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 commercial property, casualty and surety insurance coverages
- ***Pacific Compensation Corporation —*** an underwriter of workers' compensation insurance primarily in California
- ***Roundwood Asset Management LLC —*** manager of our public equity investments
- ***Alleghany Capital Corporation —*** manager of our private capital investments

Financial Highlights *Alleghany Corporation and Subsidiaries*

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

	Year Ended December 31,		
	2013	2012	2011
Revenues	$ 4,971.7	$ 4,753.2	$ 981.8
Net earnings available to Alleghany stockholders	$ 628.4	$ 702.2	$ 143.3
Basic earnings per share of common stock available to Alleghany stockholders			
Operations[1]	$ 30.16	$ 38.96	$ 7.14
Security gains[2]	7.28	6.52	9.12
Net earnings available to Alleghany stockholders[1]	$ 37.44	$ 45.48	$ 16.26
Common stockholders' equity available to Alleghany stockholders per share[1]	$ 412.96	$ 379.13	$ 342.12
Average number of shares of common stock outstanding[1]	16,786,608	15,441,578	8,807,487

(1) 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 Corporation of 8,360,959 shares of its common stock.

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

Per Share Net Earnings (Losses)

Year Ended December 31,

	Reinsurance and Insurance Segments	Corporate Activities	Total
2013			
Operations	$29.33	$ 0.83	$30.16
Security gains[1]	5.95	1.33	7.28
Total	$35.28	$ 2.16	$37.44
2012[2]			
Operations	$12.26	$26.70	$38.96
Security gains[1]	4.84	1.68	6.52
Total	$17.10	$28.38	$45.48
2011			
Operations	$12.71	$ (5.57)	$ 7.14
Security gains[1]	5.62	3.50	9.12
Total	$18.33	$ (2.07)	$16.26

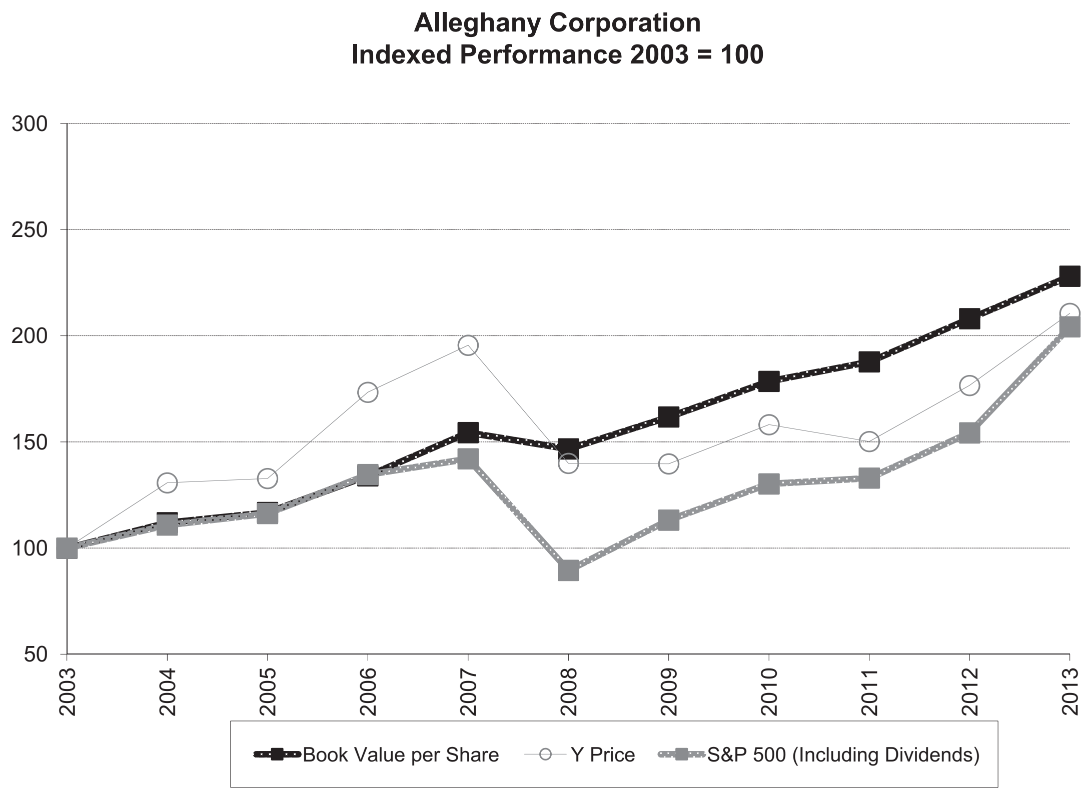
(1) Includes net realized capital gains and other than temporary impairment losses.

(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 Corporation of 8,360,959 shares of its common stock.

To Our Stockholders

Alleghany's common stockholders' equity per share at year-end 2013 was $412.96, an increase of 8.9% from common stockholders' equity per share of $379.13 at year-end 2012. For 2013, Alleghany reported net earnings to common stockholders of $628 million, or $37.44 per share. For the five years ended December 31, 2013, Alleghany's common stockholders' equity per share increased at a compound annual rate of 9.1%, compared with a compound annual rate of return of 17.9% 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, 2003. For the ten years ended December 31, 2013, Alleghany's common stockholders' equity per share increased at a compound annual rate of 8.5%, compared with a compound annual rate of return of 7.4% for the S&P 500 over the same time period. Alleghany's share price appreciated at a 7.7% compound annual rate of return over the past decade (adjusted for stock dividends).



The table below summarizes the change in common stockholders' equity in 2013 ($ millions):

Net earnings before items below	$ 440
Gains on equity securities and other	449
Losses on fixed income securities	(293)
Foreign exchange	(36)
Share repurchases	(40)
Increase in common stockholders' equity	$ 520

Strong underwriting results, primarily at TransRe and RSUI, along with appreciation in our equity portfolio more than offset a decline in the value of our bond portfolio caused by higher market interest rates. Although higher market interest rates slowed the growth rate of our book value, they hold the potential for improved future returns. This is because unrealized losses on the bond portfolio will be reversed in future periods barring credit losses, and positive operating cash flow is invested at higher interest rates, adding to future investment income growth.

Alleghany's growth in book value per share in 2013 can be further analyzed by looking at growth in book value by insurance subsidiary and corporate & other. The table below summarizes our 2013 results in this manner:

(in millions, except per share data)	Book Value 2012	Net Earnings	Other Changes	Capital Transactions	Book Value 2013	ROE	Growth in Book Value
TransRe	$4,330.6	$450.9	$(145.7)	$(150.0)	$4,485.8	10.2%	7.0%
RSUI	1,484.4	168.5	44.9	(100.0)	1,597.8	10.9%	14.4%
Capitol	307.8	(8.9)	13.7	(15.0)	297.6	-2.9%	1.6%
PacificComp	127.0	(18.6)	(4.8)	—	103.6	-16.1%	-18.4%
TOTAL	$6,249.8	$591.9	$ (91.9)	$(265.0)	$6,484.8	9.3%	8.0%
Corporate & Other	154.0	36.5	(16.5)	265.0	439.0	12.3%	13.0%
Consolidated	$6,403.8	$628.4	$(108.4)	$ —	$6,923.8	9.4%	8.1%
Shares outstanding	16.89				16.77		
Book value per share	**$ 379.13**				**$ 412.96**		**8.9%**

TransRe and RSUI, which together account for 88% of our consolidated stockholders' equity, both produced double-digit returns on equity. RSUI's growth in book value (adjusted for dividends) was 14.4%, while TransRe's growth rate was 7.0%. TransRe has proportionately more exposure to fixed income securities than RSUI.

Reinsurance and Insurance Subsidiaries – Challenges and Opportunities

The commercial insurance industry, like many industries, has undergone significant consolidation over the past 25 years. Major primary commercial lines underwriters are now large and formidable competitors, with established distribution systems, superior technology and data analytics, and significant capital resources with which to absorb volatility. The latter point is leading some companies to elect to retain more risk, which incrementally reduces potential demand for reinsurance.

At the same time, large, national insurers have been known to make broad underwriting decisions that can sometimes result in mispricing certain subclasses of risk, which create opportunities for more nimble competitors. Over the past three years, we have seen market leaders exercise pricing discipline and as a result drive some business away. If re-priced and re-underwritten, this business can be highly profitable.

Alleghany's principal reinsurance and insurance operations compete with the giants in their respective segments by exploiting market inefficiencies. TransRe is a valuable partner to many large and mid-sized insurers, bringing expertise and an industry-wide view to their underwriting decisions. In addition, TransRe is pursuing opportunities to support risks that flow through the MGA-market by offering specialists highly-rated issuing carrier paper and reinsurance capacity. RSUI captures opportunities in the wholesale excess and surplus lines market, where it has a leadership position and a demonstrated ability to profitably underwrite more challenging risks. Capitol has a strong position in surety and regional binding authority business, and under Stephen Sills's leadership, it is expanding into various classes of professional liability.

In short, we have a portfolio of companies that has the ability to uncover profitable growth opportunities. Each company is reviewed in more detail below.

TransRe

TransRe completed its first full-year as part of Alleghany in 2013, and what a year it was! The company posted the lowest combined ratio and largest dollar amount of annual underwriting profit in its entire corporate history. After a challenging 2012, this was a welcomed result.

TransRe finished 2013 with gross premiums written of approximately $3.4 billion and net premiums written of approximately $3.2 billion. Net premiums written declined approximately 7% when compared with 2012, including the period prior to the date of Alleghany's acquisition of TransRe. TransRe saw a double-digit decrease in net premiums written in Europe, where a weak economy and a highly competitive market made profitable growth a challenge. In North America, net premiums written declined more modestly, while in Latin America the figure was unchanged. It is important to note that net premiums written is not always a good indicator of growth in the reinsurance business, as changes from pro rata to excess contracts can result in unfavorable premium comparisons yet expected underwriting profits may actually improve. Net premiums written can also be inflated by multi-year or one-off transactions. Finally, because of the lags in the reinsurance business, much of the 7% decline in TransRe's calendar year net premiums written had its origins in 2011 when the company was dealing with uncertainty regarding its future.

TransRe's business is highly diversified by geography and line of business. Approximately 55% of TransRe's premium volume comes from North America, with the balance sourced from Europe, Asia, and Latin America. Approximately 30% of the company's premium base is property reinsurance, with 70% being casualty and other lines such as marine, aviation, and credit. About half of the company's casualty business consists of specialty casualty lines; TransRe has relatively little exposure to workers' compensation or heavy casualty lines.

The professional reinsurance market has long been an essential part of the global risk transfer system. Recently however, structural changes in the economic environment and the insurance industry itself are presenting new challenges for established companies. Consolidation among primary insurers has resulted in larger, more diversified primary insurers that find themselves able to assume more loss volatility. Some of these insurers have decided to retain more risk, resulting in less demand for certain classes of reinsurance. Consolidation among reinsurance intermediaries has also put pressure on the professional reinsurer through increased acquisition costs. At the same time, record low interest rates have encouraged institutional investors such as pension funds to allocate a small, yet growing, portion of their investment portfolio to insurance risk vehicles that bypass the traditional reinsurance markets. The reinsurance industry itself, having had a number of years of robust capital growth, now finds itself with abundant capital resources relative to probable loss scenarios.

TransRe has responded to this changing environment in a number of ways. As one of the few global reinsurers that have been a constant presence in the markets since the late 1970s, TransRe enjoys very strong client and intermediary relationships, and as a consequence it sees all the business that is available. The company has long enjoyed one of the lowest expense structures in the industry, which positions it well for a more competitive environment. TransRe's low expense structure is made possible by a highly efficient, internally-developed management information system, and a culture that emphasizes action over process. TransRe's management is highly entrepreneurial, and decisions are made quickly and without excessive bureaucracy. In any 24-hour period, e-mails from TransRe underwriters are flying through cyberspace, with transactions coordinated real-time through a global information system. It is this culture and infrastructure that allows just over 600 employees to efficiently and intelligently manage a diversified portfolio of $3.4 billion of premium coming from over 1,300 clients throughout the world, many of which have had ongoing relationships with TransRe for over 20 years.

With regard to the emergence of non-traditional risk transfer structures, TransRe has been quietly building capabilities through its investment in Pillar Capital Holdings Limited, which manages catastrophe capital pools for institutional investors, and Pangaea, the company's global side-car facility. Finally, in 2013 Alleghany made a strategic investment in Ares Management LLC, an $80+ billion alternative asset manager, and we are working together to find ways to provide insurers with more efficient risk management vehicles, leveraging Ares' asset management skills and deep relationships with pension and sovereign wealth funds.

In 2013, TransRe's Latin America Division celebrated its 20th anniversary. Clients from 18 different countries throughout the region came to Miami to be with Javier Vijil, head of the division, and his executive management team. I mention this event because it is a great case study in what makes the company unique. Javier has been head of this division for the entire period, and his clients are like family. It is a remarkable accomplishment for Javier and the entire TransRe executive management team (past and present) to have built such a strong franchise.

We had always felt that one of the "synergies" that would result from the combination of TransRe with Alleghany would be to provide an environment in which TransRe's talented senior management team could focus exclusively on serving its clients and addressing the challenges of a changing reinsurance environment. Alleghany relieves its operating subsidiaries of the necessary activities of being a public company, allowing them to do what they do best. As evidence of this, I am pleased to report that TransRe had a very successful January 2014 renewal season – despite an increasingly competitive environment – increasing the volume of expiring business.

Alleghany acquired TransRe in March of 2012 for total consideration valued at $3.5 billion. At the end of 2013, TransRe's stockholder's equity was approximately $4.5 billion, and the company had paid Alleghany $150 million of dividends. As of the end of 2013, TransRe's book value plus the dividends we have received from the company exceed our purchase price by approximately $1.12 billion.

RSUI

RSUI had a solid year in 2013, with its third consecutive year of strong top-line growth. In addition, the company recorded underwriting profits of $151 million. The table below summarizes RSUI's underwriting performance and annual ROE since becoming part of Alleghany in 2003 ($ in millions):

Year	U/W Profit	ROE
2003[1]	$ 92	18%
2004	83	11
2005	(133)	(8)
2006	197	18
2007	220	17
2008	138	4
2009	190	14
2010	160	13
2011	108	9
2012	5	7
2013	151	11
TOTAL	$1,211	11%

As can be seen from this table, RSUI has produced truly outstanding results under Alleghany's ownership. In a period of unprecedented catastrophe activity, RSUI has produced cumulative underwriting profits of over $1.2 billion. The gradual decline in the company's ROE is due to two factors: 1) a decline in investment yields due to the general interest rate environment, and 2) a decrease in operating leverage over the period shown. In 2003, RSUI had annualized gross written premium of approximately $1.2 billion and ending stockholder's equity of $707 million. In 2013, gross written premium was $1.3 billion, and ending stockholder's equity was $1.6 billion.

RSUI's success results from four aspects of its strategy:

1. exclusive focus on the wholesale brokerage community;
2. a "reactive" approach to its markets, offering to write business at appropriate prices without regard to top-line growth objectives;
3. a compensation system that rewards underwriters exclusively based on the firm's underwriting profits; and
4. a high-performance culture that perpetuates underwriting expertise.

In 2013, all but one of RSUI's product lines posted attractive top-line growth (in spite of not having that as an objective) and an underwriting profit. Growth was especially noteworthy in Binding Authority (+32%), Professional Liability (+26%), Umbrella/Excess (+16%), and D&O Liability (+14%).

Property insurance continues to be one of RSUI's most important departments. In 2013, the Property Department accounted for approximately 44% of the company's gross premiums written, down from over 50% several years ago. Over the past three years, RSUI has been successful in growing its property business by over 20% without increasing its peak catastrophe zone exposure. Since the end of 2008, renewal property rates for RSUI have fluctuated in a band of +/- 5%. In the current environment of increased reinsurance capacity and strong industry results, it is likely that property price competition will

[1] Six months underwriting result; annualized ROE.

increase in 2014. In such an environment, RSUI's expertise and operating model have tended to perform relatively well. By contrast, RSUI is continuing to see renewal rate increases in a number of casualty classes, including Umbrella/Excess, selected D&O and Professional Liability lines, and Binding Authority.

Alleghany acquired RSUI in July of 2003 for an initial investment of $628 million. Since then, our investment has been reduced to $229 million through net upstream dividends. At year-end 2013, RSUI's stockholder's equity was approximately $1.6 billion, or approximately 2.5-times our initial investment.

Capitol

The year just ended was one of significant change at Capitol. Although the company had produced modest growth in book value for Alleghany over the past decade, it was in a strategic box in that it lacked adequate scale to have a competitive expense structure. In addition, Capitol's results have suffered from an ill-fated entry into specialty program business, which once again was a contributing factor to the underwriting loss reported in 2013.

First the good news. In 2013, Capitol's net premiums written increased by 15% and in the fourth quarter alone were up 28%. This growth is coming primarily from the company's core regional property and casualty business. For the full-year, Capitol's current accident year loss ratio was under 50%, which suggests that with the right expense structure underwriting profitability is attainable.

However, additions to reserves for prior accident years – mainly related to the discontinued specialty program – overwhelmed the ongoing business, and as a result the company reported a $31 million underwriting loss for 2013. Capitol's ongoing business had an underwriting loss of $15 million in 2013, with almost $11 million of adverse reserve development, mostly related to a few specific unusual claims. In addition to an unacceptable underwriting result, Capitol's expense structure is too high relative to the volume of business that it writes.

To address these and other issues, in mid-2013 we decided to merge PRMS, owned by TransRe, into Capitol, and appointed Stephen Sills, who was head of PRMS, as CEO of Capitol. Stephen's plan is to keep the best parts of Capitol – namely its regional binding authority business and its exceptionally profitable surety business – while spreading its cost structure over a larger premium base by expanding in various classes of professional liability for smaller organizations. Stephen has already made a number of new hires, and is moving aggressively to build a high performance organization. Based on our past experience with Stephen, we believe he will be successful. More to come.

Alleghany acquired Capitol Transamerica Corporation in January of 2002. Including our investment in Platte River Insurance Company, which was combined with Capitol for management purposes, our initial investment in the company was $242 million. Since then, Capitol has returned approximately $130 million in dividends to Alleghany, reducing our net investment to $112 million. At the end of 2013, Capitol had a stockholder's equity of approximately $298 million.

PacificComp

PacificComp made progress in 2013 in repositioning itself for profitability. Under Janet Frank's leadership, the company has revamped its distribution and pricing strategies.

Annualized premium in force has increased to approximately $49 million at the end of 2013, up from $25 million at the end of 2012. In order to achieve underwriting profitability at current loss ratios, we believe that this figure needs to almost triple from current levels.

In her first year with Alleghany, Jan has focused on rebuilding the foundation of PacificComp for future growth. Jan has made a number of management changes, recruiting underwriting talent from an established, well-respected competitor, and strengthening her executive management team. PacificComp is rolling out a highly-automated small comp product, and is implementing new segmented pricing strategies to exploit a repositioned distribution system, which emphasizes production from outside of the Los Angeles basin. The majority of the company's new business is now coming from outside this highly competitive area, where loss volatility is extreme (to say the least) and it is difficult to make an underwriting profit. The jury is out on whether Jan's and our efforts will succeed, but we believe that PacificComp has a reasonable chance of materially improving its results.

Homesite

On December 31, 2013, Homesite was sold to American Family Insurance Company. Alleghany's net proceeds from this sale are expected to total approximately $184 million. We acquired our 33% interest in Homesite at the end of 2006 for $121 million. Over our seven-year holding period, Homesite more than tripled its size, improved its relative cost position, and solidified its relationships with key insurance partners. However, the company produced large underwriting losses in 2011 and 2012, primarily due to elevated weather-related losses. In 2013, after significant re-pricing and re-underwriting efforts, Homesite returned to underwriting profitability, and is now well-positioned to generate strong earnings for its new owner. We wish the management of Homesite much success with American Family.

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Investment Initiatives

In 2013, we made a number of changes to our investment organization in order to improve the long-term return potential of our almost $19 billion investment portfolio. Acknowledging the increased size and complexity of our $15 billion fixed income portfolio, in April 2013, we separated the role of CFO from oversight of this portfolio and appointed Roger Gorham as SVP – Head of Fixed Income and Treasurer. On the equity portfolio side, until July of last year, we had one investment team handling both public and private equity investments. In the second half of 2013, we split this group in two, with one team handling private investments and the other focusing on public equities only. The private investment group, which consists of four investment professionals, is called Alleghany Capital Corporation. The public equities group has been renamed Roundwood Asset Management LLC[2].

In addition to these internal changes, in mid-2013 we made a strategic investment in Ares. Alleghany invested $250 million in Ares and will receive the greater of 6.25% of the manager's distributed profits or a 5.0% return on our investment. In addition, we agreed to allocate $1 billion of our fixed income assets to investment strategies managed by Ares. Approximately half of this allocation will be invested in below-investment-grade strategies. Finally, we are working with Ares to develop opportunities in the alternative reinsurance markets, potentially combining their significant relationships with pension and sovereign wealth funds and asset management expertise with TransRe's global reinsurance underwriting platform.

[2] Roundwood Manor, built in 1924 in Ohio, was the home of Oris and Mantis Van Sweringen, who formed Alleghany Corporation in 1929.

Alleghany Capital

Alleghany Capital is headed by David Van Geyzel and Udi Toledano, both of whom have considerable experience in the private investment markets. Alleghany Capital's primary strategy is to make long-term control investments in non-insurance businesses that can be expected to generate attractive cash returns. We believe that there is a large universe of companies where family ownership and a continuing interest in the business makes a stable, long-term owner with significant capital resources a superior alternative to selling to a traditional private equity firm or a strategic buyer. Alleghany Capital's investments in Bourn & Koch, Inc. and R.C. Tway Company, LLC, known as Kentucky Trailer, fall into this category. A second focus of Alleghany Capital is to invest in growth capital opportunities with the potential to return multiples of our investment, but with more operating and business risk. Our investments in Stranded Oil Resources Corporation and ORX Exploration, Inc. fall into the latter category.

A brief update on each of Alleghany Capital's investments is shown below:

- **Bourn & Koch** is a Rockford, Illinois based manufacturer and remanufacturer / retrofitter of precision machine tools. The company also has a profitable replacement parts business for legacy machine tool products that produces consistent profits throughout the economic cycle. Alleghany purchased an 80% interest in Bourn & Koch in April of 2012, and has invested approximately $47 million in the company to date. The company's performance since our acquisition has been in line with expectations. Bourn & Koch had a solid 2013, generating strong cash flow as it successfully shipped numerous high technology machines to customers worldwide.
- **Kentucky Trailer** is the leading manufacturer of custom trailer and truck bodies for the moving and storage industry and other markets. At the end of 2013, Alleghany owned approximately 35% of the common equity of Kentucky Trailer, with an option to increase this ownership to 80%. In January of 2014 Alleghany exercised this option and now owns 80% of the company. Our cumulative investment in the company is approximately $40 million.
- **Stranded Oil Resources Corporation** was formed in 2011 to acquire legacy oil fields and apply innovative enhanced oil recovery techniques. In 2013, SORC made significant progress in developing its first major project, and it is making additional investments to create additional project opportunities in other locations. We have an economic interest of approximately 80% of SORC, and have invested approximately $59 million in the company.
- **ORX** is a Louisiana-based oil and gas exploration company in which Alleghany owns a 39% interest. The company has secured and developed a number of on-shore, sub-salt oil and gas resource opportunities called "the Louisiana Heritage Play." In 2013, the company sold a working interest in one of its prospects to a large independent oil and gas company.

Roundwood Asset Management

Roundwood is headed by F. Jack Liebau, Jr., who joined Alleghany in 2013. Jack is supported by five investment analysts, and now oversees our subsidiary equity investment portfolios. Although new to Alleghany as an employee, Jack is not new to the Alleghany management team. In 2003, we worked with Jack to start an asset management firm that initially managed $50 million for a subsidiary of Alleghany. Over the following decade, Jack produced strong investment results, and eventually sold his firm to a major asset manager. We expect that under Jack's leadership, our subsidiary equity portfolios will hold 15-25 stocks in strong businesses with above-average, long-term performance potential.

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Investments

With over $19 billion of cash and invested assets, the decisions we make on asset allocation have a significant effect on our future growth in book value. Although five years have passed since the Financial Crisis of 2008, the macro environment remains complex, uncertain, and sure to throw investors many curve balls.

The world economy continues to fight powerful deflationary forces. There are good arguments why recent central bank actions may ultimately be sufficient to offset these deflationary forces, but the case is not overwhelming.

Mature economies, despite the economic pain of the Great Recession, remain highly leveraged. Because money creation in a modern fiat money system comes from expanding credit, it is difficult for these economies to expand as borrowers are deleveraging. The effect of the new debt is to bring consumption forward, while the effect of new savings is to defer consumption. As private borrowers have reached the limit of debt expansion in relation to their income, governments have attempted to offset the deflationary impact of private sector deleveraging through deficit spending, partially indirectly funded by central bank balance sheet expansion. At this point however, government debt levels have also reached their upper limit, with debt-to-GDP ratios above 200% in Japan, above 100% in the United States, and above 90% in the Eurozone.

Even China "levered up" over the past five years, and some observers believe that there may have been a significant misallocation of capital. While we are certainly not experts in this area, common sense says that when credit expands to over twice GDP, future economic growth is at risk.

Globalization has greatly improved economic growth, but with globalization comes potential instability. Even with the rise of China and emerging markets, most of world trade continues to be dollar-based. Following the Financial Crisis, the Federal Reserve acted swiftly to expand its balance sheet, and in so doing weakened the U.S. Dollar relative to trading partners. The result was a gradual improvement in the U.S. economy, which now seems to be one of the few bright spots among major economic blocks. There is a problem, however, in that according to *Triffin's Dilemma,* the national interests of a country whose currency functions as the world's reserve currency will ultimately be at odds with the interests of the world economy. This may in fact be happening now, as an improving U.S. economy is reducing the current account deficit and thereby reducing the supply of U.S. Dollars outside of the United States, making it more challenging for foreign countries to settle their trade obligations. It would not be hard to envision a scenario of a banking crisis in some country off the radar screen that quickly rattles through the global banking system and turns a recovery into a recession.

Moreover, labor market trends are also deflationary. In particular, the "Robolution[3]," or widespread automation of repetitive high-skill and low-skill jobs, is creating a powerful headwind to job creation, as well as contributing to stagnant median wages. The January jobs report, announced earlier this year, illustrates the problem: while the unemployment rate fell to 6.6%, the labor force participation rate is extremely low (63.0%). The composition of employment growth is also not encouraging, with lower-wage or temporary jobs continuing to comprise a large portion of the net growth. As a consequence, with little income growth for the majority of households, the economic value of productivity improvement through automation is inuring to owners of capital, where at the margin it is saved rather than spent. We continue to be at a loss to understand how monetary policy can "fix" these trends. In 2013, the Federal Reserve created $1 trillion of new money, yet the economy grew by only $400 billion. Seems like a pretty steep price for tepid growth.

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[3] A term coined by Louis Gave in his 2013 book, *Too Different for Comfort.*

Demographic trends in the United States, Europe and Japan are also deflationary, as aging populations increasingly save for later-life expenses, less confident in their ability to rely on government to support their health and basic needs in old age. The fact that many mature governments have reached levels of borrowing that are no longer sustainable is likewise potentially deflationary, as they are forced into austerity actions rather than continued debt-financed expansion.

We have for some time also been concerned with the global energy industry's impact on these trends. Not only is geopolitical instability a continuing risk on oil supply, but the marginal cost of oil production remains stubbornly high for new sources of petroleum. The so-called Energy Returned on Energy Invested ("EROEI") has fallen over time, and new sources of oil – shale oil for example – are relatively low EROEI sources of oil. Cheap, efficient sources of energy are necessary to support high levels of economic growth, and to the extent such sources are unavailable, debt levels are more difficult to sustain and economic growth is likely to be subdued. As we have seen several times in the past, extremely expensive or unavailable energy has historically been sufficient to cause the world economy to tip into recession. Given the highly leveraged nature of the global economy, we view such a scenario as also highly deflationary.

Finally, although the capital position of major U.S. banks has improved significantly since the Financial Crisis of 2008, the global banking system as a whole remains fragile, with loan growth subdued. Banks are flush with liquidity, but can't seem to find a way to grow their loan portfolios. Maybe it is because there is a shortage of credit-worthy borrowers and/or reasonably valued assets against which to lend.

Inflation in the United States and Europe has fallen to about 1% over the past several months. This compares to market inflation expectations at the end of 2013 of approximately 2.25%[4]. Our current view is that the market expectations are too high, and that with weak aggregate demand, long-term interest rates will ultimately fall. We reserve the right to revise this forecast at any time, however, as facts change!

Outright deflation could be very negative for equity prices. With approximately $2 billion allocated to common stocks, as well as exposure to below-investment grade credit, such a scenario ("deflationary bust") could be very negative for these asset classes. For this reason, in late 2013, we allocated approximately $400 million to U.S. Treasury strips – long duration assets that should act as a "hedge" to our equity and lower quality bond exposure.

Although we worry about equity valuations, we also recognize that the structure of many industries has changed considerably over the past decade. Weaker companies, industry-by-industry, have been absorbed through consolidation, and while there are few true monopolies, there are many industries where two or three companies dominate their industry. Such industry structures have tended to produce higher profit margins and more durable cash flow streams to providers of capital. In addition, central bank policies of zero interest rates have allowed many companies to improve stock prices even though their revenues are not growing by substituting debt for equity in their capital structure (i.e. the private equity playbook). While this strategy can produce short-term rewards for shareholders, if carried too far it can increase a company's exposure to loss in the event of severe economic stress.

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[4] Measured as the 10-year treasury less the TIPS yield.

Alleghany's equity portfolio returned 35% in 2013, a solid result in a strong stock market, especially as our equity accounts maintained a 15-20% cash position. In other words, we took 80-85% of market risk, but produced returns that exceeded the broad stock market as measured by the S&P 500. At year-end 2013, we had approximately $19 billion of cash and invested assets, $2 billion of which was allocated to equity securities, with the balance ($17 billion) invested primarily in cash and fixed income securities.

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
2013	2.7	(1.0)	3.7
Cumulative	97.7	52.6	45.1
Annualized	7.1	4.3	2.8

Management Compensation

In last year's annual report, I discussed Alleghany's perspective on management compensation. We believe that our corporate compensation plans are consistent with the perspective of a *long-term owner*. Because many of us (management) have a significant portion of our personal assets invested in Alleghany, we care not only about return on our investment but return ***of*** our investment as well. We continue to shun management stock options, as they can give management a shorter-term incentive that is linked to the stock price. It is likely that we could improve Alleghany's return on equity and stock price in the short-term by taking a number of actions that would increase our risk profile. However, many of these actions would increase the probability of a permanent loss of value in times of stress and lead to future cohorts of disappointed investors. We prefer to see Alleghany's stock price fairly valued, so that one cohort of shareholders does not prosper excessively at the expense of another.

The difference in perspective between companies that focus on long-term shareholder value and near-term stock price movements was well-summarized by Jim Collins in his book *How The Mighty Fall*:

> Those who built the great companies in our research distinguished between share *value* and share *price*, between share*holders* and share*flippers*, and recognized that their responsibility lay in building shareholder value, not in maximizing shareflipper price.

Many hedge funds today measure themselves by their performance adjusted for market exposure. A fund that produces a market-beating return with below-market exposure adds value, whereas a leveraged fund that only matches a market return is not adding value at all – it's just taking risk.

Over the past decade, Alleghany's equity valuation has ranged from a discount to book value to a premium to book value. Over long-periods of time (i.e. a decade or more) it is likely that the return that our shareholders will receive will be close to the growth rate in our book value per share. We have said that we believe that in the current economic environment, we can produce 7-10% growth in book value per share with below-average risk. In a world of ~1% inflation and a ~3% 10-year treasury yield, we view this as an attractive return ***relative to our risk profile.***

If Alleghany were an investment fund, our "book value beta[5]" measured on a quarterly basis would be about 0.24 – meaning that the quarterly change in our book value per share is only 24% as volatile as the quarterly change in the return of the S&P 500. Alleghany's stock price has a quarterly beta of 0.54, while its beta measured on a daily basis is about 0.80. For the long-term investor, our book value per share has grown faster than the total return on the S&P 500 and is only 24% as volatile as the market return.

The chart at the beginning of my letter shows how Alleghany's book value per share and stock price have grown over the past decade. Our stock price tends to fluctuate in relation to book value, but over the long-term, has wound up at almost the same place. Another way to look at our performance is in the table below, which summarizes cumulative five-year returns (adjusted for/including dividends) for each five-year period ended in the year shown (BV = Book Value, MV = Market Value):

	Alleghany		S&P
Year	BV	MV	500
2003	34%	31%	-3%
2004	65%	70%	-3%
2005	58%	53%	-11%
2006	51%	109%	34%
2007	77%	150%	82%
2008	50%	40%	-10%
2009	50%	7%	2%
2010	58%	19%	12%
2011	43%	-13%	-1%
2012	37%	-10%	9%
2013	55%	51%	126%
Average	53%	46%	22%
Volatility[6]	12%	50%	44%

[5] The correlation between the quarterly change in our book value per share and the quarterly return on the S&P 500.
[6] Standard deviation.

Several observations can be made in reviewing this data series. First, Alleghany's book value per share growth (the BV column above) has been quite consistent, averaging 53%, with annual volatility of 12%. By contrast, Alleghany's stock price has considerably more volatility, as does the general stock market. Alleghany's 5-year book value growth has exceeded the S&P 500 total return in eight of the last ten years. Its 5-year stock price return has exceeded the S&P 500 total return in seven of the last ten five-year periods. Our failure to match the market's 5-year return in 2013 is primarily the result of the starting point valuation for the S&P 500 (very depressed at the end of 2008), coupled with the liquidity-fueled multiple expansion of the market in 2013. This too shall pass.

We regularly review our parent company and subsidiary compensation plans to ensure that they support the objective of building long-term value. In 2013, I recommended to the Alleghany Compensation Committee that we freeze Alleghany's Executive Retirement Plan, a deferred compensation plan that provided Alleghany executives with significant economic value at retirement. Because this value was purely based on continued employment, this plan did not support our long-term value growth objective and seemed to have outlived its usefulness. The Committee and Board agreed with my recommendation, and the change was made. Other changes over the past year included terminating our post-retirement medical plan, removing upside leverage for Alleghany executives from our annual incentive plan, and adopting a policy that prohibits Alleghany directors and officers from the hedging or pledging of Alleghany securities.

Awards of performance shares under Alleghany's long-term incentive plan, which comprise a significant amount of my and other Alleghany executives' compensation, continue to be based on our ability to compound book value per share relative to our cost of equity capital. We believe that this plan, which has been in place since 2003, aligns compensation with the returns provided to the long-term owner of the company. If we suffer a decline in book value per share in any one year, it negatively impacts four periods of four-year performance share awards, reduces the number of shares that executives receive, and because the stock price is likely to be lower than it would have been without a decline in book value in that one year, the dollar value of the award is reduced even further. Full details of this plan are described in our annual proxy statement.

At the subsidiary level, we believe in aligning the compensation of management with their individual business responsibility. For our insurance subsidiaries, we continue to try to craft plans that give management a stake in the underwriting profitability of their company and make them think and act like long-term owners. We do this primarily through phantom stock plans, where the value of the stock is based on the subsidiary's growth in book value.

With the reorganization of our investment subsidiaries, we also revamped the long-term compensation elements for investment professionals. At Roundwood, we created a deferred compensation plan in which investment professionals, on an annual basis, are awarded an amount of compensation that will be paid in cash three years hence, adjusted for the total return that Roundwood produces for its clients (all currently internal). Continued employment is required to receive the payment. At Alleghany Capital, the investment team will have a carried interest in returns above a hurdle rate, however, unlike the typical private equity plan, the carry decreases as a percentage of the gain as the gain gets larger (i.e., no unlimited upside).

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Outlook

Alleghany's insurance and reinsurance subsidiaries take a myriad of low-probability investment and underwriting risks. By taking a long-term perspective on capital allocation, we believe that we can produce attractive returns for our shareholders. But given the frequency with which low probability events occur, performance is best judged by looking in the rear view mirror after a significant amount of time has passed. Over the past decade, we have experienced several extreme weather events (Super Storm Sandy, Hurricane Katrina) and one severe economic event (the 2008 Financial Crisis). In years such as 2013 (a "risk-on" year) when there are no extreme events, our relatively low-risk business model may lag the broader market. However, when markets are tested, our value proposition becomes clear.

We believe that our business model, with its inherent risk diversification (bonds, equities, private investments, underwriting, catastrophes) offers our shareholders a lower-risk proposition than the average company in the S&P 500. Moreover, this assertion is supported by our below-average financial and operating leverage and confirmed by our low beta. In particular, our after-tax exposure to extreme weather events appears to be less than many of the "offshore" competitors against which our subsidiaries compete. Despite this low-risk profile, our book value per share has compounded 1.1%-points faster than the S&P 500 over the past decade. Shareholders of companies that took extreme risks and lost (we all know the notorious names by now) have suffered a permanent loss of capital.

Our performance in 2013 benefitted from a benign catastrophe year and very strong equity markets. The rise in interest rates, however, offset some of this fortuity, causing a decline in the value of our fixed income portfolio. Operating income and equity gains were sufficiently robust that we were able to generate near-10% growth in book value despite a decrease in the value of our bond portfolio. Without the negative effect of market value accounting on our bonds, which for the most part are held until maturity, our growth in book value would have been almost 4-points higher.

Yours sincerely,

Weston M. Hicks

Weston M. Hicks
President