Allied World Assurance Co Holdings, AG
Form 10-Q
October 22, 2014
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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, 2014
OR

¨ 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, AG
(Exact Name of Registrant as Specified in Its Charter)

Switzerland	98-0681223
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

Lindenstrasse 8
6340 Baar
Zug, Switzerland
(Address of Principal Executive Offices and Zip Code)

41-41-768-1080
(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 ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes þ No ¨

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 ¨ Non-accelerated filer ¨ Smaller reporting company ¨
(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 ¨ No þ

As of October 13, 2014, 96,409,738 common shares were outstanding.

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PART I
FINANCIAL INFORMATION
Item 1. Financial Statements.
ALLIED WORLD ASSURANCE COMPANY HOLDINGS, AG
UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS
as of September 30, 2014 and December 31, 2013
(Expressed in thousands, except share and per share amounts)

	As of September 30, 2014	As of December 31, 2013
ASSETS:		
Fixed maturity investments trading, at fair value (amortized cost: 2014: $6,074,752; 2013: $6,065,350)	$6,128,237	$6,100,798
Equity securities trading, at fair value (cost: 2014: $901,300; 2013: $647,301)	945,076	699,846
Other invested assets	929,201	911,392
Total investments	8,002,514	7,712,036
Cash and cash equivalents	831,270	531,936
Restricted cash	178,958	149,393
Insurance balances receivable	926,183	664,731
Funds held	405,703	632,430
Prepaid reinsurance	376,651	340,992
Reinsurance recoverable	1,349,009	1,234,504
Accrued investment income	30,554	32,236
Net deferred acquisition costs	171,827	126,661
Goodwill	278,085	268,376
Intangible assets	46,931	48,831
Balances receivable on sale of investments	60,122	76,544
Net deferred tax assets	41,312	37,469
Other assets	110,449	89,691
Total assets	$12,809,568	$11,945,830
LIABILITIES:		
Reserve for losses and loss expenses	$6,052,263	$5,766,529
Unearned premiums	1,716,927	1,396,256
Reinsurance balances payable	203,428	173,023
Balances due on purchases of investments	166,026	104,740
Senior notes	798,725	798,499
Dividends payable	21,686	16,732
Accounts payable and accrued liabilities	176,914	170,225
Total liabilities	$9,135,969	$8,426,004
Commitments and contingencies		
SHAREHOLDERS' EQUITY:		
Common shares: 2014: par value CHF 4.10 per share and 2013: par value CHF 4.10 per share (2014: 100,775,256; 2013: 103,477,452 shares issued and 2014: 96,382,238; 2013: 100,253,646 shares outstanding)	407,990	418,988
Treasury shares, at cost (2014: 4,393,018; 2013: 3,223,806)	(134,633)	(79,992)
Retained earnings	3,400,242	3,180,830
Total shareholders' equity	3,673,599	3,519,826
Total liabilities and shareholders' equity	$12,809,568	$11,945,830

See accompanying notes to the consolidated financial statements.

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ALLIED WORLD ASSURANCE COMPANY HOLDINGS, AG
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
AND COMPREHENSIVE INCOME
for the three and nine months ended September 30, 2014 and 2013
(Expressed in thousands, except share and per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
REVENUES:				
Gross premiums written	$707,884	$580,893	$2,369,682	$2,183,174
Premiums ceded	(139,142)	(127,816)	(475,402)	(453,823)
Net premiums written	568,742	453,077	1,894,280	1,729,351
Change in unearned premiums	(27,005)	57,696	(285,011)	(248,079)
Net premiums earned	541,737	510,773	1,609,269	1,481,272
Net investment income	43,412	39,271	127,824	110,294
Net realized investment (losses) gains	(35,136)	27,487	104,286	(8,074)
Other income	1,032	—	1,032	—
	551,045	577,531	1,842,411	1,583,492
EXPENSES:				
Net losses and loss expenses	336,090	276,970	926,231	807,276
Acquisition costs	72,403	65,114	214,404	186,416
General and administrative expenses	88,294	88,553	264,822	251,818
Other expense	6,575	—	6,575	—
Amortization of intangible assets	633	633	1,900	1,900
Interest expense	14,325	14,094	43,451	42,416
Foreign exchange loss	278	4,353	978	7,361
	518,598	449,717	1,458,361	1,297,187
Income before income taxes	32,447	127,814	384,050	286,305
Income tax expense	1,532	4,971	24,300	6,332
NET INCOME	30,915	122,843	359,750	279,973
Other comprehensive income	—	—	—	—
COMPREHENSIVE INCOME	$30,915	$122,843	$359,750	$279,973
PER SHARE DATA				
Basic earnings per share	$0.32	$1.20	$3.67	$2.72
Diluted earnings per share	$0.31	$1.18	$3.60	$2.66
Weighted average common shares outstanding	96,458,231	101,974,077	97,926,378	103,020,681
Weighted average common shares and common share equivalents outstanding	98,444,238	104,184,579	99,965,296	105,393,276
Dividends paid per share	$0.225	$0.167	$0.559	$0.292

See accompanying notes to the consolidated financial statements.

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ALLIED WORLD ASSURANCE COMPANY HOLDINGS, AG
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
for the nine months ended September 30, 2014 and 2013
(Expressed in thousands)

	Share Capital	Treasury Shares	Retained Earnings	Total
December 31, 2013	$418,988	$(79,992)	$3,180,830	$3,519,826
Net income	—	—	359,750	359,750
Dividends	—	—	(60,017)	(60,017)
Stock compensation	—	17,235	1,333	18,568
Share repurchases	—	(164,528)	—	(164,528)
Shares cancelled	(10,998)	92,652	(81,654)	—
September 30, 2014	$407,990	$(134,633)	$3,400,242	$3,673,599
December 31, 2012	$454,980	$(113,818)	$2,985,173	$3,326,335
Net income	—	—	279,973	279,973
Dividends — par value reduction	(12,981)	—	—	(12,981)
Dividends	—	—	(34,069)	(34,069)
Stock compensation	—	26,093	(18,278)	7,815
Share repurchases	—	(123,145)	—	(123,145)
Shares cancelled	(17,162)	125,025	(107,863)	—
September 30, 2013	$424,837	$(85,845)	$3,104,936	$3,443,928

See accompanying notes to the consolidated financial statements.

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ALLIED WORLD ASSURANCE COMPANY HOLDINGS, AG
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
for the nine months ended September 30, 2014 and 2013
(Expressed in thousands)

	Nine Months Ended September 30, 2014	2013
CASH FLOWS PROVIDED BY OPERATING ACTIVITIES:		
Net income	$359,750	$279,973
Adjustments to reconcile net income to cash provided by operating activities:		
Net realized gains on sales of investments	(118,640)	(76,104)
Mark to market adjustments	(5,634)	80,136
Stock compensation expense	10,822	9,282
Undistributed loss (income) of equity method investments	10,452	(4,313)
Changes in:		
Reserve for losses and loss expenses, net of reinsurance recoverables	171,229	50,308
Unearned premiums, net of prepaid reinsurance	285,012	248,079
Insurance balances receivable	(260,627)	(229,580)
Funds held	226,727	(38,763)
Reinsurance balances payable	30,405	57,379
Net deferred acquisition costs	(45,166)	(37,941)
Net deferred tax assets	(3,511)	(16,252)
Accounts payable and accrued liabilities	4,473	(18,540)
Other items, net	4,441	34,508
Net cash provided by operating activities	669,733	338,172
CASH FLOWS (USED IN) PROVIDED BY INVESTING ACTIVITIES:		
Purchases of trading securities	(5,608,594)	(4,955,817)
Purchases of other invested assets	(242,227)	(211,501)
Sales of trading securities	5,500,176	5,137,280
Sales of other invested assets	243,123	189,155
Purchases of fixed assets	(14,490)	(4,171)
Change in restricted cash	(29,565)	(74,032)
Net cash paid for acquisitions	(2,565)	—
Net cash (used in) provided by investing activities	(154,142)	80,914
CASH FLOWS USED IN FINANCING ACTIVITIES:		
Dividends paid - partial par value reduction	—	(12,981)
Dividends paid	(55,064)	(17,117)
Proceeds from the exercise of stock options	7,640	8,465
Share repurchases	(166,207)	(120,163)
Net cash used in financing activities	(213,631)	(141,796)
Effect of exchange rate changes on foreign currency cash	(2,626)	(6,122)
NET INCREASE IN CASH AND CASH EQUIVALENTS	299,334	271,168
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	531,936	681,879
CASH AND CASH EQUIVALENTS, END OF PERIOD	$831,270	$953,047
Supplemental disclosure of cash flow information:		
Cash paid for income taxes	$18,052	$17,249
Cash paid for interest expense	$45,750	$45,750

See accompanying notes to the consolidated financial statements.

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ALLIED WORLD ASSURANCE COMPANY HOLDINGS, AG
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Expressed in thousands, except share, per share, percentage and ratio information)

1. GENERAL

Allied World Assurance Company Holdings, AG, a Swiss holding company ("Allied World Switzerland"), through its wholly-owned subsidiaries (collectively, the "Company"), provides property and casualty insurance and reinsurance on a worldwide basis. References to $ are to the lawful currency of the United States and to CHF are to the lawful currency of Switzerland.

The Company has reached definitive agreements to acquire the Hong Kong and Singapore operations of Royal & Sun Alliance Insurance plc for approximately $211,000, at current exchange rates, subject to adjustments at closing. In addition to the purchase price, the Company expects to contribute an additional $90,000 to capitalize the business on an ongoing basis. Subject to regulatory approvals in both Hong Kong and Singapore, as well as court approval in Singapore, the acquisition is expected to be completed in the first half of 2015.

2. BASIS OF PREPARATION AND CONSOLIDATION

These unaudited condensed consolidated financial statements include the accounts of the Company 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 outstanding losses and loss expenses,
- Valuation of ceded reinsurance recoverables,
- Determination of impairment of goodwill and other intangible assets, and
- Valuation of financial instruments.

Intercompany accounts and transactions have been eliminated on consolidation and all entities meeting consolidation requirements have been included in the unaudited condensed consolidated financial statements.

On May 1, 2014, the shareholders approved a 3-for-1 stock split of the Company's common shares. All historical share and per share amounts reflect the effect of the stock split.

These unaudited condensed consolidated financial statements, including these notes, should be read in conjunction with the Company's audited consolidated financial statements, and related notes thereto, included in the Company's Annual Report on Form 10-K for the year ended December 31, 2013.

3. NEW ACCOUNTING PRONOUNCEMENTS

In April 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update 2014-08, "Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity" ("ASU 2014-08"). ASU 2014-08 changes the requirements for reporting discontinued operations, such that a disposal of a component of the Company's operations is required to be reported as discontinued operations if the disposal represents a strategic shift that has, or will have, a major effect on the Company's operations and financial results. Examples of strategic shifts that could have a major effect on the Company's operations could include a disposal of a major geographical area, a major line of business, a major equity method investment, or other major parts of the Company. ASU 2014-08 is effective for all disposals that occur after January 1, 2015. The Company does not believe the adoption of ASU 2014-08 will have a material impact on future financial statements and related disclosures.

(Expressed in thousands, except share, per share, percentage and ratio information)

In May 2014, the FASB issued Accounting Standards Update 2014-09, "Revenue from Contracts with Customers" ("ASU 2014-09"). ASU 2014-09 provides a framework, through a five-step process, for recognizing revenue from customers, improves comparability and consistency of recognizing revenue across entities, industries, jurisdictions and capital markets, and requires enhanced disclosures. Certain contracts with customers are specifically excluded from the scope of ASU 2014-09, including; amongst others, insurance contracts accounted for under Accounting Standard Codification 944, Financial Services - Insurance. ASU 2014-09 is effective on January 1, 2017 with retrospective adoption required for the comparative periods. The Company is currently assessing the impact the adoption of ASU 2014-09 will have on future financial statements and related disclosures.

In August 2014, the FASB issued Accounting Standards Update 2014-15, "Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern" ("ASU 2014-15"). Currently, there is no guidance under U.S. GAAP regarding management's responsibility to assess whether there is substantial doubt about an entity's ability to continue as a going concern. Under ASU 2014-15, the Company will be required to assess its ability to continue as a going concern each interim and annual reporting period and provide certain disclosures if there is substantial doubt about the entity's ability to continue as a going concern, including management's plan to alleviate the substantial doubt. ASU 2014-15 is effective on January 1, 2017 and early adoption is permitted. The Company is currently assessing the impact the adoption of ASU 2014-15 will have on future financial statements and related disclosures.

4. INVESTMENTS

a) Trading Securities

Securities accounted for at fair value with changes in fair value recognized in the unaudited condensed consolidated statements of operations and comprehensive income (“consolidated income statements”) by category are as follows:

	September 30, 2014		December 31, 2013	
	Fair Value	Amortized Cost	Fair Value	Amortized Cost
U.S. Government and Government agencies	$1,184,115	$ 1,186,185	$1,676,788	$ 1,684,832
Non-U.S. Government and Government agencies	219,287	229,792	191,776	197,082
States, municipalities and political subdivisions	260,690	251,628	231,555	234,406
Corporate debt:				
Financial institutions	1,194,949	1,185,637	958,794	943,518
Industrials	1,202,906	1,201,341	1,174,047	1,165,448
Utilities	125,513	125,202	69,426	69,658
Mortgage-backed	1,240,362	1,196,683	1,292,502	1,267,863
Asset-backed	700,415	698,284	505,910	502,543
Total fixed maturity investments	$6,128,237	$ 6,074,752	$6,100,798	$ 6,065,350

	September 30, 2014		December 31, 2013	
	Fair Value	Original Cost	Fair Value	Original Cost
Equity securities	$945,076	$901,300	$699,846	$647,301
Other invested assets	806,124	701,794	764,081	658,683
	$1,751,200	$1,603,094	$1,463,927	$1,305,984

Other invested assets, included in the table above, include investments in private equity funds, hedge funds and a high yield loan fund that are accounted for at fair value, but excludes other private securities described below in Note 4(b) that are accounted for using the equity method of accounting.

ALLIED WORLD ASSURANCE COMPANY HOLDINGS, AG
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Expressed in thousands, except share, per share, percentage and ratio information)

b) Other Invested Assets

Details regarding the carrying value, redemption characteristics and unfunded investment commitments of the other invested assets portfolio as of September 30, 2014 and December 31, 2013 were as follows:

Investment Type	Carrying Value as of September 30, 2014	Investments with Redemption Restrictions	Estimated Remaining Restriction Period	Investments without Redemption Restrictions	Redemption Frequency(1)	Redemption Notice Period(1)	Unfunded Commitments
Private equity	$179,196	$179,196	2 - 9 Years	$—			$ 223,030
Mezzanine debt	114,399	114,399	5 - 9 Years	—			251,486
Distressed	9,516	9,516	4 Years	—			5,119
Total private equity	303,111	303,111		—			479,635
Distressed	173,111	173,111	1 Year	—			—
Equity long/short	111,627	86,721	1 Year	24,906	Quarterly	30 -60 Days	—
Multi-strategy	81,576	—		81,576	Quarterly	45 -90 Days	—
Relative value credit	105,155	—		105,155	Quarterly	60 Days	—
Total hedge funds	471,469	259,832		211,637			—
High yield loan fund	31,544	—		31,544	Monthly	30 days	—
Total other invested assets at fair value	806,124	562,943		243,181			479,635
Other private securities	123,077	—		123,077			—
Total other invested assets	$929,201	$562,943		$366,258			$ 479,635

Investment Type	Carrying Value as of December 31, 2013	Investments with Redemption Restrictions	Estimated Remaining Restriction Period	Investments without Redemption Restrictions	Redemption Frequency(1)	Redemption Notice Period(1)	Unfunded Commitments
Private equity	$144,422	$144,422	2 - 9 Years	$—			$ 263,519
Mezzanine debt	64,627	64,627	8 - 9 Years	—			198,756
Distressed	7,776	7,776	4 Years	—			5,249
Total private equity	216,825	216,825		—			467,524
Distressed	151,227	151,227	1 - 2 Years	—			—
Equity long/short	99,365	—		99,365	Quarterly	30 -60 Days	—
Multi-strategy	136,958	—		136,958	Quarterly	45 -90 Days	—
Event driven	14,018	—		14,018	Annual	60 Days	—
Relative value credit	113,730	—		113,730	Quarterly	60 Days	—
Total hedge funds	515,298	151,227		364,071			—
High yield loan fund	31,958	—		31,958	Monthly	30 days	—
Total other invested assets at fair value	764,081	368,052		396,029			467,524
Other private securities	147,311	—		147,311			—
Total other invested assets	$911,392	$368,052		$543,340			$ 467,524

(1) The redemption frequency and notice periods only apply to the investments without redemption restrictions. Some or all of these investments may be subject to a gate as described below.

In general, the Company has invested in hedge funds that require at least 30 days’ notice of redemption and may be redeemed on a monthly, quarterly, semi-annual, annual or longer basis, depending on the fund. Certain hedge funds have lock-up periods ranging from one to three years from initial investment. A lock-up period refers to the initial amount of time an investor is contractually required to invest before having the ability to redeem. Funds that provide for periodic redemptions may, depending on the funds' governing documents, have the ability to deny or delay a redemption request, called a "gate." The fund may implement this restriction because the aggregate amount of redemption requests as of a particular date exceeds a specified level, generally ranging from 15% to 25% of the fund's net assets. The gate is a method for executing an orderly redemption process to reduce the possibility of adversely affecting investors in the fund. Typically, the imposition of a gate delays a portion of the requested redemption, with the remaining portion settled in cash sometime after the redemption date. Certain funds may impose a redemption fee on early redemptions. Interests in private equity funds cannot be redeemed because the investments include restrictions that do not allow for redemption until termination of the fund.

The following describes each investment type:

- Private equity funds: Primary funds may invest in companies and general partnership interests. Secondary funds buy limited partnership interests from existing limited partners of primary private equity funds. As owners of private equity funds seek liquidity, they can sell their existing investments, plus any remaining commitment, to secondary market participants. These funds cannot be redeemed because the investments include restrictions that do not allow for redemption until termination of the fund.
- Mezzanine debt funds: Mezzanine debt funds primarily focus on providing capital to upper middle market and middle market companies and private equity sponsors, in connection with leveraged buyouts, mergers and acquisitions, recapitalizations, growth financings and other corporate transactions. The most common position in the capital structure will be between the senior secured debt holder and the equity; however, the funds will utilize a flexible approach when structuring investments, which may include secured debt, subordinated debt, preferred stock and/or private equity. These funds cannot be redeemed because the investments include restrictions that do not allow for redemption until termination of the fund.
- Distressed funds: In distressed debt investing, managers take positions in the debt of companies experiencing significant financial difficulties, including bankruptcy, or in certain positions of the capital structure of structured securities. The manager relies on the fundamental analysis of these securities, including the claims on the assets and the likely return to bondholders. Certain funds cannot be redeemed because the investments include restrictions that do not allow for redemption until termination of the fund.
- Equity long/short funds: In equity long/short funds, managers take long positions in companies they deem to be undervalued and short positions in companies they deem to be overvalued. Long/short managers may invest in countries, regions or sectors and vary by their use of leverage and by their targeted net long position.
- Multi-strategy funds: These funds may utilize many strategies employed by specialized funds including distressed investing, equity long/short, merger arbitrage, convertible arbitrage, fixed income arbitrage and macro trading.
- Event driven funds: Event driven strategies seek to deploy capital into specific securities whose returns are affected by a specific event that affects the value of one or more securities of a company. Returns for such securities are linked primarily to the specific outcome of the events and not by the overall direction of the bond or stock markets. Examples could include mergers and acquisitions (arbitrage), corporate restructurings and spin-offs, and capital structure arbitrage.
- Relative value credit funds: These funds seek to take exposure to credit-sensitive securities, long and/or short, based upon credit analysis of issuers and securities and credit market views.
- High yield loan fund: A long-only private mutual fund that invests in high yield fixed income securities.
- Other private securities: These securities include strategic non-controlling minority investments in private asset management companies and other insurance related investments that are accounted for using the equity method of

accounting.

ALLIED WORLD ASSURANCE COMPANY HOLDINGS, AG
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Expressed in thousands, except share, per share, percentage and ratio information)

c) Net Investment Income

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Fixed maturity investments	$38,762	$31,179	$110,998	$96,366
Equity securities	3,711	6,110	12,876	13,718
Other invested assets: hedge funds and private equity	2,249	3,812	8,767	6,001
Other invested assets: other private securities	3,292	1,997	7,291	5,115
Cash and cash equivalents	552	302	1,562	1,319
Expenses	(5,154)	(4,129)	(13,670)	(12,225)
Net investment income	$43,412	$39,271	$127,824	$110,294

Net investment income from other invested assets: other private securities included the distributed and undistributed net income from investments accounted for using the equity method of accounting. The income reported for other invested assets: other private securities for the nine months ended September 30, 2014 included a loss of $9,348 recorded for an equity method investment due to impairment charges that it recorded.

d) Components of Realized Gains and Losses

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Gross realized gains on sale of invested assets	$28,773	$51,915	$146,780	$154,387
Gross realized losses on sale of invested assets	(9,955)	(40,770)	(26,228)	(82,812)
Net realized and unrealized gains (losses) on derivatives	2,171	(4,169)	(24,469)	3,392
Mark-to-market (losses) gains:				
Fixed maturity investments, trading	(40,843)	30,383	18,039	(101,205)
Equity securities, trading	(8,479)	(17,198)	(8,768)	(18,555)
Other invested assets, trading	(6,803)	7,326	(1,068)	36,719
Net realized investment (losses) gains	$(35,136)	$27,487	$104,286	$(8,074)

e) Pledged Assets

As of September 30, 2014 and December 31, 2013, $3,082,601 and $2,894,401, respectively, of cash and cash equivalents and investments were deposited, pledged or held in trust accounts in favor of ceding companies and other counterparties or government authorities to comply with reinsurance contract provisions, insurance laws and other contract provisions.

In addition, as of September 30, 2014 and December 31, 2013, a further $543,828 and $1,053,632, respectively, of cash and cash equivalents and investments were pledged as collateral for the Company’s letter of credit facilities. See Note 10(d) to the Consolidated Financial Statements included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2013 for details on the Company’s credit facilities.

5. DERIVATIVE INSTRUMENTS

As of September 30, 2014 and December 31, 2013, none of the Company's derivatives were designated as hedges for accounting purposes. The following table summarizes information on the location and amounts of derivative fair values on the unaudited condensed consolidated balance sheets ("consolidated balance sheets"):

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ALLIED WORLD ASSURANCE COMPANY HOLDINGS, AG
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Expressed in thousands, except share, per share, percentage and ratio information)

	September 30, 2014				December 31, 2013			
	Asset Derivative Notional Amount	Asset Derivative Fair Value	Liability Derivative Notional Amount	Liability Derivative Fair Value	Asset Derivative Notional Amount	Asset Derivative Fair Value	Liability Derivative Notional Amount	Liability Derivative Fair Value
Foreign exchange contracts	$38,940	$ 814	$ 2,355	$ 22	$294,788	$ 6,254	$122,439	$ 1,176
Interest rate swaps	565,600	414	—	—	491,400	6,829	40,000	4,214
Total derivatives	$604,540	$ 1,228	$ 2,355	$ 22	$786,188	$ 13,083	$162,439	$ 5,390

Derivative assets and derivative liabilities are classified within “other assets” or “accounts payable and accrued liabilities” on the consolidated balance sheets.

The following table provides the net realized and unrealized gains (losses) on derivatives not designated as hedges recorded on the consolidated income statements:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Foreign exchange contracts	$1,886	$(2,336)	$(580)	$(1,091)
Total included in foreign exchange loss	1,886	(2,336)	(580)	(1,091)
Put options	—	—	—	(3,822)
Foreign exchange contracts	1,701	(4,164)	857	1,925
Interest rate futures and swaps	470	(5)	(25,325)	5,289
Total included in net realized investment gains (losses)	2,171	(4,169)	(24,468)	3,392
Total realized and unrealized gains (losses) on derivatives	$4,057	$(6,505)	$(25,048)	$2,301

The loss related to interest rate future and swap contracts for the nine months ended September 30, 2014 was the result of selling interest rate future and swap contracts to reduce the duration of the investment portfolio. Given the decrease in interest rates during the year, the Company recorded a loss related to these interest rate future and swap contracts.

Derivative Instruments Not Designated as Hedging Instruments

The Company is exposed to foreign currency risk in its investment portfolio. Accordingly, the fair values of the Company’s investment portfolio are partially influenced by the change in foreign exchange rates. These foreign currency hedging activities have not been designated as specific hedges for financial reporting purposes.

The Company’s insurance and reinsurance subsidiaries and branches operate in various foreign countries and consequently the Company’s underwriting portfolio is exposed to foreign currency risk. The Company manages foreign currency risk by seeking to match liabilities under the insurance policies and reinsurance contracts that it writes and that are payable in foreign currencies with cash and investments that are denominated in such currencies. When necessary, the Company may also use derivatives to economically hedge un-matched foreign currency exposures, specifically forward contracts and currency options.

The Company also purchases and sells interest rate future and interest rate swap contracts to actively manage the duration and yield curve positioning of its fixed income portfolio. Interest rate futures and interest rate swaps can efficiently increase or decrease the overall duration of the portfolio. Additionally, interest rate future and interest rate swap contracts can be utilized to obtain the desired position along the yield curve in order to protect against certain future yield curve shapes.

The Company also purchases options to actively manage its equity portfolio.

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6. FAIR VALUE OF FINANCIAL INSTRUMENTS

In accordance with U.S. GAAP, fair value is defined 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. There is 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.

The following table shows the fair value of the Company’s financial instruments and where in the fair value hierarchy the fair value measurements are included as of the dates indicated below:

September 30, 2014	Carrying Amount	Total Fair Value	Level 1	Level 2	Level 3
Fixed maturity investments:					
U.S. Government and Government agencies	$1,184,115	$1,184,115	$998,487	$185,628	$—
Non-U.S. Government and Government agencies	219,287	219,287	—	219,287	—
States, municipalities and political subdivisions	260,690	260,690	—	260,690	—
Corporate debt	2,523,368	2,523,368	—	2,523,368	—
Mortgage-backed	1,240,362	1,240,362	—	1,120,454	119,908
Asset-backed	700,415	700,415	—	609,045	91,370
Total fixed maturity investments	6,128,237	6,128,237	998,487	4,918,472	211,278
Equity securities	945,076	945,076	907,041	—	38,035
Other invested assets	806,124	806,124	—	—	806,124
Total investments	$7,879,437	$7,879,437	$1,905,528	$4,918,472	$1,055,437
Derivative assets:					
Foreign exchange contracts	$814	$814	$—	$814	$—
Interest rate swaps	414	414	—	414	—
Derivative liabilities:					
Foreign exchange contracts	$22	$22	$—	$22	$—
Interest rate swaps	—	—	—	—	—
Senior notes	$798,725	$888,370	$—	$888,370	$—

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December 31, 2013	Carrying Amount	Total Fair Value	Level 1	Level 2	Level 3
Fixed maturity investments:					
U.S. Government and Government agencies	$1,676,788	$1,676,788	$1,370,088	$306,700	$—
Non-U.S. Government and Government agencies	191,776	191,776	—	191,776	—
States, municipalities and political subdivisions	231,555	231,555	—	231,555	—
Corporate debt	2,202,267	2,202,267	—	2,202,267	—
Mortgage-backed	1,292,502	1,292,502	—	1,145,164	147,338
Asset-backed	505,910	505,910	—	412,497	93,413
Total fixed maturity investments	6,100,798	6,100,798	1,370,088	4,489,959	240,751
Equity securities	699,846	699,846	625,942	—	73,904
Other invested assets	764,081	764,081	—	—	764,081
Total investments	$7,564,725	$7,564,725	$1,996,030	$4,489,959	$1,078,736
Derivative assets:					
Foreign exchange contracts	$6,254	$6,254	$—	$6,254	$—
Interest rate swaps	6,829	6,829	—	6,829	—
Derivative liabilities:					
Foreign exchange contracts	$1,176	$1,176	$—	$1,176	$—
Interest rate swaps	$4,214	$4,214	$—	$4,214	$—
Senior notes	$798,499	$897,601	$—	$897,601	$—

“Other invested assets” excluded other private securities that the Company did not measure at fair value, but are accounted for using the equity method of accounting. Derivative assets and derivative liabilities relating to foreign exchange contracts and interest rate swaps are classified within “other assets” or “accounts payable and accrued liabilities” on the consolidated balance sheets.

The following describes the valuation techniques used by the Company to determine the fair value of financial instruments held as of the balance sheet date.

Recurring Fair Value of Financial Instruments

U.S. Government and 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 and the spreads for these securities 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 international indices and 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 the new issue market, and are included in the Level 2 fair value hierarchy.

Corporate debt: Comprised of bonds issued by or loan obligations of corporations that are diversified across a wide range of issuers and industries. The fair values of corporate debt that are short-term are priced using spread above the LIBOR yield curve, and the fair values of corporate debt 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 debt are included in the Level 2 fair value hierarchy.

Mortgage-backed: Primarily comprised of residential and commercial mortgages originated by both U.S. government agencies (such as the Federal National Mortgage Association) and non-U.S. government agencies. 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 the 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, unless the significant inputs used to price the mortgage-backed securities are broker-dealer quotes and the Company is not able to determine if those quotes are based on observable market inputs, in which case the fair value is included in the Level 3 hierarchy.

Asset-backed: Principally comprised of bonds backed by pools of automobile loan receivables, home equity loans, credit card receivables and collateralized loan obligations 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 or broker-dealer quotes. 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, unless the significant inputs used to price the asset-backed securities are broker-dealer quotes and the Company is not able to determine if those quotes are based on observable market inputs, in which case the fair value is included in the Level 3 hierarchy.

Equity securities: Comprised of common and preferred stocks and mutual funds. Equities are generally included in the Level 1 fair value hierarchy as prices are obtained from market exchanges in active markets. Non-U.S. mutual funds where the net asset value is not provided on a daily basis are included in the Level 3 fair value hierarchy.

Other invested assets: Comprised of funds invested in a range of diversified strategies. In accordance with U.S. GAAP, the fair values of the funds are based on the net asset value ("NAV") of the funds as reported by the fund manager. The fair value of these investments are included in the Level 3 fair value hierarchy as the Company believes NAV is an unobservable input and these securities are not redeemable in the near term.

Derivative instruments: The fair value of foreign exchange contracts, interest rate futures and interest rate swaps are priced from quoted market prices for similar exchange-traded derivatives and pricing valuation models that utilize independent market data inputs. The fair value of derivatives are included in the Level 2 fair value hierarchy.

Senior notes: The fair value of the senior notes is based on reported trades. The fair value of the senior notes is included in the Level 2 fair value hierarchy.

Non-recurring Fair Value of Financial Instruments

The Company measures the fair value of certain assets on a non-recurring basis, generally quarterly, annually or when events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. These assets include investments accounted for using the equity method, goodwill and intangible assets. The Company uses a variety of techniques to measure the fair value of these assets when appropriate, as described below:

Investments accounted for using the equity method: When the Company determines that the carrying value of these assets may not be recoverable, the Company records the assets at fair value with the loss recognized in income. In such cases, the Company measures the fair value of these assets using discounted cash flow models and market multiple models.

Goodwill and intangible assets: The Company tests goodwill and intangible assets for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable, but at least annually for goodwill and indefinite-lived intangibles. If the Company determines that goodwill and intangible assets may be impaired, the Company uses techniques, including discounted expected future cash flows and market multiple models, to measure fair value.

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Rollforward of Level 3 Financial Instruments

The following is a reconciliation of the beginning and ending balance of financial instruments using significant unobservable inputs (Level 3):

Three Months Ended September 30, 2014	Other invested assets	Mortgage-backed	Asset-backed	Equities
Opening balance	$ 804,505	$ 146,801	$ 71,232	$ 34,863
Realized and unrealized gains (losses) included in net income	6,797	(882)	(253)	3,172
Purchases	78,629	16,311	18,021	—
Sales	(83,807)	(28,761)	(9,970)	—
Transfers into Level 3 from Level 2	—	1,628	17,863	—
Transfers out of Level 3 into Level 2 (1)	—	(15,189)	(5,523)	—
Ending balance	$ 806,124	$ 119,908	$ 91,370	$ 38,035
Three Months Ended September 30, 2013				
Opening balance	$ 714,391	$ 198,003	$ 61,285	$ 53,499
Realized and unrealized gains (losses) included in net income	9,403	464	(313)	3,972
Purchases	67,554	69,775	16,969	10,000
Sales	(24,277)	(79,001)	(1,302)	—
Transfers into Level 3 from Level 2	—	13	3,394	—
Transfers out of Level 3 into Level 2 (1)	—	—	—	—
Ending balance	$ 767,071	$ 189,254	$ 80,033	$ 67,471
Nine Months Ended September 30, 2014	Other invested assets	Mortgage-backed	Asset-backed	Equities
Opening balance	$ 764,081	$ 147,338	$ 93,413	$ 73,904
Realized and unrealized gains (losses) included in net income	51,921	3,654	(659)	(6,572)
Purchases	267,549	34,187	35,526	—
Sales	(277,427)	(65,038)	(19,871)	(29,297)
Transfers into Level 3 from Level 2	—	1,253	13,923	—
Transfers out of Level 3 into Level 2 (1)	—	(1,486)	(30,962)	—
Ending balance	$ 806,124	$ 119,908	$ 91,370	$ 38,035
Nine Months Ended September 30, 2013				
Opening balance	$ 655,888	$ 167,825	$ 62,246	$ 54,680
Realized and unrealized gains (losses) included in net income	53,365	(5,910)	(791)	2,791
Purchases	237,506	102,369	42,956	10,000
Sales	(179,688)	(69,968)	(26,728)	—
Transfers into Level 3 from Level 2	—	5,073	2,350	—
Transfers out of Level 3 into Level 2 (1)	—	(10,135)	—	—
Ending balance	$ 767,071	$ 189,254	$ 80,033	$ 67,471

(1) Transfers out of Level 3 are primarily attributable to the availability of market observable information.

The Company attempts to verify the significant inputs used by broker-dealers in determining the fair value of the securities priced by them. If the Company could not obtain sufficient information to determine if the broker-dealers were using significant observable inputs, then such securities have been transferred to the Level 3 fair value hierarchy. The Company believes the prices obtained from the broker-dealers are the best estimate of fair value of the securities being priced as the broker-dealers are typically involved in the initial pricing of the security, and the Company has compared the price per the broker-dealer to other pricing sources and noted no material differences. The Company recognizes transfers between levels at the end of the reporting period. There were no transfers between Level 1 and Level 2 during the period.

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The Company’s external investment accounting service provider receives prices from internationally recognized independent pricing services to measure the fair values of its fixed maturity investments. Pricing sources are evaluated and selected in a manner to ensure that the most reliable sources are used. The Company uses a pricing service ranking to consistently select the most appropriate pricing service in instances where it receives multiple quotes on the same security. The Company obtains multiple quotes for the majority of its securities. The independent pricing sources obtain market quotations and actual transaction prices for securities that have quoted prices in active markets. Each pricing service has its own proprietary method for determining the fair value of securities that are not actively traded. In general, these methods involve the use of “matrix pricing” in which the independent pricing service uses observable market inputs, including, but not limited to, reported trades, benchmark yields, broker-dealer quotes, interest rates, prepayment speeds, default rates and such other inputs as are available from market sources to determine a reasonable fair value.

All of the Company’s securities classified as Level 3, other than investments in other invested assets, are valued based on unadjusted broker-dealer quotes. This includes less liquid securities such as lower quality asset-backed securities, commercial mortgage-backed securities and residential mortgage-backed securities. The primary valuation inputs include monthly payment information, the probability of default, loss severity rates and estimated prepayment rates. Significant changes in these inputs in isolation would result in a significantly lower or higher fair value measurement. In general, a change in the assumption of the probability of default is accompanied by a directionally similar change in the assumption used for the loss severity in an event of default and prepayment rates.

The Company records the unadjusted price provided and validates this price through a process that includes, but is not limited to, monthly and/or quarterly: (i) comparison of prices between two independent sources, with significant differences requiring additional price sources; (ii) quantitative analysis (e.g., comparing the quarterly return for each managed portfolio to their target benchmark, with significant differences identified and investigated); (iii) evaluation of methodologies used by external parties to calculate fair value, including a review of the inputs used for pricing; (iv) comparing the price to the Company’s knowledge of the current investment market; and (v) back-testing, which includes randomly selecting purchased or sold securities and comparing the executed prices to the fair value estimates from the pricing service. In addition to internal controls, management relies on the effectiveness of the valuation controls in place at the Company’s external investment accounting service provider (supported by a Statement on Standards for Attestation Engagements No. 16 report) in conjunction with regular discussion and analysis of the investment portfolio’s structure and performance.

7. RESERVE FOR LOSSES AND LOSS EXPENSES

The reserve for losses and loss expenses consists of the following:

	September 30, 2014	December 31, 2013
Outstanding loss reserves	$1,585,900	$1,520,867
Reserves for losses incurred but not reported	4,466,363	4,245,662
Reserve for losses and loss expenses	$6,052,263	$5,766,529

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The table below is a reconciliation of the beginning and ending liability for unpaid losses and loss expenses. Losses incurred and paid are reflected net of reinsurance recoverables.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Gross liability at beginning of period	$5,935,678	$5,696,865	$5,766,529	$5,645,549
Reinsurance recoverable at beginning of period	(1,301,742)	(1,179,525)	(1,234,504)	(1,141,110)
Net liability at beginning of period	4,633,936	4,517,340	4,532,025	4,504,439
Net losses incurred related to:				
Current year	382,970	338,420	1,067,111	961,224
Prior years	(46,880)	(61,450)	(140,880)	(153,948)
Total incurred	336,090	276,970	926,231	807,276
Net paid losses related to:				