This is Alleghany

Our objective is to create value through owning and managing operating subsidiaries and investments, anchored by a core position in property and casualty reinsurance and insurance. We are managed by a small company staff which seeks out attractive investment opportunities, delegates responsibilities to competent and motivated managers, sets operating subsidiary goals, assists managers in the achievement of these goals, defines risk parameters and appropriate incentives, and monitors progress against long-term objectives. The operating subsidiaries function in an entrepreneurial climate as quasi-autonomous enterprises.

Conservatism dominates our management philosophy. We shun investment fads and fashions in favor of acquiring relatively few interests in basic financial and industrial enterprises that offer the potential to deliver long-term value to our investors.

Our primary operating subsidiaries include:

- ***Transatlantic Holdings, Inc. —*** a leading global reinsurer
- ***RSUI Group, Inc. —*** a national underwriter of property and liability specialty insurance coverages
- ***Capitol Transamerica Corporation —*** an underwriter of small commercial property, casualty and surety insurance coverages
- ***Pacific Compensation Corporation —*** an underwriter of workers' compensation insurance primarily in California

Financial Highlights *Alleghany Corporation and Subsidiaries*

(in millions, except for per share and share amounts)

	Years Ended December 31,		
	2012	**2011**	**2010**
Revenues	$ 4,753.2	$ 981.8	$ 985.4
Net earnings	$ 702.2	$ 143.3	$ 198.5
Basic earnings per share of common stock(1)			
Operations(2)	$ 38.96	$ 7.14	$ 15.76
Security gains(3)	6.52	9.12	6.09
Net earnings(1)(2)	$ 45.48	$ 16.26	$ 21.85
Common stockholders' equity per share(1)	$ 379.13	$ 342.12	$ 325.31
Average number of shares of common stock outstanding(1)	15,441,578	8,807,487	9,081,535

(1) Amounts have been adjusted for subsequent common stock dividends.

(2) 2012 per share figures reflect the impact of the Transatlantic Holdings, Inc. merger, including a $494.9 million gain on bargain purchase and the issuance by Alleghany of 8,360,959 shares of its common stock.

(3) Includes net realized capital gains and other than temporary impairment losses.

Per Share Net Earnings (Losses)(1)

Years Ended December 31,

	Reinsurance and Insurance Segments	Corporate Activities	Total
2012(2)			
Operations	$12.26	$26.70	$38.96
Security gains(3)	4.84	1.68	6.52
Total	$17.10	$28.38	$45.48
2011			
Operations	$12.71	$ (5.57)	$ 7.14
Security gains(3)	5.62	3.50	9.12
Total	$18.33	$ (2.07)	$16.26
2010			
Operations	$17.90	$ (2.14)	$15.76
Security gains(3)	5.76	0.33	6.09
Total	$23.66	$ (1.81)	$21.85

(1) Amounts have been adjusted for subsequent common stock dividends.

(2) 2012 per share figures reflect the impact of the Transatlantic Holdings, Inc. merger, including a $494.9 million gain on bargain purchase and the issuance by Alleghany of 8,360,959 shares of its common stock.

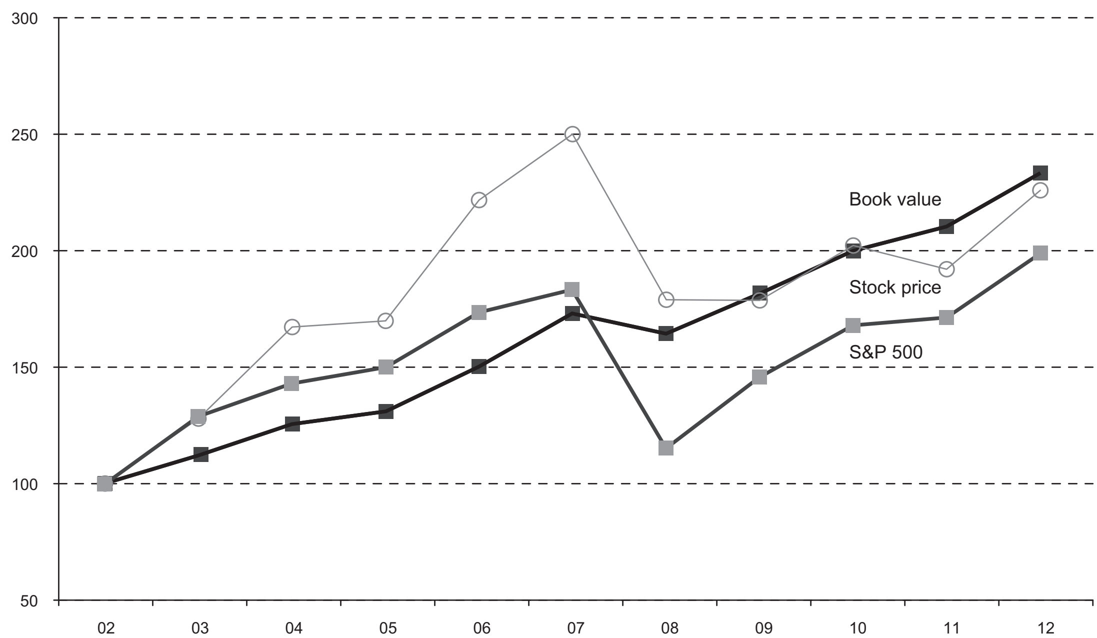
(3) Includes net realized capital gains and other than temporary impairment losses.

To Our Stockholders

Alleghany's common stockholders' equity per share at year-end 2012 was $379.13, an increase of 10.8% from common stockholders' equity per share of $342.12 at year-end 2011. For 2012, Alleghany reported net earnings to common stockholders of $702.2 million, or $45.48 per share. For the five years ended December 31, 2012, Alleghany's common stockholders' equity per share increased at a compound annual rate of 6.1%, compared with a compound annual rate of return of 1.6% for the S&P 500 over the same time period.

The chart below summarizes Alleghany's longer-term performance, with all values indexed to December 31, 2002. For the ten years ended December 31, 2012, Alleghany's common stockholders' equity per share increased at a compound annual rate of 8.8%, compared to a compound annual rate of return of 7.1% for the S&P 500 over the same time period. Alleghany's share price appreciated at an 8.5% compound annual rate of return over the past decade (adjusted for stock dividends).

Alleghany Corporation
Indexed Performance 2002=100



The table below summarizes the change in common stockholders' equity in 2012 ($ millions):

Net earnings before items below	$ 375
Net realized investment gains	101
Change in unrealized investment gains, other	79
Losses from Super Storm Sandy	(268)
Subtotal	$ 287
Bargain purchase gain on acquisition	495
Share issuance in connection with acquisition	2,696
Increase in common stockholders' equity	$3,478

The vast majority of the increase in Alleghany's common stockholders' equity in 2012 was due to the financial effects of the Transatlantic Holdings, Inc. ("TransRe") acquisition, which was highly accretive to our earnings and common stockholders' equity per share in 2012. Additionally, the acquisition of TransRe has diversified our sources of earnings and added international exposure to our spread of risk.

Including the amortization of certain intangible assets associated with the acquisition of TransRe, our 2012 results reflected a small underwriting loss (something we generally seek to avoid), offset by the investment income generated by a substantially larger invested asset base. Although the property and casualty insurance industry remained competitive in 2012, we did see some upward movement in rates, and the marketplace provided some opportunities for profitable growth.

On a GAAP reported basis, Alleghany had a consolidated underwriting profit in 2012 of $220 million. However, when we acquired TransRe we wrote-off the company's deferred acquisition costs, which normally make their way into the income statement as commission expenses, and replaced them (more or less) with an intangible asset called "value of business acquired," or VOBA. VOBA was then amortized into the income statement as amortization of intangibles, which does not make its way into the underwriting account. In comparing our underwriting results with those of other companies, we believe that stockholders and prospective investors *should* deduct this amortization, which totaled about $266 million in 2012. After deducting amortization of VOBA, our consolidated underwriting account produced a loss of $46 million.

Our underwriting results reflected significant losses resulting from Super Storm Sandy, which made landfall near Atlantic City, New Jersey on October 29th. Sandy is called a "Super Storm" because even though the maximum sustained wind speeds of the storm were only those usually associated with a category one hurricane just prior to landfall, it interacted with an upper level trough to produce an extremely large amount of energy. In addition, the storm took a highly unusual left turn off the coast of New Jersey and headed west instead of northeast, increasing the wind speed of the northwest quadrant of the storm.

As the second most powerful storm in recent history, Sandy produced a storm surge that was unprecedented in the metropolitan New York area (including New Jersey and Connecticut). Lower Manhattan, an area with a significant concentration of insured values, sustained highly damaging flooding, in addition to the wide-spread damage in New Jersey, New York, and Connecticut.

Super Storm Sandy cost TransRe $251 million (before-tax), and it resulted in $161 million (after reinsurance and before-tax) of losses at RSUI Group, Inc. (“RSUI”). Excluding the impact of Super Storm Sandy, our consolidated “adjusted” underwriting loss of $46 million would have been a profit of $366 million. Both TransRe and RSUI would have had a low-teens return on equity in 2012 absent Super Storm Sandy; including losses from the storm, TransRe had an annualized return on equity of 9.8%, and RSUI 6.1%.

Our 2012 results were again negatively affected by weak results at the Capitol Insurance Companies and PacificComp. Capitol produced an underwriting loss of $20.5 million in 2012, largely due to $23 million of adverse development that resulted from a specialty program discontinued in 2011. Additionally, Capitol’s underwriting results reflected a $5 million charge due to a change in the accounting rules for deferred acquisition costs. Absent these two items, Capitol had a $7.5 million underwriting profit. We believe the reserves that Capitol now has for its discontinued specialty program segment are adequate and believe there should not be any further adverse development in the future. PacificComp had a $31 million underwriting loss in 2012. Most of this loss represents our continuing investment in the business without sufficient revenues to cover its overhead costs. In addition, PacificComp had $5.6 million of adverse reserve development in 2012.

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TransRe

On March 6, 2012, Alleghany acquired TransRe for approximately $3.5 billion. Because Alleghany was not in the reinsurance business in any significant way immediately prior to the acquisition, the integration of TransRe has been relatively straightforward and has been largely confined to the activities of the staff functions of the two companies. As part of the transaction, we revised the compensation plans of TransRe, making key executives and employees co-owners of the company through a phantom restricted stock plan that awards them with an economic interest in TransRe’s book value.

TransRe is led by Mike Sapnar, whose knowledge of the global reinsurance business is second to none. In his first year as CEO, not only did he have to deal with a new parent company, but also the effects of Super Storm Sandy, which resulted in significant losses to TransRe’s customers, the loss of access to the company’s headquarters, and considerable personal disruption to the company’s executives and staff. Mike and his team managed admirably through this period. We are fortunate to have such a capable management team at TransRe, and believe that the company is well-positioned to produce underwriting profits and growth in the future.

TransRe’s premiums written for the year 2012 were down about 10% (on a full-year basis) due to underwriting decisions made in 2011 and 2012 to non-renew or reduce participation on certain casualty treaties, shifting from proportional to non-proportional exposure, and reduced business from a significant client. These decreases were partially offset by some rate increases on property business in geographic areas affected by 2011 catastrophe events.

TransRe’s loss reserves developed favorably in the aggregate in 2012, and the company further strengthened its balance sheet, ending 2012 with approximately $4.3 billion of stockholder’s equity, which is an increase of over $300 million from March 6, 2012 when the acquisition closed – despite Super Storm Sandy. This rock-solid balance sheet enables TransRe to provide superior security to ceding companies throughout the world.

RSUI Group, Inc.

RSUI produced a $5 million underwriting profit in 2012, and a combined ratio of 99%. As mentioned earlier, these results reflect a loss (after reinsurance and before-tax) from Super Storm Sandy of $161 million, or 25 percentage-points on the company's annual combined ratio. Absent Sandy, RSUI would have produced an underwriting profit of $166 million and a combined ratio of 74%.

Gross premiums written increased by 13.9% to $1.1 billion in 2012. All lines of business except for Umbrella posted double-digit increases. As a "reactive" market, RSUI thrives when the industry at large is faced with difficult loss conditions. Importantly, RSUI's strong growth in 2012 was accomplished with a fairly modest increase in peak catastrophe exposure. Premium growth was due to good renewal retention rates, strong new business submissions, and mid-single-digit price increases.

RSUI's losses from Super Storm Sandy were in line with what we would expect from a $25 billion industry loss event. The company is in the business of taking severity risk, and its gross losses from a large event in a geographic area with significant accumulations of insured exposure are expected to be in the range of 1% of the industry loss. RSUI's catastrophe reinsurance program operated as expected, with losses confined to the lower layer, for which the company's reinsurers are paid a significant premium.

In early 2012, David E. Leonard became CEO of RSUI. Dave has a long history with the company, a wealth of underwriting and wholesale insurance experience, and has already demonstrated strong leadership in challenging times. We believe that Dave and his team are well-positioned for profitable growth in 2013 and beyond.

RSUI ended 2012 with cash and invested assets of $3.0 billion and $1.5 billion of stockholder's equity. Since our acquisition of RSUI in July of 2003, the company has produced over $1 billion of cumulative underwriting profit.

Capitol Insurance Companies

Over the past five years, Capitol Insurance Companies has upgraded its technology infrastructure, enabling it to provide better service offerings to independent and general agents. As a result, the company has been able to grow its property and casualty business by providing highly competitive turnaround times to agents while maintaining pricing discipline. Although the commercial surety market is highly competitive, Capitol is leveraging its strong producer relationships to expand into the construction contract surety market.

Unfortunately, during part of the same period, Capitol has also had to deal with the consequences of a foray into the specialty program business. One program in particular produced significant losses, and although largely discontinued over two years ago, it has continued to negatively affect the company's results. In 2012, Capitol had to again add to reserves for this program, as loss emergence in the first half of the year exceeded previous actuarial expectations. On a more positive note, however, loss emergence appeared to stabilize in the second half of the year. Although there are never any guarantees in this business, we believe that Capitol's reserves related to this program are adequate and the program should not affect future results.

If the underwriting losses from this discontinued program and a change in accounting for deferred acquisition costs are excluded, Capitol had a $7.5 million underwriting profit in 2012 and a combined ratio of 95%. Net premiums written on continuing business increased 8.7% in 2012, with property and casualty business up 12.1% and surety up 2.8%.

Capitol concluded the year with $308 million of stockholder's equity. The company remains strongly capitalized for the amount of business it writes, allowing us to invest a portion of its capital in equity securities that have, over time, produced additional growth in the company's book value.

Pacific Compensation Corporation

The California workers' compensation market continues to be challenging, as the industry has been unable to achieve sufficient pricing to offset escalating claims costs. According to the WCIRB[1], the industry wrote business at close to a 140% combined ratio in both 2012 and 2011. Fortunately, PacificComp was largely out of the market during those two years. Although it has not been pleasant to sustain operating losses due to insufficient revenue, the alternative was to write business at market prices that are likely to produce even larger underwriting losses.

In December 2012, Janet Frank took over as CEO of PacificComp. Jan has a wealth of experience in this market, having worked at a nearby competitor as well as having headed the State Compensation Insurance Fund for two years. We believe that Jan's strong reputation among California insurance agents and brokers and her considerable underwriting experience will help PacificComp return to profitability.

PacificComp had gross premiums written of $19.4 million in 2012, compared with $4.1 million in 2011. Market conditions are improving, with many competitors filing for significant rate increases. PacificComp enters this improving market with over $100 million of surplus, $127 million of stockholder's equity, new management, and adequate reserves.

Homesite

Homesite (33% ownership) had a difficult year in 2012, with elevated weather-related losses in the first half of the year followed by the impact of Super Storm Sandy in the fourth quarter. For the past three years, Homesite, along with other homeowners' insurance companies, has experienced rising weather-related losses (hail, thunderstorms, etc.) that have outpaced the company's ability to increase rates. Management is singularly focused at this point on increasing rate adequacy. In 2012, Homesite produced net premiums of slightly more than $500 million and had disappointing underwriting results. Rate adequacy will continue to improve in 2013, and underwriting profitability is possible as long as weather-related losses do not continue to increase from already elevated levels. Homesite continues to offer its partners through which it markets its products an excellent technological infrastructure, superior customer service, and considerable product expertise.

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Alleghany Capital Partners

As primarily an insurance and reinsurance holding company, most of our capital is invested in financial businesses where the best case is that we collect premium and are able to make an underwriting profit. The worst case is that we lose a lot of money if we fail to control risk properly. This is what Nassim Nicholas Taleb refers to as a "negative-skew business."[2]

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[1] Workers' Compensation Insurance Rating Bureau of California.

[2] Nassim Nicholas Taleb, *Antifragile: Things That Gain From Disorder*.

Because this is the essential nature of financial businesses, they must be approached with a conservative mindset and an emphasis on underwriting profit, not growth, as the only viable long-term objective.

A key part of Alleghany's strategy is to combine this (re)insurance chassis with "positive-skew" businesses. Such businesses may operate at a loss in the near-term, but have the possibility to make large amounts if the business is successful.

Alleghany Capital Partners is primarily responsible for finding and overseeing these non-insurance businesses. A brief update on each is shown below:

- **Bourn & Koch** is a Rockford, Illinois-based manufacturer and remanufacturer / retrofitter of specialized machine tools. The company has a profitable replacement parts business for legacy machine tool products that produces consistent profits throughout the economic cycle. It also manufactures highly specialized machine tools that add to earnings when its customers invest in new capital equipment. The company has recently had considerable success with a double headed gear shaper for herringbone and double helical gears. Bourn & Koch had strong earnings in its first year under Alleghany ownership (80%).

- **ORX Exploration** is a Louisiana-based oil and gas exploration company in which Alleghany owns a 38% interest following a second round investment during 2012. The company has secured and developed a number of on-shore, sub-salt oil and gas resource opportunities which it calls "the Louisiana Heritage Play." Working with its drilling partner, ORX expects to spud its second sub-salt project within the next year, and continues to market its other Louisiana Heritage Play opportunities. In addition, ORX made several investments in 2012 that significantly added to its legacy production and reserves.

- **Stranded Oil Resources Corporation** was formed in 2011 and is on its way to developing its first major project. The company acquires legacy oil fields with the goal of improving the amount of oil recovered. We have an economic interest of approximately 80% of Stranded Oil Resources Corporation.

- **Article One Partners** provides patent validation solutions to high technology companies, among others, by using a crowd-sourcing model. Alleghany owns approximately 40% of the company following a second round investment in early 2012.

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Investments

Alleghany's equity portfolio returned 4% in 2012, a disappointing performance in a market that returned 16%. At year-end 2012, we had approximately $19 billion of cash and invested assets, $1.4 billion of which was invested in equity securities, with the balance ($17.6 billion) invested in cash and fixed income securities.

As we have noted in the past, our orientation in investing in equities is to emphasize industries that can be expected to perform well if bonds don't. This means we tend to favor commodity-oriented sectors and de-emphasize interest-rate sensitive sectors. In 2012, as global fears mounted that Europe was about to implode, and as evidence mounted that growth in China was slowing, the energy and materials sectors were sold and investors rotated toward sectors with direct and indirect exposure to the U.S. housing market – including financials and consumer sectors. With over half of our portfolio in energy and additional exposure to materials, we were negatively impacted by this rotation in investor preference.

We continue to believe that our concentrated equity strategy makes sense, and will prove to be superior over time to a strategy of all-bonds. I discuss my perspective on the energy industry later in this letter. As can be seen by the table below, Alleghany's total investment return on its bonds and stock portfolios have significantly exceeded the alternative of an all-bond portfolio, as shown by the total return on the Barclays Intermediate Aggregate Bond Index:

Year	Alleghany Total Return	Barclays 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
2010	8.7	6.2	2.5
2011	7.1	6.0	1.1
2012	5.4	3.6	1.8
Cumulative	92.5	54.2	38.3
Annualized	7.6	4.9	2.7

In light of the significantly increased size and complexity of our fixed income portfolio, Alleghany is expanding its executive leadership team by separating the role of CFO from management of our $16.0 billion fixed income portfolio. I am pleased that Roger Gorham, who has been our SVP – Finance and Investments and CFO since May 2005, will bring his expertise and dedication to the management of this portfolio in his new role as SVP – Head of Fixed Income and Treasurer once a new CFO is named.

Investment Outlook

The world economy continues to struggle with the forces of a global debt deflation. Private sector borrowing capacity remains constrained and OECD governments are dealing with unsustainable debt burdens. As we have observed in the past, in a debt-based monetary system, the money supply can increase only if aggregate debt outstanding expands. With both the private sector and the government sector at borrowing limits, the Federal Reserve and other central banks have become the main source of money supply expansion through asset purchases – although such purchases clearly have a mixed record of success.

Much like Theodoric of York, the Medieval Barber on Saturday Night Live whose solution to every health problem was more bloodletting, central bankers continue to force liquidity in the banking system without any objective proof that it is helping. We do know that it isn't helping retirees, pension funds, or insurance companies, as interest rates are suppressed, penalizing savers to the benefit of the banking system.

The Federal Reserve's policies, if pursued in a vacuum, would likely result in a weaker U.S. dollar and more inflation, as excess demand is supported by the indirect monetization of government deficits. However, when all major central banks are doing the same thing, the picture is not as clear. Much of the movement in exchange rates therefore will depend upon relative GDP growth rates, as well as confidence in each region's political environment. In particular, if the U.S. government is able to make progress in narrowing the deficit, confidence could improve which in turn could aid economic growth. However, if the U.S. government remains paralyzed, the policies risk a collapse in confidence in the United States which could cause capital flight out of the U.S. dollar. Needless to say, it is extremely difficult, if not impossible, to predict how this will unfold.

The situation is further complicated by the fact that the United States enjoys a position of "exorbitant privilege" as the world's reserve currency, which makes confidence in the U.S. government's finances all the more important. Although some argue that Federal government deficits should not be reduced too quickly due to the risk of recession, it is clear that annual deficits of 7-8% of GDP are not sustainable and will ultimately lead to severe problems.

An additional issue is that money supply expansion that occurs due to government deficits that are ultimately monetized by a country's central bank is not a productive allocation of capital. This is, in my view, at the core of the economic debate.

While the equity market remains expensive by historical standards, it appears to be less overvalued than the bond market, which now discounts all but the most extreme deflationary scenarios. In many cases, we are finding that we can achieve a higher current return on a quality dividend-paying stock, especially considering preferable corporate taxation of dividend income, than we can achieve on a comparable quality bond. If this environment persists, we would expect over time to increase our allocation to equity securities, subject to external regulatory constraints.

Equity investing in this environment, however, is not the same game as it used to be. Unlike the 1980s and 1990s, when the economies of the United States and Europe were growing at a healthy rate and credit was expanding, today's economic growth is near stall-speed, creating more sector rotation within the stock market as investors seek to avoid holding the "hot potato." It follows that this requires more portfolio turnover to remain properly positioned for a shifting macro environment – especially as pure value opportunities are few and far between.

Energy

At the end of 2012, Alleghany had over $500 million of investments in publicly-traded energy investments, in addition to our two private energy ventures. Here's our perspective on the industry.

With OECD economies barely growing in the aggregate, markets have been unwilling to place much value on the historically cyclical earnings of the energy industry. It is interesting, however, that despite weak economic growth in the United States, Europe, and Japan, oil prices remained at a fairly high level in 2012. As of early 2013, crude oil is trading at over $90 / barrel (West Texas Intermediate benchmark) and above $110 / barrel (Brent (North Sea) benchmark). North American natural gas prices, which were as low as $2.27/mcf ("thousand cubic feet") in early 2012, have rebounded to $3.30 /mcf. At these prices, most major energy producers with a typical mix of oil and natural gas are reasonably profitable but with limited growth prospects.

Sentiment toward the energy industry was extremely negative in 2012 for several reasons. Early in the year, the weak economic performance of the Eurozone raised fears that the world economy could return to a deep recession (it didn't). In the third quarter, some industry observers proclaimed that North America will become the largest energy producer in the world by 2025 due to the shale revolution. And finally, throughout 2012, China's economic growth slowed, which weighed on investor sentiment. Toward the end of 2012, all eyes focused on Washington where fears of the "fiscal cliff" weighed heavily on cyclical stocks.

In 2012, the U.S. produced approximately 6.3 million barrels per day of crude oil, against total demand of 18.7 million barrels per day. Assuming optimistic forecasts of shale production, industry analysts are projecting production of 7.8 million barrels per day by 2017, still well short of demand. This difference must be met by imports, tying U.S. oil prices to those of the world market.

And despite all of the economic headwinds, world oil demand increased to an all-time record in 2012 of 91.8 million barrels per day. Although OECD demand is stagnant, oil demand from the rest of the world continues to grow rapidly and now exceeds 50% of the total.

We continue to believe that the marginal cost of oil production is high, and provides strong support to current world oil prices. In addition, supply from many parts of the world is geopolitically unstable, which could lead to higher oil prices at any time. These potential scenarios are not reflected in energy equity prices, and thus we believe we are receiving a "free option" in investing in energy stocks today. Finally, Chinese demand for oil has recently been increasing, and Saudi Arabia has reduced production from the elevated levels of mid-2012. Both of these developments are conducive to higher world oil prices.

Several of our core holdings in the energy sector appear to discount a significant drop in oil prices. Although this could occur – especially with a global recession – we think a more likely scenario is a muddling along, with a low-probability of significantly higher energy prices. In the central case, our core holdings in the energy industry offer good long-term value and balance our considerable fixed income exposure.

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A Word on Management Compensation

A key part of Alleghany's operating philosophy is its approach to management compensation. There are two parts to this: compensation for holding company executives, and compensation for the executives of our operating subsidiaries.

At the holding company level, Alleghany executives allocate capital, manage investments, buy (and sometimes sell) companies, control risk, and work with the executives of our operating subsidiaries to improve their performance. We believe that the effectiveness with which the holding company management performs these functions can only be determined over fairly long periods of time, so a significant portion of our compensation is based on long-term performance.

Alleghany has made a number of acquisitions and divestitures over its history. Since joining the company in 2002, I have overseen a number of these transactions. Generally, I believe that we have done a good job in positioning Alleghany to acquire companies at reasonable prices. For example, we acquired RSUI Group in 2003 at what was effectively a price-to-book multiple of slightly more than 1.2x ($626 million on a tangible opening investment of approximately $500 million). Since then, RSUI has grown to $1.5 billion in stockholder's equity, and the company has paid us approximately $300 million in dividends, net of capital contributions post-acquisition. Time will tell, but we think our acquisition of TransRe at a discount to the company's book value will prove to have been at a good price. Some of our acquisitions are less successful. In hindsight, the acquisition of Employers Direct (now known as PacificComp) for approximately $193 million in 2007 was ill-timed due to the difficult conditions in the California workers' compensation market and the financial crisis that followed that acquisition. Fortunately, that cost was mostly offset by the fortuitously-timed sale of Darwin Professional Underwriters in 2008, just before the financial crisis.

I believe that the growth in Alleghany's book value per share is a reasonable yardstick against which management's performance should be measured. Over long periods of time (a decade or more), our stock price has tended to grow at the same rate as the growth rate of the company's book value per share. Over shorter time-periods, however, the two can move in very different directions, due to changes in investor expectations about the future relative growth rate of Alleghany's book value compared to other alternatives in the stock market.

Which brings me to an emerging governance trend — that of linking executive pay to stock price performance, or reducing pay in the event that the stock price performance of a company is negative. There are three problems with this approach, in our view. First, a company's stock price may move up or down over short periods of time (less than five years) due to cyclical trends in its industry, changes in investor preferences (e.g., a rotation to defensive stocks from cyclical stocks because the economy is weakening) or other reasons that are unrelated to the company's performance. Second, as discussed above, a company's risk profile may not be adequately tested over short periods of time. If a shareholder invests in a company for long-term growth in capital, it is imperative that the company not suffer a permanent loss. It is relatively easy for management in an insurance or reinsurance holding company to produce what may appear to be good short-term results, either by encouraging premium growth through more aggressive pricing or taking more "tail risk" in the company's operations. The negative effects of such actions may not show up over short periods of time, but time is the enemy of the imprudent risk taker. Eventually companies are tested, and it is only then that the shareholder finds out how good a job management has done in controlling risk. Third, extreme stock market moves can produce perverse results. A stock market bubble can reward management when an increasing share price overcomes the impact of poor financial performance. Similarly, a stock market crash can penalize management when excellent financial performance is masked by share price declines unrelated to the company.

In Alleghany's case, over the past decade we have watched our stock price move from 90% of book value to 140% of book value and back to 90% of book value (see chart at the beginning of this letter). All the while, book value per share steadily grew at near 9% per year, with only one down year (2008). Long-term investors who bought our stock at 90% of book value and held it for a decade more than doubled their money. Investors who purchased our stock at 140% of book value and sold at 90% of book value would have been quite disappointed with their investment.

The turnover rate in the shareholder base of most public companies continues to accelerate, with the long-term shareholder increasingly becoming a rare breed. This being the case, it makes little sense in our view to run a company and compensate management based on the relative preferences of a transitory shareholder base. We believe that investing in Alleghany will be most attractive to investors with a long-term perspective since we focus on building long-term value by controlling risk, avoiding permanent loss of capital, and hitting singles and doubles.

Alleghany's executives are primarily compensated through annual cash compensation (salary and annual bonus opportunity), and a performance share plan. The performance share plan grants performance shares to each executive on an annual basis. In order for any of these shares to vest, Alleghany's book value per share must grow at a minimum hurdle rate. Our compensation committee has set this rate at 5% for the period 2013-2016, which we believe approximates our cost of equity capital in the current interest rate environment. At this rate of growth, the plan will pay out 50% of target awards. At a 7% growth rate, the plan will pay out 100% of target awards. At a 9% growth rate or higher, the plan will pay out 150% of target awards. One subtlety to the plan is that the dollar value of the award is likely to change depending upon the growth rate in book value per share, because the price of Alleghany's stock will vary with the growth rate in book value per share. In the past for example, largely due to the financial crisis of 2008, the growth rates in book value per share for four-year periods including 2008 were impaired, reducing the value of the awards paid out for those periods both in terms of number of shares earned as well as the dollar value of the shares earned.

In sum, I believe that Alleghany's approach to holding company executive compensation is timeless and effective. It is designed to incentivize performance over the long-term and link executives' interests with that of Alleghany's long-term shareholders. We believe that the program is effective in achieving these objectives.

Our approach to compensation of our operating subsidiary executives is somewhat different. Here we try to craft plans that give underwriters a stake in the underwriting profitability of their company. The challenge of course is to create plans that recognize the inherent volatility of the business, so we typically smooth catastrophe losses by considering average catastrophe losses over multi-year periods. We also take the approach that we want the executives of our subsidiaries to think and act like owners. The best way to do this is to make them owners. Because our largest subsidiaries are wholly-owned, we do this by creating phantom stock in their company, the value of which is based on the book value of that company. This gives the management of each company an economic reward for profitable growth, serves as a retention incentive, and holds them accountable should losses occur.

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The Past Decade

2012 marked my tenth year with Alleghany. As illustrated by the Parent Company Balance Sheet below, Alleghany has grown and changed dramatically over this time period. We now have approximately 95% of our capital invested in the property and casualty reinsurance and insurance industry, with the balance in relatively small non-insurance investments with high return potential.

Parent Company Balance Sheet*
2002-2012

(in millions, except per share data)	As of December 31, 2002	2012
Liquid assets	$ 1,001	$ 554
Investments in operating subsidiaries**	542	6,546
Other assets	—	89
Total assets	1,543	7,189
Parent debt	—	699
Other liabilities	130	86
Stockholders' equity	1,413	6,404
Total liabilities and stockholders' equity	1,543	7,189
Shares outstanding	8.681	16.891
Book value per share	$162.75	$379.13
Investments in operating subsidiaries:**		
TransRe	$ —	$ 4,331
RSUI Group	—	1,484
Capitol Insurance Companies	239	308
PacificComp	—	127
Total (re)insurance	239	6,250
World Minerals	206	—
Heads & Threads	56	—
Alleghany Properties	26	31
Other**	15	265
Total investments in operating subsidiaries	$ 542	$ 6,546

* Includes AIHL.
**Includes minority-owned subsidiaries.

In 2012, as part of the acquisition of TransRe, we expanded Alleghany's executive team through the addition of Joe Brandon, a seasoned reinsurance executive. Joe has been appointed Chairman of TransRe, and President of Alleghany Insurance Holdings LLC, the parent company of all of our insurance operations. Joe brings a wealth of insurance and reinsurance experience and expertise to Alleghany, which will prove invaluable in helping to increase the value of our reinsurance and insurance businesses. He was instrumental in helping Alleghany identify, negotiate, and complete the acquisition of TransRe, for which all Alleghany shareholders should be very thankful.

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Outlook

Super Storm Sandy was either the second or third costliest U.S. natural catastrophe in history (in current dollars). This loss comes on the heels of 2011, the costliest year of international natural catastrophe losses in recorded history. Eight of the ten costliest U.S. natural catastrophes *ever* occurred during the past ten years – only Hurricanes Andrew (1992) and Hugo (1989) otherwise make the list. The only conclusion one can make from these cold, hard facts is that our industry can expect more large loss events – sooner than we would like. It is imperative, therefore, that we set prices at levels that anticipate the less frequent, large loss and also consider the reduced value of "float" in the current interest rate environment.

Alleghany enters 2013 with strongly capitalized subsidiaries, an improved spread of risk, a well-capitalized and liquid holding company, and moderate financial leverage. It is likely that underwriting profitability will improve in 2013, but we will continue to fight the headwind of lower interest rates and we must effectively navigate volatile financial markets.

Our consolidated investment portfolio, net of all debt, is about 2.6x the size of our consolidated stockholders' equity. In a world of 2% after-tax fixed income returns, this means that our ROE will be about 5% if everything else breaks even in the aggregate. While rising interest rates would have a negative effect on our book value growth in the short-run, it would improve the long-term economics of our businesses and increase the long-term growth potential of the company. We invest a portion of our capital in marketable equity securities which, for the most part, can be expected to add to returns in a stronger economy with gradually rising interest rates. Finally, we expect that our reinsurance and insurance subsidiaries will, over time, produce underwriting profits that will also add to our returns.

As discussed earlier, we invest a small amount of our current earnings in "positive-skew" businesses that we expect will produce accounting losses in the near-term but which hold the potential for outsized gains in the future. Most of these investments are relatively early in their life cycle, so they have yet to contribute much to our results. However, we believe that over the longer-term, there is the potential for significant value accretion from several of these investments.

We continue to believe that our portfolio of businesses and investments can produce 7-10% growth in book value per share per year over the long term, with a relatively low chance of loss in any one given year. Such a strategy should result in a doubling of shareholder value at least every ten years. We are optimistic that with our capital now more fully-deployed than in the past, we can meet or exceed this goal going forward.

Yours sincerely,

Weston M. Hicks
President