PROSPECTOR FUNDS, INC.

January 30, 2018

Dear Shareholders of the Prospector Capital Appreciation Fund and Prospector Opportunity Fund,

We often repeat the mantra "now is the most difficult time to invest" in our communications to you. This feels especially germane today. A significant stock market correction is overdue after nine years of upward markets. We are concerned that the consequences of a correction, should it occur, could be high.

The U.S. economy continues to expand, even accelerating from a below 2% annualized rate a year ago, to an above 3% current growth rate. Economic conditions are healthy globally as well. Interest rates remain close to historically low levels and short rates in particular are gently lifting at a pace that would make Goldilocks proud. Corporate earnings delivered a strong statement in 2017, well above the expectations that were in place when the year began, driven by healthy business conditions and reduced regulation.

All of this manifested itself in a fantastic year for stocks, both in the U.S. and around the world. 2017 was an extraordinary year in the stock market which increased every month for the first time in history, a feat accompanied with record low levels of volatility. Stocks in the U.S., as represented by the S&P 500, rose 21.83% for the full year without once experiencing a 3% correction, another first. Growth stocks outperformed value stocks by a significant amount, regardless of the size of the company. Large growth stocks, as measured by the Russell 1000 Growth Index, rose 30.21%, easily outpacing the Russell 1000 Value Index which posted a 13.64% gain. In addition large capitalization shares handily beat their smaller capitalization brethren with the Russell 1000 Index earning 21.68% as compared to the Russell 2000 Index which gained 14.65%.

The key driver of these strong results was the technology sector which delivered almost 40% of the total return for the S&P 500. By year end 2017, the technology sector represented 24% of the market capitalization of the S&P 500, the third highest sector weighting ever (after the technology sector during 1999-00 internet "bubble" and the energy sector in 1980-81). Other strong sectors included healthcare, which rebounded sharply from dual fears over the repeal of Obamacare and/or price controls, and consumer discretionary, which was propelled by strong performance from Amazon and Netflix.

While we are satisfied with the absolute performance of the Funds, we are somewhat disappointed with the performance relative to broad market indices. Our value orientation and affinity for also investing in smaller and medium sized companies conspired to mute our gains. With the benefit of hindsight, 2017 was not a year to play defense of any sort.

While the environment for equity investing was benign in 2017, there are no shortage of issues to worry about either. China is finding its way through a tough transition from an emerging market, export driven country to a global economic leader with a difficult North Korean neighbor rattling its sabre on the world stage. The UK is attempting to extricate itself from the European Union, which has other issues such as the Catalan independence movement to consider. Iran's nuclear ambitions continue to loom unabated, adding fuel to the combustible Middle East equation.

Recent Catastrophic Events

The hurricane season of 2017 will likely be remembered for many years, given the significant catastrophic activity experienced. In total, current estimates of insured losses from all catastrophes in 2017 is about $135B, potentially the highest level ever recorded. These losses have validated the risk management models for many companies and the negative impact was well contained in the context of balance sheet positions. Recent years had experienced

relatively light catastrophic loss experience, and at a minimum, this year's results will be a healthy reminder of the volatility inherent in the business.

There are both cyclical and secular forces at work in the insurance and reinsurance industries. In our view, the huge catastrophe losses will have a demonstrable cyclical impact and a negligible secular impact. Pricing will cyclically improve in catastrophe-prone lines of business such as homeowners, personal auto, commercial property, and business interruption, as well as property reinsurance. Indeed, during the recent January 1st reinsurance renewal period, pricing improved in catastrophe-prone lines of business and will likely improve at the mid-year renewals in a similar manner. Recent industry pricing surveys for U.S. primary commercial lines have illustrated pricing stability and personal lines pricing trends have been favorable for some time; we suspect that higher reinsurance costs will likely further this trend. At the same time, nontraditional capital sources that have entered the industry, mostly through the reinsurance channel, will continue to grow in scope and influence.

This nontraditional capital, which is able to react quickly to industry events, has served to somewhat mute the sharp rate hikes once seen following large industry events. In part due to this dynamic, we had concentrated your portfolios' reinsurance holdings to a handful of what we believe are the best run companies with solid balance sheets and which were trading well below our estimates of private market value. Examples of companies fitting this description, and which were holdings in both Funds during hurricane season are RenaissanceRe (RNR) and Validus Holdings (VR).

It's noteworthy that, while we went into storm season comfortable in our reinsurance-exposed holdings, we made some modest tactical changes in both Funds as storms approached or hit – using our industry knowledge to trim names which we felt could be over-exposed to certain catastrophes, and adding to names which were likely to weather the events relatively well (or even be net beneficiaries from the catastrophes). We will go into more specifics in the Highlights sections below.

Subsequent to year end, AIG announced the acquisition of Validus (on the date it was announced, a significant position in both Funds) for $68.00 per share – a 46% premium to the prior day's close, and significantly above where the stock traded prior to hurricane season. This transaction illustrates the attractive growth opportunities in third-party (reinsurance) capital management (of which VR is an industry leader), as well as the longer-term pressures faced by management teams of traditional reinsurance companies. We also believe this reaffirms our thesis that these portfolio companies trade significantly below private market value.

Prospector Opportunity Fund Highlights

The Prospector Opportunity Fund advanced 10.33% for the year ended December 31, 2017. While this is an acceptable absolute result, it trailed in comparison to the 14.65% increase in the Russell 2000 Index and the 18.52% rise in the Russell Midcap Index. The outstanding returns in the overall stock market were heavily fueled by technology and healthcare stocks. The portfolio underweighting in POPFX to these two sectors hampered our results. Also our value orientation worked against us as growth investing decisively led the market. Our results were broadly in line with other value investors who are active in the small and midcap arena.

Not surprisingly our second half of 2017 portfolio activity was dominated by a repositioning of our insurance holdings in the wake of the heavy catastrophe losses incurred in Texas, Florida, Puerto Rico, and California. Specifically, our two largest purchases during the second half were White Mountains Insurance Group and Cincinnati Financial. White Mountains is a merchant banking operation with expert insurance and reinsurance

operating and acquisition skills plus significant undeployed capital following the 2017 sale of OneBeacon Insurance Group. White Mountains is well poised to opportunistically deploy capital into an improving fundamental insurance pricing market. Also White Mountains sells for an attractive discount to tangible book value valuation. Cincinnati Financial is a solid regional underwriter with a long tradition of conservative reserving whose stock has lagged the growth-oriented stock market the last few years. The improved pricing environment post catastrophe translates into better business conditions for this blue chip company which sells for a reasonable 1.6 times tangible book value.

Another top purchase during the second half was Powell Industries which sells systems that manage the flow of electricity in heavy industry, including oil & gas. Not surprisingly, the profitability of Powell has collapsed with the decline in energy prices since 2015. Powell management has elected to endure the downturn, hold onto their skilled labor force, and await the recovery which is signaled by the 2017 oil price rise. This strategy is enabled by Powell's pristine balance sheet. Tom Powell, the Chairman and founder is 77, and would have no shortage of bidders should he decide to entertain them. The combination of a fortress balance sheet and a share price that fell from $70 to current levels below $30 make this an attractive investment.

On the sales side, POPFX benefited from merger and acquisition activity. Buffalo Wild Wings was the largest divestiture from the portfolio following a buyout from Arby's restaurant Group. We owned Buffalo Wild Wings for less than a year and remained attracted to the potential turnaround of this unique franchise. We believe Arby's has a winner on their hands. Another large divestiture was State National Companies, a growing insurance enterprise bought in a cash transaction at a 38% premium by Markel Insurance.

Prospector Capital Appreciation Fund Highlights

The Prospector Capital Appreciation Fund gained 11.38% for the year ended December 31, 2017. As mentioned above, these results trailed the tech-heavy benchmark S&P 500, but were more in line with value indices. While we are never happy trailing "the market," we gain comfort when considering your portfolio's holdings, which we constantly question as to valuation and downside protection offered. This includes our allocation to fixed income and convertible securities – many of which trade near par value, but offer the ability to participate in the upside of their relevant stocks. Significantly, your portfolio's relative underweight to technology stocks explained the majority of the Fund's underperformance relative to the S&P 500 during 2017. It should be noted that while the tech sector certainly contains many well-run companies with solid balance sheets, our under exposure has historically stemmed from avoiding companies threatened by short product cycles that could be made obsolete in the blink of an eye (we have a similar aversion to consumer stocks exposed to the latest fashion trends).

A significant portion of portfolio movements during the second half of 2017 could be attributed to the aforementioned trading surrounding the summer's hurricanes (Harvey, Irma, and Maria). More specifically, as hurricane Irma approached Florida, we sold positions we believed would be more heavily impacted than peers to the (then forecasted) direct hit up the center of the state. The largest such position being Validus – a company we admire, and viewed as a potential takeout target. For this reason, we re-initiated a position in the company following storm season and have benefited from their acquisition by AIG. We also added to positions which would likely benefit either from potentially increasing insurance rates (e.g., insurance broker Brown & Brown), or from real estate demand just outside of Harvey-impacted Houston (e.g., real estate developer Howard Hughes).

The Fund's convert position was also reduced during the latter part of the year. This was due to our Hologic (HOLX) issue being called by the company as well as the sale of our Electronics for Imaging (EFII) position – small additions of convertibles did not fully offset these deletions. Given still low interest rates, issuances of convertible

securities remains sparse (when debt is so cheap, companies don't feel the need to add a convertible feature and opt to issue straight debt instead). Add to that the long-running bull market, and the pool of attractive converts continues to dwindle. We do, however, occasionally find the attractive issue, and continue to look for opportunities. Patience is a virtue.

Delving into the convert sales a bit more: As you may recall from our first half 2015 letter, after a successful investment in HOLX's 2037 convertible, we initiated a position in the 2043 issue given better downside protection while still being able to participate in much of the upside. We felt that new CEO (at the time) Steve MacMillan had effected positive change quickly, and that there could be more upside. While we eked out a small gain in the 2043 issue, it was called by the company before we could achieve the larger gains we believed attainable. We continue to follow the company closely.

The EFII convert was sold under very different circumstances. Electronics for Imaging, a leader in the manufacturing of digital printers (which are in a period of secular growth as they take share from analog printing), saw its stock take a hit of over 40% when it was announced they were conducting an internal review of their accounting policies. EFII has a strong balance sheet and a history of producing solid cash flows; and, while the accounting issue seemed likely to be less severe than the plummeting stock price would suggest, prudency dictated that we sell the convert position (which we purchased slightly above par) at a small loss and follow the story from the sidelines.

Outlook

After a nine year post-financial crisis period of consistent underlying conditions for equity investing, things are slightly shifting. The interest rate and regulatory cycles have reached an inflection point. One thing that hasn't changed is that the equity market continues to perform better than the underlying economy. The U.S. economy remains in a modest growth mode with signs of improvement. Our economy's performance remains a global leader, but the margin has shrunk relative to Europe and the rest of the world.

Energy prices are still low, despite their 2017 increase. This stimulates consumer spending and confidence in the long run both here and for non-oil producing countries abroad. In the U.S. we enjoy the competitive advantage of a long-term supply of abundant cheap natural gas. The USD Index fell 10% in 2017, reversing the strong dollar trend and giving a boost to our export competitiveness.

Interest and mortgage rates continue near historically low levels, although they have moved off the lows and look poised to move higher still. Ultimately, higher rates will likely accompany better economic performance and some inflation, both of which are relative positives for equities compared to bonds. Much depends on the path and pace of interest rates' return to normalcy. The yield curve flattened markedly in recent months, which is usually a precursor to an economic slowdown. Although we are clearly late in the economic cycle, the odds of an imminent recession seem low.

Investment-grade corporations have solid balance sheets and are accumulating excess cash and capital. Importantly, post tax reform they should start to spend more on new capital projects, new employees, and new acquisitions. The corporate tax cuts and the inducement to repatriate foreign cash holdings, of which there is more than $3 trillion, is fueling optimism. High-yield financing remains abundant and relatively inexpensive. Profit margins sit near all-time high levels, currently 10%.

In our estimation equity valuations remain at historically extended levels, in the tenth decile on trailing operating earnings. We feel we are in the later stages of a bull market, although nothing is certain. Equities look most reasonable when comparing earnings yields to Treasury or even corporate bond yields. In any case, the values inherent in your portfolio should attract acquirers and other investors over time. Meanwhile, we believe equities are a superior asset allocation alternative to bonds over the longer term.

Thank you for entrusting us with your money.

Respectfully submitted,

John D. Gillespie Kevin R. O'Brien Jason A. Kish

Performance data quoted represents past performance; past performance does not guarantee future results.

Opinions expressed are those of the Funds and are subject to change, are not guaranteed, and should not be considered a recommendation to buy or sell any security.

Mutual fund investing involves risk. Principal loss is possible. Investments in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. The Funds invest in foreign securities which involve greater volatility and political, economic and currency risks and differences in accounting methods. The Funds invest in smaller and mid-cap companies, which involve additional risks such as limited liquidity and greater volatility. The Funds may hold restricted securities purchased through private placements. Such securities can be difficult to sell without experiencing delays or additional costs. Derivatives involve risks different from, and in certain cases, greater than the risks presented by more traditional investments. These risks are fully disclosed in the prospectus.

The S&P 500 Index is a broad based unmanaged index of 500 stocks, which is widely recognized as representative of the equity market in general. You cannot invest directly in an index.

The Russell 1000 Growth Index is an unmanaged index that measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values. You cannot invest directly in an index.

The Russell 1000 Value Index is an unmanaged index that measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower expected growth values.

The Russell 1000 Index is an unmanaged index that measures the performance of the highest-ranking 1,000 stocks in the Russell 3000 Index, which represents about 90% of the total market capitalization of that index. You cannot invest directly in an index.

The Russell 2000 Index is an unmanaged small-cap index that measures the performance of the 2,000 smallest companies in the Russell 3000 Index. You cannot invest directly in an index.

The Russell MidCap Index is an unmanaged mid-cap index that measures the performance of the 800 smallest companies in the Russell 1000 Index. You cannot invest directly in an index.

Tangible Book value is the total net asset value of a company's assets that shareholders would theoretically receive if a company were liquidated less intangible assets and goodwill.

The U.S. dollar index is a measure of the value of the U.S. dollar relative to the value of a basket of currencies of the majority of the U.S.'s most significant trading partners.

Fund holdings and/or security allocations are subject to change at any time and are not recommendations to buy or sell any security. Please see the Schedule of Investments section in this report for a full listing of the Fund's holdings.

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