ALLIED WORLD ASSURANCE CO HOLDINGS LTD
Form 10-Q
November 10, 2008

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

(Mark One)

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended: September 30, 2008

OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from __________ to __________

Commission file number: 001-32938

ALLIED WORLD ASSURANCE COMPANY HOLDINGS, LTD

(Exact Name of Registrant as Specified in Its Charter)

Bermuda	**98-0481737**
(State or Other Jurisdiction of Incorporation or Organization)	*(I.R.S. Employer Identification No.)*

27 Richmond Road, Pembroke HM 08, Bermuda

(Address of Principal Executive Offices and Zip Code)

(441) 278-5400

(Registrant s Telephone Number, Including Area Code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer þ	Accelerated filer o	Non-accelerated filer o	Smaller Reporting Company o
		(Do not check if a smaller reporting company)	

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No þ

The number of outstanding common shares, par value $0.03 per share, of Allied World Assurance Company Holdings, Ltd as of November 3, 2008 was 49,022,495.

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PART I
FINANCIAL INFORMATION

Item 1. ***Financial Statements.***

ALLIED WORLD ASSURANCE COMPANY HOLDINGS, LTD
UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS
as of September 30, 2008 and December 31, 2007
(Expressed in thousands of United States dollars, except share and per share amounts)

	As of September 30, 2008	As of December 31, 2007
ASSETS:		
Fixed maturity investments available for sale, at fair value (amortized cost: 2008: $5,440,019; 2007: $5,595,943)	$ 5,433,260	$ 5,707,143
Other invested assets available for sale, at fair value (cost: 2008: $81,262; 2007: $291,458)	71,528	322,144
Other invested assets, at fair value	167,674	
Total investments	5,672,462	6,029,287
Cash and cash equivalents	744,245	202,582
Restricted cash	47,689	67,886
Securities lending collateral	48,815	147,241
Insurance balances receivable	359,921	304,499
Prepaid reinsurance	166,161	163,836
Reinsurance recoverable	777,283	682,765
Accrued investment income	49,641	55,763
Deferred acquisition costs	117,348	108,295
Goodwill and other intangible assets	19,837	3,920
Balances receivable on sale of investments	36,264	84,998
Net deferred tax assets	10,198	4,881
Other assets	52,387	43,155
Total assets	$ 8,102,251	$ 7,899,108
LIABILITIES:		
Reserve for losses and loss expenses	$ 4,198,761	$ 3,919,772
Unearned premiums	880,211	811,083
Unearned ceding commissions	28,172	28,831
Reinsurance balances payable	79,592	67,175
Securities lending payable	48,815	147,241
Balances due on purchase of investments	68,681	141,462
Senior notes	498,767	498,682
Accounts payable and accrued liabilities	26,424	45,020
Total liabilities	$ 5,829,423	$ 5,659,266
SHAREHOLDERS EQUITY:		
	1,471	1,462

Common shares, par value $0.03 per share, issued and outstanding 2008: 49,022,495 shares and 2007: 48,741,927 shares		
Additional paid-in capital	1,307,185	1,281,832
Retained earnings	983,947	820,334
Accumulated other comprehensive income: net unrealized (losses) gains on investments, net of tax	(19,775)	136,214
Total shareholders equity	2,272,828	2,239,842
Total liabilities and shareholders equity	$ 8,102,251	$ 7,899,108

See accompanying notes to the unaudited condensed consolidated financial statements.

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ALLIED WORLD ASSURANCE COMPANY HOLDINGS, LTD
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME
for the three and nine months ended September 30, 2008 and 2007
(Expressed in thousands of United States dollars, except share and per share amounts)

	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
REVENUES:				
Gross premiums written	$ 290,981	$ 276,253	$ 1,134,638	$ 1,245,208
Premiums ceded	(57,078)	(56,956)	(253,913)	(281,480)
Net premiums written	233,903	219,297	880,725	963,728
Change in unearned premiums	38,070	64,362	(66,804)	(90,384)
Net premiums earned	271,973	283,659	813,921	873,344
Net investment income	76,916	76,133	226,192	222,718
Net realized investment losses	(151,876)	(4,196)	(152,804)	(12,161)
	197,013	355,596	887,309	1,083,901
EXPENSES:				
Net losses and loss expenses	176,010	173,246	497,591	515,466
Acquisition costs	28,615	29,198	81,720	90,266
General and administrative expenses	40,794	36,050	130,445	103,685
Interest expense	9,515	9,481	28,538	28,337
Foreign exchange gain	(2,728)	(976)	(2,651)	(412)
	252,206	246,999	735,643	737,342
(Loss) income before income taxes	(55,193)	108,597	151,666	346,559
Income tax (recovery) expense	(8,826)	(362)	(12,117)	392
NET (LOSS) INCOME	(46,367)	108,959	163,783	346,167
Other comprehensive (loss) gain				
Unrealized (losses) gains on investments arising during the period net of applicable deferred income tax recovery (expense) for three months 2008: $2,359; 2007: ($2,637); and nine months 2008: $2,601; 2007: ($4,929)	(183,081)	84,384	(243,047)	44,292
Reclassification adjustment for net realized losses included in net (loss) income	124,258	4,196	113,320	12,161
Other comprehensive (loss) gain	(58,823)	88,580	(129,727)	56,453
COMPREHENSIVE (LOSS) INCOME	$ (105,190)	$ 197,539	$ 34,056	$ 402,620

PER SHARE DATA				
Basic (loss) earnings per share	$ (0.95)	$ 1.80	$ 3.37	$ 5.73
Diluted (loss) earnings per share	$ (0.95)	$ 1.72	$ 3.22	$ 5.51
Weighted average common shares outstanding	49,007,389	60,413,019	48,547,839	60,381,867
Weighted average common shares and common share equivalents outstanding	49,007,389	63,250,024	50,869,098	62,808,186
Dividends declared per share	$ 0.18	$ 0.15	$ 0.54	$ 0.45

See accompanying notes to the unaudited condensed consolidated financial statements.

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ALLIED WORLD ASSURANCE COMPANY HOLDINGS, LTD
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY
for the nine months ended September 30, 2008 and 2007
(Expressed in thousands of United States dollars)

	Share Capital	Additional Paid-in Capital	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Total
December 31, 2007	$ 1,462	$ 1,281,832	$ 136,214	$ 820,334	$ 2,239,842
Cumulative effect adjustment upon adoption of FAS 159			(26,262)	26,262	
Net income				163,783	163,783
Dividends				(26,432)	(26,432)
Other comprehensive loss			(129,727)		(129,727)
Stock compensation	9	25,353			25,362
September 30, 2008	$ 1,471	$ 1,307,185	$ (19,775)	$ 983,947	$ 2,272,828

	Share Capital	Additional Paid-in Capital	Accumulated Other Comprehensive Income	Retained Earnings	Total
December 31, 2006	$ 1,809	$ 1,822,607	$ 6,464	$ 389,204	$ 2,220,084
Net income				346,167	346,167
Dividends				(27,174)	(27,174)
Other comprehensive income			56,453		56,453
Stock compensation	3	17,242			17,245
September 30, 2007	$ 1,812	$ 1,839,849	$ 62,917	$ 708,197	$ 2,612,775

See accompanying notes to the unaudited condensed consolidated financial statements.

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ALLIED WORLD ASSURANCE COMPANY HOLDINGS, LTD
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
for the nine months ended September 30, 2008 and 2007
(Expressed in thousands of United States dollars)

	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
CASH FLOWS PROVIDED BY OPERATING ACTIVITIES:		
Net income	$ 163,783	$ 346,167
Adjustments to reconcile net income to cash provided by operating activities:		
Net realized losses (gains) on sales of investments	1,016	(25,544)
Impairment charges for other-than-temporary impairments on investments	112,304	37,705
Change in fair value of hedge fund investments	39,484	
Amortization of premiums net of accrual of discounts on fixed maturities	(9,917)	(3,072)
Amortization and depreciation of fixed assets	6,957	6,335
Amortization of discount and expenses on senior notes	341	316
Stock compensation expense	20,980	17,333
Insurance balances receivable	(55,422)	(15,809)
Prepaid reinsurance	(2,325)	(19,232)
Reinsurance recoverable	(94,518)	14,707
Accrued investment income	6,122	6,889
Deferred acquisition costs	(9,053)	(23,606)
Net deferred tax assets	(2,716)	1,433
Other assets	(8,442)	(1,965)
Reserve for losses and loss expenses	278,989	194,965
Unearned premiums	69,128	109,616
Unearned ceding commissions	(659)	6,908
Reinsurance balances payable	12,417	(24,218)
Accounts payable and accrued liabilities	(18,595)	(10,117)
Net cash provided by operating activities	509,874	618,811
CASH FLOWS PROVIDED BY (USED IN) INVESTING ACTIVITIES:		
Purchases of fixed maturity investments	(3,544,183)	(3,244,366)
Purchases of other invested assets	(39,855)	(124,828)
Sales of fixed maturity investments	3,593,861	2,584,697
Sales of other invested assets	76,574	69,836
Net cash used for acquisition	(44,052)	
Changes in securities lending collateral received	98,426	(490,744)
Purchase of fixed assets	(6,333)	(7,066)
Change in restricted cash	20,197	91,320
Net cash provided by (used in) investing activities	154,635	(1,120,611)
CASH FLOWS (USED IN) PROVIDED BY FINANCING ACTIVITIES:		
Dividends paid	(26,432)	(27,174)
Proceeds from the exercise of stock options	3,765	580
Changes in securities lending collateral	(98,426)	490,744

Net cash (used in) provided by financing activities	(121,093)	464,150
Effect of exchange rate changes on foreign currency cash	(1,753)	695
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	541,663	(36,955)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	202,582	366,817
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 744,245	$ 329,862
Supplemental disclosure of cash flow information:		
Cash paid for income taxes	$ 6,162	$ 2,824
Cash paid for interest expense	37,500	38,021
Supplemental disclosure of non-cash flow information:		
Change in balance receivable on sale of investments	48,734	8,594
Change in balance payable on purchase of investments	(72,781)	123,482

See accompanying notes to the unaudited condensed consolidated financial statements.

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1. GENERAL

Allied World Assurance Company Holdings, Ltd (Holdings) was incorporated in Bermuda on November 13, 2001. Holdings, through its wholly-owned subsidiaries (collectively, the Company), provides property and casualty insurance and reinsurance on a worldwide basis through operations in Bermuda, the United States, Ireland, Switzerland and the United Kingdom.

2. BASIS OF PREPARATION AND CONSOLIDATION

These unaudited condensed consolidated financial statements include the accounts of Holdings and its subsidiaries and have been prepared in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP) for interim financial information and with Article 10 of Regulation S-X as promulgated by the U.S. Securities and Exchange Commission (SEC). Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. In the opinion of management, these unaudited condensed consolidated financial statements reflect all adjustments that are normal and recurring in nature and necessary for a fair presentation of financial position and results of operations as of the end of and for the periods presented. The results of operations for any interim period are not necessarily indicative of the results for a full year.

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The significant estimates reflected in the Company s financial statements include, but are not limited to:

- The premium estimates for certain reinsurance agreements,
- Recoverability of deferred acquisition costs,
- The reserve for losses and loss expenses,
- Valuation of ceded reinsurance recoverables,
- Valuation of financial instruments, and
- Determination of other-than-temporary impairment of investments.

Intercompany accounts and transactions have been eliminated on consolidation, and all entities meeting consolidation requirements have been included in the consolidation. Certain immaterial reclassifications in the unaudited condensed consolidated statements of cash flows have been made to the prior period s amounts to conform to the current period s presentation.

These unaudited condensed consolidated financial statements, including these notes, should be read in conjunction with the Company s audited consolidated financials statements, and related notes thereto, included in the Company s Annual Report on Form 10-K for the year ended December 31, 2007.

3. NEW ACCOUNTING PRONOUNCEMENTS

In February 2007, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (FAS) No. 159 The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115 (FAS 159). FAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. This statement is expected to expand the use of fair value measurement, which is consistent with the FASB s long-term measurement objectives for accounting for financial instruments. The fair value option permits all entities to choose to measure eligible items at fair value at specified election dates. An entity shall record unrealized gains and losses on items for which the fair value option has been elected through net income in the statement of operations at each subsequent reporting date. The Company adopted FAS 159 as of January 1, 2008. See Note 7 Fair Value of Financial Instruments regarding the Company s adoption of FAS 159.

In September 2006, the FASB issued FAS No. 157 Fair Value Measurements (FAS 157). This statement defines fair value, establishes a framework for measuring fair value under U.S. GAAP and expands disclosures about fair value measurements. FAS 157 applies under other accounting pronouncements that require or permit fair value measurements. FAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. In October 2008, the FASB issued FASB Staff Position 157-3 Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active (FSP 157-3). FSP 157-3 clarifies the application of FAS 157 in a market that is not active. The determination of whether a market is not active requires significant judgment including whether individual transactions are forced liquidations or distressed sales, whether observable inputs require significant adjustment based on unobservable data and whether broker or pricing service quotes are determinative of fair value. FSP 157-3 was effective upon issuance and is applicable to the unaudited condensed consolidated balance sheet as of September 30, 2008. The Company adopted FAS 157 as of January 1, 2008. See Note 7 Fair Value of Financial Instruments regarding the Company s adoption of FAS 157.

In December 2007, the FASB issued FAS No. 141(R) Business Combinations (FAS 141(R)). FAS 141(R) replaces FAS No. 141 Business Combinations (FAS 141), but retains the fundamental requirements in FAS 141 that the acquisition method of accounting be used for all business combinations and for an acquirer to be identified for each business combination. FAS 141(R) requires an acquirer to recognize the assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at the acquisition date, measured at their fair values as of that date. FAS 141(R) also requires acquisition-related costs to be recognized separately from the acquisition, requires assets acquired and liabilities assumed arising from contractual contingencies to be recognized at their acquisition-date fair values and requires goodwill to be recognized as the excess of the consideration transferred plus the fair value of any noncontrolling interest in the acquiree at the acquisition date over the fair values of the identifiable net assets acquired. FAS 141(R) applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008 (January 1, 2009 for calendar year-end companies).

In December 2007, the FASB issued FAS No. 160 Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51 (FAS 160). FAS 160 amends ARB No. 51 to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. FAS 160 clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements. FAS 160 requires consolidated net income to be reported at the amounts that include the amounts attributable to both the parent and the noncontrolling interest. This statement also establishes a method of accounting for changes in a parent s ownership interest in a subsidiary that do not result in deconsolidation and for changes in a parent s ownership interest in a subsidiary that does result in deconsolidation. FAS 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008 (January 1, 2009 for calendar year-end companies). The presentation and disclosure requirements of FAS 160 shall be applied retrospectively for all periods presented.

In March 2008, the FASB issued FAS No. 161 Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133 (FAS 161). FAS 161 requires enhanced interim and annual disclosures about an entity s derivative and hedging activities including how and why the entity uses derivative instruments, how the entity accounts for its derivatives under FAS Statement No. 133 (Accounting for Derivative Instruments and Hedging Activities), and how derivative instruments and related hedged items affect the entity s financial position, financial performance and cash flows. FAS 161 is effective for fiscal years and interim periods beginning after November 15, 2008 (January 1, 2009 for calendar year-end companies). The Company is currently evaluating the provisions of FAS 161 and its potential impact on future financial statements.

In May 2008, the FASB issued FAS No. 162 The Hierarchy of Generally Accepted Accounting Principles (FAS 162). FAS 162 identifies the sources of accounting principles and the framework for selecting principles to be used in the preparation of financial statements of entities that are presented in conformity with U.S. GAAP. The current U.S. GAAP hierarchy is found in auditing literature and is focused on the auditor rather than the entity. FAS 162 shall be effective 60 days after the SEC s approval of the Public Accounting Oversight Board amendments to AU Section 411 *The Meaning of* Present Fairly in Conformity with Generally Accepted Accounting Principles . The Company does not anticipate any impact on future financial statements due to the adoption of FAS 162.

In May 2008, the FASB issued FAS No. 163 Accounting for Financial Guarantee Insurance Contracts an Interpretation of FASB Statement No. 60 (FAS 163). FAS 163 clarifies how FAS 60 Accounting and Reporting by Insurance Enterprises applies to financial guarantee insurance contracts, including the recognition and measurement of premium revenue and claim liabilities. FAS 163 also requires expanded disclosures about financial guarantee insurance contracts. FAS 163 is effective for fiscal years beginning after December 15, 2008 (January 1, 2009 for calendar year-end companies), and interim periods within those fiscal years. The Company currently does not provide financial guarantee insurance, and as such does not anticipate any impact on future financial statements due to the adoption of FAS 163.

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4. ACQUISITIONS

In November 2007, Allied World Assurance Holdings (U.S.) Inc. entered into an agreement to purchase all of the outstanding stock of Finial Insurance Company (formerly known as Converium Insurance (North America) Inc.) from Finial Reinsurance Company, an affiliate of Berkshire Hathaway Inc. Finial Insurance Company was renamed Allied World Reinsurance Company, is currently licensed to write insurance and reinsurance in 50 states and the District of Columbia and has been used to launch the Company s reinsurance operations in the United States. This transaction closed on February 29, 2008 for a purchase price of $12,000, the Finial Insurance Company s policyholders surplus of $47,082, an adjustment for the difference between the fair values of investments acquired under U.S. GAAP and statutory reporting of $300 and direct expenses of $387. The total purchase price of $59,769 was paid in cash with available capital. As a part of the acquisition, the Company recorded $12,000 of intangible assets with indefinite lives for the value of the insurance and reinsurance licenses acquired. The remaining assets and liabilities acquired were principally comprised of bonds, at fair value, of $31,690, cash of $15,330, other assets of $1,176, deferred tax liabilities of $4,344 and a reserve for losses and loss expenses of $104,914, of which 100% were recorded as reinsurance recoverable as the entire reserve for losses and loss expenses is ceded to National Indemnity Company, an affiliate of Berkshire Hathaway Inc. The Company also recognized goodwill of $3,917 related to this acquisition, which is included in goodwill and other intangible assets in the unaudited condensed consolidated balance sheets.

For additional acquisition information, please refer to Note 13 regarding the acquisition of Darwin Professional Underwriters, Inc.

5. INVESTMENTS

The amortized cost, gross unrealized gains, gross unrealized losses and fair value of total investments by category as of September 30, 2008 and December 31, 2007 are as follows:

	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
September 30, 2008				
U.S. government and government agencies	$ 1,778,853	$ 44,029	$ (366)	$ 1,822,516
Non-U.S. government and government agencies	121,001	7,389	(9)	128,381
Corporate	1,260,158	4,712	(16,146)	1,248,724
States, municipalities and political subdivisions	56,903	61		56,964
Mortgage backed	2,115,265	12,601	(58,793)	2,069,073
Asset backed	107,839	18	(255)	107,602
Total fixed maturity investments, available for sale	5,440,019	68,810	(75,569)	5,433,260
Hedge funds	167,674			167,674
Global high-yield bond fund	81,262		(9,734)	71,528
	$ 5,688,955	$ 68,810	$ (85,303)	$ 5,672,462
December 31, 2007				
U.S. government and government agencies	$ 1,987,577	$ 65,653	$ (6)	$ 2,053,224
Non-U.S. government and government agencies	100,440	18,694	(291)	118,843
Corporate	1,248,338	10,114	(5,835)	1,252,617
Mortgage backed	2,095,561	22,880	(902)	2,117,539
Asset backed	164,027	897	(4)	164,920
	5,595,943	118,238	(7,038)	5,707,143

Total fixed maturity investments, available for sale				
Hedge funds	215,173	27,250	(988)	241,435
Global high-yield bond fund	75,125	4,424		79,549
Other invested asset	1,160			1,160
	$ 5,887,401	$ 149,912	$ (8,026)	$ 6,029,287

Due to the adoption of FAS 159 as of January 1, 2008, the Company s investment in hedge funds is included in other invested assets, at fair value on the unaudited condensed consolidated balance sheet. As of September 30, 2008, the Company s investment in the global high-yield bond fund is included in other invested assets available for sale, at fair value on the unaudited condensed consolidated balance sheet. As of December 31, 2007, the Company s investment in hedge funds, the global high-yield bond fund and other invested assets were included in other invested assets available for sale, at fair value on the unaudited condensed consolidated balance sheet.

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On a quarterly basis, the Company reviews the carrying value of its investments to determine if a decline in value is considered to be other than temporary. This review involves consideration of several factors including: (i) the significance of the decline in value and the resulting unrealized loss position; (ii) the time period for which there has been a significant decline in value; (iii) an analysis of the issuer of the investment, including its liquidity, business prospects and overall financial position; and (iv) the Company s intent and ability to hold the investment for a sufficient period of time for the value to recover. For certain investments, the Company s investment advisers have the discretion to sell those investments at any time. As such, the Company recognizes an other-than-temporary charge for those securities in an unrealized loss position each quarter as the Company cannot assert it has the intent to hold those investments until anticipated recovery. The identification of potentially impaired investments involves significant management judgment that includes the determination of their fair value and the assessment of whether any decline in value is other than temporary. If the decline in value is determined to be other than temporary, then the Company records a realized loss in the consolidated statements of operations and comprehensive income in the period that it is determined.

The following table summarizes the market value of those investments in an unrealized loss position for periods less than or greater than 12 months:

	September 30, 2008		December 31, 2007	
	Gross Fair Value	Unrealized Losses	Gross Fair Value	Unrealized Losses
Less than 12 months				
U.S. Government and Government agencies	$ 7,071	$ (366)	$	$
Non U.S. Government and Government agencies				
Corporate	354,019	(14,724)	359,880	(5,734)
States, municipalities and political subdivisions				
Mortgage backed	658,245	(58,567)	172,673	(835)
Asset backed	15,955	(254)	11,536	(4)
Hedge funds			51,512	(988)
Global high-yield bond fund	71,528	(9,734)		
	$ 1,106,818	$ (83,645)	$ 595,601	$ (7,561)
More than 12 months				
U.S. Government and Government agencies	$	$	$ 71,404	$ (6)
Non U.S. Government and Government agencies	2,752	(9)	33,227	(291)
Corporate	9,100	(1,423)	22,544	(101)
States, municipalities and political subdivisions				
Mortgage backed	2,429	(226)	13,805	(67)
Asset backed				
	$ 14,281	$ (1,658)	$ 140,980	$ (465)
	$ 1,121,099	$ (85,303)	$ 736,581	$ (8,026)

As of September 30, 2008, the Company s investment portfolio had gross unrealized losses of $85,303, that were primarily the result of increases in market interest rates during 2008 that caused the market price of our fixed maturity investments to decrease, as well as widening credit spreads related to increases in market risk premium and reduced market liquidity. Following the Company s review of the securities in its investment portfolio, 181 and 388 securities were considered to be other-than-temporarily impaired for the three and nine months ended September 30, 2008, respectively. Consequently, the Company recorded an other-than-temporary-impairment charge of $75,028 and $112,304 within net realized investment losses on the unaudited condensed consolidated statements of operations and comprehensive income for the three and nine months ended September 30, 2008, respectively. An other-than-temporary charge was recognized for those securities in an unrealized loss position that the Company s investment advisers had the discretion to sell. The following shows the other-than-temporary charges for fixed maturity investments by category for the three and nine months ended September 30, 2008:

	Other-than-temporary-impairment charges	
	For the three months ended September 30, 2008	For the nine months ended September 30, 2008
U.S. government and government agencies	$ 10,293	$ 15,493
Non-U.S. government and government agencies	233	684
Corporate	44,293	51,761
States, municipalities and political subdivisions	260	813
Mortgage backed	18,213	39,818
Asset backed	1,736	3,735
Total other-than-temporary charges	$ 75,028	$ 112,304

The Company recorded other-than-temporary-impairment charges, within net realized investment losses on the unaudited condensed consolidated statements of operations and comprehensive income, of $25,382 and $37,705 for the three and nine months ended September 30, 2007, respectively. Included in the other-than-temporary-impairment charges for the three and nine months ended September 30, 2007 was a charge of $23,915 for the Company s investment in the Goldman Sachs Global Alpha Hedge Fund PLC. As of September 30, 2007, the Company s basis in the fund was $57,495 and the fair value was $33,580, resulting in a loss of $23,915. The Company reviewed its carrying value of this investment in light of the significant changes in economic conditions that occurred during the third quarter of 2007, which included subprime mortgage exposure, tightening of credit spreads and overall market volatility. These economic conditions caused the fair value of this investment to decline. On December 31, 2007, the Company sold its investment in this fund. The remaining other-than-temporary-impairment charges were solely due to changes in interest rates.

During 2007, the Company submitted a redemption notice to sell its shares in the Goldman Sachs Global Equity Opportunities Fund, plc. The Company sold its shares on February 29, 2008 and recognized a loss on the sale of $278, which is included in net realized investment losses in the unaudited condensed consolidated statements of operations and comprehensive income for the nine months ended September 30, 2008.

On June 30, 2007, the Company sold its shares in the Goldman Sachs Liquid Trading Opportunities Fund Offshore, Ltd. The gain on the sale amounted to $484, which has been included in net realized investment losses in the unaudited condensed consolidated statements of operations and comprehensive income for the nine months ended September 30, 2007.

6. DEBT AND FINANCING ARRANGEMENTS

On July 21, 2006, the Company issued $500,000 aggregate principal amount of 7.50% Senior Notes due August 1, 2016 (Senior Notes), with interest on the Senior Notes payable on August 1 and February 1 of each year, commencing on February 1, 2007. The Senior Notes were offered by the underwriters at a price of 99.71% of their principal amount, providing an effective yield to investors of 7.54%. The Company used a portion of the proceeds from the Senior Notes to repay the outstanding amount of its then existing credit agreement as well as to provide additional capital to its subsidiaries and for other general corporate purposes.

The Senior Notes can be redeemed by the Company prior to maturity subject to payment of a make-whole premium. The Company has no current expectations of calling the Senior Notes prior to maturity. The Senior Notes contain certain covenants that include: (i) limitations on liens on stock of designated subsidiaries; (ii) limitation as to the disposition of stock of designated subsidiaries; and (iii) limitations on mergers, amalgamations, consolidations or sale of assets. The Company was in compliance with all covenants related to its Senior Notes as of September 30, 2008 and December 31, 2007.

Events of default include: (i) the default in the payment of any interest or principal on any outstanding notes, and the continuance of such default for a period of 30 days; (ii) the default in the performance, or breach, of any of the covenants in the indenture (other than a covenant added solely for the benefit of another series of debt securities) and continuance of such default or breach for a period of 60 days after the Company has received written notice specifying such default or breach; and (iii) certain events of bankruptcy, insolvency or reorganization. Where an event of default occurs and is continuing, either the trustee of the Senior Notes or the holders of not less than 25% in principal amount of the Senior Notes may have the right to declare that all unpaid principal amounts and accrued interest then outstanding be due and payable immediately.

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In March 2007, the Company entered into a collateralized $750,000 amended letter of credit facility (the Credit Facility) with Citibank Europe plc. The Credit Facility will be used to issue standby letters of credit.

In November 2007, the Company entered into a $800,000 five-year senior credit facility (the Facility) with a syndication of lenders. The Facility consists of a $400,000 secured letter of credit facility for the issuance of standby letters of credit (the Secured Facility) and a $400,000 unsecured facility for the making of revolving loans and for the issuance of standby letters of credit (the Unsecured Facility). Both the Secured Facility and the Unsecured Facility have options to increase the aggregate commitments by up to $200,000, subject to approval of the lenders. The Facility will be used for general corporate purposes and to issue standby letters of credit. The Facility contains representations, warranties and covenants customary for similar bank loan facilities, including a covenant to maintain a ratio of consolidated indebtedness to total capitalization as of the last day of each fiscal quarter or fiscal year of not greater than 0.35 to 1.0 and a covenant under the Unsecured Facility to maintain a certain consolidated net worth. In addition, each material insurance subsidiary must maintain a financial strength rating from A.M. Best Company of at least A- under the Unsecured Facility and of at least B++ under the Secured Facility. The Company is in compliance with all covenants under the Facility as of September 30, 2008 and December 31, 2007.

There are a total of 13 lenders who make up the Facility syndication and have varying commitments ranging from $20,000 to $87,500. Of the 13 lenders, four have commitments of $87,500 each, four have commitments of $62,500 each, four have commitments of $45,000 each and one has a commitment of $20,000. One of the lenders in the Facility with a $20,000 commitment has declared bankruptcy under Chapter 11 of the U.S. Bankruptcy Code. The Company does not expect this lender to be able to meet its commitment under the Facility.

The Company currently has access to up to $1,550,000 in letters of credit under the two letter of credit facilities described above. These facilities are used to provide security to reinsureds and are collateralized by the Company, at least to the extent of letters of credit outstanding at any given time. As of September 30, 2008 and December 31, 2007, there were outstanding letters of credit totaling $908,033 and $922,206, respectively, under the two facilities. Collateral committed to support the letter of credit facilities was $1,090,982 as of September 30, 2008, compared to $1,170,731 as of December 31, 2007.

At this time, the Company uses trust accounts primarily to meet security requirements for inter-company and certain related-party reinsurance transactions. The Company also has cash and cash equivalents and investments on deposit with various state or government insurance departments or pledged in favor of ceding companies in order to comply with relevant insurance regulations. As of September 30, 2008, total trust account deposits were $698,354 compared to $802,737 as of December 31, 2007.

7. FAIR VALUE OF FINANCIAL INSTRUMENTS

The Company adopted FAS 159 as of January 1, 2008, and has elected the fair value option for its hedge fund investments, which are classified as other invested assets, at fair value in the unaudited condensed consolidated balance sheets. At the time of adoption, the fair value and carrying value of the hedge fund investments were $241,435 and the net unrealized gain was $26,262. The Company has elected the fair value option for its hedge fund investments as the Company believes that recognizing changes in the fair value of the hedge funds in the consolidated statements of operations and comprehensive income each period better reflects the results of the Company s investment in the hedge funds rather than recognizing changes in fair value in accumulated other comprehensive income.

Upon adoption of FAS 159, the Company reclassified the net unrealized gain related to the hedge funds of $26,262 from accumulated other comprehensive income and recorded a cumulative-effect adjustment in retained earnings . There was no net deferred tax liability associated with the net unrealized gain as the hedge fund investments are held by a Bermuda insurance subsidiary that pays no income tax. Any subsequent change in unrealized gain or loss of other invested assets, at fair value will be recognized in the consolidated statements of operations and comprehensive income and included in net realized investment gains or losses. Prior to the adoption of FAS 159 any change in unrealized gain or loss was included in accumulated other comprehensive income in the unaudited condensed consolidated balance sheet. The net loss recognized for the change in fair value of the hedge fund investments in the unaudited condensed consolidated statements of operations and comprehensive income during the three and nine months ended September 30, 2008 was $27,617 and $39,484, respectively.

The Company adopted FAS 157 as of January 1, 2008. This statement defines fair value and establishes a framework for measuring fair value under U.S. GAAP. FAS 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. FAS 157 also established a three-level valuation hierarchy for disclosure of fair value measurements. The valuation hierarchy is based upon whether the inputs to the

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valuation of an asset or liability are observable or unobservable in the market at the measurement date, with quoted market prices being the highest level (Level 1) and unobservable inputs being the lowest level (Level 3). A fair value measurement will fall within the level of the hierarchy based on the input that is significant to determining such measurement. The three levels are defined as follows:

Level 1: Observable inputs to the valuation methodology that are quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2: Observable inputs to the valuation methodology other than quoted market prices (unadjusted) for identical assets or liabilities in active markets. Level 2 inputs include quoted prices for similar assets and liabilities in active markets, quoted prices for identical assets in markets that are not active and inputs other than quoted prices that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the asset or liability.

Level 3: Inputs to the valuation methodology that are unobservable for the asset or liability.

The following table shows the fair value of the Company s financial instruments and where in the FAS 157 fair value hierarchy the fair value measurements are included as of September 30, 2008.

			Fair value measurement using:		
	Carrying amount	Total fair value	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
U.S. government and government agencies	$ 1,822,516	$ 1,822,516	$ 922,117	$ 900,399	$
Non-U.S. government and government agencies	128,381	128,381		128,381	
Corporate	1,248,724	1,248,724		1,248,724	
States, municipalities and political subdivisions	56,964	56,964		56,964	
Mortgage backed	2,069,073	2,069,073		2,069,073	
Asset backed	107,602	107,602		107,602	
Total fixed maturity investments, available for sale	5,433,260	5,433,260			
Total other invested assets, fair value	167,674	167,674			167,674
Total other invested assets, available for sale	71,528	71,528		71,528	
Total investments	5,672,462	5,672,462			
Senior notes	498,767	442,300		442,300	

The following describes the valuation techniques used by the Company to determine the fair value of financial instruments held as of September 30, 2008.

U.S. government and U.S. government agencies: Comprised primarily of bonds issued by the U.S. Treasury, the Federal Home Loan Bank, the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association. The fair values of the Company s U.S. government securities are based on quoted market prices in active markets, and are included in the Level 1 fair value hierarchy. The Company believes the market for U.S. Treasury securities is an actively traded market given the high level of daily trading volume. The fair values of U.S. government agency securities are priced using the spread above the risk-free yield curve. As the yields for the risk-free yield curve are observable market inputs, the fair values of U.S. government agency securities are included in the Level 2 fair value hierarchy.

Non-U.S. government and government agencies: Comprised of fixed income obligations of non-U.S. governmental entities. The fair values of these securities are based on prices obtained from broker/dealers and international indices, and are included in the Level 2 fair value hierarchy.

Corporate: Comprised of bonds issued by corporations that on acquisition are rated BBB-/Baa3 or higher provided that, in aggregate, corporate bonds with ratings of BBB-/Baa3 do not constitute more than 5% of the market value of the Company s fixed income securities and are diversified across a wide range of issuers and industries. The fair values of corporate bonds that are short-

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term are priced using spread above the London Interbank Offering Rate yield curve, and the fair value of corporate bonds that are long-term are priced using the spread above the risk-free yield curve. The spreads are sourced from broker/dealers, trade prices and the new issue market. As the significant inputs used to price corporate bonds are observable market inputs, the fair values of corporate bonds are included in the Level 2 fair value hierarchy.

States, municipalities and political subdivisions: Comprised of fixed income obligations of U.S. domiciled state and municipality entities. The fair values of these securities are based on prices obtained from broker/dealers and the new issue market, and are included in the Level 2 fair value hierarchy.

Mortgage-backed: Principally comprised of AAA-rated pools of residential and commercial mortgages originated by both agency (such as the Federal National Mortgage Association) and non-agency originators. The fair values of mortgage-backed securities originated by U.S. government agencies and non-U.S. government agencies are based on a pricing model that incorporates prepayment speeds and spreads to determine appropriate average life of mortgage-backed securities. The spreads are sourced from broker/dealers, trade prices and the new issue market. As the significant inputs used to price the mortgage-backed securities are observable market inputs, the fair values of these securities are included in the Level 2 fair value hierarchy.

Asset-backed: Comprised of primarily AAA-rated bonds backed by pools of automobile loan receivables, home equity loans and credit card receivables originated by a variety of financial institutions. The fair values of asset-backed securities are priced using prepayment speed and spread inputs that are sourced from the new issue market. As the significant inputs used to price the asset-backed securities are observable market inputs, the fair values of these securities are included in the Level 2 fair value hierarchy.

Other invested assets, at fair value: Comprised of four hedge funds invested in a range of diversified strategies. The fair values of the hedge funds are based on the net asset value of the funds as reported by the fund manager less a liquidity discount where hedge fund investments contain lock-up provisions that prevent immediate dissolution. The Company considers these lock-up provisions to be obligations that market participants would assign a value to in determining the price of these hedge funds, and as such have considered these obligations in determining the fair value measurement of the related hedge funds. The liquidity discount was estimated by calculating the value of a protective put over the lock-up period. The protective put measures the risk of holding a restricted asset over a certain time period. The Company used the Black-Scholes option-pricing model to estimate the value of the protective put for each hedge fund. The aggregate liquidity discount recognized during the three and nine months ended September 30, 2008 was $(33) and $237, respectively. The net asset value and the liquidity discount are significant unobservable inputs, and as such the fair values of the Company s hedge funds are included in the Level 3 fair value hierarchy.

Other invested assets available for sale: Comprised of an open-end global high-yield bond fund that invests in non-investment grade bonds issued by various issuers and industries. The fair value of the global high-yield bond fund is based on the net asset value as reported by the fund manager. The net asset value is an observable input as it is quoted on a market exchange on a daily basis. The fair value of the global high-yield bond fund is included in the Level 2 fair value hierarchy.

Senior notes: The fair value of the senior notes is based on the price as published by Bloomberg, which was 88.46% of their principal amount, providing an effective yield of 9.63% as of September 30, 2008. The fair value of the senior notes is included in the Level 2 fair value hierarchy.

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The following is a reconciliation of the beginning and ending balance of financial instruments using significant unobservable inputs (Level 3) for the three and nine months ended September 30, 2008.

	Fair value measurement using significant unobservable inputs (Level 3): hedge funds	
	Three months ended September 30, 2008	**Nine months ended September 30, 2008**
Opening balance	$ 192,661	$ 241,435
Total gains or losses included in earnings:		
Realized gains	2,449	8,562
Change in fair value of hedge fund investments	(27,617)	(39,484)
Purchases or sales	181	(42,839)
Transfers in and/or out of Level 3		
Ending balance, September 30, 2008	$ 167,674	$ 167,674

8. INCOME TAXES

Certain subsidiaries of Holdings file U.S. federal income tax returns and various U.S. state income tax returns, as well as income tax returns in the U.K. and Ireland. The tax years open to examination by the U.S. Internal Revenue Service for the U.S. subsidiaries are the fiscal years from 2004 to the present. The tax years open to examination by the Inland Revenue for the U.K. branches are fiscal years from 2004 to the present. The tax years open to examination by Irish Revenue Commissioners for the Irish subsidiaries are the fiscal years from 2003 to the present. To the best of the Company s knowledge, there are no examinations pending by the U.S. Internal Revenue Service, the Inland Revenue or the Irish Revenue Commissioners.

Management has deemed all material tax positions to have a greater than 50% likelihood of being sustained based on technical merits if challenged. The Company has not recorded any interest or penalties during the three and nine months ended September 30, 2008 and 2007 and has not accrued any payment of interest or penalties as of September 30, 2008 and December 31, 2007.

The Company does not expect any material unrecognized tax benefits within 12 months of January 1, 2008.

9. SHAREHOLDERS EQUITY

a) Authorized shares

The authorized share capital of Holdings as of September 30, 2008 and December 31, 2007 was $10,000.

The issued share capital consists of the following:

	September 30, 2008	**December 31, 2007**
Common shares issued and fully paid, par value $0.03 per share	49,022,495	48,741,927
Share capital at end of period	$ 1,471	$ 1,462

As of September 30, 2008, there were outstanding 35,412,797 voting common shares and 13,609,698 non-voting common shares.

b) Dividends

In 2008, the Company has paid quarterly dividends of $0.18 per common share on April 3, 2008, June 12, 2008 and September 11, 2008, payable to shareholders of record on March 18, 2008, May 27, 2008 and August 26, 2008, respectively. The total dividends paid amounted to $26,432.

For the nine months ended September 30, 2007, the Company paid quarterly dividends of $0.15 per common share on April 5, 2007, June 14, 2007 and September 13, 2007, payable to shareholders of record on March 20, 2007, May 29, 2007 and August 28, 2007, respectively. The total dividends paid amounted to $27,174.

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10. EMPLOYEE BENEFIT PLANS

a) Employee option plan

In 2001, the Company implemented the Allied World Assurance Company Holdings, Ltd Second Amended and Restated 2001 Employee Stock Option Plan (the Plan). Under the Plan, up to 4,000,000 common shares of Holdings may be issued. Holdings has filed a registration statement on Form S-8 under the Securities Act of 1933, as amended, to register common shares issued or reserved for issuance under the Plan. These options are exercisable in certain limited conditions, expire after 10 years, and generally vest pro-rata over four years from the date of grant. The exercise price of options issued are determined by the compensation committee of the Board of Directors but shall not be less than 100% of the fair market value of the common shares of Holdings on the date the option award is granted.

	Nine months ended September 30, 2008	
	Options	**Weighted Average Exercise Price**
Outstanding at beginning of period	1,223,875	$ 31.03
Granted	294,300	42.75
Exercised	(138,615)	27.31
Forfeited	(14,209)	37.26
Outstanding at end of period	1,365,351	$ 33.87

Assumptions used in the option-pricing model for the options granted during the nine months ended September 30, 2008:

	Options granted during the nine months ended September 30, 2008
Expected term of option	6.25 years
Weighted average risk-free interest rate	2.58%
Expected volatility	23.57%
Dividend yield	1.66%
Weighted average fair value on grant date	$9.77

There is limited historical data available for the Company to base the expected term of the options. As these options are considered to have standard characteristics, the Company has used the simplified method to determine the expected life as set forth in the SEC s Staff Accounting Bulletins 107 and 110. Likewise, as the Company became a public company in July 2006, there is limited historical data available on which to base the volatility of its common shares. As such, the Company used the average of five volatility statistics from comparable companies, as well as the Company s volatility, in order to derive the volatility value above. The Company has assumed a forfeiture rate of 4.91% in determining the compensation expense over the service period.

Compensation expense of $614 and $620 relating to the options has been recognized in general and administrative expenses in the Company s unaudited condensed consolidated statements of operations and comprehensive income for the three months ended September 30, 2008 and 2007, respectively. Compensation expense of $1,794 and $1,936 relating to the options has been recognized in general and administrative expenses in the Company s unaudited condensed consolidated statements of operations and comprehensive income for the nine months ended September 30, 2008 and 2007, respectively. As of September 30, 2008 and December 31, 2007, the Company recorded in additional paid-in capital on the unaudited condensed consolidated balance sheets amounts of $17,438 and $11,840, respectively, in connection with all options granted.

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b) Stock incentive plan

In 2004, the Company implemented the Allied World Assurance Company Holdings, Ltd Second Amended and Restated 2004 Stock Incentive Plan (the Stock Incentive Plan). The Stock Incentive Plan provides for grants of restricted stock, restricted stock units (RSUs), dividend equivalent rights and other equity-based awards. A total of 2,000,000 common shares may be issued under the Stock Incentive Plan. To date only RSUs have been granted. These RSUs generally vest pro-rata over four years from the date of grant or in the fourth or fifth year from the original grant date.

	Nine months ended September 30, 2008	
	RSUs	**Weighted Average Grant Date Fair Value**
Outstanding RSUs at beginning of period	820,890	$ 36.09
RSUs granted	262,061	42.87
RSUs fully vested	(140,620)	37.25
RSUs forfeited	(36,710)	36.29
Outstanding RSUs at end of period	905,621	$ 37.86

Compensation expense of $2,178 and $1,990 relating to the issuance of the RSUs has been recognized in general and administrative expenses in the Company s unaudited condensed consolidated statements of operations and comprehensive income for the three months ended September 30, 2008 and 2007, respectively. Compensation expense of $5,930 and $5,836 relating to the issuance of the RSUs has been recognized in general and administrative expenses in the Company s unaudited condensed consolidated statements of operations and comprehensive income for the nine months ended September 30, 2008 and 2007, respectively. The compensation expense for the RSUs is based on the fair market value of Holdings common shares at the time of grant. The Company has assumed a forfeiture rate of 4.30% in determining the compensation expense over the service period. As of September 30, 2008 and December 31, 2007, the Company has recorded $18,189 and $12,337, respectively, in additional paid-in capital on the unaudited condensed consolidated balance sheets in connection with the RSUs awarded.

c) Long-term incentive plan

In 2006, the Company implemented the Allied World Assurance Company Holdings, Ltd Long-Term Incentive Plan (LTIP), which provides for performance based equity awards to key employees in order to promote the long-term growth and profitability of the Company. Each award represents the right to receive a number of common shares in the future, based upon the achievement of established performance criteria during the applicable performance period. A total of 2,000,000 common shares may be issued under the LTIP. The awards granted in 2008 will generally vest after the fiscal year ending December 31, 2010, or in the fourth or fifth year from the original grant date, subject to the achievement of the performance conditions and terms of the LTIP.

	Nine months ended September 30, 2008	
	LTIP	**Weighted Average Grant Date Fair Value**
Outstanding LTIP awards at beginning of period	590,834	$ 40.09
LTIP awards granted	507,152	43.27
LTIP awards subjected to accelerated vesting	(11,667)	34.00

LTIP awards forfeited	(20,000)	43.40
Outstanding LTIP awards at end of period	1,066,319	$ 41.61

Compensation expense of $4,563 and $2,960 relating to the LTIP has been recognized in general and administrative expenses in the Company s unaudited condensed consolidated statements of operations and comprehensive income for the three months ended September 30, 2008 and 2007, respectively. Compensation expense of $13,256 and $9,561 relating to the LTIP has been recognized in general and administrative expenses in the Company s unaudited condensed consolidated statements of operations and comprehensive income for the nine months ended September 30, 2008 and 2007, respectively. The compensation expense for the LTIP is based on the fair market value of Holdings common shares at the time of grant. As of September 30, 2008 and December 31,

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2007, the Company has recorded $29,643 and $16,403, respectively, in additional paid-in capital on the unaudited condensed consolidated balance sheets in connection with the LTIP awards.

In calculating the compensation expense, and in the determination of share equivalents for the purpose of calculating diluted earnings per share, it is estimated for the LTIP awards granted in 2006 and 2007 that the maximum performance goals as set by the LTIP are likely to be achieved over the performance period. For the LTIP awards granted in 2008 it is estimated that the target performance goals as set by the LTIP are likely to be achieved over the performance period. Based on the target performance goals, the LTIP awards granted in 2008 are expensed at 100% of the fair market value of Holdings common shares on the date of grant. The expense is recognized over the performance period.

The following table shows the stock compensation expense relating to the stock options, RSUs and LTIP awards for the three and nine months ended September 30, 2008 and 2007.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Stock options	$ 614	$ 620	$ 1,794	$ 1,936
RSUs	2,178	1,990	5,930	5,836
LTIP	4,563	2,960	13,256	9,561
Total stock compensation expense	$ 7,355	$ 5,570	$ 20,980	$ 17,333

11. EARNINGS PER SHARE

The following table sets forth the comparison of basic and diluted earnings per share:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Basic earnings per share				
Net (loss) income	$ (46,367)	$ 108,959	$ 163,783	$ 346,167
Weighted average common shares outstanding	49,007,389	60,413,019	48,547,839	60,381,867
Basic (loss) earnings per share	$ (0.95)	$ 1.80	$ 3.37	$ 5.73

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Diluted earnings per share				
Net (loss) income	$ (46,367)	$ 108,959	$ 163,783	$ 346,167
Weighted average common shares outstanding	49,007,389	60,413,019	48,547,839	60,381,867
Share equivalents:				
Warrants and options		2,053,905	1,233,430	1,776,360
Restricted stock units		391,907	405,064	370,878
LTIP awards		391,193	682,765	279,081
Weighted average common shares and common share equivalents outstanding	49,007,389	63,250,024	50,869,098	62,808,186

diluted				
Diluted (loss) earnings per share	$ (0.95)	$ 1.72	$ 3.22	$ 5.51

For the three-month period ended September 30, 2008, no common share equivalents were included in calculating diluted earnings per share as there was a net loss, and any additional shares would be antidilutive. As a result, a total of 5,500,000 warrants, 1,365,351 employee stock options, 905,621 RSUs and 1,066,319 LTIP awards have been excluded from this calculation. For the nine-month period ended September 30, 2008, a weighted average of 419,439 employee stock options were antidilutive and were therefore excluded from the calculation of the diluted earnings per share.

For the three-month period ended September 30, 2007, all common share equivalents were considered dilutive and have been included in the calculation of the diluted earnings per share. For the nine-month period ended September 30, 2007, a weighted average of 7,778 employee stock options were antidilutive and were therefore excluded from the calculation of the diluted earnings per share.

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12. SEGMENT INFORMATION

The determination of reportable segments is based on how senior management monitors the Company s underwriting operations. The Company measures the results of its underwriting operations under three major business categories, namely property insurance, casualty insurance and reinsurance. All product lines fall within these classifications.

The property segment provides direct coverage of physical property and energy-related risks. These risks generally relate to tangible assets and are considered short-tail in that the time from a claim being advised to the date when the claim is settled is relatively short. The casualty segment provides direct coverage of general liability risks, professional liability risks and healthcare risks. Such risks are long-tail in nature since the emergence and settlement of a claim can take place many years after the policy period has expired. The reinsurance segment includes any reinsurance of other companies in the insurance and reinsurance industries. The Company writes reinsurance on both a treaty and facultative basis.

Responsibility and accountability for the results of underwriting operations are assigned by major line of business on a worldwide basis. Because the Company does not manage its assets by segment, investment income, interest expense and total assets are not allocated to individual reportable segments.

Management measures results for each segment on the basis of the loss and loss expense ratio , acquisition cost ratio , general and administrative expense ratio and the combined ratio . The loss and loss expense ratio is derived by dividing net losses and loss expenses by net premiums earned. The acquisition cost ratio is derived by dividing acquisition costs by net premiums earned. The general and administrative expense ratio is derived by dividing general and administrative expenses by net premiums earned. The combined ratio is the sum of the loss and loss expense ratio, the acquisition cost ratio and the general and administrative expense ratio.

The following table provides a summary of the segment results for the three and nine months ended September 30, 2008 and 2007.

Three Months Ended September 30, 2008	**Property**	**Casualty**	**Reinsurance**	**Total**
Gross premiums written	$ 57,437	$ 140,003	$ 93,541	$ 290,981
Net premiums written	35,460	106,157	92,286	233,903
Net premiums earned	42,919	105,492	123,562	271,973
Net losses and loss expenses	(71,243)	(46,813)	(57,954)	(176,010)
Acquisition costs	(2,434)	(2,212)	(23,969)	(28,615)
General and administrative expenses	(9,240)	(19,852)	(11,702)	(40,794)
Underwriting (loss) income	(39,998)	36,615	29,937	26,554
Net investment income				76,916
Net realized investment losses				(151,876)
Interest expense				(9,515)
Foreign exchange gain				2,728
Loss before income taxes				$ (55,193)
Loss and loss expense ratio	166.0%	44.4%	46.9%	64.7%
Acquisition cost ratio	5.7%	2.1%	19.4%	10.5%
General and administrative expense ratio	21.5%	18.8%	9.5%	15.0%
Combined ratio	193.2%	65.3%	75.8%	90.2%

Three Months Ended September 30, 2007	**Property**	**Casualty**	**Reinsurance**	**Total**

Gross premiums written	$ 60,192	$ 122,212	$ 93,849	$ 276,253
Net premiums written	32,400	92,917	93,980	219,297
Net premiums earned	44,246	114,977	124,436	283,659
Net losses and loss expenses	(29,271)	(71,369)	(72,606)	(173,246)
Acquisition costs	811	(2,927)	(27,082)	(29,198)
General and administrative expenses	(8,421)	(17,876)	(9,753)	(36,050)
Underwriting income	7,365	22,805	14,995	45,165
Net investment income				76,133
Net realized investment losses				(4,196)
Interest expense				(9,481)
Foreign exchange gain				976
Income before income taxes				$ 108,597
Loss and loss expense ratio	66.2%	62.1%	58.4%	61.1%
Acquisition cost ratio	(1.8)%	2.5%	21.8%	10.3%
General and administrative expense ratio	19.0%	15.6%	7.8%	12.7%
Combined ratio	83.4%	80.2%	88.0%	84.1%

Nine Months Ended September 30, 2008	Property	Casualty	Reinsurance	Total
Gross premiums written	$ 275,470	$ 439,277	$ 419,891	$ 1,134,638
Net premiums written	136,346	326,127	418,252	880,725
Net premiums earned	130,664	320,210	363,047	813,921
Net losses and loss expenses	(148,583)	(161,692)	(187,316)	(497,591)
Acquisition costs	(7)	(10,711)	(71,002)	(81,720)
General and administrative expenses	(30,697)	(67,846)	(31,902)	(130,445)
Underwriting (loss) income	(48,623)	79,961	72,827	104,165
Net investment income				226,192
Net realized investment losses				(152,804)
Interest expense				(28,538)
Foreign exchange gain				2,651
Income before income taxes				$ 151,666
Loss and loss expense ratio	113.7%	50.5%	51.6%	61.1%
Acquisition cost ratio	0.0%	3.3%	19.6%	10.0%
General and administrative expense ratio	23.5%	21.2%	8.8%	16.0%
Combined ratio	137.2%	75.0%	80.0%	87.1%

Nine Months Ended September 30, 2007	Property	Casualty	Reinsurance	Total
Gross premiums written	$ 318,520	$ 435,492	$ 491,196	$ 1,245,208
Net premiums written	137,479	335,182	491,067	963,728
Net premiums earned	137,055	363,101	373,188	873,344
Net losses and loss expenses	(70,285)	(222,644)	(222,537)	(515,466)
Acquisition costs	374	(13,998)	(76,642)	(90,266)
General and administrative expenses	(24,341)	(49,894)	(29,450)	(103,685)
Underwriting income	42,803	76,565	44,559	163,927
Net investment income				222,718
Net realized investment losses				(12,161)
Interest expense				(28,337)
Foreign exchange gain				412
Income before income taxes				$ 346,559
Loss and loss expense ratio	51.3%	61.3%	59.6%	59.0%
Acquisition cost ratio	(0.3)%	3.9%	20.5%	10.3%
General and administrative expense ratio	17.8%	13.7%	7.9%	11.9%
Combined ratio	68.8%	78.9%	88.0%	81.2%

The following table shows an analysis of the Company s net premiums written by geographic location of the Company s subsidiaries for the three and nine months ended September 30, 2008 and 2007.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Bermuda	$ 113,301	$ 156,166	$ 567,865	$ 749,248
United States	87,432	34,529	189,790	91,642
Europe	33,170	28,602	123,070	122,838
Total net premiums written	$ 233,903	$ 219,297	$ 880,725	$ 963,728

13. COMMITMENTS AND SUBSEQUENT EVENTS

On November 6, 2008, the Company declared a quarterly dividend of $0.18 per common share, payable on December 11, 2008 to shareholders of record on November 25, 2008.

Holdings entered into a definitive agreement and plan of merger (the Merger Agreement) on June 27, 2008 with Allied World Merger Company, a newly formed Delaware corporation and an indirect wholly-owned subsidiary of the Company (Merger Sub), and Darwin Professional Underwriters, Inc., a Delaware corporation (Darwin). The Merger Agreement provided for the merger of Merger Sub with and into Darwin, with Darwin continuing as the surviving corporation and an indirect wholly-owned subsidiary of Holdings. Darwin is a holding company whose subsidiaries are engaged in the executive and professional liability insurance business with an emphasis on coverage for the healthcare industry. The transaction was completed on October 20, 2008 and has been accounted for as a purchase. Under the purchase method of accounting for a business combination, the assets and liabilities of Darwin will be recorded at their fair values on the acquisition date.

Pursuant to the terms of the Merger Agreement, stockholders of Darwin received $32.00 in cash for each share of Darwin common stock in exchange for 100% of their interests in Darwin. Also, each outstanding Darwin stock option became fully vested and was converted into an amount in cash equal to (i) the excess, if any, of $32.00 over the exercise price per share of the stock option, multiplied by (ii) the total number of shares of Darwin common stock subject to the stock option. In addition, each outstanding Darwin restricted share became fully vested and was converted into the right to receive $32.00 in cash per restricted share, and each outstanding director share unit was converted into the right to receive $32.00 in cash per share unit. The total cash consideration paid by the Company was $550,122, excluding direct costs of the acquisition, and was paid with available capital.

The following table shows Darwin s unaudited selected financial data for the three and nine months ended September 30, 2008.

	Three months ended September 30, 2008	Nine months ended September 30, 2008
Gross premiums written	$ 71,453	$ 215,489
Net premiums written	56,383	165,510
Net premiums earned	54,454	161,365
Net investment income	6,272	18,271
Net realized investment losses	2,714	3,329
Net losses and loss expenses	23,535	64,152
Acquisition costs and general and administrative expenses(1)	24,240	54,516
Net income(1)	5,532	33,855

(1) Included in Darwin s acquisition costs and general and administrative expenses for the three and nine months September 30, 2008 was $8,470 and $9,663, respectively, of costs incurred by Darwin for external advisory and other fees directly related to the acquisition.

During September 2008, the Company submitted redemption requests for its hedge fund investments in Goldman Sachs Multi-Strategy VI, Ltd (the Portfolio VI Fund) and AIG Select Hedge Ltd. (the AIG Select Fund). The Company is the sole investor in the Portfolio VI Fund and the market value of this fund was $65,501 as of September 30, 2008. The market value of the AIG Select Fund was $62,595 as of September 30, 2008.

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Item 2. ***Management s Discussion and Analysis of Financial Condition and Results of Operations.***

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our condensed consolidated financial statements and related notes included elsewhere in this Form 10-Q. References in this Form 10-Q to the terms we, us, our, the company or other similar terms mean the consolidated operations of Allied World Assurance Company Holdings, Ltd and its subsidiaries, unless the context requires otherwise. References in this Form 10-Q to the term Holdings means Allied World Assurance Company Holdings, Ltd only.

Note on Forward-Looking Statement

This Form 10-Q and other publicly available documents may include, and our officers and representatives may from time to time make, projections concerning financial information and statements concerning future economic performance and events, plans and objectives relating to management, operations, products and services, and assumptions underlying these projections and statements. These projections and statements are forward-looking statements within the meaning of The Private Securities Litigation Reform Act of 1995 and are not historical facts but instead represent only our belief regarding future events, many of which, by their nature, are inherently uncertain and outside our control. These projections and statements may address, among other things, our strategy for growth, product development, financial results and reserves. Actual results and financial condition may differ, possibly materially, from these projections and statements and therefore you should not place undue reliance on them. Factors that could cause our actual results to differ, possibly materially, from those in the specific projections and statements are discussed throughout this Management s Discussion and Analysis of Financial Condition and Results of Operations and in Risk Factors in Item 1A of Part I of our 2007 Annual Report on Form 10-K filed with the U.S. Securities and Exchange Commission (SEC) on February 29, 2008. We are under no obligation (and expressly disclaim any such obligation) to update or revise any forward-looking statement that may be made from time to time, whether as a result of new information, future developments or otherwise.

Overview

Our Business

We write a diversified portfolio of property and casualty insurance and reinsurance lines of business internationally through our subsidiaries or branches based in Bermuda, the United States, Ireland, Switzerland and the United Kingdom. We manage our business through three operating segments: property, casualty and reinsurance. As of September 30, 2008, we had $8.1 billion of total assets, $2.3 billion of shareholders equity and $2.8 billion of total capital, which includes shareholders equity and senior notes.

During the year ended December 31, 2007, we experienced rate declines from increased competition across all of our operating segments. This trend of increased competition and decreasing rates has continued during the nine months ended September 30, 2008, and we expect this trend to continue during the remainder of 2008. Given this trend, we continue to be selective in the policies and reinsurance contracts we underwrite. Our consolidated gross premiums written increased $14.7 million, or 5.3%, for the three months ended September 30, 2008 compared to the three months ended September 30, 2007. Our consolidated gross premiums decreased $110.6 million, or 8.9%, for the nine months ended September 30, 2008 compared to the nine months ended September 30, 2007. Our net income for the three months ended September 30, 2008 decreased $155.4 million, or 142.6%, to a net loss of $46.4 million compared to net income of $109.0 million for the three months ended September 30, 2007. During the three months ended September 30, 2008, we were negatively impacted by net losses and loss expenses recognized of $71.6 million related to Hurricanes Ike and Gustav, as well as realized investment losses, including other-than-temporary charges, of $151.9 million. Our net income for the nine months ended September 30, 2008 decreased $182.4 million, or 52.7%, to $163.8 million compared to $346.2 million for the nine months ended September 30, 2007.

Recent Developments

On June 27, 2008, we entered into a definitive merger agreement to acquire Darwin Professional Underwriters, Inc. (Darwin). Darwin is a holding company whose subsidiaries are engaged in the executive and professional liability insurance business with an emphasis on coverage for the healthcare industry. The transaction was completed on October 20, 2008 and has been accounted for as a purchase. Under the purchase method of accounting for a business combination, the assets and liabilities of Darwin were recorded at their fair values on the acquisition date. Under the terms of the merger agreement, stockholders of Darwin received $32.00 per share in cash for each share of Darwin common stock in exchange for 100% of their interests in Darwin. Also, each outstanding Darwin stock option became fully vested and was converted into an amount in cash equal to (i) the excess, if any, of $32.00 over the exercise price per share of the stock option, multiplied by (ii) the total number of shares of Darwin common stock subject to the stock option. In addition, each outstanding Darwin restricted share became fully vested and was converted into the right to receive $32.00 in cash per restricted share, and each outstanding director share unit was converted to receive $32.00 in cash per share unit. The total cash consideration paid was $550.1 million, excluding direct costs of the acquisition, and was paid with available capital.

During the past several months, there has been significant turmoil in the U.S. and international financial markets. The ability to borrow funds has become limited as there has been a general lock-up of liquidity. The recent events have impacted us in two significant ways. The first is the lack of liquidity, which has reduced the fair value of our overall investment portfolio since June 30, 2008. The market for certain securities has become inactive, which has made pricing certain securities difficult and which has had the effect of lowering the fair value of our investment portfolio. Approximately 99% of our fixed income investments (which included individually held securities and securities held in a global high-yield bond fund) consisted of investment grade securities, whose average credit rating is AA+ as rated by Standard & Poor s. Our investment portfolio does not include any real estate, collateralized debt obligations, collateralized loan obligations, direct investment in common equities or other complex financial structures. Our investment portfolio has no transactions that require the posting of collateral. While we have taken significant net realized losses of $151.9 million from the sale of fixed income securities, mark-to-market adjustments on our hedge fund investments and other-than-temporary impairment charges during the three months ended September 30, 2008, we believe that our investment portfolio remains well diversified, conservative and of high quality. The second significant impact that the recent events have had on us, as well as others in the industry, is the ability to raise additional capital if necessary given the current market conditions. However, we have a credit facility with a syndication of 13 lenders that is comprised of a secured credit facility and an unsecured credit facility. We currently have the ability to draw up to $400 million from our unsecured credit facility. For more information on our credit facility, please see Liquidity and Capital Resources Restrictions and Specific Requirements .

Relevant Factors

Revenues

We derive our revenues primarily from premiums on our insurance policies and reinsurance contracts, net of any reinsurance or retrocessional coverage purchased. Insurance and reinsurance premiums are a function of the amounts and types of policies and contracts we write, as well as prevailing market prices. Our prices are determined before our ultimate costs, which may extend far into the future, are known. In addition, our revenues include income generated from our investment portfolio, consisting of net investment income and net realized gains or losses. Investment income is principally derived from interest and dividends earned on investments, partially offset by investment management fees and fees paid to our custodian bank. Net realized gains or losses include (1) net realized investment gains or losses from the sale of investments, (2) write-downs related to declines in the market value of securities on our available for sale portfolio that were considered to be other than temporary and (3) the change in the fair value of investments that we mark-to-market in the consolidated statements of operations and comprehensive income.

Expenses

Our expenses consist largely of net losses and loss expenses, acquisition costs and general and administrative expenses. Net losses and loss expenses incurred are comprised of three main components:

- losses paid, which are actual cash payments to insureds or losses payable to insureds, net of recoveries from reinsurers;

- outstanding loss or case reserves, which represent management s best estimate of the likely settlement amount for known claims, less the portion that can be recovered from reinsurers; and

- reserves for losses incurred but not reported, or IBNR , which are reserves established by us for claims that are not yet reported but can reasonably be expected to have occurred based on industry information, management s experience and/or actuarial evaluation. The portion recoverable from reinsurers is deducted from the gross estimated loss.

Acquisition costs are comprised of commissions, brokerage fees and insurance taxes. Commissions and brokerage fees are usually calculated as a percentage of premiums and depend on the market and line of business. Acquisition costs are reported after (1) deducting commissions received on ceded reinsurance, (2) deducting the part of acquisition costs relating to unearned premiums and (3) including the amortization of previously deferred acquisition costs.

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General and administrative expenses include personnel expenses including stock-based compensation charges, rent expense, professional fees, information technology costs and other general operating expenses. We are experiencing increases in general and administrative expenses resulting from additional staff, increased stock-based compensation expense, increased rent expense for our U.S. offices, increased professional fees and additional amortization expense for building-related and infrastructure expenditures. We believe this trend will continue during the remainder of 2008 as we continue to hire additional staff and build our infrastructure.

Ratios

Management measures results for each segment on the basis of the loss and loss expense ratio, acquisition cost ratio, general and administrative expense ratio, expense ratio and the combined ratio. Because we do not manage our assets by segment, investment income, interest expense and total assets are not allocated to individual reportable segments. General and administrative expenses are allocated to segments based on various factors, including staff count and each segment s proportional share of gross premiums written. The loss and loss expense ratio is derived by dividing net losses and loss expenses by net premiums earned. The acquisition cost ratio is derived by dividing acquisition costs by net premiums earned. The general and administrative expense ratio is derived by dividing general and administrative expenses by net premiums earned. The expense ratio is the sum of the acquisition cost ratio and the general and administrative expense ratio. The combined ratio is the sum of the loss and loss expense ratio, the acquisition cost ratio and the general and administrative expense ratio.

Critical Accounting Policies

It is important to understand our accounting policies in order to understand our financial position and results of operations. Our unaudited condensed consolidated financial statements reflect determinations that are inherently subjective in nature and require management to make assumptions and best estimates to determine the reported values. If events or other factors cause actual results to differ materially from management s underlying assumptions or estimates, there could be a material adverse effect on our financial condition or results of operations. We believe that some of the more critical judgments in the areas of accounting estimates and assumptions that affect our financial condition and results of operations are related to reserves for losses and loss expenses, reinsurance recoverables, premiums and acquisition costs, valuation of financial instruments and other-than-temporary impairment of investments. For a detailed discussion of our critical accounting policies please refer to our Annual Report on Form 10-K for the year ended December 31, 2007 filed with the SEC. There were no material changes in the application of our critical accounting estimates subsequent to that report, except as discussed below related to the valuation of financial instruments.

Fair Value of Financial Instruments

Under existing accounting principles generally accepted in the United States (U.S. GAAP), we are required to recognize certain assets at their fair value in our condensed consolidated balance sheets. This includes our fixed maturity investments, global high-yield bond fund and hedge funds. Fair value, as defined in Financial Accounting Standard No. 157 Fair Value Measurements (FAS 157), is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. FAS 157 also established a three-level valuation hierarchy for disclosure of fair value measurements. The valuation hierarchy is based upon whether the inputs to the valuation of an asset or liability are observable or unobservable in the market at the measurement date, with quoted market prices being the highest level (Level 1) and unobservable inputs being the lowest level (Level 3). A fair value measurement will fall within the level of the hierarchy based on the input that is significant to determining such measurement. The three levels are defined as follows:

Level 1: Observable inputs to the valuation methodology that are quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2: Observable inputs to the valuation methodology other than quoted market prices (unadjusted) for identical assets or liabilities in active markets. Level 2 inputs include quoted prices for similar assets and liabilities in active markets, quoted prices for identical assets in markets that are not active and inputs other than quoted prices that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the asset or liability.

Level 3: Inputs to the valuation methodology that are unobservable for the asset or liability.

At each measurement date, we estimate the fair value of the financial instruments using various valuation techniques. We utilize, to the extent available, quoted market prices in active markets or observable market inputs in estimating the fair value of our financial instruments. When quoted market prices or observable market inputs are not available, we utilize valuation techniques that rely on unobservable inputs to estimate the fair value of financial instruments. The following describes the valuation techniques we used to determine the fair value of financial instruments held as of September 30, 2008 and what level within the FAS 157 fair value hierarchy the valuation technique resides.

U.S. government and U.S. government agencies: Comprised primarily of bonds issued by the U.S. Treasury, the Federal Home Loan Bank, the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association. The fair values of U.S. government securities are based on quoted market prices in active markets, and are included in the Level 1 fair value hierarchy. We believe the market for U.S. Treasury securities is an actively traded market given the high level of daily trading volume. The fair values of U.S. government agency securities are priced using the spread above the risk-free yield curve. As the yields for the risk-free yield curve are observable market inputs, the fair values of U.S. government agency securities are included in the Level 2 fair value hierarchy.

Non-U.S. government and government agencies: Comprised of fixed income obligations of non-U.S. governmental entities. The fair values of these securities are based on prices obtained from broker/dealers and international indices, and are included in the Level 2 fair value hierarchy.

Corporate: Comprised of bonds issued by corporations that on acquisition are rated BBB-/Baa3 or higher provided that, in aggregate, corporate bonds with ratings of BBB-/Baa3 do not constitute more than 5% of the market value of our fixed income securities, and are diversified across a wide range of issuers and industries. The fair values of corporate bonds that are short-term are priced using the spread above the London Interbank Offering Rate yield curve, and the fair value of corporate bonds that are long-term are priced using the spread above the risk-free yield curve. The spreads are sourced from broker/dealers, trade prices and the new issue market. As the significant inputs used to price corporate bonds are observable market inputs, the fair values of corporate bonds are included in the Level 2 fair value hierarchy.

States, municipalities and political subdivisions: Comprised of fixed income obligations of U.S. domiciled state and municipality entities. The fair values of these securities are based on prices obtained from broker/dealers and the new issue market, and are included in the Level 2 fair value hierarchy.

Mortgage-backed: Principally comprised of AAA-rated pools of residential and commercial mortgages originated by both agency (such as the Federal National Mortgage Association) and non-agency originators. The fair values of mortgage-backed securities originated by U.S. government agencies and non-U.S. government agencies are based on a pricing model that incorporates prepayment speeds and spreads to determine appropriate average life of mortgage-backed securities. The spreads are sourced from broker/dealers trade prices and the new issue market. As the significant inputs used to price the mortgage-backed securities are observable market inputs, the fair values of these securities are included in the Level 2 fair value hierarchy.

Asset-backed: Comprised of primarily AAA-rated bonds backed by pools of automobile loan receivables, home equity loans and credit card receivables originated by a variety of financial institutions. The fair values of asset-backed securities are priced using prepayment speed and spread inputs that are sourced from the new issue market. As the significant inputs used to price the asset-backed securities are observable market inputs, the fair values of these securities are included in the Level 2 fair value hierarchy.

Other invested assets available for sale: Comprised of an open-end global high-yield bond fund that invests in non-investment grade bonds issued by various issuers and industries. The fair value of the global high-yield bond fund is based on the net asset value as reported by the fund manager. The net asset value is an observable input as it is quoted on a market exchange on a daily basis. The fair value of the global high-yield bond fund is included in the Level 2 fair value hierarchy.

Other invested assets, at fair value: Comprised of four hedge funds invested in a range of diversified strategies. The fair values of the hedge funds are based on the net asset value of the funds as reported by the fund manager less a liquidity discount where hedge fund investments contain lock-up provisions that prevent immediate dissolution. We consider these lock-up provisions to be obligations that market participants would assign a value to in determining the price of these hedge funds, and as such have considered these obligations in determining the fair value measurement of the related hedge funds. The liquidity discount was estimated by calculating the value of a protective put over the lock-up period. The protective put measures the risk of holding a restricted asset over a certain time period. We used the Black-Scholes option-pricing model to estimate the value of the protective put for each hedge fund. The aggregate liquidity discount recorded during the three months ended September 30, 2008 was not significant and $0.2 million for the nine months ended September 30, 2008. The net asset value and the liquidity discount are significant unobservable inputs, and as such the fair values of the hedge funds are included in the Level 3 fair value hierarchy. Our hedge funds are the only assets that have significant Level 3 inputs in determining fair value and represent 3.0% of our total investments.

The following table shows the pricing sources of our fixed maturity investments held as of September 30, 2008:

Pricing Sources	Fair Value of Fixed Maturity Investments as of September 30, 2008	Percentage of Total Fixed Maturity Investments	SFAS 157 Fair Value Hierarchy Level
Lehman Brothers Index	$ 3,869.3	71.2%	1 and 2
Interactive Data Pricing	665.0	12.2	2
Reuters pricing service	552.0	10.2	2
International indices	84.8	1.6	2
Other (including broker/dealers)	262.2	4.8	2
	$ 5,433.3	100.0%	

Lehman Brothers Index: We use the Lehman Brothers Index to price our U.S. government, U.S. government agencies, corporate, agency and non-agency mortgage-backed and asset-backed securities. There are several observable inputs that the Lehman Brothers Index uses in determining its prices, which include among others, treasury yields, new issuance and secondary trades, information provided by broker/dealers, security cash flows and structures, sector and issuer level spreads, credit rating, underlying collateral and prepayment speeds. For U.S. government securities, traders that act as market makers are the primary source of pricing. As such, for U.S. government securities we believe the Lehman Brothers Index reflects quoted prices (unadjusted) for identical securities in active markets.

Interactive Data Pricing: We use Interactive Data Pricing to price our U.S. government agencies, municipalities, non-agency mortgage-backed and asset-backed securities. There are several observable inputs that Interactive Data Pricing uses in determining its prices, which include among others, benchmark yields, reported trades and issuer spreads.

Reuters pricing service: We use the Reuters pricing service to price our U.S. government agencies, corporate, agency and non-agency mortgage-backed and asset-backed securities. There are several observable inputs that the Reuters pricing service uses in determining its prices, which include among others, option-adjusted spreads, treasury yields, new issuance and secondary trades, sector and issuer level spreads, underlying collateral and prepayment speeds.

International indices: We use international indices, which include the FTSE, Deutche Teleborse and the Scotia Index, to price our non-U.S. government and government agencies securities. The observable inputs used by international indices to determine its prices are based on new issuance and secondary trades and information provided by broker/dealers.

Other (including broker/dealers): We also utilize, to a lesser extent, other pricing services including broker/dealers to price our U.S. government agencies, corporate, municipalities, agency and non-agency mortgage-backed and asset-backed securities. The pricing sources include JP Morgan Securities Inc., Merrill Lynch & Co. and other broker/dealers and Standards & Poor s.

To validate the prices obtained from the above pricing sources, which are our primary sources of prices, we also obtain prices from our investment portfolio managers, and compare the prices obtained from the above pricing sources to those obtained from our investment portfolio managers. We investigate any differences between the two sources and determine which price best reflects the fair value of the individual security. There were no material differences between the prices from the above sources and the prices obtained from our investment portfolio managers as of September 30, 2008. In addition, all the pricing sources that we utilize have their own due-diligence procedures to ensure the price used for a particular security is based on observable inputs and reflects the best available information.

There have been no material changes to any of our valuation techniques from those used as of December 31, 2007. We have still been able to obtain observable market inputs for our investments, despite the market conditions that existed as of September 30, 2008. Based on all reasonably available information received, we believe the prices that were obtained from inactive markets were orderly transactions, and therefore, reflected the current price a market participant would pay for the asset. We based our determination of whether a market is active or inactive based on the spread between what a seller is asking for a security and what a buyer is bidding for that security. Spreads that are significantly above historical spreads are considered inactive markets. We also consider the volume of trading activity in our determination of whether a market is active or inactive. Since fair valuing a financial instrument is an estimate of what a willing buyer would pay for our asset if we sold it, we will not know the ultimate value of our financial instruments until they are sold. We believe the valuation techniques utilized provide us with the best estimate of the price that would be received to sell our assets in an orderly transaction between participants at the measurement date.

Results of Operations

The following table sets forth our selected consolidated statement of operations data for each of the periods indicated.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
	($ in millions)			
Gross premiums written	$ 291.0	$ 276.3	$ 1,134.6	$ 1,245.2
Net premiums written	$ 233.9	$ 219.3	$ 880.7	$ 963.7
Net premiums earned	272.0	283.7	813.9	873.3
Net investment income	76.9	76.1	226.2	222.7
Net realized investment losses	(151.9)	(4.2)	(152.8)	(12.1)
	$ 197.0	$ 355.6	$ 887.3	$ 1,083.9
Net losses and loss expenses	$ 176.0	$ 173.2	$ 497.6	$ 515.5
Acquisition costs	28.6	29.2	81.7	90.2
General and administrative expenses	40.8	36.1	130.5	103.7
Interest expense	9.5	9.5	28.5	28.3
Foreign exchange gain	(2.7)	(1.0)	(2.7)	(0.4)
	$ 252.2	$ 247.0	$ 735.6	$ 737.3
(Loss) income before income taxes	$ (55.2)	$ 108.6	$ 151.7	$ 346.6
Income tax (recovery) expense	(8.8)	(0.4)	(12.1)	0.4
Net (loss) income	$ (46.4)	$ 109.0	$ 163.8	$ 346.2
Ratios				
Loss and loss expense ratio	64.7%	61.1%	61.1%	59.0%
Acquisition cost ratio	10.5	10.3	10.0	10.3
General and administrative expense ratio	15.0	12.7	16.0	11.9
Expense ratio	25.5	23.0	26.0	22.2
Combined ratio	90.2	84.1	87.1	81.2

Comparison of Three Months Ended September 30, 2008 and 2007

Premiums

Gross premiums written increased by $14.7 million, or 5.3%, for the three months ended September 30, 2008 compared to the three months ended September 30, 2007. The increase in gross premiums written was primarily the result of the following:

In our casualty segment, our gross premiums written increased by $17.8 million, primarily due to increased gross premiums written by our U.S. offices. Gross premiums written by our U.S. offices increased by $12.4 million, or 32.1%, for the three months ended September 30, 2008 compared to the three months ended September 30, 2007.

In our reinsurance segment, adjustments on estimated premiums were higher by $1.7 million during the three months ended September 30, 2008 compared to the three months ended September 30, 2007. We recognized net upward adjustments of $2.8 million during the three months ended September 30, 2008 compared to net upward adjustments of $1.1 million during the three months ended September 30, 2007. We also recognized $2.7 million in reinstatement premiums related to Hurricane Ike during the three months ended September 30, 2008.

Offsetting the increased gross premiums written in our casualty segment was the continued trend of the non-renewal of business that did not meet our underwriting requirements (which included inadequate pricing and/or policy or contract terms and conditions), increased competition and inadequate pricing for new business in each of our operating segments. This included our reducing the amount of gross premiums written in our energy line of business within our property segment by $8.0 million, or 44.4%, and reducing the amount of gross premiums written for certain energy classes of business within our casualty segment by $1.6 million in response to deteriorating market conditions.

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The table below illustrates our gross premiums written by geographic locations for the three months ended September 30, 2008 and 2007.

	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007	Dollar Change	Percentage Change
	($ in millions)			
Bermuda	$ 137.6	$ 181.2	$ (43.6)	(24.1)%
United States	106.6	51.9	54.7	105.4
Europe	46.8	43.2	3.6	8.3
	$ 291.0	$ 276.3	$ 14.7	5.3%

The decrease in gross premiums written for our Bermuda operations, in addition to the continued trend of the non-renewal of business that did not meet our underwriting requirements (which included inadequate pricing and/or policy or contract terms and conditions), increased competition and inadequate pricing for new business was due to the fact that certain policies and treaties that were previously written in Bermuda during the three months ended September 30, 2007 were renewed in one of our U.S. companies during the three months ended September 30, 2008. Our U.S. reinsurance company commenced operations in April 2008 and renewed treaties previously written in Bermuda of $17.6 million during the three months ended September 30, 2008.

Net premiums written increased by $14.6 million, or 6.7%, for the three months ended September 30, 2008 compared to the three months ended September 30, 2007. The difference between gross and net premiums written is the cost to us of purchasing reinsurance, both on a proportional and a non-proportional basis, including the cost of property catastrophe reinsurance coverage. We ceded 19.6% of gross premiums written for the three months ended September 30, 2008 compared to 20.6% for the same period in 2007. The decrease in the percentage of premiums ceded was caused by a reduction in the cession percentage on our general property quota share reinsurance treaty from 55% to 40%, partially offset by the purchase of an additional property catastrophe excess-of-loss reinsurance treaty for our general property business with a limit of $75 million excess of $50 million, of which 25% was placed with external reinsurers and the remainder was retained by us. This excess-of-loss reinsurance treaty covers property damage within the United States and Canada caused by a named windstorm and has a term from July 1, 2008 to November 30, 2008. The total ceded premiums written for this excess-of-loss treaty were $2.5 million. There was no such additional property catastrophe excess-of-loss treaty in place during the three months ended September 30, 2007.

Net premiums earned decreased by $11.7 million, or 4.1%, for the three months ended September 30, 2008 compared to the three months ended September 30, 2007 due to the continued earning of lower net premiums that were written prior to the three months ended September 30, 2008.

We evaluate our business by segment, distinguishing between property insurance, casualty insurance and reinsurance. The following chart illustrates the mix of our business on both a gross premiums written and net premiums earned basis.

	Gross Premiums Written		Net Premiums Earned	
	Three Months Ended September 30,			
	2008	2007	2008	2007
Property	19.7%	21.8%	15.8%	15.6%
Casualty	48.1	44.2	38.8	40.5
Reinsurance	32.2	34.0	45.4	