3% compared to a year earlier. In total, career agent sales for the first nine months of 2007 decreased 6.8% compared to the same period in 2006, reflecting the lower number of agents in the current period as well as a decrease in average overall productivity per agent, driven by the level of annuity sales. Average agent productivity is measured as new sales premiums from the exclusive agent force per the average number of exclusive agents for the period.

Total voluntary automobile and homeowners premium written increased 1.1%, or \$4.4 million, in the first nine months of 2007, including the \$1.1 million reduction due to the higher cost of catastrophe reinsurance in 2007. The automobile average written premium per policy decreased while the homeowners average premium increased in the current period compared to prior year, with the change in average premium for both lines adversely impacted by the improved quality of the books of business. At September 30, 2007, there were 535,000 voluntary automobile and 266,000 homeowners policies in force, for a total of 801,000 policies, compared to a total of 799,000 policies at December 31, 2006 and 796,000 at September 30, 2006.

Based on policies in force, the total property and casualty 12-month retention rate for new and renewal policies was 86% at September 30, 2007, equal to September 30, 2006. For the first nine months of 2007, approved rate increases for the Company's automobile and homeowners business were minimal, similar to rate actions in 2006.

Voluntary automobile premium written decreased 1.0% (\$2.8 million) compared to the first nine months of 2006. Average written premium per policy and average earned premium per policy both decreased 3% compared to a year ago. Automobile policies in force at September 30, 2007 increased by 2,000 compared to December 31, 2006 and 4,000 compared to September 30, 2006, with the growth reflecting an increase in educator policies in each of the preceding ten quarters.

Homeowners premium written increased 6.0% (\$7.2 million) compared to the first nine months of 2006 including the higher amount of catastrophe reinsurance premiums described above. Homeowners average written premium per policy increased 6% compared to a year earlier, while average earned premium per policy increased 3%. Homeowners policies in force at September 30, 2007 increased by 1,000 compared to September 30, 2006 and was equal to December 31, 2006, as growth in the number of educator policies was offset by expected reductions, primarily in non-educator policies, due to the Company's pricing and underwriting actions, including actions in catastrophe-prone coastal areas. The Company continues to evaluate and implement actions to further mitigate its risk exposure in hurricane-prone areas. Such actions could include, but are not limited to, non-renewal of homeowners policies, restricted agent geographic placement, limitations on agent new business sales, further tightening of underwriting standards and development of third-party vendor marketing alliances.

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The primary component of involuntary and other property and casualty premiums, which represented less than 2% of total property and casualty premiums for full year 2006, has been educator excess professional liability insurance purchased by the National Education Association ( NEA ) for all of its members. The NEA's contract to purchase this insurance from the Company expired on August 31, 2007 and represented approximately \$8.6 million of premiums written in the three and nine months ended September 30, 2006, with approximately \$0.7 million, or 1/12, of that premium earned each month during the September 2006 through August 2007 coverage period. The Company's underwriting results from educator excess professional liability insurance have generally represented amounts which were not a material portion of net income for the Company or for the property and casualty segment.

Annuity deposits received for the nine months ended September 30, 2007 increased 7.1% compared to the same period in 2006. In the first nine months of 2007, scheduled annuity deposits increased 17.1% while single premium and rollover deposits decreased 5.5%. New deposits to fixed accounts increased 5.9%, or \$8.2 million, compared to prior year-to-date and new deposits to variable accounts increased 8.8%, or \$9.0 million.

The Company utilizes a nationwide network of independent agents who comprise a supplemental distribution channel for the Company's 403(b) tax-qualified annuity products. The independent agent distribution channel included 887 authorized agents at September 30, 2007. During the first nine months of 2007, this channel generated \$27.2 million in annualized new annuity sales for the Company compared to \$25.2 million for the same period in 2006.

Total annuity accumulated cash value of \$3.8 billion at September 30, 2007 increased 8.1% compared to a year earlier, reflecting the increase from new deposits received, continued favorable retention and improved financial market performance over the 12 months. At September 30, 2007, the number of annuity contracts outstanding of 164,000 decreased 0.6%, or 1,000 contracts, compared to December 31, 2006 and increased 0.6%, or 1,000 contracts, compared to September 30, 2006.

Variable annuity accumulated balances were 13.9% higher at September 30, 2007 than at September 30, 2006 and annuity segment contract charges earned increased 12.3%, or \$1.8 million, compared to the first nine months of 2006.

Life segment premiums and contract deposits declined 1.3%, or \$1.0 million, compared to the first nine months of 2006. The ordinary life insurance in force lapse ratio was 5.6% for the 12 months ended September 30, 2007 compared to 6.0% for the twelve months ended September 30, 2006.

In 2006, the Company introduced new Horace Mann manufactured and branded products to better address the financial planning needs of educators. In February 2006, the Company introduced Life by Design, a new portfolio of life insurance products. In March 2006, the Company introduced new fixed and variable annuity products and in May 2006, the Company added 12 new investment options to its variable annuity products. See additional description of these new products in Business Life Segment and Business Annuity Segment of the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

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*Net Investment Income*

For the three months ended September 30, 2007, pretax investment income of \$56.0 million increased 5.5%, or \$2.9 million, (5.2%, or \$1.9 million, after tax) compared to the same period in 2006. Pretax investment income of \$166.3 million for the nine months ended September 30, 2007 increased 7.4%, or \$11.5 million, (7.1%, or \$7.5 million, after tax) compared to prior year. For both comparisons, the increase reflects growth in the size of the investment portfolio and a modest increase in the portfolio yield. Average invested assets (excluding securities lending collateral) increased 5.2% over the past 12 months. The average pretax yield on the investment portfolio was 5.47% (3.72% after tax) for the first nine months of 2007, compared to a pretax yield of 5.35% (3.65% after tax) a year earlier.

*Net Realized Investment Gains and Losses*

For the three months ended September 30, 2007, pretax net realized investment losses were \$0.5 million compared to net realized investment gains of \$0.8 million in the third quarter of 2006. Net realized investment gains (pretax) were \$2.1 million for the first nine months of 2007 compared to net realized investment gains of \$5.3 million in the prior year. The Company recorded impairment charges of \$2.6 million and \$0.1 million in the nine months ended September 30, 2007 and 2006, respectively. In the third quarter of 2007, the Company recorded impairment charges of \$0.3 million related to fixed income securities from one issuer in the paper sector, and a portion of these securities were subsequently sold in October 2007. In the second quarter of 2007, the Company recorded impairment charges of \$2.3 million from the home builder sector of its fixed income security portfolio, and these securities were subsequently sold in July 2007. In the nine months ended September 30, 2006, the \$0.1 million impairment charge was recorded in the third quarter and related to one issuer. Net realized investment gains in the first nine months of 2007 included \$2.9 million from sales of securities for which impairment charges were recorded in 2002, while net realized investment gains in the first nine months of 2006 included \$0.3 million from sales of securities for which impairment charges were recorded in 2005. Net realized investment gains in the first nine months of 2007 also included \$0.2 million of litigation proceeds on previously impaired WorldCom, Inc. debt securities. The net gains and losses in all periods were realized from ongoing investment portfolio management activity.

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The table below presents the Company's fixed maturity securities portfolio as of September 30, 2007 by major asset class, including the ten largest sectors of the Company's corporate bond holdings.

|  | Number of<br>Issuers | Fair<br>Value | Amortized<br>Cost | Pretax<br>Unrealized<br>Gain (Loss) |
|--|----------------------|---------------|-------------------|-------------------------------------|
| Corporate bonds                                  |                      |               |                   |                                     |
| Banking and Finance                              | 60                   | \$ 426.6      | \$ 431.6          | \$ (5.0)                            |
| Energy   | 47                   | 263.2         | 264.5             | (1.3)                               |
| Utilities  | 28                   | 194.3         | 195.8             | (1.5)                               |
| Telecommunications                               | 24                   | 174.2         | 171.9             | 2.3                                 |
| Health Care                                      | 29                   | 148.9         | 152.9             | (4.0)                               |
| Insurance  | 25                   | 94.2          | 93.3              | 0.9                                 |
| Transportation                                   | 11                   | 67.1          | 66.6              | 0.5                                 |
| Automobiles                                      | 13                   | 67.0          | 65.9              | 1.1                                 |
| Metal and Mining                                 | 10                   | 65.6          | 67.0              | (1.4)                               |
| Broadcasting and Media                           | 14                   | 56.7          | 56.5              | 0.2                                 |
| All Other Corporates (1)                         | 122                  | 373.9         | 380.8             | (6.9)                               |
| Total corporate bonds                            | 383                  | 1,931.7       | 1,946.8           | (15.1)                              |
| Mortgage-backed securities                       |                      |               |                   |                                     |
| U.S. government and federally sponsored agencies | 417                  | 896.3         | 909.7             | (13.4)                              |
| Other  | 32                   | 148.5         | 153.5             | (5.0)                               |
| Municipal bonds                                  | 173                  | 557.7         | 555.5             | 2.2                                 |
| Government bonds                                 |                      |               |                   |                                     |
| U.S.   | 8                    | 191.5         | 191.5             | *                                   |
| Foreign  | 10                   | 25.0          | 23.8              | 1.2                                 |
| Collateralized debt obligations (2)              | 5                    | 18.8          | 22.8              | (4.0)                               |
| Asset-backed securities                          | 15                   | 66.6          | 66.4              | 0.2                                 |
| Total fixed maturity securities                  | 1,043                | \$ 3,836.1    | \$ 3,870.0        | \$ (33.9)                           |

\* Less than \$0.1 million.

- (1) The All Other Corporates category contains 18 additional industry classifications. Food and beverage, defense, cable, real estate, technology and manufacturing represented \$285.9 million of fair value at September 30, 2007, with the remaining 12 classifications each representing less than \$33 million.
- (2) All of the collateralized debt obligation securities were rated investment grade by Standard and Poor's Corporation and/or Moody's Investors Service, Inc. at September 30, 2007.

At September 30, 2007, the Company's diversified fixed maturity portfolio consisted of 1,360 investment positions, issued by 1,043 entities, and totaled approximately \$3.8 billion in fair value. The portfolio was 94.6% investment grade, based on fair value, with an average quality rating of AA-. At September 30, 2007, the Company had limited exposure to subprime and Alt-A mortgage loans, comprised primarily of 2 securities with a total fair value of approximately \$8.5 million, both with quality ratings of AAA. At September 30, 2007, the Company did not record any investment write-downs related to its sub-prime or Alt-A residential mortgage-backed securities. At the time of this Quarterly Report on Form 10-Q, management does not anticipate any other-than-temporary impairments of these securities. At September 30, 2007, the total portfolio had \$71.9 million pretax of gross unrealized losses related to 723 positions, including \$1.2 million of unrealized loss related to the two sub-prime / Alt-A securities.

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The following table provides information regarding fixed maturity securities that had an unrealized loss at September 30, 2007, including the length of time that the securities have continuously been in an unrealized loss position.

**Investment Positions With Unrealized Losses Segmented by Quality****and Period of Continuous Unrealized Loss****As of September 30, 2007**

|                             | <b>Number of<br/>Positions</b> | <b>Fair<br/>Value</b> | <b>Amortized<br/>Cost</b> | <b>Pretax<br/>Unrealized<br/>Loss</b> |
|-----------------------------|--------------------------------|-----------------------|---------------------------|---------------------------------------|
| <b>Investment grade</b>     |                                |                       |                           |                                       |
| 6 Months or less            | 157                            | \$ 604.1              | \$ 619.3                  | \$ (15.2)                             |
| 7 through 12 months         | 76                             | 425.5                 | 437.6                     | (12.1)                                |
| 13 through 24 months        | 76                             | 336.4                 | 346.8                     | (10.4)                                |
| 25 through 36 months        | 162                            | 800.5                 | 822.0                     | (21.5)                                |
| 37 through 48 months        | 33                             | 152.5                 | 156.4                     | (3.9)                                 |
| Greater than 48 months      | 12                             | 52.4                  | 55.8                      | (3.4)                                 |
| <b>Total</b>                | <b>516</b>                     | <b>\$ 2,371.4</b>     | <b>\$ 2,437.9</b>         | <b>\$ (66.5)</b>                      |
| <b>Non-investment grade</b> |                                |                       |                           |                                       |
| 6 Months or less            | 107                            | \$ 74.3               | \$ 76.8                   | \$ (2.5)                              |
| 7 through 12 months         | 33                             | 18.8                  | 19.7                      | (0.9)                                 |
| 13 through 24 months        | 29                             | 17.1                  | 17.9                      | (0.8)                                 |
| 25 through 36 months        | 29                             | 14.0                  | 14.7                      | (0.7)                                 |
| 37 through 48 months        | 1                              | 0.4                   | 0.4                       | *                                     |
| Greater than 48 months      | 1                              | 0.1                   | 0.1                       | *                                     |
| <b>Total</b>                | <b>200</b>                     | <b>\$ 124.7</b>       | <b>\$ 129.6</b>           | <b>\$ (4.9)</b>                       |
| <b>Not rated</b>            |                                |                       |                           |                                       |
| 6 Months or less            | 4                              | \$ 0.7                | \$ 1.2                    | \$ (0.5)                              |
| Greater than 48 months      | 3                              | 0.6                   | 0.6                       | *                                     |
| <b>Total</b>                | <b>7</b>                       | <b>\$ 1.3</b>         | <b>\$ 1.8</b>             | <b>\$ (0.5)</b>                       |
| <b>Grand total</b>          | <b>723</b>                     | <b>\$ 2,497.4</b>     | <b>\$ 2,569.3</b>         | <b>\$ (71.9)</b>                      |

\* Less than \$0.1 million.

Of the investment positions with unrealized losses, no issuers had pretax unrealized losses greater than \$1.2 million. Three fixed maturity securities were trading below 80% of book value at September 30, 2007. Two of these securities are CDOs which were priced below 80% due to the illiquidity of the market. The other security declined in value because the issuer was unable to access the credit markets for funding purposes. The Company views the decrease in value of all of the securities with unrealized losses at September 30, 2007 which was largely driven by the interest rate and credit environments as temporary, expects recovery in fair value, anticipates continued payments under the terms of the securities, and has the intent and ability to hold these securities until maturity or a recovery in fair value occurs. Therefore, no impairment of these securities was recorded at September 30, 2007. Future changes in circumstances related to these and other securities could require subsequent recognition of other-than-temporary impairment losses. The Company's investment guidelines generally limit single corporate issuer concentrations to 1.0% of invested assets for AA or AAA rated securities, 0.75% of invested assets for A rated securities, 0.5% of invested assets for BBB rated securities, and 0.2% of invested assets for non-investment grade securities.



**Table of Contents***Benefits, Claims and Settlement Expenses*

|  | Nine Months Ended<br>September 30, |          | Change From<br>Prior Year |          |
|--|------------------------------------|----------|---------------------------|----------|
|  | 2007                               | 2006     | Percent                   | Amount   |
| Property and casualty  | \$ 270.3                           | \$ 257.6 | 4.9%                      | \$ 12.7  |
| Annuity  | 0.9                                | 0.7      | 28.6%                     | 0.2      |
| Life   | 35.8                               | 34.6     | 3.5%                      | 1.2      |
| Total  | \$ 307.0                           | \$ 292.9 | 4.8%                      | \$ 14.1  |
| Property and casualty catastrophe losses, included above (1) | \$ 17.7                            | \$ 18.6  | -4.8%                     | \$ (0.9) |

(1) See footnote (2) to the table below.

**Property and Casualty Claims and Claim Expenses ( losses )**

|   | Nine Months Ended<br>September 30, |          |
|---|------------------------------------|----------|
|   | 2007                               | 2006     |
| Incurred claims and claim expenses:                                     |                                    |          |
| Claims occurring in the current year                                    | \$ 285.1                           | \$ 274.8 |
| Decrease in estimated reserves for claims occurring in prior years (1): |                                    |          |
| Policies written by the Company (2)                                     | (14.8)                             | (17.2)   |
| Business assumed from state reinsurance facilities                      |                                    |          |
| Total (2)   | (14.8)                             | (17.2)   |
| Total claims and claim expenses incurred                                | \$ 270.3                           | \$ 257.6 |
| Property and casualty loss ratio:                                       |                                    |          |
| Total   | 67.7%                              | 64.3%    |
| Effect of catastrophe costs, included above (2)                         | 4.4%                               | 4.7%     |

- (1) Shows the amounts by which the Company increased or decreased its reserves in each of the periods indicated for claims occurring in previous periods to reflect subsequent information on such claims and changes in their projected final settlement costs.
- (2) (Favorable)/unfavorable development of prior years' reserves was recorded as follows:

|                    | 2007      | 2006      |
|--------------------|-----------|-----------|
| Three months ended |           |           |
| March 31           | \$ (5.5)  | \$ (4.0)  |
| June 30            | (5.6)     | (8.1)     |
| September 30       | (3.7)     | (5.1)     |
| Total year-to-date | \$ (14.8) | \$ (17.2) |

Property and casualty catastrophe losses were incurred as follows:

|                    |        |        |
|--------------------|--------|--------|
| Three months ended |        |        |
| March 31           | \$ 2.5 | \$ 3.0 |



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|                    |         |         |
|--------------------|---------|---------|
| June 30            | 4.9     | 8.4     |
| September 30       | 10.3    | 7.2     |
| Total year-to-date | \$ 17.7 | \$ 18.6 |

The nine months ended September 30, 2006 included development of prior years' reserves for catastrophe losses, recorded in the second quarter, in captions related to catastrophe losses/costs as well as captions related to prior years' reserve development as follows: total property and casualty, unfavorable development of \$1.4 million; voluntary automobile, favorable development of \$1.5 million; and total property, unfavorable development of \$2.9 million.

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For the three months ended September 30, 2007, the Company's benefits, claims and settlement expenses of \$108.6 million increased 6.3%, or \$6.4 million, compared to the same period in 2006. This increase was largely due to an increase in catastrophe losses and a reduced level of favorable prior years' property and casualty reserve development. Catastrophe losses for the three months ended September 30, 2007 were due largely to storms in Minnesota. In addition, current accident year, non-catastrophe loss costs increased, particularly in the homeowners line, due in large part to the effects of non-catastrophe weather.

For the nine months ended September 30, 2007, the Company's benefits, claims and settlement expenses increased compared to the prior year, including a modest decrease in catastrophe losses and a decrease in estimated reserves for property and casualty claims occurring in prior years, more than offset by a modest increase in auto and property claim frequencies for the current accident period, consistent with industry experience. For the nine months, the current period favorable development of prior years' reserves was the result of actual and remaining projected losses for prior years, primarily accident years 2006 and 2005, being below the level anticipated in the December 31, 2006 loss reserve estimate for both the voluntary automobile and homeowners lines of business, which was driven primarily by emerging claim trends related to severity. Catastrophe losses in the first nine months of 2006 included \$1.4 million of adverse development of prior years' catastrophe loss reserves, primarily due to increases in ultimate net settlement cost related to two third quarter 2005 events: a severe hail storm in Minnesota and Hurricane Katrina.

For the nine months ended September 30, 2007, the voluntary automobile loss ratio of 69.5% increased by 5.0 percentage points compared to the same period a year earlier, including a 3.1 percentage point increase due to the lower level of favorable development of prior years' non-catastrophe reserves in the current period and a 0.5 percentage point increase compared to the favorable prior years' catastrophe reserve development recorded in 2006. The homeowners loss ratio of 61.2% for the nine months ended September 30, 2007 decreased 0.2 percentage points compared to a year earlier, primarily reflecting the higher level of favorable development of prior years' reserves recorded in the current period as well as the lower level of catastrophe costs. Catastrophe costs represented 13.8 percentage points of the homeowners loss ratio for the current nine months compared to 14.6 percentage points for the prior year, including adverse development of prior years' catastrophe reserves in 2006, a decrease of 0.8 percentage point. The \$1.1 million increase in ceded premium in 2007 related to the Company's catastrophe reinsurance program added approximately 0.5 percentage point to the homeowners loss ratio for the nine months ended September 30, 2007.

For the annuity segment, benefits increased by a minimal amount in the first nine months of 2007 compared to prior year. The Company's guaranteed minimum death benefits (GMDB) reserve was \$0.8 million at September 30, 2007, compared to \$0.7 million at both December 31, 2006 and September 30, 2006.

For the life segment, benefits were higher in the current nine months compared to prior year, reflecting liability growth which more than offset favorable mortality costs.

**Table of Contents***Interest Credited to Policyholders*

|              | Nine Months Ended<br>September 30, |                | Change From<br>Prior Year |               |
|--------------|------------------------------------|----------------|---------------------------|---------------|
|              | 2007                               | 2006           | Percent                   | Amount        |
| Annuity      | \$ 67.2                            | \$ 64.2        | 4.7%                      | \$ 3.0        |
| Life         | 27.8                               | 26.9           | 3.3%                      | 0.9           |
| <b>Total</b> | <b>\$ 95.0</b>                     | <b>\$ 91.1</b> | <b>4.3%</b>               | <b>\$ 3.9</b> |

For the three months ended September 30, 2007, interest credited of \$32.2 million increased 3.9%, or \$1.2 million, consistent with the change reflected for the nine months.

Compared to the first nine months of 2006, the current period increase in annuity segment interest credited reflected a 5.2% increase in average accumulated fixed deposits, partially offset by a 3 basis point decline in the average annual interest rate credited to 4.34%. Life insurance interest credited increased as a result of the growth in interest-sensitive life insurance reserves.

The net interest spread on fixed annuity account value on deposit measures the difference between the rate of income earned on the underlying invested assets and the rate of interest which policyholders are credited on their account values. Fixed annuity crediting rates were lowered in recent years to reflect the decline in the rate of income on invested assets caused by lower investment rates on new and reinvested funds. The net interest spreads for the nine months ended September 30, 2007 and 2006 were 141 basis points and 125 basis points, respectively.

As of September 30, 2007, fixed annuity account values totaled \$2.1 billion, including \$1.9 billion of deferred annuities. Approximately 18% of the deferred annuity account values had minimum guaranteed interest rates of 3% or lower while approximately 71% of account values had minimum guaranteed rates of 4.5% or greater. For \$1.6 billion of the deferred annuity account values, the credited interest rate was equal to the minimum guaranteed rate. The annuity net interest spread increased 16 basis points compared to the first nine months of 2006, due to improvements in the Company's investment portfolio yield and continued slight decreases in interest crediting rates.

*Operating Expenses*

For the first nine months of 2007, operating expenses decreased 3.3%, or \$3.1 million, compared to the prior year, including a decrease of \$3.8 million for the three months ended September 30, 2007 compared to the third quarter of 2006. A significant portion of the variance amounts between periods was due to an employee bonus accrual adjustment in the third quarter of 2007 and a litigation settlement charge in the prior year third quarter. The property and casualty expense ratio of 24.1% for the nine months ended September 30, 2007 increased 0.1 percentage point compared to the first nine months of 2006, including the effect on this ratio of a reduced level of premiums earned, and was slightly below the full year 2006 expense ratio of 24.3%.

Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123(R), *Share-Based Payment*, which requires companies to recognize compensation cost for share-based compensation plans, determined based on the fair value at the grant dates. The Company recognized \$0.7 million and \$0.5 million in expense for the nine months ended September 30, 2007 and 2006, respectively, as a result of the vesting of stock options during the respective periods.

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### *Amortization of Policy Acquisition Expenses and Intangible Assets*

For the three months ended September 30, 2007, amortization of policy acquisition expenses and amortization of intangible assets were comparable to a year earlier. For the nine months ended September 30, 2007, the combined amortization of policy acquisition expenses and intangible assets was \$59.7 million compared to \$58.9 million recorded for the same period in the prior year.

Amortized policy acquisition expenses were \$55.7 million for the first nine months of 2007 compared to \$54.7 million for the same period in 2006. The September 30, 2007 valuation of annuity deferred policy acquisition costs resulted in a decrease in amortization of \$0.2 million for the nine months compared to a \$0.2 million increase in amortization resulting from a similar valuation at September 30, 2006. For the life segment, the September 30, 2007 valuation of deferred policy acquisition costs resulted in no change in amortization compared to a \$0.1 million decrease from the 2006 valuation.

Amortization of intangible assets of \$4.0 million for the nine months ended September 30, 2007 was \$0.2 million less than the amortization for the same period a year earlier. The September 30, 2007 valuation of Annuity VIF resulted in a \$0.1 million increase in amortization for the nine months, equal to the increase for the nine months ended September 30, 2006.

### *Income Tax Expense*

The effective income tax rate on the Company's pretax income, including net realized investment gains, was 29.5% for the nine months ended September 30, 2007 compared to 29.8% for the nine months ended September 30, 2006. Income from investments in tax-advantaged securities reduced the effective income tax rate 6.1 percentage points and 5.8 percentage points for the nine months ended September 30, 2007 and 2006, respectively.

The Company records liabilities for uncertain tax filing positions where it is more-likely-than-not that the position will be sustainable upon audit by taxing authorities and reflects management's assessment of the amounts that are probable of being sustained. These liabilities are reevaluated routinely and are adjusted appropriately based upon changes in facts or law. The Company has no unrecorded liabilities from uncertain tax filing positions.

At September 30, 2007, the Company had income tax returns for the 2002 through 2006 tax years still open and subject to adjustment upon examination by taxing authorities. The Company is currently under examination by the Internal Revenue Service for tax years 2002, 2004 and 2005. The Company has recorded \$4.4 million of uncertain tax position liabilities including interest related to all open tax years.

### *Net Income*

For the three months ended September 30, 2007, the Company's net income of \$18.4 million decreased \$1.0 million compared to the prior year, including a \$0.8 million decrease in after tax realized investment gains. Third quarter 2007 property and casualty segment net income was \$4.1 million less than prior year, adversely affected by increased current accident year, non-catastrophe loss costs, particularly in the homeowners line, higher catastrophe losses and a lower level of favorable prior years' reserve development. Net income for the annuity and life segments exceeded prior year in the current quarter by \$1.8 million and \$1.5 million, respectively.

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For the nine months ended September 30, 2007, the Company's net income decreased \$5.3 million compared to the prior year, including a \$2.0 million reduction in after tax realized investment gains. Consistent with management's expectations and industry experience, the year-to-date increase in property and casualty average loss costs per policy exceeded the increase in average premium per policy for the current accident period, which adversely impacted the combined ratio and net income. Compared to the first nine months of 2006, results in the first nine months of 2007 were also negatively impacted by a lower level of favorable development of prior years' property and casualty non-catastrophe reserves as well as the increased cost of the Company's catastrophe reinsurance program. Net income in the first nine months of 2007 benefited from a decrease in catastrophe costs compared to the prior year. Including all of these factors, the property and casualty combined ratio was 91.8% for the first nine months of 2007 compared to 88.3% for 2006. Annuity segment net income increased compared to the first nine months of 2006, driven by increases in the interest margin and contract charges earned. Life segment net income increased compared to a year earlier, reflecting growth in investment income and favorable mortality experience.

Net income by segment and net income per share were as follows:

|   | Nine Months Ended<br>September 30, |           | Change From<br>Prior Year |           |
|---|------------------------------------|-----------|---------------------------|-----------|
|   | 2007                               | 2006      | Percent                   | Amount    |
| Analysis of net income (loss) by segment:                             |                                    |           |                           |           |
| Property and casualty   | \$ 45.1                            | \$ 53.3   | -15.4%                    | \$ (8.2)  |
| Annuity   | 13.7                               | 9.9       | 38.4%                     | 3.8       |
| Life  | 12.7                               | 11.0      | 15.5%                     | 1.7       |
| Corporate and other (1)   | (6.7)                              | (4.1)     | -63.4%                    | (2.6)     |
| Net income  | \$ 64.8                            | \$ 70.1   | -7.6%                     | \$ (5.3)  |
| Effect of catastrophe costs, after tax, included above                | \$ (11.5)                          | \$ (12.5) | 8.0%                      | \$ 1.0    |
| Diluted:  |                                    |           |                           |           |
| Net income per share  | \$ 1.45                            | \$ 1.55   | -6.5%                     | \$ (0.10) |
| Weighted average number of shares and equivalent shares (in millions) | 44.8                               | 46.0      | -2.6%                     | (1.2)     |
| Property and casualty combined ratio:                                 |                                    |           |                           |           |
| Total   | 91.8%                              | 88.3%     | N.M.                      | 3.5%      |
| Effect of catastrophe costs, included above                           | 4.4%                               | 4.8%      | N.M.                      | -0.4%     |

N.M. Not meaningful.

- (1) The corporate and other segment includes interest expense on debt, realized investment gains and losses, certain public company expenses and other corporate level items. The Company does not allocate the impact of corporate level transactions to the insurance segments, consistent with the basis for management's evaluation of the results of those segments.

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For the nine months ended September 30, 2007, the changes in net income for the property and casualty, annuity and life segments are described above.

For the corporate and other segment, the current period decline in net income compared to the first nine months of 2006 was due primarily to a lower amount of net realized investment gains and an increase in debt interest expense.

Return on shareholders' equity based on net income was 14% and 15% for the trailing 12 months ended September 30, 2007 and 2006, respectively.

At the time of this Quarterly Report on Form 10-Q, management is unable to fully assess the fourth quarter 2007 effect of the Southern California wildfires. However, based on the current preliminary information available, management does not anticipate that these fires will have a significant impact on the previously provided estimate of 2007 full year net income before realized investment gains and losses of between \$1.80 and \$1.95 per share. Included in the earnings estimate are additional costs, compared to 2006, totaling approximately \$0.15 per share associated with the Company's 2007 catastrophe reinsurance program, as described in Business Property and Casualty Segment Property and Casualty Reinsurance in the Company's Annual Report on Form 10-K for the year ended December 31, 2006, and an increased level of investment in strategic growth initiatives, including the Agency Business Model, partially offset by improvement in annuity profit margins compared to prior year. As described in Critical Accounting Policies, certain of the Company's significant accounting measurements require the use of estimates and assumptions. As additional information becomes available, adjustments may be required. Those adjustments are charged or credited to income for the period in which the adjustments are made and may impact actual results compared to management's current estimate. A projection of net income including realized investment gains and losses is not accessible on a forward-looking basis because it is not possible to provide a reliable forecast of realized investment gains and losses, which can vary substantially from one period to another and may have a significant impact on net income.

## **Liquidity and Financial Resources**

### *Off-Balance Sheet Arrangements*

At September 30, 2007 and 2006, the Company did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or for other contractually narrow or limited purposes. As such, the Company is not exposed to any financing, liquidity, market or credit risk that could arise if the Company had engaged in such relationships.

### *Investments*

Information regarding the Company's investment portfolio, which is comprised primarily of investment grade, fixed income securities, is located in Results of Operations Net Realized Investment Gains and Losses and in the Notes to Consolidated Financial Statements Note 3 Investments.

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### *Cash Flow*

The short-term liquidity requirements of the Company, within a 12-month operating cycle, are for the timely payment of claims and benefits to policyholders, operating expenses, interest payments and federal income taxes. Cash flow generated from operations has been, and is expected to be, adequate to meet the Company's operating cash needs in the next 12 months. Cash flow in excess of operational needs has been used to fund business growth, retire short-term debt, pay dividends to shareholders and repurchase shares of the Company's common stock. Long-term liquidity requirements, beyond one year, are principally for the payment of future insurance policy claims and benefits and retirement of long-term debt.

### *Operating Activities*

As a holding company, HMEC conducts its principal operations in the personal lines segment of the property and casualty and life insurance industries through its subsidiaries. HMEC's insurance subsidiaries generate cash flow from premium and investment income, generally well in excess of their immediate needs for policy obligations, operating expenses and other cash requirements. Cash provided by operating activities primarily reflects net cash generated by the insurance subsidiaries. For the first nine months of 2007, net cash provided by operating activities increased compared to the same period in 2006, primarily reflecting an increase in investment income collected.

Payment of principal and interest on debt, dividends to shareholders and parent company operating expenses are dependent upon the ability of the insurance subsidiaries to pay cash dividends or make other cash payments to HMEC, including tax payments pursuant to tax sharing agreements. Payments for the share repurchase program also have this dependency. The insurance subsidiaries are subject to various regulatory restrictions which limit the amount of annual dividends or other distributions, including loans or cash advances, available to HMEC without prior approval of the insurance regulatory authorities. Dividends which may be paid by the insurance subsidiaries to HMEC during 2007 without prior approval are approximately \$106 million, of which \$18 million was paid during the nine months ended September 30, 2007 and an additional \$10 million was declared in September 2007 and subsequently paid in October 2007. Although regulatory restrictions exist, dividend availability from subsidiaries has been, and is expected to be, adequate for HMEC's capital needs.

### *Investing Activities*

HMEC's insurance subsidiaries maintain significant investments in fixed maturity securities to meet future contractual obligations to policyholders. In conjunction with its management of liquidity and other asset/liability management objectives, the Company, from time to time, will sell fixed maturity securities prior to maturity and reinvest the proceeds in other investments with different interest rates, maturities or credit characteristics. Accordingly, the Company has classified the entire fixed maturity securities portfolio as available for sale.

### *Financing Activities*

Financing activities include primarily payment of dividends, the receipt and withdrawal of funds by annuity contractholders, repurchases of the Company's common stock, fluctuations in bank overdraft balances, and borrowings, repayments and repurchases related to its debt facilities.

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For the nine months ended September 30, 2007, receipts from annuity contracts increased \$17.2 million, or 7.1%, compared to the prior year. Annuity contract benefits and withdrawals increased \$37.5 million, or 33.9%, compared to the prior year. Cash value retentions for variable and fixed annuity options were 90.8% and 91.9%, respectively, for the 12 month period ended September 30, 2007. Net transfers to variable annuity accumulated cash values increased \$19.9 million, or 22.7%, compared to the prior year.

On May 14, 2007, pursuant to provisions of the indenture, the Company redeemed all of its outstanding 1.425% Senior Convertible Notes (Senior Convertible Notes), \$68.6 million aggregate principal amount, utilizing a portion of the proceeds from the issuance of the Senior Notes due 2016. The aggregate cost of the redemption was \$32.6 million. Detailed information regarding the Senior Convertible Notes is contained in the Notes to Consolidated Financial Statements Note 4 Debt of the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

*Contractual Obligations*

The annual disclosure of the Company's contractual obligations was provided in Management's Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Financial Resources Contractual Obligations in the Company's Annual Report on Form 10-K for the year ended December 31, 2006. With the exception of the Company's long-term debt obligations, the Company's contractual obligations at September 30, 2007 were not materially different than those at December 31, 2006. Discussion of the recent changes in the Company's long-term debt obligations is included in Capital Resources. The table below identifies the future payments due on debt obligations that were outstanding as of September 30, 2007.

|                                 | Payments Due By Period As of September 30, 2007 |                        |                                      |                                      |   |
|---------------------------------|---|------------------------|--------------------------------------|--------------------------------------|---|
|                                 |   | Less<br>Than<br>1 Year | 1 - 3<br>Years<br>(2008 and<br>2009) | 3 - 5<br>Years<br>(2010 and<br>2011) | More<br>Than<br>5 Years<br>(2012 and<br>beyond) |
| Total                           | (2007)(1)                                       |                        |                                      |                                      |   |
| Long-Term Debt Obligations (2): |   |                        |                                      |                                      |   |
| Senior Notes Due June 15, 2015  | \$ 111.3  | \$ 2.2                 | \$ 9.1                               | \$ 9.1                               | \$ 90.9   |
| Senior Notes Due April 15, 2016 | 202.0   | 4.3                    | 17.1                                 | 17.1                                 | 163.5   |
| Total                           | \$ 313.3  | \$ 6.5                 | \$ 26.2                              | \$ 26.2                              | \$ 254.4  |

(1) October 1, 2007 through December 31, 2007.

(2) Includes principal and interest.



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### *Capital Resources*

The Company has determined the amount of capital which is needed to adequately fund and support business growth, primarily based on risk-based capital formulas including those developed by the National Association of Insurance Commissioners ( NAIC ). Historically, the Company's insurance subsidiaries have generated capital in excess of such needed capital. These excess amounts have been paid to HMEC through dividends. HMEC has then utilized these dividends and its access to the capital markets to service and retire long-term debt, pay dividends to its shareholders, fund growth initiatives, repurchase shares of its common stock and for other corporate purposes. Management anticipates that the Company's sources of capital will continue to generate capital in excess of the needs for business growth, debt interest payments and shareholder dividends.

The total capital of the Company was \$880.4 million at September 30, 2007, including \$199.5 million of long-term debt and no short-term debt outstanding. Total debt represented 22.1% of total capital excluding unrealized investment gains and losses (22.7% including unrealized investment gains and losses) at September 30, 2007, which was below the Company's long-term target of 25%.

Shareholders' equity was \$680.9 million at September 30, 2007, including a net unrealized loss in the Company's investment portfolio of \$20.6 million after taxes and the related impact on deferred policy acquisition costs and the value of acquired insurance in force associated with annuity and interest-sensitive life policies. The market value of the Company's common stock and the market value per share were \$853.3 million and \$19.71, respectively, at September 30, 2007. Book value per share was \$15.73 at September 30, 2007 (\$16.21 excluding investment fair value adjustments).

In September 2007, HMEC's Board of Directors authorized a new \$50 million share repurchase program and ended the May 1999 authorization. The new program authorizes the repurchase of common shares in open market or privately negotiated transactions, from time to time, depending on market conditions. As of September 30, 2007, no shares were repurchased under the new program. See also Notes to Consolidated Financial Statements Note 4 Share Repurchase Program and Treasury Shares .

As of September 30, 2007, the Company had outstanding \$75.0 million aggregate principal amount of 6.05% Senior Notes ( Senior Notes due 2015 ), which will mature on June 15, 2015, issued at a discount resulting in an effective yield of 6.1%. Interest on the Senior Notes due 2015 is payable semi-annually at a rate of 6.05%. Detailed information regarding the redemption terms of the Senior Notes due 2015 is contained in the Notes to Consolidated Financial Statements Note 4 Debt of the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

The Senior Notes due 2015 have an investment grade rating from S&P (BBB), Moody's (Baa3), and A.M. Best (bbb-). See also Financial Ratings . The Senior Notes due 2015 are traded in the open market (HMN 6.05).

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As of September 30, 2007, the Company had outstanding \$125.0 million aggregate principal amount of 6.85% Senior Notes ( Senior Notes due 2016 ), which will mature on April 15, 2016, issued at a discount of 0.305% resulting in an effective yield of 6.893%. Interest on the Senior Notes due 2016 is payable semi-annually at a rate of 6.85%. Detailed information regarding the redemption terms of the Senior Notes due 2016 is contained in the Notes to Consolidated Financial Statements Note 4 Debt of the Company s Annual Report on Form 10-K for the year ended December 31, 2006.

The Senior Notes due 2016 have an investment grade rating from S&P (BBB), Moody s (Baa3), and A.M. Best (bbb-). See also Financial Ratings . The Senior Notes due 2016 are traded in the open market (HMN 6.85).

As of September 30, 2007, the Company had no balance outstanding under its Bank Credit Facility. The Bank Credit Facility provides for unsecured borrowings of up to \$125.0 million and expires on December 19, 2011. Interest accrues at varying spreads relative to corporate or Eurodollar base rates and is payable monthly or quarterly depending on the applicable base rate. The unused portion of the Bank Credit Facility is subject to a variable commitment fee, which was 0.125% on an annual basis at September 30, 2007.

To provide additional capital management flexibility, the Company filed a universal shelf registration on Form S-3 with the SEC in December 2003. The registration statement, which registers the offer and sale by the Company from time to time of up to \$300 million of various securities, which may include debt securities, preferred stock, common stock and/or depository shares, was declared effective on December 30, 2003. Unless fully utilized or withdrawn by the Company earlier, this registration statement will remain effective through December 1, 2008. The \$75.0 million face amount of Senior Notes due 2015 and \$125.0 million face amount of Senior Notes due 2016 were issued utilizing this registration statement. No other securities associated with the registration statement have been issued as of the date of this Quarterly Report on Form 10-Q.

Total shareholder dividends were \$13.8 million for the nine months ended September 30, 2007. In March, May and September 2007, the Board of Directors announced regular quarterly dividends of \$0.105 per share.

For the Company s property and casualty subsidiaries, effective January 1, 2007, the Company purchased both catastrophe excess of loss and catastrophe aggregate reinsurance coverage. The excess of loss coverage consists of two contracts in addition to the Florida Hurricane Catastrophe Fund ( FHCF ) described below. The primary contract ( first event ) provides 95% coverage of catastrophe losses above a retention of \$25.0 million per occurrence up to \$130.0 million per occurrence. This contract consists of three layers, each of which provide for one mandatory reinstatement. The layers are \$25.0 million excess of \$25.0 million, \$40.0 million excess of \$50.0 million, and \$40.0 million excess of \$90.0 million. The other excess of loss contract ( second and third events ) provides 95% coverage of catastrophe losses above a retention of \$15.0 million per occurrence up to \$25.0 million per occurrence, after the Company retains \$10.0 million of losses above \$15.0 million per occurrence. This contract also provides for one mandatory reinstatement. Coverage for any event under this contract is conditional on the size of the industry loss associated with that event being less than \$20.1 billion. The Company s predominant insurance subsidiary for property and casualty business written in Florida reinsures 90% of hurricane losses in that state above an estimated retention of \$14.7 million up to \$87.2 million with the FHCF, based on the FHCF s financial resources. The FHCF contract is a one-year contract, effective June 1, 2007. The Company s FHCF coverage reflects the acquisition, in the

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current period, of additional coverage made available to the industry by the FHCF for the 2007-2008 contract period which resulted in changes to attachment points under the Company's primary reinsurance contract. The increased coverage made available to the industry in 2007 by the FHCF could increase the likelihood of future assessments in periods following significant hurricane losses. The catastrophe aggregate contract provides 95% coverage of the Company's 2007 catastrophe losses, capped at \$10.0 million per occurrence, above an annual retention of \$21.0 million, up to an annual limit of \$40.0 million. Additional information regarding the reinsurance program for the Company's property and casualty segment is located in Business Property and Casualty Segment Property and Casualty Reinsurance of the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

Information regarding the reinsurance program for the Company's life segment is located in Business Life Segment of the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

**Financial Ratings**

The Company's principal insurance subsidiaries are rated by Standard & Poor's Corporation (S&P), Moody's Investors Service, Inc. (Moody's) and A.M. Best Company, Inc. (A.M. Best). These rating agencies have also assigned ratings to the Company's long-term debt securities.

Assigned ratings as of October 31, 2007, which were unchanged from the disclosure in the Company's Annual Report on Form 10-K for the year ended December 31, 2006, were as follows:

|                               | <b>Insurance<br/>Financial<br/>Strength Ratings (1)<br/>(Outlook)</b> | <b>Debt Ratings<br/>(Outlook)</b> |
|-------------------------------|---|-----------------------------------|
| <u>As of October 31, 2007</u> |   |                                   |
| S&P (2)                       | A(stable)   | BBB(stable)                       |
| Moody's (2)                   | A3(stable)  | Baa3(stable)                      |
| A.M. Best                     | A-(stable)  | bbb-(stable)                      |

- (1) The insurance financial strength ratings for the Company's property and casualty insurance subsidiaries and the Company's principal life insurance subsidiary are the same.
- (2) This agency has not yet rated Horace Mann Lloyds.

**Market Value Risk**

Market value risk, the Company's primary market risk exposure, is the risk that the Company's invested assets will decrease in value. This decrease in value may be due to (1) a change in the yields realized on the Company's assets and prevailing market yields for similar assets, (2) an unfavorable change in the liquidity of the investment, (3) an unfavorable change in the financial prospects of the issuer of the investment, or (4) a downgrade in the credit rating of the issuer of the investment. See also Results of Operations Net Realized Investment Gains and Losses.

Significant changes in interest rates expose the Company to the risk of experiencing losses or earning a reduced level of income based on the difference between the interest rates earned on the Company's investments and the credited interest rates on the Company's insurance liabilities. See also Results of Operations Interest Credited to Policyholders.

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The Company seeks to manage its market value risk by coordinating the projected cash inflows of assets with the projected cash outflows of liabilities. For all its assets and liabilities, the Company seeks to maintain reasonable durations, consistent with the maximization of income without sacrificing investment quality, while providing for liquidity and diversification. The investment risk associated with variable annuity deposits and the underlying mutual funds is assumed by those contractholders, and not by the Company. Certain fees that the Company earns from variable annuity deposits are based on the market value of the funds deposited.

More detailed descriptions of the Company's exposure to market value risks and the management of those risks is presented in Management's Discussion and Analysis of Financial Condition and Results of Operations Market Value Risk of the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

## **Recent Accounting Changes**

### *SFAS No. 159*

In February 2007, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, Including an Amendment of FASB Statement No. 115. This standard will be effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007, which for the Company will be January 1, 2008. SFAS No. 159 permits all entities to choose to elect, at specified election dates, to measure eligible financial instruments, as defined in SFAS No. 159, at fair value. Changes in unrealized gains and losses on items for which the fair value option has been elected will be reported in earnings at each subsequent reporting date and upfront costs and fees related to those items will be reported in earnings as incurred and not deferred. At adoption, for those financial assets and financial liabilities which management has elected to carry at fair value, an entity shall report the effect of the first remeasurement to fair value as a cumulative-effect adjustment to the opening balance of retained earnings. Management is currently assessing the impact of this SFAS to determine whether it will elect to measure any of its eligible financial assets or financial liabilities at fair value. An election to measure any or all of its eligible financial instruments at fair value could have a material effect on the results of operations or financial position of the Company. In any event, the Company will not be electing to early adopt SFAS No. 159 and, as a result, retrospective application will be prohibited.

### *SFAS No. 157*

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. This standard will be effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Generally, the provisions of this statement are to be applied prospectively as of the beginning of the fiscal year of adoption. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in accordance with GAAP and expands disclosures about fair value measurements. This pronouncement does not require any new fair value measurements. Management is currently assessing the impact of this SFAS but anticipates that its adoption will not have a material effect on the results of operations or financial position of the Company.

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### *The Pension Protection Act of 2006*

In the third quarter of 2006, the federal government enacted the Pension Protection Act of 2006 (the Act) which changes the manner in which pension funding is determined. The new rules are effective for funding beginning in 2008. Management does not expect the Act to have a material impact on the Company's funding activity.

The Company's funding policy for the defined benefit pension plan is to contribute amounts which are actuarially determined to provide the plan with sufficient assets to meet future benefit payments consistent with the funding requirements of federal laws and regulations. There was no minimum funding requirement for the defined benefit pension plan as of September 30, 2007. The Company's obligations have not changed as a result of these developments.

### **Other Matters**

#### *Section 403(b) Regulations*

On July 26, 2007, final new Internal Revenue Service (IRS) Section 403(b) regulations were published in the Federal Register. The new regulations largely parallel those proposed in November 2004 and disclosed in Business Regulation Regulation at Federal Level in the Company's Annual Reports on Form 10-K for the years ended December 31, 2006, 2005 and 2004. The effective date of the new regulations is generally January 1, 2009 with limited exceptions. Beginning with that date, contributions to Section 403(b) tax-qualified arrangements, including annuities, will need to be made pursuant to a written plan which includes all of the terms and conditions for eligibility, limitations and benefits under the plan, and which may incorporate other documents by reference including annuity contracts issued by approved product providers. Other highlights of the new regulations include modified distribution and transfer rules and the incorporation of numerous positions previously taken by the IRS since last issuing formal comprehensive Section 403(b) regulations in 1964. The lead time to the effective date, combined with preparations made by the Company since the new regulations were first proposed, should permit ample time to assist the key school districts where Horace Mann has Section 403(b) payroll slots with the development of their written plans and to implement the new products and services required to enable the Company to continue to effectively serve this market.

One immediate impact of the new Section 403(b) regulations is that previous rules governing a participant's ability to exchange, without incurring income tax liability, one 403(b) annuity or funding agreement for another were changed effective September 24, 2007. New rules require that exchanges be limited to the product providers authorized in the sponsor's written plan or that have entered into an information sharing agreement with the sponsor. Many school district sponsors have been willing to enter into these information sharing agreements to allow participants the right to exchange contracts while their written plans are being completed; other districts have chosen to temporarily suspend their participants' right to make such exchanges until they are more comfortable in their understanding of the new requirements or their written plans are complete. During this period of uncertainty, new sales related to 403(b) exchanges could be adversely impacted; conversely, an industry-wide reduction in exchanges should provide a temporary increase in retention ratios.

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### *Other*

Ariel Capital Management, LLC, HMEC's largest shareholder with 17.0% of the common shares outstanding per their SEC filing on Form 13G as of June 30, 2007, is the investment adviser for two of the mutual funds offered to the Company's annuity customers.

### **Item 3: Quantitative and Qualitative Disclosures About Market Risk**

The information required by Item 305 of Regulation S-K is contained in Management's Discussion and Analysis of Financial Condition and Results of Operations contained in this Quarterly Report on Form 10-Q.

### **Item 4: Controls and Procedures**

#### **Management's Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures**

Under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, the Company conducted an evaluation of the effectiveness of the design and operation of the Company's disclosure controls and procedures, as such term is defined in Rule 13a-15(e) of the Securities Exchange Act of 1934 as amended (the "Exchange Act"), as of September 30, 2007 pursuant to Rule 13a-15(b) of the Exchange Act. Based on this evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective in timely alerting them to material information relating to the Company (including its consolidated subsidiaries) that is required to be included in the Company's periodic Securities and Exchange Commission filings. No significant deficiencies or material weaknesses in the Company's disclosure controls and procedures were identified in the evaluation and therefore, no corrective actions were taken. There were no significant changes in the Company's internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation.

#### **Changes in Internal Control Over Financial Reporting**

There were no changes in the Company's internal control over financial reporting that occurred during the Company's last fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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**PART II: OTHER INFORMATION**

**Item 1A. Risk Factors**

At the time of this Quarterly Report on Form 10-Q, management believes there are no material changes from the risk factors as previously disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

A description of recent developments regarding IRS Section 403(b) regulations is included in Management's Discussion and Analysis of Financial Condition and Results of Operations - Other Matters - Section 403(b) Regulations.

**Item 4: Submission of Matters to a Vote of Security Holders**

None.

**Item 5: Other Information**

The Company is not aware of any information required to be disclosed in a report on Form 8-K during the three months ended September 30, 2007 which has not been filed with the SEC.

**Item 6: Exhibits**

**Exhibit Description**

(a) The following items are filed as Exhibits. Management contracts and compensatory plans are indicated by an asterisk (\*).

- (11) Statement re computation of per share earnings.
- (15) KPMG LLP letter regarding unaudited interim financial information.
- (31) Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
  - 31.1 Certification by Louis G. Lower II, Chief Executive Officer of HMEC.
  - 31.2 Certification by Peter H. Heckman, Chief Financial Officer of HMEC.
- (32) Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
  - 32.1 Certification by Louis G. Lower II, Chief Executive Officer of HMEC.
  - 32.2 Certification by Peter H. Heckman, Chief Financial Officer of HMEC.
- (99.1) Glossary of Selected Terms.

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SIGNATURES

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

HORACE MANN EDUCATORS CORPORATION

(Registrant)

Date November 8, 2007

/s/ Louis G. Lower II  
Louis G. Lower II

President and Chief Executive Officer

Date November 8, 2007

/s/ Peter H. Heckman  
Peter H. Heckman

Executive Vice President

and Chief Financial Officer

Date November 8, 2007

/s/ Bret A. Conklin  
Bret A. Conklin

Senior Vice President

and Controller



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HORACE MANN EDUCATORS CORPORATION

EXHIBITS

To

FORM 10-Q

For the Quarter Ended September 30, 2007

VOLUME 1 OF 1

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The following items are filed as Exhibits to Horace Mann Educators Corporation's Quarterly Report on Form 10-Q for the quarter ended September 30, 2007. Management contracts and compensatory plans are indicated by an asterisk (\*).

### EXHIBIT INDEX

| <b>Exhibit No.</b> | <b>Description</b>   |
|--------------------|--|
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