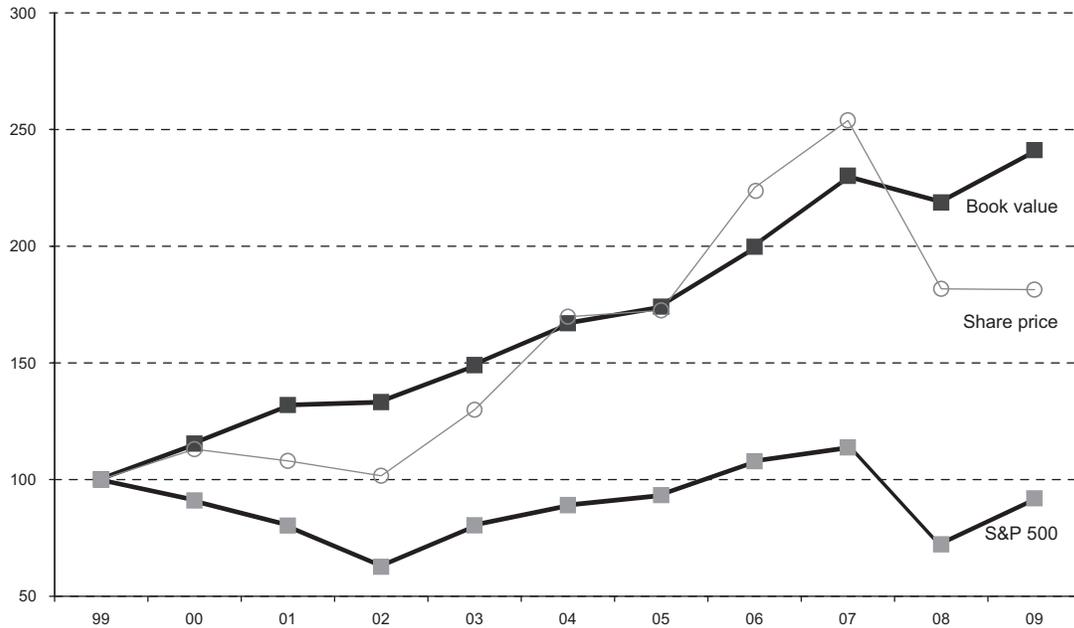


## To Our Stockholders

Alleghany's common stockholders' equity per share at year-end 2009 was \$306.71, an increase of 10.3% from common stockholders' equity per share of \$278.17 at year-end 2008, adjusted for stock dividends. For 2009, Alleghany reported net earnings to common stockholders of \$271.0 million, or \$30.43 per share. For the five years ended December 31, 2009, Alleghany's common stockholders' equity per share increased at a compound annual rate of 7.6%, compared with a compound annual rate of return of 0.4% for the S&P 500 over the same time period. Consolidated cash and invested assets have increased over this time period from \$2.4 billion to \$4.4 billion, a compound annual growth rate of 13.2%.

The chart below summarizes Alleghany's longer-term performance. For the ten-years ended December 31, 2009, Alleghany's common stockholders' equity per share increased at a compound annual rate of 9.2%, compared with a compound annual rate of return of negative 1.0% for the S&P 500 over the same time period. Alleghany's share price appreciated at a 6.1% compound annual rate of return over the decade (adjusted for stock dividends). It can be seen from reviewing the chart that our long-term record is built on capital preservation — not losing much money in bad times — as much as it is on making money in good times.

**Alleghany Corporation  
Indexed Performance 1999=100**



The table below summarizes the change in common stockholders' equity in 2009 (\$ millions):

Net earnings before items below	\$112.4
Net realized capital gains from sales of Burlington Northern common stock	129.0
Other net realized capital gains	79.3
Other than temporary impairment losses	<u>(55.9)</u>
Net earnings available to common stockholders	\$264.8
Common stock repurchases	(75.9)
Conversion of preferred stock	182.2
Other changes	<u>(0.9)</u>
Increase in common stockholders' equity	<u><u>\$370.2</u></u>

Our performance in 2009 was good, but not without room for improvement. On the positive side of the ledger, RSUI posted very strong underwriting results, aided by favorable claims trends and a lack of major natural catastrophes. The Capitol Insurance Companies also performed well, producing an underwriting profit in a challenging industry environment. By contrast, Employers Direct produced poor results (more on this later). Investment returns were solid in 2009. Our equity portfolio produced very strong returns, and our bond portfolio performed in line with benchmarks.

During 2009, we issued new common shares as a result of the conversion of our previously-issued mandatory convertible preferred stock into common stock. We repurchased a portion of the outstanding preferred stock prior to its conversion. We also repurchased \$75.9 million of common stock at an average cost of \$256.73. The net effect of all of the above was that we ended 2009 with 8,860,354 outstanding shares, compared with 8,438,226 at the beginning of the year.

### **Is the Great Recession Over?**

Toward the end of 2009, evidence began to mount that the Great Recession of 2008-2009 was nearing an end. Massive intervention by governments and central banks around the world appears to have prevented a complete meltdown of the financial system. That's the good news. The bad news, in our opinion, is that we may be in the eye of the storm.

After the inflationary period of the 1970s, the U.S. economy began to enjoy a period of unparalleled prosperity. Liberalization of capital markets allowed for a twenty-five year period during which total debt outstanding (household, financial, and government) grew faster than the nominal economy and incomes. One way to look at this trend is to observe that as time went on, it took an increasing amount of debt to produce a dollar of GDP. Some have observed that we now appear to be at the point where an additional dollar of aggregate debt outstanding produces *no* increase in GDP.

Our economy functions with a debt-based monetary system. This system requires the expansion of debt to increase the supply of money<sup>1</sup>. Much like the Madoff scheme, our financial system requires an ever increasing supply of borrowers to create the money necessary to pay the interest on all outstanding debt. In 2007 and 2008, it appears that we reached the limit of the ability of the economy to bring in the marginal borrower. Twenty-five years of expanding debt relative to incomes has created increasingly skewed household incomes and possibly inflated asset values as well.

The latest chapter in this saga is the explosion of government debt. It should be apparent that widespread defaults and the contraction of corporate and consumer debt outstanding *reduces* the supply of money, and unless there is an offset the economy will spiral into a deflationary bust. It is for this reason that governments throughout the world have had to borrow in unprecedented amounts to keep the global economy from collapsing.

In the case of the United States, the Federal Government ended 2009 with the national debt in excess of \$12 trillion, or well over 80% of GDP. Including state, local, and GSE (government-sponsored-entity) debt, the figure increases to approximately 125%. The Federal Government will have to issue over \$2.5 trillion of debt in 2010 to fund new borrowing requirements and existing debt maturities. It is not clear at this point what the source of sufficient demand will be for debt issuance on this scale. Should foreign central banks, households, and other investors lose confidence, it is possible that a “dollar crisis” could result. At a minimum, interest rates would rise and economic activity would take another leg down. Of course, the finances of governments represented by other major currencies—the Euro and the Yen in particular—are no better, making it difficult to project the resolution of these issues. It would seem likely, however, that over time central banks of surplus-generating countries will prefer to hold real assets in their reserves rather than promises to pay from national borrowers with deteriorating credit quality.

An additional complicating factor is the natural resource position of many of the OECD (Organization for Economic Cooperation and Development) countries, the United States, Japan, and much of Europe in particular. We believe that over the next three-to-five years, economic development will increasingly be affected by the lack of readily available cheap energy. Higher energy input costs hurt productivity and may also reduce the velocity of money, as dollars sent to OPEC are less likely to be spent on consumption or capital investment. Moreover, the United States in particular does not seem to be responding to the reality of structurally higher energy costs with any coherent long-term plan for energy independence. Add to this the potential for unfavorable geopolitical developments in the Middle East and one realizes how truly fragile the current economic situation really is.

We also believe that the demise of the markets for securitized credit will continue to weigh on economic activity and asset prices. Since 2007, private credit has sharply contracted, and it appears that the system for the provision of credit and allocation of capital continues to be structurally impaired. Individual businesses are having difficulty attracting capital, as the Federal Government has thrown billions of dollars to prop up the major financial institutions in what we suspect will prove to be an unsuccessful attempt to revive the securitization

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<sup>1</sup> The idea of money supply being debt-dependent has been brilliantly articulated by Ellen Hodgson Brown in her book, *Web of Debt*.

market. Meanwhile, bank lending continues to contract as well, as many banks are undercapitalized following unprecedented credit losses.

The policies of the Federal Reserve—cutting short-term interest rates to near zero to subsidize the banking system at the expense of savers (like Allegheny) and the public at large—is really its only choice in a debt-based money system. That is not to say, however, that an alternative system would not have merit, especially since the U.S. economy appears to have so much excess productive capacity.<sup>2</sup>

Finally, as noted in last year’s annual report, one cannot evaluate investment and acquisition opportunities without recognizing that we operate in a global economic system where China in particular manages the value of its currency for trade advantage. We recently came across a 1994 Charlie Rose interview of Sir James Goldsmith where he predicted that the entry of China and India into the world economy without floating exchange rates would ultimately destroy the fabric of Western economies. We hope he’s not proven right.

To summarize, our view of the outlook considers the following:

1. The U.S. economy has reached the limit of its ability to expand through debt-financed consumption, and a new fundamental driver of economic growth has yet to emerge.
2. Unemployment remains extremely high; broad measures of unemployment and underemployment are approaching 20% in 2010. We do not see a return to healthy employment levels in the United States anytime soon due to structural issues in the economy.
3. Option ARM (Adjustable Rate Mortgages) mortgages will reset in size in 2010-2011, causing further consumer stress.
4. Massive intervention by the Federal Reserve (through quantitative easing) and the Treasury (through increased deficit spending) has stopped the collapse, but federal, state, and local fiscal imbalances are approaching a crisis level and could again destabilize the economy.
5. Energy supply and related geopolitical developments will become increasingly important in 2010 and beyond, working to the disadvantage of energy importing countries.
6. We are most likely witnessing an historic shift in economic power from the highly leveraged, industrialized West to the “BRIC” nations (Brazil, Russia, India and China); as this occurs there will be increasing challenges to the U.S. dollar as the world’s reserve currency. This transition could be long and perhaps painful for the United States.

## **Investments**

All of the above does not bode well for future investment returns on equities and fixed income securities. We continue to see a significant risk of higher interest rates in the future, and as a consequence we have positioned our bond portfolios defensively. It should be noted that this has a cost, and the cost is foregone investment income. Although equities staged a strong rebound in 2009, they remain well below levels before the crash of 2008, and in our estimation are currently priced at best for 5-7% long-term returns, assuming the economy is able to transition to a self-sustaining recovery. As a consequence of this outlook, we had only roughly 20% of our consolidated stockholders’ equity invested in equities, a figure that easily could be doubled if we

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<sup>2</sup> In China, for example, banks are owned by the government, so bad loans and deficit spending are really one and the same.

were more optimistic on the outlook. It is important to note, however, that we make equity investments not based on a “macro call,” but rather, based on longstanding principles of value investing, seeking investments in high quality companies where, in our view, the prospect for positive return is significantly greater than the probability of loss.

On a consolidated basis, Alleghany’s equity portfolio returned 29.3% in 2009, modestly ahead of the 26.5% total return on the S&P 500. For the five years ended December 31, 2009, our equity portfolio has produced an average annual return of 9.2%, compared with an annual average return of 0.4% 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 fixed income 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:

Year	Alleghany Total Return <sup>3</sup>	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)
2009	11.4	6.5	4.9
Cumulative	56.6%	32.3%	24.3%
Annualized	7.8%	4.8%	3.0%

### **RSUI Group, Inc.**

RSUI focusses on the specialty insurance market, writing complex insurance products exclusively through wholesale insurance brokers. The company’s strategy is to be a “reactive market,” meaning it will write more business when prices, terms, and conditions are attractive, and less business when the market sets the wrong price, or insufficient terms and conditions, relative to the risk. This approach has produced superior underwriting results over time, but it should be clear that it is impossible for the company’s top-line to grow at a consistent rate year-to-year with this strategy. As we have noted before, 2006 and 2007 were exceptionally profitable years for the specialty insurance market, but competitive forces began to take their toll in 2008 and 2009. We expect that market conditions will remain highly competitive in 2010, and perhaps 2011 as well. RSUI’s principal goal in such an environment is to provide superior service to its customers, write business only when the market allows it to be written at satisfactory prices, terms, and conditions, and to protect capital from unexpected underwriting losses.

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<sup>3</sup> Total return on cash and invested assets, including both fixed income securities and equities.

The table below shows RSUI's long-term record under Alleghany's ownership. Initially capitalized at \$628.1 million, RSUI's stockholder's equity at the end of 2009 was \$1,252.2 million; during this time frame, the company has provided Alleghany with just under \$100 million of dividends, net of capital contributions.

(\$ millions)	Beginning	Operating Earnings (Losses)	Realized Capital Gains (Losses)	Other Comprehensive Income (Loss)	Net Capital Transactions	Ending
7/1/03-12/31/03	\$ 628.1	\$ 60.4	\$ 0.1	\$ 18.7	\$ —	\$ 707.3
2004	707.3	56.6	22.6	(14.9)	—	771.6
2005	771.6	(64.4)	3.0	5.9	125.8	841.9
2006	841.9	157.0	5.4	6.8	—	1,011.1
2007	1,011.1	178.5	17.5	32.3	(75.0)	1,164.4
2008	1,164.4	134.7	(92.3)	(78.6)	—	1,128.2
2009	1,128.2	<u>158.8</u>	<u>24.5</u>	<u>90.7</u>	<u>(150.0)</u>	1,252.2
Total		<u>\$681.6</u>	<u>\$(19.2)</u>	<u>\$ 60.9</u>	<u>\$ (99.2)</u>	

Since acquisition, RSUI has produced \$786.8 million of underwriting profits under Alleghany's ownership. During this time period, the U.S. property and casualty industry experienced eight of the ten costliest hurricanes in history in current dollars, including Jeanne (2004), Frances (2004), Rita (2005), Ivan (2005), Charley (2004), Wilma (2005), Ike (2008), and of course, Katrina (2005).

RSUI had an excellent year in 2009, posting its third highest annual underwriting profit under Alleghany's ownership. Gross premiums written declined slightly, an accomplishment considering the more significant declines reported by many of RSUI's competitors. Underwriting profits totaled \$189.8 million, and the combined ratio was 70.0%. RSUI ended 2009 with cash and invested assets of \$2.6 billion and stockholder's equity of \$1.25 billion. Including a dividend of \$150 million paid to Alleghany in 2009, RSUI's stockholder's equity increased by 24%.

### Capitol Insurance Companies

The Capitol Insurance Companies had a good year in 2009, producing \$10.1 million of underwriting profits and a combined ratio of 93.9%. Approximately 73% of the group's gross premiums written comes from various classes of small commercial property and casualty insurance, with 27% derived from commercial surety. Progress in diversifying distribution sources continued in 2009, as the Specialty Markets division continued to grow. In addition, Capitol acquired a small agency specializing in errors and omissions insurance coverage in the fourth quarter. The Capitol Insurance Companies ended 2009 with cash and invested assets of \$555 million and stockholder's equity of \$327 million.

### Employers Direct Corporation

Employers Direct Corporation had another difficult year in 2009. Unfavorable claims emergence in the first half of the year required a significant strengthening of reserves in the second quarter. Additionally, extremely competitive market conditions prompted the company to exit the direct distribution channel in 2009. Prior to exiting the direct distribution channel, EDC increased its rates significantly to levels that were not competitive relative to others in the industry. We believe this is due to the fact that many are writing business that will prove to be severely unprofitable.

However, much progress has been made in positioning the company to re-emerge as an agency carrier in 2010. Employers Direct is now seeing claims being resolved at or below case reserved amounts, an encouraging sign for future reserve adequacy. Year-end actuarial reviews indicated that our overall loss reserves, including IBNR, were reasonable. Operational and systems initiatives are underway to create superior agency interface capability, so that when industry pricing returns to rationality, the company can start to build new distribution relationships.

The management of Employers Direct is singularly focused on the California workers' compensation market. In our opinion, there are a number of market participants that have not yet recognized that the reforms enacted during 2002-2004, which dramatically lowered workers' compensation claims costs, had significantly eroded by 2008 and 2009. Inadequate case reserving can allow a company to think it is making money when it is not. As others in the industry begin to recognize the deterioration in claims trends that Employers Direct has already observed and recognized, we expect that industry pricing conditions will improve and the company will again be able to produce profitable growth.

### **Alleghany Properties**

Alleghany Properties owns approximately 320 acres of land in Sacramento, California. Development activities have ceased recently due both to the state of the local real estate economy and basin-specific flood control issues. Management continues to work to keep entitlements current and is exploring opportunistic acquisitions of additional properties, some of them income-producing. We believe that there is significant potential long-term value in the assets held by Alleghany Properties, but the realization of such value depends on a normalization of the economy and the completion of flood control remediation, neither of which will occur in 2010.

### **Affiliated investments**

Alleghany has an approximately 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. In 2009, Homesite significantly increased its penetration of strategic relationships. Gross premiums written increased by 25%, and the company produced a combined ratio of 109.1%. It should be noted that Homesite's distribution model results in high front-end costs, with new business producing much higher combined ratios than renewal business.

We also have an approximately 38% ownership interest in ORX Exploration, 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. In late 2009, ORX began marketing one of its best prospects to major oil and gas companies for development.

### **Balance sheet, liquidity, and risk management**

At the end of 2009, Alleghany had no debt and substantial parent company liquidity. Approximately \$1.9 billion of our consolidated stockholders' equity was represented by our investments in wholly-owned subsidiaries and our affiliated investments, with the balance (approximately \$825 million) consisting of invested assets either at the parent company or non-regulated intermediate holding companies. At year-end 2009, Alleghany's market capitalization was approximately \$2.4 billion. This figure represents a multiple of 87% of

our stated book equity. If all excess capital were to be removed from the company, the market is valuing our operating businesses and affiliated investments at 85% of book value.

During 2009, we decided not to renew our bank credit agreement. Not only was the proposed cost of this agreement unreasonable, but the facility itself was not especially useful to us. Our holding company cash requirements are very modest, and our subsidiaries are for the most part highly liquid.

Over the past five years, we have encountered the largest insured catastrophe loss in U.S. history, and we experienced a severe stock market correction. I believe that the soundness of our risk management approach has been demonstrated. We continuously challenge ourselves to think of the many things that can go wrong and try to ensure that Alleghany is positioned to survive these events and hopefully emerge as a viable competitor. Our balance sheet leverage, with invested assets equal to only 1.62x our consolidated stockholders' equity, ensures that changes in asset values will have only a modest impact on our capital. Our insurance subsidiaries are conservatively capitalized, not only in relation to the investment risks that they assume, but more importantly, in relation to the extreme "tail" exposures that are endemic to their business. Because we are relatively small in size, the rating agencies tend to view Alleghany as a lower investment grade credit; perhaps if we were large and levered the balance sheet at 30:1, we would receive higher ratings!

### **Corporate developments**

In 2009, our management team was stable. In anticipation of the eventual age-mandated retirement of some of our directors, Alleghany appointed two new directors in 2009: Phillip Martineau and Karen Brenner. Each brings a valuable set of experiences and skills to our Board of Directors, and we are pleased that each of them has joined us.

The management and Board of Directors of Alleghany Corporation also wish to thank Allan P. Kirby, Jr. who will retire this Spring after forty years of service as a director and thirty years as Chairman of the Executive Committee. His wisdom and guidance played a key role in Alleghany's success over this time period.

### **Outlook**

Alleghany's future growth in stockholders' equity per share depends upon three factors: 1) underwriting results, 2) investment income and investment returns, and 3) potential accretion from future acquisitions. Each of these factors will be discussed separately.

The commercial property and casualty insurance industry is cyclical, with the 2006-2007 period marking the peak of the most recent profit cycle. Since then, insurance pricing has been under pressure, and the weak economy has made exposure growth difficult. We do not see any prospect for significant improvement in either of these external factors in 2010. Our consolidated underwriting profits of approximately \$129 million in 2009 reflected very modest natural catastrophe losses at RSUI but significant losses at Employers Direct. We would expect lower underwriting profits from RSUI in 2010 but lower underwriting losses at Employers Direct as well.

Our investment income continues to suffer from extremely low short-term interest rates and our decision to position the portfolio for rising interest rates. Unless interest rates rise significantly, investment income will likely fall in 2010 as higher-coupon fixed income investments mature and are reinvested at lower interest rates. Our equity returns of almost 30% likewise cannot be expected to repeat, although our long-term record would indicate that double-digit returns are certainly possible.

On the acquisition front, each year we look at many potential acquisitions. We have several initiatives underway to try to increase our opportunity set, but only time will tell if we will be successful in finding suitable acquisitions. As always, we will continue to evaluate the repurchase of Alleghany common shares when we can repurchase them at a price that makes sense for long-term Alleghany stockholders.

Much will depend on our ability to capitalize on volatility in 2010. Given the factors discussed above, there are many ways that the next phase of the financial crisis could unfold.

Yours sincerely,

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

Weston M. Hicks  
President

February 25, 2010