

To Our Stockholders

Alleghany's common stockholders' equity per share at year-end 2008 was \$283.73, a decrease of 5.0% from common stockholders' equity per share of \$298.58 at year-end 2007, adjusted for stock dividends. For 2008, Alleghany reported net earnings to common stockholders of \$130.8 million, or \$15.73 per share. Our insurance subsidiaries for the most part produced satisfactory underwriting results, but equity investment performance was poor. In addition, we determined that the goodwill attributable to our 2007 purchase of Employers Direct Corporation was impaired, resulting in a charge of \$48.7 million, or \$5.86 per share. Finally, we recognized other than temporary impairments, primarily related to some of our equity securities holdings, of \$158.5 million after-tax, or \$19.07 per share. Because equity securities are carried at market value, these charges have no effect on book value per share.

For the five years ended December 31, 2008, Alleghany's common stockholders' equity per share increased at a compound annual rate of 8.0%, compared with a compound annual rate of return of (2.2)% for the S&P 500 over the same time period. Consolidated cash and invested assets have increased over this five-year period from \$1.9 billion at year-end 2003 to \$4.3 billion, a compound annual growth rate of 17.9%.

The table below summarizes the change in common stockholders' equity in 2008:

(in millions)	
Net earnings before items below	\$ 100.4
Net realized capital losses	(28.3)
Goodwill impairment charge	(48.7)
Earnings related to Darwin Professional Underwriters	<u>107.4</u>
Net earnings available to common stockholders	\$ 130.8
Other changes to common stockholders' equity	<u>(268.2)</u>
Change in common stockholders' equity	<u><u>\$(137.6)</u></u>

As can be seen from the table above, the principal cause of the decline in book value per share in 2008 was the decline in value of our investment portfolio, most of which did not flow through the income statement (the market value decreases were the principal cause of "other changes to common stockholders' equity"). Negative equity returns were partially offset by the earnings (excluding net realized capital losses) of our insurance subsidiaries and the earnings (including our portion of a gain on sale) of Darwin Professional Underwriters.

Thoughts on the big picture

The imbalances that are evident today in the global economy trace their origins to August of 1994, when China embarked upon a course of a managed, nominal currency peg of the renminbi (RMB) against the U.S. dollar. Few remember today that as recently as 1981, the RMB/USD exchange rate was as strong as 1.53 yuan per dollar; by 1994 it had weakened to as low as 8.76 yuan per dollar, and was pegged at 8.28 until 2005. Over the following decade and a half, this currency policy contributed to stagnant U.S. household incomes (real median U.S. household income is lower today than it was in 1998), as U.S. labor could not compete with a massive, artificially priced Chinese labor pool due to the currency devaluation. The mechanism with which China (and other countries with pegged currencies) kept its currency artificially depressed was to recycle dollars into U.S. treasury securities and agency securities, thereby keeping U.S. interest rates artificially low, exporting deflation, and importing inflation. The prime beneficiary of this policy in the United States and other OECD (Organization for Economic Cooperation and Development) countries was the financial services industry, which took advantage of excessively easy money and low interest rates to fund credit

expansion to middle class households, who sought to improve their standard of living despite stagnant incomes by borrowing to fund consumption.

With perfect hindsight, it is now clear that 2007 probably marked the end of a 25-year credit binge in the United States. By the third quarter of 2008, total debt in the United States—government, corporate, financial, and household—exceeded 350% of GDP, a higher level than was the case in 1929. Over the past ten years, each incremental dollar of debt in the U.S. economy produced less and less growth in nominal GDP, with the marginal productivity of debt headed toward zero by 2013. The global economy, increasingly unbalanced and held together by a highly unstable and complex financial system, began to teeter in 2007 and collapsed in 2008. Inflationary pressures, which were significant in the first half of last year, turned to a deflationary collapse in the second half of the year.

The epicenter of the credit collapse was the investment banking industry and other capital providers, including private equity firms, hedge funds, and a variety of securitization vehicles. This system—referred to by some as “the shadow banking system”¹—became the dominant provider of credit to households to fund consumption through the creation of structured securities that linked global savers to, primarily, U.S. consumers. Household debt began to expand at a very rapid rate, doubling from \$7 trillion in 2000 to \$14 trillion by the third quarter of 2008. A casual review of the Federal Reserve’s Flow of Funds report makes clear that at least \$3.6 trillion of this debt may never be repaid as growth in personal income was far slower than growth in household debt. The majority of these assets appear to be held by the largest financial institutions in the world, placing their solvency at risk.

Like a finely-engineered Swiss watch, the global economy depends on the proper functioning of all of its pieces for the mechanism to work. As the weakest borrowers in the system began to collapse, the global economy came under increasing stress in 2008 and, following the collapse of several major financial institutions, the system virtually shut down in late 2008.

Most economists view the world through a profit-maximization model. The assumption is that given stimulus—either tax cuts or cheaper money—consumers will consume, and businesses will invest. However, another model—the survival model—suggests that liquidity and debt reduction become the overriding factors in economic motivation following a long period of easy credit, inflated asset values, and ultimately an asset collapse.² Moreover, it seems to us that we are likely in for a long economic winter, as households attempt to reduce leverage and businesses fight for survival in deteriorating economic conditions. In such an environment, an abundance of caution is in order.

Governments and policy makers continue to attempt to address the problem of inadequate aggregate demand in the OECD economies by trying to increase demand for credit. Unfortunately, a reasonable case can be made that there is no demand for credit because borrowers are either insolvent or financially impaired. The dramatic expansion of the money supply in response to collapsing velocity has not yet produced inflationary pressure, but this eventuality cannot be dismissed. A reasonable scenario, in our opinion, would be for a prolonged (3-5 years) period of negligible economic growth, continued credit problems, and rising inflationary pressure.

Equity investment strategy

Our primary goal as stewards of stockholder capital is capital preservation, especially as the forces of deflation appear to gain strength. It is also possible that this economic maelstrom could resolve itself in renewed inflationary pressure. Given the fact that we do not know whether the current financial

¹ The term “Shadow Banking System” is generally attributed to Paul McCulley of PIMCO (Pacific Investment Management Company, LLC).

² This view has been brilliantly articulated by Richard C. Koo, Chief Economist of Nomura Research Institute, in his book *The Holy Grail of Macroeconomics: Lessons from Japan’s Great Recession*.

crisis will be resolved with continued debt deflation or emerging inflationary pressure, it is prudent to have some of our investment portfolio exposed to real assets.

At the end of 2008, approximately 46% of our equity portfolio was represented by investments in the energy industry, with 36% represented by our holdings of Burlington Northern Santa Fe. Although a collapse in economic activity has reduced near-term demand for oil and natural gas, mature oil fields have rapid decline rates, and with reduced exploration and development, the supply of natural gas in the United States, and the non-OPEC supply of oil globally, may soon decline. Given the structural constraints to non-OPEC oil supply, it seems likely that oil prices will increase over the intermediate term. As discussed below, our equity investment process reflects a 3-5 year investment horizon, and for the most part, we continue to believe that our investments in energy stocks will produce satisfactory long-term returns. Notwithstanding this optimism, the accounting profession requires a much shorter-term horizon in determining whether or not the decrease in value of equity investments in 2008 is “other than temporary.” This accounting policy, like many accounting policies today, may be contributing to self-reinforcing disequilibria in financial markets.

In 2008, our equity portfolio had a negative total return of 31.4%, compared to the negative total return of 37.0% for the S&P 500. For the five years ended December 31, 2008, our equity portfolio has produced an average annual return of 10.6%, compared with a negative annual average return of 2.2% for the S&P 500. We invest in equity securities with a 3-5 year investment horizon, in part to counterbalance the substantial amount of debt securities that our insurance subsidiaries are required to hold as an integral part of their insurance operations. In most years, investing in equities has enhanced the total return on our investment portfolio relative to the alternative of investing exclusively in bonds, as illustrated below. Last year, however, was the exception:

Year	Alleghany Total Return ³	Barclays Intermediate Aggregate Bond Index	Excess (Shortfall)
2004	13.2%	3.7%	9.5%
2005	10.8	2.0	8.8
2006	6.8	4.6	2.2
2007	9.4	7.0	2.4
2008	(4.1)	4.9	(9.0)
Cumulative	40.6%	24.2%	16.4%
Annualized	7.0%	4.4%	2.6%

RSUI Group, Inc.

RSUI Group performed well in 2008. Despite a difficult year from a natural catastrophe point of view, RSUI was able to generate \$137.6 million of underwriting profits and a combined ratio of 80.1%. Slightly less than half of RSUI’s gross written premium relates to commercial property insurance, with the balance derived from casualty product lines, including umbrella/excess liability, general liability, directors and officers liability, and professional liability, all originated through wholesale insurance agents and brokers. RSUI also has a small but growing binding authority department. I am pleased to report that despite challenging market conditions, all of RSUI’s product lines produced underwriting profits in 2008. RSUI ended 2008 with cash and invested assets of \$2.3 billion and stockholder’s equity of \$1.1 billion.

In early 2008, James Dixon, one of the founders of RSUI, retired as CEO, although he remains a member of the company’s board. Jim has been succeeded by his long-time partner, E.G. Lassiter, with

³ Total return on cash and invested assets, including both bonds and equities.

Dave Leonard becoming the President of RSUI. We thank Jim for his tremendous contribution to Alleghany's success.

Capitol Insurance Companies

Capitol Insurance Companies had another solid year in 2008, producing \$15.2 million of underwriting profits and a combined ratio of 91.8%. Approximately 76% of the group's gross written premium comes from various classes of small commercial property and casualty insurance, with 24% derived from surety. The Capitol Insurance Companies distribute property and casualty and surety insurance through family-owned general agencies, independent agencies and, beginning in 2008, through other specialty markets. Although competition is intense in many of the group's markets, management has been able to produce an underwriting profit by maintaining pricing and underwriting discipline and improving agent and customer service through investments in technology. The Capitol Insurance Companies ended 2008 with cash and invested assets of \$516 million and stockholder's equity of \$300 million.

Employers Direct Corporation

Employers Direct Corporation had a difficult year in 2008, partly due to a deteriorating environment in California workers' compensation. By way of background, the California state legislature passed comprehensive workers' compensation reform in April 2004 (Senate Bill 899), which was intended to promote employment in the state of California by reducing the cost of workplace injuries while improving care for injured workers. According to the Workers' Compensation Insurance Rating Bureau of California (WCIRB), workers' compensation claims costs declined following SB 899, allowing carriers to significantly reduce their premium rates.

Beginning in 2008, Employers Direct began to see some deterioration in claims experience, necessitating an increase in mid-2008 to reserves for prior years. Management began to try to increase pricing in the third quarter, but was largely unable to achieve significant rate increases due to competitive forces. Moreover, we believe that the reforms implemented in early 2004 have gradually been eroded, resulting in increasing claims severity, especially related to medical costs.

Employers Direct's 2008 results were poor. The company had an underwriting loss of \$60.9 million, of which \$25.4 million was due to adverse development on prior accident years. Given the severity of the deterioration that emerged in 2008 in EDC's prior reserves and the financial markets, we determined that the goodwill associated with the purchase of Employers Direct in the second quarter of 2007 was impaired, and we therefore incurred a non-cash charge of \$48.7 million to write off this goodwill.

Because Employers Direct has reduced its premium volume dramatically in 2008, its 2008 combined ratio is unacceptably high. However, we determined that it was better to shrink aggressively rather than write more unprofitable business. Looking forward, management is taking action to strengthen the claims department, and to increase prices wherever possible. We believe that the current pricing structure of California workers' compensation is not sustainable over the long-term, and that others will increase prices in response to accelerating claims costs. Employers Direct remains financially secure, with \$342 million of cash and invested assets, and stockholders' equity of \$170 million.

Darwin Professional Underwriters

In October 2008, Darwin Professional Underwriters was sold to a major Bermuda-based insurance group. As a result of this sale, Alleghany realized approximately \$300 million in proceeds for its 55% interest in the company. In just five years, under the leadership of Stephen Sills, Darwin grew from a start-up managing agency with one employee to an innovative and highly successful specialty insurer. We wish the management of Darwin and its new owner much success in the future, and thank Stephen Sills for his contributions to Alleghany.

Other operations

Our wholly-owned subsidiary Alleghany Properties (\$25 million of stockholder's equity) owns approximately 315 acres of undeveloped land in North Natomas, California. We believe this land has long-term value, but development is unlikely in the near term due to local flood control issues and a difficult economic environment. Alleghany also has a 33% interest in Homesite Insurance Group, a specialist in providing homeowners, renters, and condominium owners insurance in 45 states, distributing through partnerships with other personal lines carriers. Homesite increased its business significantly in 2008, with gross written premiums increasing by 23%. Finally, we have a 40% ownership interest in ORX Resources, a Louisiana-based oil and gas exploration and production company. ORX is developing deep, onshore sub-salt oil and gas resource opportunities utilizing state-of-the-art seismic technology.

Balance sheet and liquidity

Over the past five years, Alleghany has expanded into commercial property and casualty insurance through acquisition. Fortunately, we have done this with internally-generated funds, with the result being that we have no corporate debt. At the end of 2008, each of our insurance subsidiaries was conservatively capitalized, and we had cash, fixed income securities, and equity securities with a total market value of over \$900 million at the parent company and other non-regulated subsidiaries.

We remain well positioned to capitalize on acquisition opportunities that may emerge. Each year, Alleghany reviews a number of potential acquisitions. In 2008, we were actively involved in several potential acquisitions, but none of these was consummated. Our orientation will continue to be to find strong businesses with engaged and motivated management teams and to acquire them at reasonable prices.

Thoughts on management compensation

The collapse of the financial markets in 2008 has once again raised investors' concerns about management compensation and incentives. Although I have briefly discussed this topic in past stockholder letters, I think it merits a more extensive discussion in this year's letter. Of course, a full description of Alleghany's compensation program can be found in our 2009 proxy statement, and I encourage you to review it.

Alleghany's goal is to compound its book value per share at attractive rates of return over a long period of time. Our research has led us to conclude that over the long term, the return to our stockholders will bear a close relationship to the growth in book value per share. The goal of long-term compounding requires that large losses are avoided. In 2008, the long-term investment records of many accomplished professional investors were severely hurt by the third worst nominal return in stock market history. It is basic mathematics, but a 10% loss requires an 11% gain to recover the amount of the loss; a 25% loss requires a 33% gain, and a 40% loss requires a 67% gain to get back to even.

Many corporations, including large financial institutions, blindly pursued the goal of high returns on equity without considering how added risk—both financial and operational—could increase the volatility of these returns. In some cases, the senior management of such institutions received leveraged exposure to this volatility in the form of stock options. Financial and operating leverage, while increasing potential returns on equity, also increases the volatility of these returns, as has been made all too clear by the events of 2008. Our philosophy is that we aim to produce attractive *risk-adjusted* returns, avoiding large decreases in book value per share that will take heroic performance to recover.

Alleghany's senior management does not have any stock option compensation. Each year, our compensation committee considers the economic and financial environment and awards "performance shares" that are sized relative to each executive's salary. A target level is established in monetary terms and converted to a number of performance shares based on the price of Alleghany's stock at the date of grant. Over the following four years, we measure the growth rate in book value per share and compare this growth rate with a previously-established target level. If the growth rate exceeds this target level, executives are eligible to receive a multiple of the target award; if the growth rate is below the target level, the payout is reduced. Below a certain level, no payout is made.

We believe that this structure effectively aligns management's incentives with those of the long-term stockholder. The 2008 financial collapse resulted in a decline in book value per share, which will reduce the growth rate in book value per share over the four-year periods that include 2008, resulting in a reduction in the value of all outstanding performance shares. We're not happy about this, but it is reality. Please see our annual proxy statement for a more detailed description of these incentive plans.

We also believe in aligning the compensation of management of our operating subsidiaries with their individual business responsibility. Unlike many large organizations, we compensate each subsidiary management team based solely on its company's results. In addition, because our insurance subsidiaries rely on the parent company to manage their investment portfolios, we compensate their management teams primarily based on underwriting results.

Outlook

Depression-like economic conditions will make earnings and book value growth difficult in 2009. Our ability to generate investment income is deteriorating due to dramatically lower interest rates, coupled with our unwillingness to prematurely take higher levels of credit risk. A global recession in 2009 will hit corporate earnings hard, and could continue to pressure equity returns. Insurance markets remain competitive, and it is likely that underwriting profits will be lower in 2009 than they were in 2008. Our approach in this environment will be to manage expenses prudently, preserve capital where possible, and remain positioned to participate in a recovery when such a recovery eventually emerges.

Insurance is a cyclical business and must be managed on a long-term basis. In 2006 and 2007, we enjoyed very strong insurance results, and it is clear that these years marked a peak in the recent profitability cycle of the property and casualty insurance business. Since the end of 2001 through last year, our insurance businesses have produced \$705 million of underwriting profits⁴, including all natural catastrophe losses. It is natural therefore to expect a more challenging environment in 2009 and possibly 2010 as well. However, insurance pricing has stopped declining, and in fact is starting to improve in the most troubled line, California workers' compensation.

⁴ Including Alleghany's share of underwriting profits of Darwin Professional Underwriters through the third quarter of 2008.

Investment markets are also cyclical, and we may be experiencing a more significant adjustment process as the U.S. economy de-leverages. Alleghany Corporation was formed in 1929 as a holding company for the railroad interests of Oris and Mantis Van Sweringen. When the Great Depression hit in the early 1930s, the company became financially impaired, as falling revenues and cash flow could no longer support a highly-leveraged capital structure. Allan Kirby, the father and grandfather of two of our current directors, rehabilitated Alleghany and established operating principles that continue to guide us. Today, Alleghany is well-positioned to survive a difficult economic environment and to take advantage of opportunities that may emerge. We're in much better shape than we were in the last Great Depression.

Yours sincerely,

A handwritten signature in green ink that reads "Weston M. Hicks". The signature is written in a cursive style with a large, prominent initial 'W'.

Weston M. Hicks
President

February 26, 2009