

To Our Stockholders

Alleghany's common stockholders' equity per share at year-end 2015 was \$486.02, an increase of 4.4% from common stockholders' equity per share of \$465.51 at year-end 2014. For 2015, Alleghany reported net earnings attributable to common stockholders of \$560.3 million, or \$35.14 per share, while changes in the market value of our investments and other items reduced book value per share by \$14.63 per share. For the five years ended December 31, 2015, Alleghany's common stockholders' equity per share increased at a compound annual rate of 8.4%, compared to a compound annual rate of return of 12.6% for the S&P 500 over the same time period. A year ago in my letter I suggested that the S&P 500 might be at an elevated level and unfortunately my observation is looking correct -- since the end of 2014, the S&P 500 has had a negative total return.

The table below summarizes Alleghany's longer-term performance. For the ten years ended December 31, 2015, Alleghany's common stockholders' equity per share increased at a compound annual rate of 8.6%, compared to a compound annual rate of return of 7.3% for the S&P 500 over the same time period, and a compound annual rate of return of 7.4% for the Russell 3000³. Alleghany's share price appreciated at a 6.6% compound annual rate of return over the past decade (adjusted for stock dividends). Alleghany's share price performance lagged the growth in book value per share because the share price was 119% of book value on December 31, 2005, and was 98% of book value on December 31, 2015.

Although our growth rate in book value per share was modest in 2015, we are satisfied with the result given the low levels of returns available elsewhere in the capital markets. Over the past decade, our book value per share has increased in every year but one -- 2008 -- when it declined 5.0%, compared to a 37.0% decline in the S&P 500.

Performance Summary

Average Annual Return or Growth Rate

Periods Ended December 31, 2015

	Alleghany		S&P 500	Russell
	BVPS ¹	Stock Price ²		3000 ³
1 year	4.4%	3.1%	1.4%	0.5%
3 years	8.5%	12.4%	15.0%	14.7%
5 years	8.4%	9.7%	12.6%	12.2%
10 years	8.6%	6.6%	7.3%	7.4%

¹ Book value per share.

² Because Alleghany has not paid a common dividend during these periods, stock price appreciation is equal to total return.

³ The Russell 3000 is a broader measure of stock market performance, and is less distorted by the performance of "mega cap" stocks.

The table below summarizes the change in stockholders' equity attributable to Alleghany common stockholders in 2015 (\$ in millions):

	<u>Amount</u>	<u>% of Beg. Equity</u>
Net earnings before items below	\$ 508	6.8%
Realized and change in unrealized gains, net of tax:		
Equity securities	(73)	(1.0)
Fixed income securities	<u>(98)</u>	<u>(1.4)</u>
Total	(171)	(2.4)
Share repurchases	(244)	(3.2)
Foreign exchange	(15)	(0.2)
Other items, net	<u>3</u>	<u>0.0</u>
Increase in common stockholders' equity	\$ 81	1.0%

Strong underwriting results at TransRe and RSUI Group were the principal driver of book value growth in 2015. Investment returns were negligible: including interest and dividend income, our bond portfolios returned 0.3%, and our equity portfolios returned a negative 1.5%. Although nominal growth in stockholders' equity was only 1.0%, per share growth was 4.4% as we reduced Alleghany's share count by 3.2% in 2015. This 4.4% increase in the *per share* value of Alleghany follows a 12.7% increase in 2014.

In 2015 we repurchased \$244 million of Alleghany shares at an average price of \$468.45, or about a 4% discount to year-end 2015 common stockholders' equity per share. In addition, unlike much of Corporate America, we reduced our aggregate debt outstanding. Debt to total capital was 15.5% at year-end 2015, compared to 19.1% at year-end 2014. Total long-term debt decreased by \$377 million from \$1,767 million to \$1,390 million, and we ended 2015 with over \$800 million of marketable investments at Alleghany Corporation and its non-regulated subsidiaries. We are sometimes asked why we are deleveraging at this point, with interest rates so low. The answer is when heading into stormy seas it makes sense to batten down the hatches. We believe that *financial flexibility* and *corporate resiliency* will be more valuable in 2016 and beyond.

The table below summarizes our 2015 growth in book value per share in more detail:

	<u>TransRe</u>	<u>RSUI</u>	<u>Other⁴</u>	<u>Total</u>
Beginning Equity	\$5,130	\$1,587	\$ 756	\$7,473
Operating Income	408	148	(48)	508
Net realized gains, after tax	94	54	(9)	139
Impairment losses, after tax	(46)	(15)	(26)	(87)
Net earnings	\$ 456	\$ 187	\$ (83)	\$ 560
Other Changes ⁵	(126)	(58)	(50)	(234)
Capital Transactions	(250)	(150)	156	(244)
Ending Equity	\$5,210	\$1,566	\$ 779	\$7,555
Operating ROE	7.9%	9.3%	(6.3)%	6.8%
Growth in Book Value ⁶	6.4%	8.1%	(18.4)%	4.3%
Growth in Book Value Per Share				4.4%

TransRe and RSUI Group, which together account for 90% of our consolidated stockholders' equity, produced high single-digit returns on equity on an operating basis (excluding net realized capital gains or losses and OTTI charges). Investment returns, however, were weak in 2015 resulting in slightly lower growth in book value for each company relative to the return on equity, which is consistent with the lackluster performance of all investment classes in 2015.

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

As the table above shows, we had net assets of \$779 million at the end of 2015 in addition to the equity of TransRe and RSUI Group. The "Other" column includes our smaller

⁴ CapSpecialty, PacificComp, corporate assets, and Alleghany Capital Corporation investments, net of holding company debt.

⁵ Principally the change in unrealized appreciation (depreciation) on investments, net of tax.

⁶ Dividends and share repurchases added back to ending equity.

insurance subsidiaries (CapSpecialty and PacificComp), Alleghany Capital Corporation and its subsidiaries and investments, our holding company investments, and corporate administration costs. There are many reasons why this figure is negative, but the most important ones include 1) the relative underperformance of CapSpecialty and PacificComp (although each company improved significantly in 2015); 2) operating losses at Stranded Oil Resources Corporation; and 3) investments held for their total return (mostly equities) where dividend income is less than the cost of holding company debt. I will have more to say on each of these items later in this letter.

The table below summarizes the major items comprising our \$779 million of net assets:

Parent cash & invested assets ⁷	\$ 715
Parent debt	(997)
Parent debt, net of cash & invested assets	<u>\$ (282)</u>
Investment in Ares Management, LP	225
CapSpecialty and PacificComp ⁸	332
Alleghany Capital Corporation investments	482
Alleghany Properties	37
Other items, net	(15)
Total	<u>\$ 779</u>

Only the parent invested assets above are carried at market value. All of the other investments reflect our share of each company's results, in some cases with purchase accounting adjustments.

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In the case of Ares Management, LP the conversion value of our investment based on the quoted price of Ares at December 31, 2015 was \$162 million, approximately \$63 million below the carrying value of our investment. Because our investment is in the form of a limited partnership interest in certain Ares subsidiaries that is convertible into the publicly-traded units of Ares accounting conventions require that we carry the investment at cost adjusted for our share of earnings.

We remain constructive on the company's long-term prospects. The depressed valuation of Ares appears to reflect investor concerns about the global economic outlook, as well as changes to the fixed income liquidity environment. As noted by Michael Cembalest of JP Morgan, regulatory changes requiring increased bank capital

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

⁸ Shown net of intercompany eliminations. Gross combined equity of these two companies is \$407 million.

has reduced their role as market liquidity providers. As noted in his analysis⁹, fixed income trading revenue from global investment banks has declined from approximately \$120 billion in 2009 to an estimated \$60 billion in 2015. Fixed income trading assets – credit in particular – are down roughly 38% over that timeframe.

From a longer point of view, we believe that Ares, like other alternative asset managers, is very well positioned to deliver superior returns to institutional investors and is competitively advantaged against the now highly-regulated banking industry. Tony Ressler has assembled a first class team of investment professionals that have an excellent long-term performance record in direct lending, tradeable credit, private equity, and real estate.

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We continued to make progress in 2015 in improving the results of CapSpecialty and PacificComp. CapSpecialty produced an almost 15% increase in net premiums written and reduced its underwriting loss by almost 50% in 2015. PacificComp generated a 47% increase in net premiums written and reduced its underwriting loss from \$19.7 million in 2014 to \$13.5 million in 2015. We believe that both companies have the potential to achieve underwriting profitability in 2016.

We also continued to build out Alleghany Capital's portfolio of non-financial businesses. In the fourth quarter of last year Alleghany Capital acquired an 84% ownership interest in IPS-Integrated Project Services, a leading international provider of technical consulting, design, engineering, construction, project control, commissioning and qualification services for technically complex facilities, primarily in the biotechnology and pharmaceutical industries.

In late 2015, Alleghany Properties completed its first property sale since the 2008 Financial Crisis, and as a result reported a small profit for the year. Further sales in 2016 and beyond are now possible as the development moratorium related to required improvements in Sacramento's levy system has been lifted. Alleghany Properties continues to own over 300 acres in the greater Sacramento area.

As mentioned above, Alleghany's consolidated debt to total capital ratio, which was 19.1% at the beginning of the year, declined to 15.5% at the end of the year, a result of the repayment of debt that matured in 2015 at Transatlantic Holdings, Inc. As indicated

⁹ "When The Levee Breaks", Eye On The Market, January 19, 2016.

in the table above, our debt net of holding company marketable investments was only \$282 million at the end of 2015. Accordingly, our “net debt” to total capital ratio at the end of 2015 was 3.7%.

Alleghany’s business model

Financial markets have been extremely favorable for the past six years. Following the 2008 Financial Crisis, equity investors have enjoyed a long period of positive returns, as the S&P 500 recovered from its early 2009 low of 666 to over 2000 at the end of 2015. Insurance markets too have been accommodating. Global catastrophe losses have been significantly below average levels for the past three years, and liability claims inflation has been subdued. With conditions like this, it is easy to fall into the trap of thinking that more risk is better.

Alleghany’s approach is to increase risk when the market price of risk is high and to decrease risk when it is low. Today, expected returns on most investment classes are low, so we have tried, for the most part, to stay at the higher end of the quality spectrum, whether we are talking about bonds or equities. In the (re)insurance world, we have reduced tail risk, as evidenced by the fact that our exposure to losses from extreme events is a smaller percentage of capital than it was several years ago.

Our (re)insurance subsidiaries provide the holding company with dividends to the extent they are profitable and are unable to reinvest their earnings to support organic growth. In 2015, for example, TransRe sent \$250 million to Alleghany, and RSUI paid dividends of \$150 million. Alleghany’s role, in addition to assisting our (re)insurance subsidiaries in managing their businesses, is to redeploy this capital. We have used these dividends to make acquisitions at Alleghany Capital, reduce debt, or repurchase shares. In 2015, of the total upstream dividends of \$400 million, \$244 million was used to repurchase Alleghany common stock and \$90 million was used to acquire a controlling interest in IPS-Integrated Project Services. TransRe has also accumulated sufficient excess capital to retire a meaningful portion of its debt that existed at the time of the Alleghany merger.

The combination of risks which are, for the most part, independent – financial returns, non-financial profits, and insurance risks – produces less volatility in the aggregate than each risk by itself. We believe that in combination, they provide our stockholders with a return profile that is quite attractive relative to Alleghany’s risk. For the long-term stockholder, we aim to produce attractive real returns with a very low chance of permanent capital loss. Of course, the performance of our stock price – which can be easily blown around like leaves on an autumn day – can deviate from market returns over relatively short (3-5 year) periods of time based on investor preferences, stock price momentum, and other factors beyond our control. Because stock prices today are

increasingly a function of basket trades (due to indexing), momentum strategies (due to increased computer power and lower trading costs), and algorithmic trading, we focus on what we *can* control – growing the intrinsic value of Alleghany Corporation over the long-term – and hopefully making intelligent risk and capital allocation decisions.

Reinsurance and insurance subsidiaries

TransRe

In March of 2012, Alleghany acquired TransRe for total consideration valued at \$3.5 billion. This acquisition – which was a transformational deal – has proven to be a huge success for Alleghany, thanks to the efforts of Mike Sapnar, CEO of TransRe, and his talented management team and staff.

- TransRe has reported almost \$1 billion of adjusted underwriting profits after deducting \$291 million of VOBA (Value of Business Acquired) amortization expense related to purchase accounting, which produced an adjusted combined ratio of 92.2% on \$12.6 billion of net premiums earned.
- TransRe has generated just shy of \$1.6 billion of book value growth since March 2012, which equates to a compound annual growth rate of 9.5%.
- During this time, TransRe has paid Alleghany net dividends of \$390 million, redeemed \$667 million of its debt at par value and added \$1.2 billion to its book value, which is up 30% to \$5.2 billion at December 31, 2015 from \$4.0 billion at closing.
- Including Alleghany's \$495 million bargain purchase gain, TransRe has contributed almost \$2.1 billion to the growth in Alleghany's book value.
- Alleghany's annualized return on investment through the end of 2015 is 13.5%, assuming TransRe is valued at 1.0x book value.
- Alleghany's book value per share is about 10+% higher than it would have been had we not purchased TransRe in 2012.

TransRe had another terrific year in 2015. Not only did the company report its lowest combined ratio in its history, but it had its third highest underwriting profit ever at \$327 million (the highest was 2014 at \$345 million) and had its third consecutive year with a combined ratio of under 90%. In addition to these very strong results, TransRe was able to retain a diversified and well-underwritten book of business in a competitive and challenging market.

But wait, there's more ...

TransRe was also able in 2015 to eliminate all of its legacy exposure to accident years 1986 and prior with its former parent company, American International Group, by entering into a "Commutation and Release" agreement with the company. This is a terrific outcome for both TransRe and AIG as it eliminates costly litigation for both companies and allows TransRe to restore its trading relationship with one of the world's largest property and casualty insurers. TransRe was able to accomplish this through extensive discussions and negotiations with AIG and other parties, at a cost that exceeded its net carried reserves for the exposures of only \$38 million.

TransRe's reserves for outstanding claims remained strong at the end of 2015, and with the elimination of its past exposures, the company offers solid gold security. With its global reach, superior balance sheet strength, and breadth of product offerings, TransRe is the "go to" market in reinsurance.

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In 2015, TransRe was able to maintain what we believe will prove to be a profitable, highly diversified book of reinsurance risk in an environment that remained highly competitive and challenging. The combined ratio of 89.5% reflected solid property results (66.3% combined ratio) with casualty and other lines coming in at 98.7%. In order to maintain a properly priced portfolio, TransRe continues to be willing to increase or decrease its treaty participations depending upon terms, conditions, and underlying pricing and loss trends. For the 2015 underwriting year (treaty and facultative), approximately 14% of the expiring portfolio was cancelled and approximately 32% of the portfolio in force at the end of the underwriting year was new. Like a duck smoothly floating on a lake, beneath the surface the feet are paddling fast!

Many of the industry trends discussed last year remained a factor in 2015. Market conditions are challenging, with quota share commission pressure and decreased demand from large diversified clients (although this may be changing as their underlying results have in some cases come under pressure). Because TransRe has significant underwriting expertise and strong client relationships, it is able from time-to-time to achieve differential terms, a testament to the client's view of the value that TransRe provides.

In North America, TransRe is finding opportunities to grow in whole account contracts, mortgage risk, and regional property and casualty insurers. In late 2015, the

company was successful in writing a large whole account contract that added significantly to gross and net written premium in the quarter. In casualty lines (traditional and specialty), TransRe is seeing reduced demand, in part due to the exceptionally strong results that ceding companies have experienced over the past decade or so. TransRe's international business had mixed trends in 2015. There appears to be plenty of opportunity to write business in Asia Pacific, although TransRe has been selective in writing business and posted only modest premium growth in the region. In Latin America, TransRe has been able to find some growth opportunities as well through differentiated reinsurance transactions with existing customers. In Europe, however, the effect of intense competition is more evident, as volumes declined in 2015.

Over the past several years, TransRe has made significant investments in creating integrated underwriting and workflow systems to improve efficiency and to assist in better risk profile management. The company's systems are among the best in the industry and give TransRe a competitive advantage in analyzing and optimizing risk.

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The low interest rate environment of the past five years, along with technological and product innovation, has created an "alternative market" for reinsurance risk that is growing and becoming an increasingly important part of the global insurance risk management system. Pension funds and other investors are increasingly looking to diversify their financial risk with insurance risk, particularly in the property catastrophe arena. From a ceding company's perspective, having non-traditional suppliers of catastrophe reinsurance assume some portion of their catastrophe reinsurance needs has lowered costs and improved flexibility. It remains an open question the extent to which financial investors will "trade forward" in this market after a major loss event. Historically, the personal and institutional relationships between insurer and reinsurer become extremely important after major catastrophic events.

The TransRe Capital Partners division manages TransRe's capital market vehicles as well as traditional retrocessional transactions, and has a robust and growing position in these new markets. Side car support now exceeds \$400 million, and the company has been active in using retrocessional coverage to improve its risk-reward profile. In addition to its Pangaea facility, TransRe is also an investor in Pillar Capital Management, which manages catastrophe reinsurance funds.

RSUI Group, Inc.

RSUI had another strong year in 2015, producing \$158.1 million of underwriting profit and a combined ratio of 80.4%. Underwriting profits were lower in 2015 compared to 2014 primarily due to lower premiums and an underwriting loss in the Directors and Officers (“D&O”) product line. Although catastrophe losses were very low in 2015 (\$26.1 million compared to \$44.4 million in 2014), this favorable comparison was mostly offset by lower levels of favorable prior year reserve development. Prior year net reserve changes added \$11.9 million to underwriting profits in 2015, compared to \$35.4 million in the prior year. Most of this reduction was due to increases in prior year reserves in D&O, which were partially offset by decreases in reserves for prior years in other product lines.

Market conditions continue to be very competitive in the wholesale specialty insurance market. RSUI remains focused on underwriting profit, and as a result it is writing less new business which, compared to renewal business, is usually less favorably priced in a deteriorating market. New business declined by 15% in 2014 and another 18% in 2015. This is to be expected, and shows that RSUI is maintaining underwriting discipline in a challenging market. As a result of this discipline, renewal pricing remains more or less stable. In 2015, RSUI estimates that it achieved modest renewal rate increases in all of its product lines except for property.

RSUI has seen its top line shrink in past cycles. For example, in 2006 the company had gross written premium of approximately \$1.4 billion, and this declined to \$0.9 billion by 2010. Given the exceptionally strong underwriting results over the post-Sandy period, we expect market conditions to remain challenging near-term. By being willing to shrink when market conditions become more competitive, RSUI has been able to preserve underwriting profitability through industry cycles. Since we acquired RSUI Group in 2003, the company has produced an inception-to-date combined ratio of 82%.

RSUI is maintaining its investment in underwriting talent and remains well-positioned to grow when market conditions allow. As the company’s CEO Dave Leonard has said, “If you don’t feed your chickens, eventually you won’t have any eggs!” In an important initiative to remain a significant force in the specialty insurance marketplace in the face of increased competition, RSUI has introduced what it calls a “companion facility” whereby RSUI adds third-party capacity to sit side-by-side with RSUI on risks that it believes are appropriately structured and priced. This allows the company’s underwriters to remain front and center with key producers in more challenging market conditions.

Alleghany acquired RSUI in July of 2003 for an initial investment of \$628 million. Since then, our investment has been reduced to approximately \$(146) million through net upstream dividends of \$774 million. The company has generated \$1,549 million of underwriting profits under our ownership, and its stockholder's equity has compounded at 11.1% adjusted for dividends and capital contributions. At year-end 2015, RSUI's stockholder's equity was approximately \$1.6 billion.

CapSpecialty, Inc.

CapSpecialty made significant progress in its quest to return to underwriting profitability in 2015. The company's mission statement is to be the preferred specialty insurance and surety company for small and mid-sized businesses in the U.S. The company pursues this objective by hiring top underwriting talent, rebuilding the company's systems and operating architecture, and reorganizing into industry practice groups. Under the leadership of Stephen Sills, the company is well on its way to realizing its vision.

Net premiums written increased last year by almost 15%, resulting in an improvement in the company's expense ratio from 49.9% in 2014 to 46.1% in 2015. CapSpecialty has been refocusing its two legacy businesses – binding authority and surety – while building out a third professional lines division. Professional lines grew 156% in 2015, while the legacy property and casualty business and surety business declined modestly. The combined ratio in 2015 was 102.6%, compared to 105.8% in 2014. If prior year reserve development is excluded from both years, the combined ratio was 100.3% compared to 105.7% in 2014.

Alleghany acquired Capitol Transamerica Corporation in January of 2002. Including our investment in Platte River Insurance Company, which was combined with Capitol Transamerica for management purposes, our initial investment was \$242 million. Since then, CapSpecialty as we now call it has returned approximately \$130 million in dividends to Alleghany, reducing our net investment to \$112 million. At the end of 2015, CapSpecialty had stockholder's equity of approximately \$312 million.

Pacific Compensation Corporation

PacificComp again made very good progress in 2015 toward its goal of restoring underwriting profitability. Jan Frank and her team have meticulously cultivated new distribution relationships, implemented a rigorous underwriting platform, engineered an efficient and high service organization, and significantly strengthened the company's claims department.

As a reminder, PacificComp largely exited the California workers' compensation market in 2010 and 2011 as it judged that market prices were at a level that would not allow it to make a profit. During that time PacificComp changed its distribution strategy and repositioned its emphasis to lower hazard classes of risk in areas of the state that historically offered the potential for better results. Beginning in 2012, PacificComp emerged as essentially a new company, running off the legacy business while building the new business platform. Legacy costs, along with reserve adjustments for prior accident years, produced significant losses.

The results since we re-entered the market in late-2012 are encouraging, as illustrated below:

Pacific Compensation Corporation
Summary of Results By Year (\$ millions)

	<u>2012</u>	<u>2013</u>	<u>2014</u>	<u>2015</u>
Net premiums written	\$ 19.0	\$ 40.8	\$ 69.5	\$101.9
Underwriting loss	(31.2)	(33.2)	(19.7)	(13.5)
Net investment income	3.8	4.3	4.6	5.2
Other income (expense)	0.5	(0.9)	0.0	(0.3)
Pretax loss	<u>\$ (26.9)</u>	<u>\$ (29.8)</u>	<u>\$ (15.1)</u>	<u>\$ (8.6)</u>
Loss ratio	120.0%	113.6%	81.7%	76.6%
Expense ratio	166.5%	71.7%	47.6%	36.9%
Combined ratio	286.5%	185.3%	129.3%	113.5%
Combined ratio – Accident Year	253.2%	151.4%	125.8%	113.5%

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Investments

Alleghany's equity portfolio returned (1.5%) in 2015, compared to the return of the S&P 500 of +1.4% and the equal-weighted S&P 500 return of (2.2%).

In last year's annual report, I said that "the U.S. stock market appears to be fully- if not over-valued, especially considering the fact that many companies are producing little revenue growth and continue to enjoy record profit margins. Equities appear to offer attractive returns only in comparison to the sub-2% interest rates offered on U.S.

government bonds.” In early January, the stock market, as measured by the Russell 2000, was about 20% below where it was at the end of 2014. I wish I had been wrong ...

Like most investors, we had a challenging year in 2015. As several investors have observed, one would have to look back to 1937 to find a year in which there was so little investment opportunity.

During 2015, we changed our equity investment strategy, reorganizing our approach to be concentrated within individual sectors of the stock market but more diversified across sectors. In total, our internally-managed equity portfolio had a value of \$2,831 million at the end of the year¹⁰.

Our largest individual positions are shown below:

<u>Company</u>	<u>Value (\$ mm)</u>
Visa Inc.	\$ 232.7
Health Care SPDR	225.1
Alphabet Inc.	221.7
Walt Disney Company	212.3
CVS Health	210.2
JP Morgan Chase & Co.	191.5
Verizon Communications Inc.	172.6
Microsoft Corp.	166.4
PPG Industries Inc.	150.7
CSX Corp.	129.8
Roper Technologies	128.1
Boeing Co.	101.2
Subtotal	<u>\$ 2,142.3</u>
All other positions	<u>688.9</u>
Total	<u>\$ 2,831.2</u>

Our approach is research-intensive. We look to find companies that can reliably grow revenues, earnings, and dividends, or which perform an essential role in the economy that will, over time, generate attractive economic returns. In the case of the health care sector, we determined that we are best served by indexing – hence the position in the Health Care SPDR.

¹⁰ We also have a small amount of equity securities managed by an outside manager with a focus on small capitalization stocks.

Our exposure by sector compared to the 10-year trailing average weight of each sector in the S&P 500, was as follows:

	Alleghany <u>Weight</u>	Index <u>Weight</u>
Consumer Discretionary	14.5%	10.6%
Consumer Staples	11.0%	10.6%
Energy	2.5%	11.0%
Financials	11.0%	16.5%
Healthcare	9.6%	12.8%
Industrials	12.7%	10.7%
Materials	7.1%	3.4%
Technology	25.6%	18.0%
Telecommunications	6.0%	3.0%
Utilities	0.0%	3.4%
Total	<u>100.0%</u>	<u>100.0%</u>

As the above table shows, we are significantly overweight Consumer Discretionary, Industrials, Materials, and Telecommunications, and underweight Energy, Financials, and Utilities. We also consider our private investments in deciding how to allocate our equity portfolio. In particular, we have a \$206 million investment in energy through Stranded Oil Resources Corporation and a \$225 million investment in the alternative asset management industry through Ares.

Our new strategy was implemented in the second quarter of the year. It took some time to reposition the portfolio in 2015, but early results are encouraging. The go-forward public equity portfolio outperformed the S&P 500 in 2015 and is continuing to perform in line with expectations in 2016.

China joins the world in debtors' prison

In his 2013 book entitled "Debtors' Prison: The Politics of Austerity Versus Possibility," Robert Kuttner traces how economies and individuals have difficulty growing when burdened by excessive debts. Economic growth since the 2008 Financial Crisis has been disappointing, a result I believe of an over-indebted world.

China and the United States are the two largest economies in the world. Until recently, China has had a *de facto* currency peg against the U.S. dollar. More recently, however, China has been managing its currency against a basket of global currencies. Because the U.S. dollar has appreciated against the Euro and the Yen, China's export economy

has become less competitive, and growth is slowing. As the U.S. central bank raises interest rates (more on this later), China needs to devalue its currency to maintain a stable relationship to its other trading partners. Should the Federal Reserve continue to raise interest rates, the U.S. dollar may continue to appreciate, making the situation worse. A significant devaluation by China could be extremely disruptive to the world economy.

According to official government statistics, the service sector now accounts for 50.5% of the Chinese economy, up from 48.1% in 2014, while manufacturing is 40.5%. As industrial growth slows (from 7.3% in 2014 to 6.0% in 2015 according to government statistics), China's challenge is to transition to a more service-oriented economy. Services growth was 8.3% in 2015, compared to 7.8% in 2014. Transitions of this nature historically have not occurred smoothly.

Since the 2008 Financial Crisis, corporate debt in China increased from 98% of GDP to 160%. Total debt in China has increased from 160% of GDP to 260% at the end of last year. Debt-fueled economic growth may have resulted in unproductive capital investments in China. Moreover, other emerging markets – Latin America, which is the commodity supplier to China – and Southeast Asia, which is the technology component supplier – also borrowed, some in U.S. dollars, to invest in capacity to support China-led demand.

China's demographic profile, massive debt overhang, and underdeveloped social safety net will make the transition to a consumer-driven, services-intensive economy difficult. As market forces put pressure on the country's economy, China has been selling reserves to protect against capital flight and currency depreciation -- a sort of "reverse QE." China's foreign exchange reserves have declined from a high of \$4 trillion in mid-2014 to \$3.2 trillion at the end of January of this year, a decline of almost \$800 billion. This is reducing U.S. dollar liquidity.

We believe that in late 2015 and continuing in 2016, world financial markets are now in a powerful negative feedback loop. As commodity prices fall, emerging market commodity producers – some of whom have borrowed in U.S. dollars – are faced with declining commodity prices and a strengthening U.S. dollar, a deadly combination. To come up with more U.S. dollars to service debt, they have to sell a greater volume of the commodity, which of course causes the price to fall further. In the case of the oil market, excess production is reducing the price of oil and reducing the volume of petrodollars in circulation. Sovereign Wealth Funds, which total over \$7 trillion worldwide, may increasingly sell assets to fund their countries' fiscal deficits.

The United States has not yet resolved the debt crisis

From roughly 1980 through 2005, the United States went through 25-years of increasing debt relative to the growth in the economy. Globalization contributed to stagnant household incomes as industrial employment withered, but consumption grew by tapping available borrowing capacity. Economist A. Gary Shilling has demonstrated that a fall in the savings rate from roughly 12% in the early 1980s to 2% by 2005 added roughly 0.5% per year to U.S. GDP growth. Although one would think that 8 years after the start of the 2008 Financial Crisis things should be getting back to normal, Shilling demonstrates that debt imbalances have not yet returned to normal – and are not likely to do so for another 6-8 years.

Despite sluggish economic growth – the recovery from the Great Recession has been the slowest on record – corporations have for the most part maintained or improved profit margins through widespread adoption of technology, business process improvement, and cost cutting. In acting rationally from a micro point of view, corporations are contributing to stagnating aggregate demand.

Central banks and large-scale asset purchases: in Hotel California¹¹

The Federal Reserve’s response to the financial crisis (and the response of foreign central banks as well) was to inject significant liquidity into the banking system through so-called large scale asset purchases, or “quantitative easing.” The Federal Reserve’s balance sheet expanded to approximately \$3.5 trillion as it purchased large amounts of mortgage-backed securities and treasury securities. After talking about the need to normalize interest rates for over a year, in late 2015 the Federal Reserve began the process of increasing interest rates by paying banks higher interest rates on excess reserves – in short, paying them not to lend. A 25 basis point increase in short-term interest rates in late 2015 appears to have contributed to a further collapse in commodity prices, widening high yield spreads, and a near 10% correction in the equity market. We believe that when the Fed started quantitative easing, it entered Hotel California. As the classic Eagles song concludes, *“you can check out any time you like, but you can never leave.”*

It now appears with 20-20 hindsight that the excess liquidity provided by the Federal Reserve contributed to a massive amount of dollar borrowing in emerging markets to invest in commodity production to support debt-fueled industrial capacity in China. According to one estimate, emerging markets account for approximately 45% of global

¹¹ This discussion is a tribute to the late, great Eagles musician Glenn Frey, who passed away earlier this year at the age of 67.

capital spending,¹² half of which is commodity-related. The Bank for International Settlements estimates that there is \$9.8 trillion of U.S. dollar-denominated debt outstanding from non-U.S. borrowers. One of our advisors speculated that of this ~\$10 trillion short position in the U.S. dollar, about \$2 trillion is in China, \$3 trillion is in the commodity complex, and \$5 trillion is somewhere else. As the world scrambles for U.S. dollars, the currency continued to appreciate in 2015, while world GDP denominated in U.S. dollars actually contracted by 5% last year¹³. ***“There’s gonna be a heartache tonight, a heartache tonight, I know.”*** Already Russia, Brazil, and much of Latin America is in or near recession. Europe is growing modestly, but its banks no doubt have much of the exposure to emerging markets.

The economic expansion, now over six years old, can only be described as a ***“tequila sunrise,”*** as the hangover from the debt-fueled housing and then commodity boom continues to suppress economic activity. We agree with several observers that the Federal Reserve will be forced to back off from its stated goal of interest rate normalization, as the massive “short squeeze” in the U.S. dollar and commodity complex runs its course.

The Federal Reserve, with its dual mandate of full employment and price stability, has been trying to move inflation up to 2%, while at the same time it is worried that a tighter labor market will lead to increased inflationary pressure. In 2015, the CPI increased 0.7% and excluding food and energy the increase was 2.1%. Interestingly, the prices of most items are falling, but services – which include shelter, medical care and transportation in particular – increased 2.9% in 2015. Although real wages increased 2.5% last year, this increase was not enough for the average household to keep up with its rent, take care of its health, and pay transportation costs. To the extent there has been inflation, it appears to have emerged in asset prices, health care costs, and the real estate complex.

While the Federal Reserve is no doubt well-intentioned when it says it is concerned that a tight labor market will lead to unwanted inflation, we believe that the reality is that the Federal Reserve in particular wants to raise interest rates to prove that it can. Some have speculated that the Federal Reserve also wants to raise interest rates because with a strengthening U.S. dollar it is easier for the U.S. Government to attract the funds necessary to fund the issuance of treasury securities as foreign central banks are selling. Certainly we don’t know the truth. But as the song says, ***“you can’t hide those lyin’ eyes.”***

¹² Source: Michael Goldstein, Empirical Research Partners.

¹³ Source: A.G. van Bergeijk

There is a significant risk that if the Federal Reserve continues to raise interest rates in response to what appears to be a steadily improving U.S. employment market, the U.S. dollar will continue to strengthen, exacerbating economic challenges elsewhere in the world. We hope they decide to *“take it easy.”*

Energy markets likely to remain challenging

Because we have two private investments in the energy industry, we spend a lot of time thinking about the outlook for the energy complex. Fundamentally we agree with one of our advisors¹⁴ who says that when it comes to predicting oil prices, *“nobody knows nuttin’...”* Nevertheless, here’s how we see it at this point.

Unlike past oil price crashes, the current situation appears to have been the result of excess supply rather than a collapse in demand. It is certainly possible of course that policymakers could drive the world economy into a contraction, in which case there will be a demand problem as well. But so far this does not appear to have happened.

The success of U.S. shale producers and geopolitical factors have resulted in the global oil complex producing roughly 1.6 million barrels per day of excess supply, or about 2% of demand. Demand continues to grow despite global economic growth of 3% or less, and was up 1.8 million barrels per day in 2015 according to the IEA. As a result of these supply and demand trends, OECD inventories are about 10% above their long-term averages. This is the first time in recent history that oil prices have dropped and there has not been a supply response from OPEC. In early 2016, oil prices were below \$30 a barrel, which is approaching the average cash cost of non-OPEC producers.

In 2016, analysts at Bernstein Research project global demand growth at about 1.5 million barrels per day, while non-OPEC supply is projected to fall by 0.7 mm barrels per day. Although OPEC continues to produce “full out” there is little spare capacity in OPEC and financial strains on major OPEC producers are evident. Because this is a long-cycle business, a recovery in oil prices is unlikely to be quick.

Geopolitical aspects of oil supply add to the uncertainty. Daniel Yergin has succinctly described the situation as a “battle for market share” representing a “geopolitical struggle between Saudi Arabia and Iran.” He goes on to note that in 1974, Iran supplied 10% of the world’s oil production and Saudi Arabia supplied 14%. In 2015 Iran supplied 3%, while Saudi Arabia supplied 11%. With a fiscal deficit of ~20% of its GDP, Saudi Arabia is paying a high price for maintaining market share.

¹⁴ Michael Goldstein, Empirical Research Partners.

Because all non-OPEC producers are losing money at this point, capital investment is plummeting. According to Wood MacKenzie Ltd., \$380 billion of investment in 68 major upstream projects have been delayed since the oil price crash. These projects had an average breakeven price of \$62/barrel and account in the aggregate for 27 billion of reserves. OPEC itself expects non-OPEC supply to decline by 660,000 barrels in 2016, but Iran of course is coming back to market post-sanctions.

Although the timing is difficult, if not impossible to predict, we continue to believe that oil prices will be significantly higher in 2-3 years. Our investment in Stranded Oil Resources Corporation gives us a “call option” on higher oil prices in the future.

Alleghany’s investment strategy

Because we have to maintain a large fixed income portfolio that is, for the most part, funded by (re)insurance reserves, we believe that our business model is inherently well-positioned to maintain value in a deflationary environment. The average quality of our fixed income portfolio at the end of 2015 was AA-, and the duration of the portfolio was 4.6 years.

If we had a high level of conviction that deflation was going to dominate the global economic outlook, we would probably eliminate most of our equity exposure and, to the extent allowed, extend the duration of our bond portfolio by adding long-term government bonds. Unfortunately, things aren’t that simple. A move to a highly defensive posture would cost us income in the short-term and would only pay-off if there is a massive “reset” that would present us with the opportunity to redeploy funds at more attractive returns.

There are likely to be policy responses to deflationary pressures, and although investors worry that central banks are “out of ammo,” they are not (yet) completely powerless. Moreover, for industries and companies that are able to grow and maintain profitability, the present value of their future cash flows increases significantly in a low interest rate environment. The problem, of course, is that the universe of companies with these characteristics is not a large number.

We do believe that the world is moving toward investment markets that will be characterized by very low real and nominal returns on both fixed income and equity securities due to a combination of high valuations and slow economic growth. Our goal is to maintain a balanced position that will lock-in as much income as possible, while intelligently re-deploying capital into businesses (or share repurchases) that will add to economic value for Alleghany stockholders.

Alleghany Capital Corporation

Alleghany Capital oversees our private capital investments in non-financial companies. Our strategy is to invest in closely-held businesses with meaningful cash generative capabilities, where the owners and managers are seeking a long-term home for their businesses or patient capital to support growth. In addition, Alleghany Capital has made growth capital investments in more speculative ventures where we believe entrepreneurs have high-return opportunities. A brief update on each of Alleghany Capital's major investments is shown below:

- **Bourn & Koch** is a Rockford, Illinois based manufacturer of precision machine tools with a complementary spare parts and service business. Alleghany purchased an 80% interest in Bourn & Koch in 2012 and increased its position to approximately 88% in December 2015. In 2015, Bourn & Koch experienced a slowdown in revenue as weakness in the industrial sector slowed capital equipment purchases and the expected delivery of several machines in backlog slipped to 2016. As a result, the company's backlog entering 2016 is higher than it was entering 2015. The company continues to generate strong free cash flow and as of the end of 2015 we had received cumulative cash distributions (including tax distributions) of \$24.8 million in comparison to a gross investment (excluding deal expenses) of \$55.0 million. In 2015, the company produced EBITDA of \$5.9 million (vs. \$6.4 million in 2014), of which our 80% share¹⁵ was \$4.7 million.
- **R.C. Tway Company** ("Kentucky Trailer"), based in Louisville, Kentucky, is the leading manufacturer of custom trailer and truck bodies for the moving and storage industry and other niche markets. At the end of 2015, Alleghany owned approximately 80% of the common equity of Kentucky Trailer. In October 2015 Kentucky Trailer completed its third acquisition since Alleghany made its investment, purchasing Smit Mobile Equipment B. V. This acquisition, following the acquisition of Advanced Mobility in 2014, has made Kentucky Trailer a leading global manufacturer of mobile medical imaging trailers. Our cumulative gross investment in Kentucky Trailer was approximately \$42.6 million at the end of the year. In 2015, including 3 months of results from the Smit acquisition, Kentucky Trailer generated EBITDA of \$12.3 million (vs. \$8.3 million in 2014) of which our share was \$9.9 million.
- **Jazwares** is a Sunrise, Florida based toy company in which Alleghany acquired a 30% interest in July 2014. Jazwares continues to combine toy industry

¹⁵ Our ownership position increased on 12/31/15.

expertise with new media savvy, launching the highly innovative JazWings platform, an online brand incubator, and the *TubeHeroes* product line, a line of toys based on YouTube celebrities, in 2015. We acquired our interest for approximately \$60.3 million (excluding transaction fees) and have received \$13.4 million in cash distributions (including tax distributions) since our initial investment. In 2015, Jazwares produced EBITDA of \$35.8 million (vs. approximately \$41.3 million in 2014) with the growth in new brands such as Peppa Pig and *TubeHeroes* offset by some mature brands' natural decline and start-up spending on the new JazWings platform. Our share of 2015 EBITDA was \$10.7 million.

- **IPS-Integrated Project Services (“IPS”)**, which is headquartered in Blue Bell, Pennsylvania, delivers technical consulting, design and engineering, construction management, and commissioning, qualification and validation services, primarily for highly complex research and production facilities operated by the global pharmaceutical and biotechnology industries. Alleghany purchased approximately 84% of IPS in October 2015. In 2015, IPS generated EBITDA (excluding acquisition expenses and adjustments) of \$16.5 million. Because we only owned 84% of IPS during the seasonally slow months of November and December 2015, our share of the company's EBITDA was \$1.3 million. IPS is entering 2016 with a significantly larger backlog than last year.
- **Stranded Oil Resources Corporation** was formed in 2011 to acquire legacy oil fields and apply innovative enhanced oil recovery techniques. After completing construction of its underground facility in 2014, Stranded Oil commenced its drilling program in 2015. The drilling program, however, was delayed by third-party equipment problems that have since been corrected as well as a longer than expected trial-and-error process determining the optimum well completion technique for the reservoir. After the delays encountered in 2015, we expect production to commence in 2016. We have an economic interest of approximately 80% of Stranded Oil and have invested approximately \$245.2 million in the company as of the end of 2015, including the January 2015 purchase of the Teapot Dome Oilfield from the U.S. Department of Energy for \$45.2 million and purchase of conventional oil and gas acreage in Louisiana. In 2015, Stranded Oil had negative EBITDA of \$19.7 million as a result of (i) delays in the Fredonia drilling program and (ii) the significant decline in oil prices which overwhelmed production increases and the pace of cost cutting at Stranded Oil's conventional oil fields.

- **ORX Exploration** is a Louisiana-based oil and gas exploration company in which Alleghany owns a 40% interest. The company has secured and developed a number of on-shore, sub-salt oil and gas resource opportunities called “the Louisiana Heritage Play.” ORX continues to pursue multiple options to develop the Louisiana Heritage Play with outside industry partners, but was challenged in 2015 by the decline in oil and natural gas prices, which has significantly reduced capital budgets across the industry. At the end of 2015, we carried our investment in ORX at zero.

* * * * *

Board of Directors Changes

In 2016 Alleghany will be losing two directors due to the board's mandatory retirement policy based on age. Stephen Bradley, who joined the Alleghany board in 2012 with the TransRe acquisition, has been a valuable advisor during the past four years, especially when it comes to matters of strategy. Tom Johnson, who has been a director of Alleghany for 20 years, has made contributions too numerous to name. I want to thank Stephen and Tom for their advice and counsel over the years and wish them well in their future endeavors.

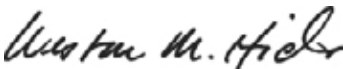
Outlook

Over the past two years, Alleghany's book value per share has increased by \$73.06 per share, or 17.7%, solidly within our 7-10% long-term annual growth objective. With over \$18 billion of cash and invested assets, our ability to grow book value per share depends in part on our ability to generate returns on these assets.

As I have noted in prior years, the world economy appears to be transitioning to a slower growth, deflationary environment. Factors contributing to deflation include world economies in a "debtor's prison;" excess capacity in commodity markets; deteriorating demographics in OECD countries as well as China; automation and robotics eliminating jobs; technology allowing for capitalism to be replaced by the "sharing economy;" and a continued lack of income growth for the vast majority of the country, in part a result of highly concentrated savings. In such an environment, it is possible that our growth will depend on capital reallocation and the effect of deflation on our \$10 billion of net loss reserves.

Despite the sluggish macroeconomic environment and soft (re)insurance markets, our objective continues to be to grow Alleghany's book value per share by 7% to 10% per year over the long-term. In times past this may not have seemed like a lofty goal; in today's world, we will have to work both hard and smart to get there.

Yours sincerely,



Weston M. Hicks
President

Comment on Non-GAAP Financial Measures

Our analysis of our financial condition and results of operations is based on our consolidated financial statements which have been prepared in accordance with accounting principles generally accepted in the United States, or “GAAP.” Our results of operations have been presented in the way that we believe will be the most meaningful and useful to investors, analysts, rating agencies and others who use financial information in evaluating our performance. This presentation includes the use of adjusted earnings before interest, taxes, depreciation and amortization expense, or “Adjusted EBITDA,” which is a “non-GAAP financial measure” for certain of our non-insurance operating subsidiaries and investments, as such term is defined in Item 10(e) of Regulation S-K promulgated by the SEC. Adjusted EBITDA represents other income less certain other expenses, and does not include: (1) depreciation expense; (2) amortization of intangible assets; (3) interest expense; (4) certain acquisition accounting impacts; (5) certain adjustments related to our investment in Jazwares; (6) net investment income; (7) net realized capital gains; and (8) other than temporary impairment. We use Adjusted EBITDA as a supplement to earnings before income taxes, the most comparable GAAP financial measure, to evaluate the performance of certain of our non-insurance operating subsidiaries and investments, and believe that Adjusted EBITDA provides useful additional information to investors regarding performance. A reconciliation of Adjusted EBITDA to earnings before income taxes is provided below for 2015 and 2014.

	2015			2014		
	Corporate Activities	Total Segments	Consolidated	Corporate Activities	Total Segments	Consolidated
	(\$ in millions)					
Revenues (expenses) for Corporate Activities:						
EBITDA for Bourn & Koch	\$ 5.9			\$ 6.4		
EBITDA for Kentucky Trailer	12.3			8.3		
Alleghany’s share of EBITDA for its investment in Jazwares	10.7			9.0		
EBITDA for IPS (commencing October 31, 2015)	1.3			-		
EBITDA for SORC	(19.7)			(15.2)		
EBITDA for SORC, Bourn & Koch, Kentucky Trailer, IPS and Alleghany’s investment in Jazwares	10.5			8.5		
Add: depreciation expense for SORC, Bourn & Koch, Kentucky Trailer and IPS	(12.4)			(6.6)		
Add: amortization of intangible assets for SORC, Bourn & Koch, Kentucky Trailer and IPS	(3.1)			(0.3)		
Add: interest expense for SORC, Bourn & Koch, Kentucky Trailer and IPS	(1.5)			(0.8)		
Add: acquisition accounting impacts for SORC, Bourn & Koch, Kentucky Trailer and IPS ⁽¹⁾	(0.1)			(3.5)		
Add: earnings before taxes attributable to noncontrolling interest for Bourn & Koch, Kentucky Trailer and IPS	1.9			2.7		
Deduct: adjustments to equity in earnings of Jazwares ⁽²⁾	(0.8)			(5.8)		
Subtotal, earnings before incomes taxes of SORC, Bourn & Koch, Kentucky Trailer, IPS and equity in Jazwares’ earnings	(5.5)			(5.8)		
Add: interest expense for all other entities within corporate activities	(52.0)			(42.4)		
Add: corporate administration	(45.6)			(45.8)		
Add: other income (losses) ⁽³⁾	(43.0)			12.2		
Subtotal, earnings before incomes taxes of corporate activities	(146.1)		\$ (146.1)	(81.8)		\$ (81.8)
Revenues (expenses) for Reinsurance and Insurance Segments:						
Net premiums earned	-	\$ 4,230.3		-	\$ 4,410.6	
Net investment income	-	427.6		-	448.9	
Net realized capital gains	-	242.6		-	230.0	
Other than temporary impairment losses	-	(125.5)		-	(36.3)	
Other income	-	6.5		-	4.0	
Net loss and loss adjustment expenses	-	(2,339.8)		-	(2,494.5)	
Commissions, brokerage and other underwriting expenses	-	(1,423.9)		-	(1,421.3)	
Other operating expenses	-	(80.4)		-	(85.7)	
Corporate administration	-	(0.9)		-	(1.3)	
Amortization of intangible assets	-	5.3		-	6.1	
Interest expense	-	(38.3)		-	(46.8)	
Subtotal, earnings before incomes taxes of total segments	-	903.5	903.5	-	1,013.7	1,013.7
Earnings before income taxes	\$ (146.1)	\$ 903.5	\$ 757.4	\$ (81.8)	\$ 1,013.7	\$ 931.9

- (1) Reflects the increase in the cost of goods sold arising from the valuation of inventory at fair value as of the acquisition date.
- (2) Reflects the removal of Alleghany’s portion of Jazwares’ Adjusted EBITDA prior to Alleghany’s investment on July 31, 2014 (applicable for 2014), and adjustments for depreciation, amortization and interest expense.
- (3) Includes other revenues less other operating expenses, amortization of intangible assets and interest expense associated with Alleghany Properties and Alleghany Capital Corporation’s other private capital investments and subsidiaries, among others, and investment activity for Alleghany Corporation.