Alleghany Corporation Scorecard

($ in millions, except per share amounts)

	Book Value Per Share	Book Value % Change	% Change in S&P 500 with Dividends Included	Market Price Per Share	Market Price % Change	Market Price to Ending Book Value	10-year Treasury Yield End of Year	Common Stockholders' Equity
2000	$141.03	15.3%	-9.1%	$165.28	13.0%	1.17	5.11%	$1,191
2001	162.36	15.1%	-11.9%	157.88	-4.5%	0.97	5.05%	1,426
2002	162.75	0.2%	-22.1%	148.52	-5.9%	0.91	3.82%	1,413
2003	182.18	11.9%	28.7%	189.90	27.9%	1.04	4.25%	1,600
2004	204.08	12.0%	10.9%	248.33	30.8%	1.22	4.22%	1,800
2005	212.80	4.3%	4.9%	252.18	1.6%	1.19	4.39%	1,894
2006	244.25	14.8%	15.8%	329.32	30.6%	1.35	4.70%	2,146
2007	281.36	15.2%	5.5%	371.39	12.8%	1.32	4.02%	2,485
2008	267.37	-5.0%	-37.0%	265.74	-28.4%	0.99	2.21%	2,347
2009	294.79	10.3%	26.4%	265.28	-0.2%	0.90	3.84%	2,718
2010	325.31	10.4%	15.1%	300.36	13.2%	0.92	3.29%	2,909
2011	342.12	5.2%	2.1%	285.29	-5.0%	0.83	1.88%	2,926
2012	379.13	10.8%	16.0%	335.42	17.6%	0.88	1.76%	6,404
2013	412.96	8.9%	32.4%	399.96	19.2%	0.97	3.03%	6,924
2014	465.51	12.7%	13.7%	463.50	15.9%	1.00	2.17%	7,473
2015	486.02	4.4%	1.4%	477.93	3.1%	0.98	2.27%	7,555
2016	515.24	6.0%	12.0%	608.12	27.2%	1.18	2.44%	7,940
CAGR								
5-years	8.5%		14.7%	16.3%				22.1%
10-years	7.8%		6.9%	6.3%				14.0%
15-years	8.0%		6.7%	9.4%				12.1%

To Our Stockholders

Alleghany's common stockholders' equity per share at year-end 2016 was $515.24, an increase of $29.22, or 6.0% from common stockholders' equity per share of $486.02 at year-end 2015. For 2016, Alleghany reported consolidated revenue growth of 22.6% and net earnings to common stockholders of $457 million, or $29.60 per share. Changes in the market value of our investments, foreign exchange and other items decreased book value per share by $0.38. Our 2016 earnings reflect improved underwriting results at CapSpecialty and PacificComp, solid underwriting results at TransRe and RSUI despite higher catastrophe losses, modest investment returns and a growing economic contribution from our non-insurance businesses, offset by an impairment charge related to our oil recovery business, Stranded Oil Resources Corporation.

The accompanying scorecard summarizes Alleghany's longer-term performance. We have started this table with the year 2000, even though Alleghany's history dates back to 1929. As our longer-term shareholders know, Alleghany's performance in the 1980s and 1990s was extraordinary. From 1980 to 1989, Alleghany's book value per share compounded at 28% per year; from 1990 to 1999 it compounded at over 15% per year. During both decades Alleghany divested of several of its operating businesses, with the result being that by 2001 most of Alleghany's $1.4 billion of common stockholders' equity was invested in passive assets awaiting redeployment and earning comparatively low returns. The modern chapter of Alleghany's history therefore really began in 2002, as we began to build an investment-oriented insurance and reinsurance platform largely through acquisition. As you can see from the table, over the past 15 years we have compounded book value per share at 8.0%, compared to a compound annual return of 6.7% for the S&P 500 over this time period. Investors in Alleghany have earned a 9.4% compound annual return.

Our underwriting results in 2016 were solid and we made significant progress in the build-out of Alleghany Capital. Our investment results, however, were mixed, in part reflecting our reluctance to take excessive risk in what may be an over-valued stock market.

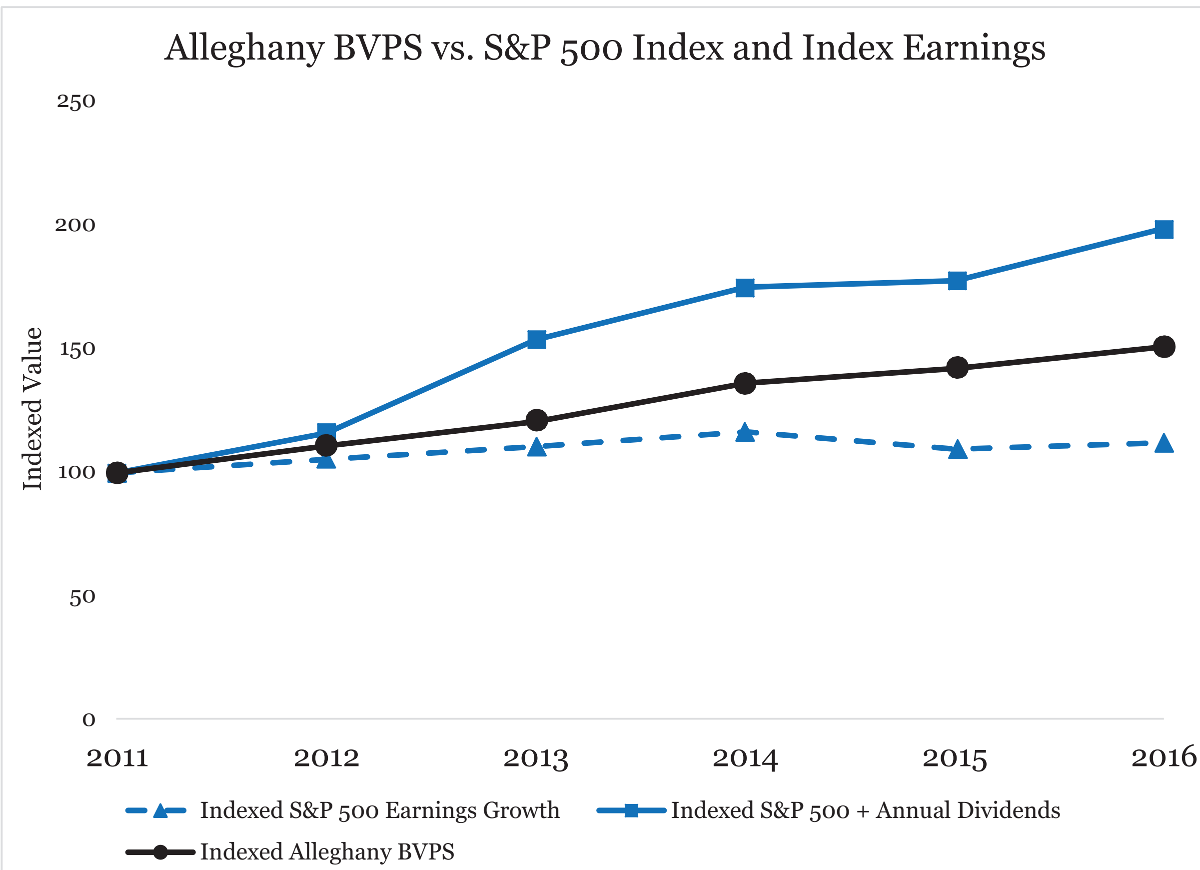
The significant decline in interest rates following the 2008 Financial Crisis created a persistent headwind to the property and casualty industry's operating profitability, as fixed income assets have yielded less than historical norms. For example, real yields[1] have averaged less than 1% so far this decade, compared to almost 2% in the prior decade and 3-4% in the 1990s. With fixed income assets greater than the capital account, this decline has had a leveraged reduction on the structural return on equity available in the property and casualty industry. Following the political changes in the United States last year, however, interest rates have begun to rise, which offers the prospect of a reversal of the multi-decade trend of declining real yields.

In addition to the direct effects of lower interest rates, disinflation has invited more competition, both within the commercial property and casualty industry and from new, non-traditional sources of capacity. We have only recently begun to see the consequences in the industry from over five years of price competition, and suspect that we will see more as the year ahead unfolds.

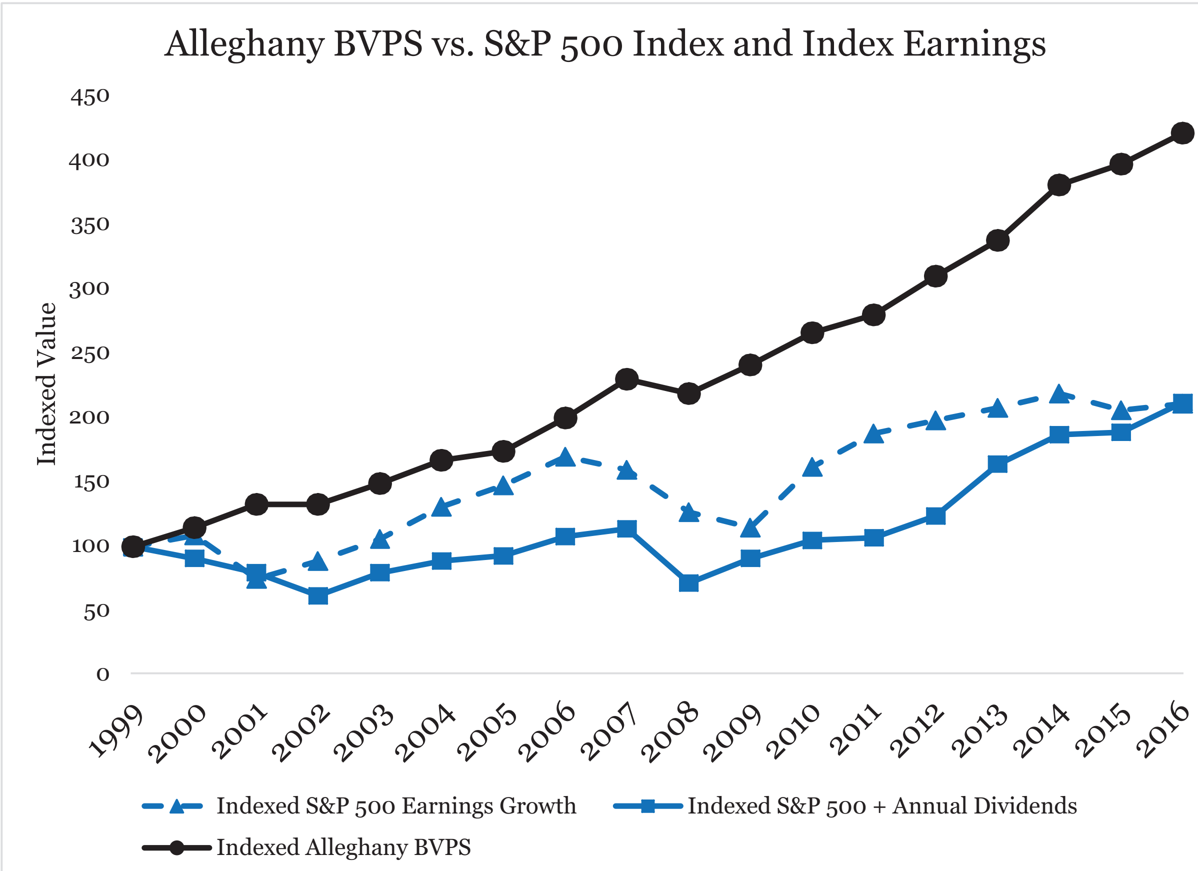
[1] The 10-year treasury yield less inflation as measured by the consumer price index.

We have responded to this environment by maintaining underwriting discipline at TransRe and RSUI and improving the operating performance of our smaller insurance businesses through better execution and the pursuit of profitable niche opportunities, namely professional liability (at CapSpecialty) and workers' compensation (at PacificComp). In addition, we have been investing in non-financial businesses at Alleghany Capital and repurchasing our stock when it is trading at a discount to book value. We believe that our Alleghany Capital investments have the potential to generate higher returns on capital than our core (re)insurance businesses in the current environment.

Since 2011 the return on the S&P 500 has been robust. Over the past five years the return on the S&P 500 has been almost 15% per year, while our book value per share has compounded at 8.5% per year. Interestingly, the *earnings* of the S&P 500 have increased at only 2.3% per year, with the vast majority of the return on the S&P 500 coming from an expanded price-earnings ratio. In addition, the price-to-book ratio of the S&P 500 has increased from 2-times to 3-times over the past five years. Moreover, this period has coincided with the Federal Reserve's intervention in financial markets, contributing to a record low level in real interest rates. We suspect that this intervention has been a major contributing factor to the significant revaluation in equities.



From a longer-term point of view, Alleghany's relative book value growth has come from preserving capital in times of stress while compounding at a steady rate in better times:



We believe that the growth rate in book value in 2016 understates Alleghany's increase in the intrinsic value because an increasing portion of our capital has been invested in non-financial businesses where GAAP accounting requires us to recognize and amortize intangible assets related to acquisitions, thereby suppressing for a period of time the resulting earnings of acquired companies. As we continue to expand Alleghany Capital, this issue will become more significant. Value creation will be evidenced by underlying earnings and growth in free cash flow from our Alleghany Capital portfolio companies compared to the cost of equity attributable to our investment in these companies.

The table below summarizes the change in stockholders' equity attributable to Alleghany common stockholders in 2016 ($ millions):

	Amount	% of Beginning Equity
Investment income, net of tax	$ 337	4.5%
Underwriting profit[2], net of tax	261	3.5
Corporate administration, net of tax	(28)	(0.4)
Subsidiary long-term compensation & other, net of tax	(72)	(1.0)
Interest expense, net of tax	(53)	(0.7)
Operating income[2]	$ 445	5.9%
Realized and change in unrealized gains, net of tax:		
Equity securities and other	70	0.9
Fixed income securities	6	0.1
Total	$ 76	1.0%
SORC impairment charge, net of tax	(64)	(0.8)
Share repurchases	(68)	(0.9)
Other items, net	(4)	(0.1)
Increase in common stockholders' equity	$ 385	5.1%

Strong underwriting results and stable investment income were the main drivers of book value growth in 2016. Per share growth in book value was 0.9% higher than our nominal growth in stockholders' equity due to a reduction in shares outstanding.

The majority of corporate administration costs is the expense associated with Alleghany's long-term incentive plan. This expense varies depending upon the rolling four-year growth rate in book value per share as well as Alleghany's stock price. On an annual basis, each executive and officer is awarded a tranche of performance shares, the vesting of which depends upon the growth rate in book value per share (with certain adjustments) over the following four years. The current performance hurdle at target is a 7% compound growth rate. Below 5% the shares do not vest, and at 9% or higher the shares vest at 150% of targeted amounts. The value of these shares depends upon the stock price if and when a payout is earned. It is important to note, however, that one tranche's gain is the next tranche's challenge. In a year where the stock price goes up considerably (such as 2016 when Alleghany's share price appreciated 27.2%), the number of shares awarded in the subsequent grant is reduced, as each dollar grant is a relatively stable amount in relation to each person's salary.

[2] Represents a non-GAAP financial measure. See "Comment on Non-GAAP Financial Measures" on page 24 for further information.

(Re)insurance subsidiary long-term incentive compensation is, for the most part, phantom restricted stock, with the value at maturity based on the book value of each individual (re)insurance company. All of our subsidiary executives primarily have a stake in their own business – not Alleghany as a whole.

The table below summarizes our 2016 growth in book value by major operating unit ($ millions):

	TransRe	RSUI	Other[3]	Total
Beginning Equity	$ 5,210	$1,566	$ 779	$7,555
Adjusted Operating Earnings[4]	341	136	8	485
P-GAAP Amortization, net of tax	4	(2)	(14)	(12)
SORC Impairment Charge, net of tax	-	-	(64)	(64)
Corporate administration, net of tax	-	-	(28)	(28)
Adjusted Net Earnings[4]	$ 345	$ 134	$ (98)	$ 381
Other Changes[5]	23	2	47	72
Capital Transactions	(375)	(100)	407	(68)
Ending Equity	$ 5,203	$1,602	$1,135	$7,940
Adjusted Operating ROE	6.5%	8.7%	1.0%	6.4%
Growth (decline) in Book Value[6]	7.1%	8.7%	-6.5%	6.0%

TransRe and RSUI, which together account for 86% of our consolidated stockholder's equity, produced 6.5% and 8.7% returns on equity on an operating basis (excluding net realized capital gains or losses and other than temporary impairment charges), respectively, reflecting increased catastrophe losses in 2016, partially offset by an increased amount of favorable prior year loss development. Investment returns were modest in 2016 resulting in growth in book value for each company that was close to each company's operating return on equity.

Both TransRe and RSUI hold a significant amount of equity securities. In measuring return on equity, we are including only the dividend income in the numerator of the calculation, with unrealized appreciation or depreciation, net of taxes, flowing through the balance sheet. Accordingly, return on equity *understates* the potential economic return of an insurance enterprise, assuming equity investments appreciate over time.

[3] CapSpecialty, PacificComp, corporate assets and Alleghany Capital investments, net of holding company debt.
[4] Represents a non-GAAP financial measure. See "Comment on Non-GAAP Financial Measures" on page 24 for further information.
[5] Principally net realized capital gains (losses) and change in unrealized appreciation (depreciation) on investments, net of tax.
[6] Dividends and share repurchases added back to ending equity.

TransRe and RSUI together provided Alleghany with $475 million of upstream dividends in 2016. Approximately $68 million of this total was used to repurchase shares at an average price of $480.49, or a modest discount to year-end 2016 common stockholders' equity per share. The balance was accumulated at the holding company level and, to a lesser extent, used to acquire an additional ownership stake in Jazwares. At year-end 2016, debt to total capital was 16%, and **net** debt to total capital was approximately 6%, as we had approximately $1 billion of marketable securities and cash at the parent company at the end of the year. We continue to believe that Alleghany's balance sheet is in extremely good shape, and we are well positioned to take advantage of opportunities that may emerge in the years ahead. We have a liquid parent company, moderate financial leverage, well-capitalized operating subsidiaries, and prudent loss reserves.

Our capital management strategy seeks to optimize long-term returns to shareholders. Our first priority is to support our (re)insurance subsidiaries in their pursuit of profitable growth. Opportunities for profitable growth in the (re)insurance industry are episodic and growing at the wrong time can destroy capital, so caution is the watchword. To the extent our (re)insurance subsidiaries generate more capital than they can profitably deploy in their businesses, they dividend these excess funds (subject to constraints imposed by insurance regulations and solvency objectives) to the parent company. Our second priority is to maintain a resilient balance sheet, with moderate levels of financial leverage and ample holding company liquidity. Holding company liquidity creates optionality in an uncertain world and, in the past, has been essential to our being able to buy assets at attractive prices when others are constrained. Our third priority is to use parent company excess funds to acquire attractive businesses within the Alleghany Capital group at reasonable prices where we believe prospective returns will exceed our cost of capital. These acquisitions can either be "bolt-on" acquisitions for existing companies or new portfolio companies. At any point in time we have several potential acquisitions in the pipeline, requiring us to be ready to close should they come to conclusion. Our final use of capital is to return it to shareholders if we cannot use it for the above-outlined purposes. Historically we have done this primarily through open market share repurchases, with all of these repurchases having been accomplished at a discount to our book value per share.

We have not historically paid a cash dividend because we continue to have significant optionality on capital redeployment. In addition, cash dividends are a tax-inefficient way to return value to taxable shareholders. Because our focus is on the *long-term* shareholder, we prefer share repurchases at prices below our estimate of intrinsic value, as the value of these actions inure to the benefit of the continuing shareholder. On the other hand, share repurchases above intrinsic value transfer value from the continuing shareholder to the selling shareholder.

As the table above shows, we had net assets of $1,135 million at the end of 2016 in addition to the equity of TransRe and RSUI Group. The "Other" column includes our smaller insurance subsidiaries (CapSpecialty and PacificComp), our holding company investments, and corporate administration costs. Improved results at CapSpecialty and PacificComp and earnings before amortization at most of the Alleghany Capital businesses were offset by operating and impairment losses at Stranded Oil Resources Corporation, amortization expenses, and corporate administration costs.

The table below summarizes the major items comprising the $1,135 million:

Parent cash & invested assets[7]	$ 965
Parent debt	(991)
Subtotal	$ (26)
Investment in Ares Management LLC	224
CapSpecialty and PacificComp[8]	359
Alleghany Capital	591
Alleghany Properties	34
Other items, net	(47)
Total	$ 1,135

In last year's stockholders' letter I noted that the market price of Ares Management at the end of 2015 was not, in our opinion, a good indicator of the value of our investment. In 2016 Ares appreciated almost 50%. As a reminder, because ours is a private investment convertible into public units, we use the equity method to account for the investment. At recent prices, the implied value of our investment is now above our carrying value.

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Alleghany Capital originates and manages our investments in non-financial companies. At the end of 2016 our investment in Alleghany Capital was almost $600 million. Our strategy is to offer privately- or founder-owned companies in basic or durable industries a source of permanent capital and to work with them to grow their companies through investments that support organic growth and "bolt-on" acquisitions. Unlike the typical private equity fund buyer, our investment horizon is not limited to a specific time period and we generally would expect to sell only if and when our management-partners believe that it is in the best interest of their company to do so. With substantial resources, Alleghany Corporation can provide stability and support to these companies, helping them to weather challenging economic times.

At the end of 2016, we had five major investments: Stranded Oil Resources Corporation, Jazwares, Kentucky Trailer, IPS-Integrated Project Services, and Bourn & Koch. Stranded Oil Resources Corporation is a venture investment, while the others are mature companies, some with a long history and all with stable market positions. Each company is reviewed below.

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[7] Includes investments of AIHL. Excludes marketable securities held at Transatlantic Holdings, Inc.

[8] Shown net of intercompany eliminations. Gross combined equity of these two companies is $438 million.

Stranded Oil Resources Corporation

Alleghany formed Stranded Oil Resources Corporation ("SORC") in 2011 to acquire legacy oil fields with the objective of improving the amount of oil that could be recovered by applying enhanced oil recovery techniques from underground. At the time of SORC's formation oil prices were near $100/barrel and they remained at this level until mid-2014. Following a change in Saudi Arabia's oil production strategy later that year, and the re-entry of Iran and Iraq to the world oil market, oil prices fell to a low of under $30/barrel in early 2016 before recovering to the low-$50s later in the year. Current conventional wisdom is that oil prices will remain in the $50-$60/barrel range for the foreseeable future due to the efficiency and short-cycle nature of shale production. If there is anything that the past five years have shown, it is that it is difficult, if not impossible, to predict future oil prices. Some observers believe the massive reduction in capital expenditures in the industry following the collapse in oil prices will inevitably lead to a shortfall in capacity in the next few years. Time will tell.

SORC has three major oil and gas projects. SORC has acquired oil and gas leases and has purchased mineral rights in Fredonia, Kansas totaling approximately 2,500 acres, and has built an underground oil recovery facility at this location. It expects to continue to produce oil from this underground facility where it makes sense to do so on a marginal cost basis. The second project is located in Caddo Parish, Louisiana, where SORC has acquired oil and gas leases on approximately 9,244 acres in a targeted oil reservoir. This oil field is currently operational and producing crude oil using conventional production methods and has the potential to be developed as an underground oil recovery project. The third project is located in Wyoming where the company acquired the Department of Energy's Naval Petroleum Reserve Number 3 ("NPR-3"), better known as the Teapot Dome Oil Field. Under the terms of this purchase, SORC acquired the ownership of all of NPR-3's mineral rights and approximately 9,000 acres of land. Subsequent adjacent purchases brought the total to 9,318 acres. This oil field is also operational and is currently producing crude oil using conventional production methods. SORC is currently assessing the oil reservoir's geological data and this too is a potential future underground oil recovery project.

After completing construction of the Fredonia, Kansas underground facility in 2014, SORC commenced its drilling program in 2015. The drilling program was delayed by some equipment problems that were subsequently resolved as well as a longer than expected trial-and-error processes determining the optimum well completion technique for the reservoir. After the delays encountered in 2015, drilling resumed in 2016. In late 2016 – as a result of having drilled a significant amount of linear footage in the field – SORC concluded that the reservoir quality was materially worse than originally estimated. These original estimates were based on core samples and external reservoir reports from an expert engineering firm. SORC now believes that the amount of recoverable oil in place is approximately 20% of what was originally estimated. SORC's first test project has demonstrated that the complex engineering required to drill into an oil field from underground can be successfully implemented, and that the recovery rate of the oil that is in the reservoir is considerably higher than many traditional techniques applied to shallow oil fields. But because of the field characteristics – namely the low vertical permeability of the field – the amount of recoverable oil is far less than originally estimated.

The impairment charge of $99 million ($64 million after-tax) that was taken in the fourth quarter of 2016 reduces the carrying value of our assets in Fredonia, Kansas to an amount that can be recovered by future oil production on a net present value basis at today's prices, and represents the vast majority of our assets in Fredonia.

Needless to say, the outcome at Fredonia was a significant disappointment as well as an expensive education. When we embarked upon the SORC venture we knew it had a risk profile that was higher than the other activities at Alleghany Capital. Although the outcome is not what we had hoped, SORC has gained valuable experience that we believe can now be applied to its other resource basins in order to leverage what we have learned. We expect to proceed on a staged basis, minimizing the amount of capital employed until we can better validate the geology, reservoir quality and oil recovery potential of the two other fields and the potential of underground oil recovery projects.

In 2016, SORC had negative Adjusted EBITDA (excluding the impairment charge) of $14.1 million, an improvement from the $19.7 million in the year-ago period. SORC had net oil and gas production of 235,986 BOE[9] in 2016, a 27% increase from the 185,539 BOE in the prior year; revenues were $9.3 million, an increase of 13% as realizations were lower in 2016 than in 2015. SORC's near-term strategy is to increase conventional production where it is justified on a marginal economic basis in order to further reduce and ultimately eliminate its cash burn. This will be accomplished by focusing on higher quality reservoirs in Teapot and scaling a proven drilling program in the Nacatoch formation in Caddo.

Jazwares

Alleghany acquired an initial 30% interest in Jazwares in July 2014, and in April 2016 we increased this ownership position to 80%. Jazwares had a challenging year in 2016 but made significant investments for future growth and is well positioned for improved results in the years ahead. When we acquired our initial interest in Jazwares its principal source of revenue was from its *Minecraft* license. Since then the company has had successful launches of *Peppa Pig* and *Animal Jam* licenses, and has developed an incubator site called *Jazwings* that helps commercialize independently-produced creative content. In 2016, Jazwares signed or renewed over 20 licenses for properties that will significantly expand its portfolio and create a pathway to faster growth. In addition, in 2016 Jazwares made two acquisitions (*First Act* and *Go Go Sports Girl*) and expects to bring its considerable design, brand management, production and distribution expertise to these companies. Judd and Laura Zebersky (the founders of the company) are enormously talented and we are confident that they will be long-term winners in their industry. We expect a significant increase in Adjusted EBITDA in 2017 as the initiatives put in place in 2016 begin to bear fruit.

Kentucky Trailer

R.C. Tway Company (aka "Kentucky Trailer") is the leading manufacturer of custom trailer and truck bodies for the moving and storage and mobile medical industries as well as other niche markets, based in Louisville, Kentucky. At the end of 2016, Alleghany owned approximately 79% of the common equity of Kentucky Trailer.

[9] BOE = barrels of oil equivalent.

Kentucky Trailer continued to execute on its strategy of acquiring related mobile and modular platforms in 2016 by acquiring select assets of Bussman Medical & Research. Based in the Netherlands, Bussman specializes in the design and construction of modular solutions for the healthcare industry with products that include standard and hybrid operating theaters, endoscopy units, dialysis units, maternity suites and other mobile health care solutions. This is the fourth acquisition by Kentucky Trailer under Alleghany's ownership.

The company's backlog remains strong in its core trailer manufacturing division, and with an improving economic environment the company should see continued demand for its essential truck bodies and trailers, including growing demand for mobile medical trailers driven by advancing imaging technology.

IPS-Integrated Project Services ("IPS")

We wish every acquisition played out like this! Under the leadership of Dave Goswami, IPS continues to expand domestically and internationally. In 2016 IPS produced a 13% increase in net service revenue and an even greater increase in Adjusted EBITDA. IPS was able to produce these strong results while investing in the future by opening new international offices in Europe and Asia and building an expanded regional presence in the United States. Headquartered in Blue Bell, Pennsylvania with almost 1,000 employees worldwide, IPS delivers technical consulting, design and engineering, construction management, and commissioning, qualification and validation services, primarily for highly complex research and production facilities operated by the global pharmaceutical and biotechnology industries. Sales in 2016 were strong, and the company enters 2017 with a significant backlog of work.

Bourn & Koch

Bourn & Koch is a Rockford, Illinois based manufacturer of precision machine tools with a complementary spare parts and service business. Alleghany purchased an 80% interest in Bourn & Koch in 2012 and increased its position to approximately 89% in December 2016. After strong years in 2012 and 2013, Bourn & Koch experienced a decline in revenue over the last several years as weakness in the industrial sector (particularly related to companies serving the global commodity complex) slowed capital equipment purchases. The company has remained profitable despite these difficult industry conditions and has paid us meaningful dividends since 2012.

Terry Derrico took over as CEO in 2016 and is already having a significant positive impact on the company. In late 2016 Bourn & Koch acquired Diamond Technology Innovations, Inc., which specializes in manufacturing orifices and nozzles used in waterjet cutting machines, one of the fastest growing segments in the machine tool market. This acquisition is the first step in a strategic plan to diversify Bourn & Koch's product portfolio and to increase the percentage of consumables in the company's sales mix. Bourn & Koch is also focusing on improved manufacturing efficiency and a more robust distribution capability.

Alleghany Capital – Summary

Collectively, these last four companies represent our manufacturing and service businesses. Given their relative size to Alleghany as a whole (7% of capital), we present these results on a combined basis. As can only happen with GAAP accounting, one would never know from our financial statements how well these businesses are doing. Our manufacturing and service businesses reported roughly $20.4 million of earnings before taxes in 2016 due to the fact that we had to absorb $22.1 million of amortization charges related to purchase accounting. Accordingly, we also disclose Adjusted EBITDA for these businesses in an effort to provide a cash flow proxy to the reader to more clearly understand the underlying economics of these businesses. For the full year 2016 these four businesses generated Adjusted EBITDA of $51.5 million, an increase of 71.7% from the $30.0 million generated in full year 2015.

Even using Adjusted EBITDA doesn't fully account for the true economics of the business in the near term. As an example, purchase accounting under GAAP requires all inventory held at the time of acquisition to be adjusted to fair market value. When this inventory is sold and recorded as a cost of sales, this higher value dilutes gross margins in the near-term. Adjusted EBITDA is therefore a conservative view of how these businesses are doing. The short answer is they are doing quite well and we are pleased with the results.

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The property and casualty industry: cracks in the foundation?

The commercial property and casualty industry remained highly competitive in 2016, with prices falling modestly in most classes of business. Since the 2008-2009 Recession the industry has enjoyed good underwriting results -- despite a lack of pricing power -- as claims emergence has generally been favorable relative to pricing and reserving expectations. The industry does a good job of adjusting its prices to trailing loss experience, but historically it has not been very good at calling inflection points in these trends.

In the second-half of 2016 cracks began to appear in the foundation of the industry's underwriting account and loss reserves. We believe that these cracks will become more visible and more significant in 2017 as stress levels in the industry continue to rise. Companies that have been excessively focused on top-line growth by definition are only able to produce growth by pricing below market, and to do so requires that underwriters assume a continuation of the benign claims environment of the past 5+ years. As the Nobel Prize winner Daniel Kahneman said:

"The illusion that we understand the past fosters
overconfidence in our ability to predict the future."[10]

[10] Thinking, Fast and Slow – Daniel Kahneman, 2011.

Alternative reinsurance markets: “Puttin’ on the Ritz!”[11]

Over the past decade the so-called “alternative reinsurance market” has taken an increasing share of the global reinsurance industry. In property catastrophe reinsurance in particular, non-traditional capital providers (pension funds, sovereign wealth funds, hedge funds, etc.) have invested in insurance risk pools through managed funds, catastrophe bonds, and other such vehicles. Faced with unattractive returns on traditional fixed income investments, these investors have turned to catastrophe risk as a diversifying return source.

While highly successful to date, these new risk transfer vehicles have not been tested by “the big one.” Will investors in these vehicles “re-up” after a significant, permanent capital loss due to a major loss event? Or have the models created a monster?

In the classic 1974 film Young Frankenstein, Dr. Frederick Frankenstein (played by Gene Wilder) brings the corpse of a dead criminal back to life by transplanting a new brain (labeled “Abnormal”) into the body. After the monster comes to life, he tries to calm the concerned citizens of the town by arranging a show in which the monster (played by Peter Boyle) and Dr. Frankenstein perform *Puttin’ On The Ritz* in top hats and tails. Needless to say, things don’t go according to plan. Are the alternative reinsurance markets today’s monster performing a bad version of a classic?

Some new business models that separate the underwriting decision from the capital provider/risk bearer are, in our view, problematic because of a misalignment of incentives. The industry has demonstrated time and time again that “giving someone the pen” without tight controls and/or an alignment of interests is a bad idea, whether it be program business or Lloyd’s prior to the creation of the Franchise Performance Director function in 2002. To the extent unaffiliated capital is used to assume (re)insurance risks, it is best done side-by-side with true risk takers who have skin in the game.

Additionally, when a major loss occurs, claims have to be settled. Ceding companies using non-traditional capacity may hear something like those famous words of another classic Gene Wilder character, Willy Wonka:

> *Wrong sir, wrong! Under section 37B of the contract signed by him it states quite clearly that all offers shall become null and void if, and you can read it for yourself in this photo static copy, I, the undersigned, shall forfeit all rights privileges and licenses, here and herein contained et cetera et cetera ...fax mentis incendium gloria culpum et cetera et cetera... memo bis punitor delicatum! It’s all there black and white, clear as crystal! …* ***so you get nothing! You lose! Good day sir!***[12]

While we are no doubt “talking our own book,” there are a number of advantages to the traditional reinsurance model or partnering with true risk takers. First, executives of a reinsurance company that receive their compensation from the underwriting results they produce on a *long-term* basis are more likely to consider what can go wrong and are also more likely to be cognizant of extreme risks than

[11] In memory of the late comic genius Gene Wilder, who passed away in August of 2016.
[12] From *Willy Wonka & The Chocolate Factory.*

underwriters that are being compensated based on volumes or assets under management with a “carry” measured on an annual basis. Second, when large complex losses do occur, a reinsurance partner is able to “trade through” with the ceding company as complex claims are settled, sometimes over multiple years. Again in the words of Willy Wonka, “Oh, you should never, never doubt what nobody is sure about.”[12]

Technology has allowed the industry to separate the risk-bearing capital provider from the underwriter who decides how much risk to take. The traditional reinsurance model keeps them together. Call us quaint and old-fashioned, but we like the alignment inherent in the traditional insurance and reinsurance company structure. To the extent investors allocate assets to insurance risk, we believe they should make sure they are partnered with a true risk taker that is, as they say at TransRe, *battle-tested*. While the alternative model is changing the playing field near-term, as long-term investors we believe TransRe’s commitment, discipline and proven approach will win out in the end.

TransRe

TransRe had another year of solid underwriting results in 2016 despite higher levels of natural catastrophe losses. Underwriting profits were $260.6 million, a decrease of 20.3% from the $327.0 million of underwriting profits reported in 2015, and the combined ratio was 93.3% compared to 89.5% in 2015. Gross premiums written were $4.3 billion, an increase of 18.2% over the $3.7 billion reported in the previous year. Net catastrophe losses and related loss adjustment expenses were $138.6 million, $107.0 million higher than in the previous year. Some of this increase was offset by favorable prior year reserve development, which was $293.5 million in 2016 compared to $208.3 million in 2015. We continue to believe that TransRe remains strongly reserved.

The vast majority of the top-line growth in 2016 was related to a large whole account quota share transaction that TransRe wrote in late 2015. Faced with an increasingly competitive market for reinsurance, TransRe’s strategy has been to both reduce and diversify the risk intensity of its reinsurance portfolio by writing whole account transactions and non-traditional risks such as mortgage reinsurance. TransRe continues to be highly selective in the reinsurance treaties that it writes. Submission count has remained strong, but TransRe will only bind business that has a high probability of producing an underwriting profit.

Mike Sapnar and his team continued to innovate in 2016 and strengthened TransRe’s position as one of the world’s premier global professional reinsurers. The highlight of the year was the five-year exclusive broker market underwriting relationship formed with General Reinsurance Corporation (“GenRe”) in which TransRe manages GenRe’s broker market treaty business in the U.S. and Canada. This agreement allows TransRe to provide brokers and their clients broader capacity and line size while providing the consistent underwriting and claims service that the market has come to expect from TransRe. With an August 1, 2016 start date, the relationship is off to a fast start, with TransRe binding over $150 million of projected premiums for GenRe.

[12] From *Willy Wonka & The Chocolate Factory.*

Also in 2016 A.M. Best Company upgraded the financial strength rating ("FSR") of TransRe to A+ (Superior) from A (Excellent). This rating action recognized TransRe's strong risk-adjusted capitalization, robust enterprise risk management and consistent operating performance. TransRe has a highly diversified risk portfolio, both by class of risk and geographic location. It has decades of experience in each market giving it an unparalleled perspective for its clients.

TransRe continues to participate in and utilize the emerging non-traditional reinsurance market through TransRe Capital Partners, which was formed in 2013 to bring together all of the company's relationships with third party capital providers under the management of one team. TransRe Capital Partners now manages approximately $500 million in sidecar support, and places a significant amount of business through retrocessions with third party capital providers.

Alleghany acquired TransRe in March of 2012 for total consideration valued at approximately $3.5 billion. Since then, TransRe has paid Alleghany net dividends of $765 million, lowering our net investment to approximately $2.7 billion. TransRe's stockholder's equity at the end of 2016 was approximately $5.2 billion.

RSUI Group

RSUI had a solid year in 2016, but market conditions precluded profitable growth. Underwriting profits totaled $138.4 million (a combined ratio of 81.6%), down 12.5% from the $158.1 million reported in 2015 (a combined ratio of 80.4%). Catastrophe losses increased to $80.7 million in 2016 from $26.1 million in 2015, with most of the catastrophe losses occurring in the fourth quarter (primarily Hurricane Matthew and the Gatlinburg, Tennessee fires). Higher catastrophe losses were partially offset by higher reserve releases related to prior accident years. Net favorable loss reserve development was $68.3 million in 2016 compared to $11.9 million in 2015.

RSUI's underwriting strategy is to underwrite for profit by providing capacity to the market when it is appropriately valued by insureds and properly priced. When the market gets more competitive, RSUI expects to write less business. Over the long-term, this has proven to be a winning strategy. In 2016 RSUI's gross premiums written declined to $1,056.4 million from $1,148.4 million, a decrease of approximately 8%. Net premiums written declined approximately 6%, and net premiums earned declined 7%. Market conditions continue to be extremely competitive as of this writing, and we do not currently expect RSUI's top-line outlook to change in the year ahead.

RSUI's gross premiums written in 2016 consisted primarily of property (34%), umbrella and general liability (20%), directors' and officers' liability (15%), binding authority (14%) and professional liability (13%), with the balance made up of other specialty lines. This diversified portfolio of risk classes allows RSUI to be an important partner to its wholesalers by providing insurance solutions for the vast majority of the risks that they place.

Alleghany acquired RSUI in July of 2003 for an initial investment of $628 million. Since then, our investment has been reduced to approximately $(246) million through net upstream dividends of $874 million. RSUI has generated cumulative underwriting profits under our ownership of $1,687 million and had $1.6 billion of stockholder's equity at year-end 2016.

CapSpecialty

CapSpecialty returned to underwriting profitability in 2016, and continued to make progress toward its goal of being the preferred specialty insurance and surety company for small and mid-sized businesses in the U.S. Gross premiums written finished the year at $266.5 million, an increase of 12.6% over the $236.6 million written in 2015. CapSpecialty has been growing by expanding its professional liability business, as shown below ($ millions):

	2015	2016	% change
Property and casualty	$ 115.0	$ 115.7	0.6%
Surety	46.7	47.8	2.4%
Subtotal	$ 161.7	$ 163.5	1.1%
Professional liability	74.3	103.0	38.6%
Total company - ongoing	$ 236.0	$ 266.5	12.9%
Discontinued	0.6	-	nm
Total company	$ 236.6	$ 266.5	12.6%

CapSpecialty's professional liability business has been built by recruiting new underwriting talent to the company and refining the company's distribution strategy. Major new lines include errors and omissions coverage, healthcare, environmental and other specialty casualty lines.

Although the traditional surety and property and casualty lines did not grow much in 2016, each made significant progress in improving its prospects. Surety has produced solid growth in standard commercial surety, while significant investments in systems and distribution refinements were made in the property and casualty business while increasingly organizing around Industry Practice Groups ("IPG"). CapSpecialty's goal is to improve the underwriting experience for its agents by focusing underwriting on the unique aspects of each IPG while supporting business process redesign with investments in new technology.

Alleghany acquired Capitol Transamerica Corporation in January of 2002. Including our investment in Platte River Insurance Company, which is combined with Capitol Transamerica for management purposes, our initial investment was $242 million. Since then, CapSpecialty, as it is now called, has returned approximately $130 million in dividends to Alleghany, reducing our net investment to $112 million. At the end of 2016, CapSpecialty had stockholders' equity of approximately $320 million.

PacificComp

PacificComp returned to profitability in 2016 and made significant progress in strengthening its growing reputation for excellent underwriting and service. Under the leadership of Jan Frank PacificComp has made a solid turnaround, as shown below ($ millions):

	2012	2013	2014	2015	2016
Net premiums written	$ 19.0	$ 40.8	$ 69.5	$ 101.9	$ 138.3
Underwriting loss	(31.2)	(33.2)	(19.7)	(13.5)	(2.6)
Operating income (loss)[13]	(27.3)	(30.4)	(15.7)	(8.2)	3.6
Combined ratio	286.5%	185.3%	129.3%	113.5%	101.9%

In 2016, net premiums written increased 36% to $138.3 million, while underwriting losses declined to $2.6 million from $13.5 million in 2015. Investment income grew 10%, and the combined ratio was 101.9%. PacificComp continues to grow into its expense base, with an expense ratio of 27.9% in 2016, compared to 36.9% in 2015.

PacificComp has transitioned its business by cultivating relationships with over 70 brokerages with almost 500 locations state-wide. The company has made significant investments in improving its technology, including launching a straight-through processing "small comp" initiative. At the same time, new management has carefully managed the run-off of 2012 and prior claims. As of the end of 2016, PacificComp had materially reduced the number of outstanding 2012 and prior claims, while maintaining conservative case and IBNR reserves relating to these older years.

With less than a 1% market share of workers' compensation in California, PacificComp has ample room to grow.

Alleghany acquired PacificComp in July of 2007. Since then, we made several additional capital contributions, for a total investment of $327 million. At the end of 2016, PacificComp had stockholders' equity of approximately $119 million.

* * * *

The End of Globalization?

From a global perspective, 2016 will likely go down as the year in which eight years of unprecedented central bank balance sheet expansion ended, and the U.S. began to look toward economic nationalism as an alternative to the globalization model that has dominated the past 25 years. As one of our advisors has succinctly noted, "…we finally have a chance at ending our reliance on asset inflation as a substitute for income."[14] Whether this transition can be accomplished without significant disruption to the global economy is a major uncertainty, and financial assets are not priced with much margin for error.

[13] Before tax, and excluding net realized capital gains and other than temporary impairment losses.

[14] Stephanie Pomboy of MacroMavens, "Mr. Trump Goes to Washington," January 5, 2017.

Globalization has been an enormous success, improving the living standards of billions of people throughout the world. However, over the past three decades it has coincided with declining manufacturing employment in the U.S., even though manufacturing output has increased significantly. Early in this process this was largely due to labor cost arbitrage, with multinational companies moving production to countries in which labor costs were significantly lower. More recently, however, this has also been due to technology and accelerating automation, which has eliminated many repetitive manufacturing tasks and is now reordering work flows such that many traditional jobs are at risk of being eliminated. While this improves productivity and makes society as a whole better off, it is disruptive to individuals and has the added downside of contributing to stagnant median incomes.

Equity markets have been acting as if the regime change in the United States will return the U.S. economy to 3-4% growth and bring back "the good old days." As one commentator[15] recently noted, the environment today is very different than it was in 1981 when the "Reagan Revolution" began. Back then the 10-year treasury yield was 15% (2.5% today), U.S. debt-to-GDP was 90% (360% today), the CPI was running at 8% (1.7% today) and the S&P 500 traded at a price-earnings ratio of 7x (20x today). In addition to the above, the demographic outlook is completely different.

Another important difference is the fact that the U.S. is now heavily integrated into the world economy and since 1971 has effectively functioned as the world's central bank. In order for the United States to run a trade surplus (or even a smaller trade deficit), the supply of dollars in foreign central banks will be greatly reduced, and in fact are already starting to fall. We have in the past discussed *Triffin's Dilemma*[16], which says that a country such as the United States whose currency functions as the world's reserve currency must run persistent trade deficits in order to supply its trading partners with dollar reserves and keep the international monetary system functioning. It is not clear as of this writing how the world's monetary system will respond, if at all, to the U.S. government's "America First" trade policy and a potential change to the availability of dollars for international trade.

Given the amount of U.S. dollar debt borrowed by foreign borrowers (approximately $10 trillion according to the BIS), the initiation of a trade war could result in a severe global economic contraction. Financial markets do not appear to be priced for such an outcome.

Cyclical Inflation vs. Secular Deflation

Since the 2008 Financial Crisis, developed economies have been struggling to avoid a deflationary bust, as excessive levels of debt, high levels of unemployment and under-employment, and stagnant incomes for the majority of Americans contributed to sluggish economic growth. Following the 2016 elections, financial markets seem to be discounting a more inflationary, higher growth outlook, in anticipation of less regulation and most importantly a tax regime that, if enacted, will encourage domestic production at the expense of imports.

[15] Larry Jeddeloh, The Institutional Strategist, "Trump/Reagan – Not the Same Environment," January 17, 2017.
[16] Named after the economist Robert Triffin.

The 10-year inflation breakeven rate[17] has risen to close to 2% from slightly above 1% earlier in 2016. With inflation expectations at almost 2%, and the 10-year treasury yielding 2.5% at the end of the year, it would seem that either economic growth will be weaker than currently expected or interest rates will rise further in 2017 and beyond. Despite all of the optimism, however, fourth quarter GDP growth was only 1.9%, and when all was said and done the U.S. economy grew only 1.6% in 2016, down from 2.6% in 2015. Nominal ("current dollar") GDP grew 2.9% in 2016, down from 3.7% in 2015. The 30-year treasury is currently trading roughly in line with trailing nominal GDP growth, suggesting that interest rates are about where they should be given current economic conditions.

Looking forward, we believe that U.S. economic growth is unlikely to exceed 2% per year on a sustained basis for several reasons. First, demographics dictate that future labor force growth will be very modest (less than 1% per year) unless there is a sea-change in the labor force participation rate. With the unemployment rate already at 4.8%, it is unlikely that a higher proportion of the labor force will be productively employed, especially given what appears to be a widespread skills gap and significant under-employment. Second, while productivity could improve with deregulation and a more vibrant private sector, it is unlikely to return to the 2-3% annual rate of the early post-war period. As perhaps best articulated by Dr. Lacy Hunt of Hoisington Investment Management, highly leveraged economies suffer from a declining velocity of money for a prolonged period of time, keeping interest rates and economic growth below potential.

The secular forces contributing to deflation are many, but the most important in our view are 1) a continuing and significant debt overhang; 2) an aging population in the industrialized world (Japan, Europe and U.S.); 3) persistent and accelerating technological change; and 4) continued income and asset concentration. Moreover, the persistently strong U.S. dollar is not consistent with secular inflation. Offsetting these forces are several factors that, at least for the short-run, appear to be inflationary, including 1) rising commodity prices; 2) increased deficit spending; 3) immigration reform; 4) a relatively tight labor market; and 5) the prospect of a border-adjusted tax regime.

Our best guess is that while there may be upward pressure on interest rates and inflation on a near-term cyclical basis, the long-term outlook has not materially changed, with real economic growth likely to be in the 2% range with modest inflation.

* * * * *

Investments

At the end of 2016 our $18 billion investment portfolio was invested primarily in high quality bonds, public equities, and other invested assets. Record low real interest rates have made fixed income management especially challenging. We have resisted the temptation to add to our investment yield by lowering credit quality in any significant way. At the end of 2016 our consolidated fixed income portfolio had an average quality of AA- and a duration of approximately 4.5 years. Below investment grade bonds were approximately 5% of the total.

[17] The excess of the 10-year treasury yield over the TIPS yield of a comparable maturity.

Despite all of the interest rate volatility in 2016, we ended the year roughly where we began – with a taxable equivalent yield (at market) on our fixed income portfolio of 2.7%. Major fixed income initiatives in 2016 included the addition of a modest allocation to high quality commercial mortgages and the addition of a hedge to some of our net foreign exchange exposure.

One of the questions we ask ourselves is whether our interest rate positioning is appropriate should interest rates rise further. In the fourth quarter of 2016 our unrealized gains on fixed income securities declined significantly with rising interest rates. Should interest rates increase more in the future we will see additional unrealized losses. Nevertheless, we believe that maintaining a 4-5 year duration bond portfolio is appropriate for Alleghany for several reasons. First and most importantly, a large portion of our liabilities manifest as loss reserves which represent estimates of a stream of future cash outflows. From an economic perspective, the effect of rising interest rates on the market value of our fixed income investments is partially offset by a decrease in the economic value of our liabilities, assuming an increase in real interest rates. Second, the yield curve is positively sloped the vast majority of the time. A consistent allocation to fixed income "out the curve" will produce a higher return than a consistent allocation to the short-end of the curve. Few bond managers have been able to consistently add value by calling the direction of interest rates. Finally, as long as we do not sustain credit losses, today's unrealized losses on fixed income are tomorrow's higher growth rates in market values. Fixed income mathematics demonstrate that when the interest rate curve shifts upwards, the change in unrealized value today is recovered over the time period measured by duration.

After the strong performance of the equity markets over the past six years, it continues to be difficult to find stocks that are compellingly priced. At the end of 2016 the EV/EBITDA multiple of the S&P 500 was approximately 11x, up significantly from 8x in 2008. Similarly, the price-to-sales ratio of the S&P 500 was 2.3x, up from 1.4x in 2008. Prior to the 2008 Financial Crisis, however, multiples were higher. The EV/EBITDA multiple averaged almost 12x from 2000-2007, and the price-to-sales multiple of the S&P 500 averaged 2.5x. We *do* know that the market valuation in the 2000-2007 period led to very modest subsequent returns. Judged by relatively recent history (since 2000) the stock market appears valued much like it was before the 2008 financial crisis. From a longer-term point of view, of course, it remains very expensive.

Alleghany's equity portfolio returned 4% in 2016, compared to the S&P 500 return of 12%. Over the long-term, our portfolio has significantly outperformed the S&P 500, but as they say, "what have you done for me lately!" Several of our large positions, after performing very well in 2015, consolidated their gains and did not contribute to performance in 2016. In addition, "unforced errors" cost us about 4% of return, but even without these mistakes it would have been hard to keep up with a market increasingly dominated by expanding multiples rather than fundamental performance given our investment orientation. We are of course not satisfied with this performance, but we take a long-term view on our equity portfolio and recognize that we will likely underperform in a market led primarily by multiple expansion. Also, our investment strategy recognizes that: 1) our (re)insurance subsidiaries are subject to single risk limitations, requiring us to limit the size of our best ideas; 2) we are a taxable investor, so when we sell an investment at a gain we have less than a dollar after taxes to reinvest in the next idea; and 3) because most of our investments are in our (re)insurance subsidiaries, we try to emphasize reducing downside risk over chasing upside potential.

Our largest individual positions at year-end are shown below:

Company	Value ($ in millions)
Alphabet Inc.	$ 251.2
Microsoft Corp.	186.4
VISA Inc.	184.1
CSX Corp.	179.7
The Walt Disney Company	178.0
Roper Technologies Inc.	164.8
Blackrock Inc.	152.2
JP Morgan Chase & Co.	150.5
Wells Fargo & Co.	111.9
Total	$ 1,558.8

We view each of these companies as well-positioned businesses both competitively and relative to the macro environment that we anticipate over the next 5+ years, but we also recognize that expected returns on these positions, like the market as a whole, are modest. Our goal is to continue to find businesses that have formidable competitive positions, reasonable growth prospects, outstanding corporate governance, and all at a fair price.

Few active managers produced results that were better than the broad stock market in 2016, and even fewer have done so consistently over longer time periods. A recent study on this topic[18] noted that asset flows into passive funds exceeded outflows from actively managed funds in 2016, and very few active managers have been able to outperform the broad market index consistently over time. As a result, investors have withdrawn close to $1.2 trillion from actively managed funds over the past ten years and have allocated $1.4 trillion into passive strategies. Moreover, structural changes to the industry may be making the pursuit of alpha even more difficult going forward. Individual investors ("non-professional investors") are shunning the ownership of individual stocks and instead investing in index funds, and information is now disseminated rapidly and equally (due to technology and regulatory changes such as Regulation FD), making it difficult for the active manager to gain an "edge." Finally, low trading costs coupled with quantitative strategies allow leveraged investment funds to rapidly exploit market inefficiencies to generate return irrespective of long-term investment value.

Over the most recent market cycle (since the Financial Crisis), central banks have massively intervened in financial markets, increasing correlations among equities within the stock market which may make it more difficult to differentiate performance. The rapid growth of ETFs also causes stocks in a group to move together – until fundamental news causes a particular company within an ETF basket to be quickly revalued (up or down).

It is difficult to say whether passive investing will continue to produce results that are superior to active management (even before fees). It may be that some combination of active and passive strategies will

[18] Looking for Easy Games: How Passive Investing Shapes Active Management, Michael J. Mauboussin, January 4, 2017.

produce the best results for Alleghany. We expect to continue to invest a significant portion of our equity portfolio in concentrated positions where we believe there is a good chance for us to generate attractive long-term returns, but we will periodically evaluate whether an explicit allocation to pure market risk and return would be an appropriate component of our equity investment strategy.

* * * * *

Possible tax changes on the horizon

Over the past five years our principal operating subsidiary – TransRe – has been one of the few domestic reinsurers in an industry predominantly domiciled offshore, despite in some cases having significant domestic operations. As a consequence of our domestic domicile TransRe has carried the burden of a higher effective tax rate than many of its competitors. Some competitors with both insurance and reinsurance operations have used intercompany reinsurance to shift underwriting profits and other sources of income offshore to locations that have a lower effective tax rate (or no income tax). Legislation was introduced in the 114th Congress that seeks to prevent the avoidance of federal income taxes by insurers through the use of reinsurance ceded to an offshore affiliate.

We are hopeful that the "America First" principles of tax reform will finally level the playing field in the insurance and reinsurance industry. Who knows, it might even put the America back in the "Reinsurance Association of America"![19]

Should U.S. tax laws change such that there is a reduction in the corporate tax rate, we would expect our structural profitability to improve, although our book value would likely be reduced initially by the change in the statutory tax rate multiplied by the amount of net deferred tax assets on the balance sheet.

* * * * *

Outlook

Since the 2008 Financial Crisis, Alleghany's book value per share has almost doubled, for an annual compound return of 8.5% per year, consistent with our 7-10% long-term annual growth objective. Should interest rates continue to rise as they did in late 2016, our near-term book value growth will be restrained but our future growth potential will improve. Perhaps this is why our stock price performance was considerably better in 2016 than in past years, as the market tends to be forward-looking. With over $18 billion of cash and invested assets, our ability to grow book value per share depends in part on our ability to generate returns on our invested assets, and higher interest rates are better than lower interest rates in this regard.

Property casualty market conditions have been challenging over the past several years. We have encouraged our underwriters to avoid the temptation to grow the top-line at inadequate rates by assuming more and more risk. TransRe has been shifting its focus away from the most competitive

[19] Only five of the thirty-one property-casualty members of the RAA are American companies or companies that are owned by American companies.

classes of business and de-risking its reinsurance portfolio, while RSUI has remained disciplined as well, as evidenced by a shrinking top-line. Our two smaller companies – CapSpecialty and PacificComp – have been able to grow because they are very small participants in large markets and have been able to exploit niches where underwriting profits are still expected. In 2016 some companies in the industry began to recognize deterioration in underwriting margins through unexpected increases to reserves; we believe that we will see more such "surprises" in 2017. Historically this has been a precursor to reduced underwriting capacity and better insurance pricing.

We expect to continue to make acquisitions at Alleghany Capital and believe that our four core businesses are well-positioned for a growing contribution to Alleghany's results. While SORC took a step back in 2016, it continues to have two interesting resource plays and it will carefully evaluate their potential for development, leveraging the considerable amount of knowledge and experience gained to date.

The world economy continues to struggle to overcome low growth and deflationary pressures. Change is in the air, however, and the rise of economic nationalism could begin to add to inflationary pressures, at least on a cyclical basis. We have considerable optionality to prosper in either environment.

Yours sincerely,

Weston M. Hicks
President

Comment on Non-GAAP Financial Measures

Our analysis of our financial condition and results of operations is based on our consolidated financial statements which have been prepared in accordance with accounting principles generally accepted in the U.S., or "GAAP." Our results of operations have been presented in the way that we believe will be the most meaningful and useful to investors, analysts, rating agencies and others who use financial information in evaluating our performance.

This presentation includes the use of adjusted earnings before interest, taxes, depreciation and amortization, or "Adjusted EBITDA," operating income and related measures, and underwriting profit, which are "non-GAAP financial measures" as defined under regulations promulgated by the Securities and Exchange Commission. The presentation of these financial measures is not intended to be considered in isolation or as a substitute for, or superior to, financial information prepared and presented in accordance with GAAP. Also note that these measures may be different from non-GAAP financial measures used by other companies, limiting their usefulness for comparison purposes. A discussion of our calculation and use of these financial measures is provided below.

Adjusted EBITDA. Adjusted EBITDA is a non-GAAP financial measure for our non-insurance operating subsidiaries and investments held by Alleghany Capital. Adjusted EBITDA represents other revenue less certain other expenses, and does not include: (i) depreciation expense (a component of other operating expenses); (ii) amortization of intangible assets; (iii) interest expense; (iv) net realized capital gains; (v) other than temporary impairment losses; and (vi) income taxes. Because Adjusted EBITDA excludes interest, income taxes, net realized capital gains, other than temporary impairment losses, depreciation and amortization, it provides an indication of economic performance that is not affected by levels of debt, interest rates, effective tax rates or levels of depreciation and amortization resulting from purchase accounting. We use Adjusted EBITDA as a supplement to earnings before income taxes, the most comparable GAAP financial measure, to evaluate the performance of certain of our non-insurance operating subsidiaries and investments. A reconciliation of Adjusted EBITDA to earnings before income taxes is presented below for 2016 and 2015.

	Year Ended December 31, 2016				Year Ended December 31, 2015			
	Mfg. & Svcs.	Oil & Gas	Corp. & other	Alleghany Capital Total	Mfg. & Svcs.	Oil & Gas	Corp. & other	Alleghany Capital Total
	($ in millions)				($ in millions)			
Earnings (losses) before income taxes	$ 20.4	$ (126.9)	$ 0.8	$ (105.7)	$ 21.8	$ (60.6)	$ (4.3)	$ (43.1)
Adjusted EBITDA	51.5	(14.1)	(12.3)	25.1	30.0	(25.3) [1]	(4.3)	0.4
Less: depreciation expense	(6.8)	(14.0)	-	(20.8)	(3.8)	(8.6)	-	(12.4)
Less: amortization of intangible assets	(22.1)	-	-	(22.1)	(3.1)	-	-	(3.1)
Less: interest expense	(1.8)	-	(0.1)	(1.9)	(1.3)	(0.2)	-	(1.5)
Add: net realized capital gains	(0.4)	(98.8)	13.2	(86.0)	0.2	(25.8)	-	(25.6)
Adjustments to equity in earnings of Jazwares and ORX	-	-	-	-	(0.2)	(0.7)	-	(0.9)
Earnings (losses) before income taxes	$ 20.4	$ (126.9)	$ 0.8	$ (105.7)	$ 21.8	$ (60.6)	$ (4.3)	$ (43.1)

[1] Comprised of: ($19.7) million for SORC and ($5.6) million for our prior investment in ORX Exploration Inc.

Operating income and related measures. This presentation includes the use of operating income and related measures, which we believe are useful to help explain changes in stockholders' equity attributable to Alleghany. A reconciliation of operating income and related measures to net earnings attributable to Alleghany stockholders is presented below.

For the Year Ended December 31, 2016	($ in millions)
Net earnings attributable to Alleghany	$ 456.9
Less: net realized capital gains, after-tax	(41.1)
Less: other than temporary impairment losses, after-tax	29.4
Operating income	$ 445.2
Add back SORC impairment loss, after-tax, deducted above	(64.2)
Adjusted Net Earnings	381.0
Back-out: SORC impairment loss, after-tax, included above	64.2
Back-out: amortization of intangible assets, after-tax	12.4
Back-out: corporate administration expense, after-tax	28.0
Adjusted Operating Earnings	$ 485.6

Underwriting profit. This presentation includes the use of underwriting profit, which is a non-GAAP financial measure for our reinsurance and insurance segments. Underwriting profit represents net premiums earned less net loss and LAE and commissions, brokerage and other underwriting expenses, all as determined in accordance with GAAP, and does not include: (i) net investment income; (ii) net realized capital gains; (iii) other than temporary impairment losses; (iv) other revenue; (v) other operating expenses; (vi) corporate administration; (vii) amortization of intangible assets; and (viii) interest expense. We consistently use underwriting profit as a supplement to earnings before income taxes, the most comparable GAAP financial measure, to evaluate the performance of our segments and believe that underwriting profit provides useful additional information to investors because it highlights net earnings attributable to a segment's underwriting performance. Earnings before income taxes may show a profit despite an underlying underwriting loss, and when underwriting losses persist over extended periods, a reinsurance or an insurance company's ability to continue as an ongoing concern may be at risk. A reconciliation of underwriting profit to earnings before income taxes is presented within Note 13 to Notes to Consolidated Financial Statements set forth in Part II, Item 8, "Financial Statements and Supplementary Data" of our Report on Form 10-K for the year ended December 31, 2016.