

FAIRFAX
LOGO

1994 Annual Report

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FAIRFAX

FINANCIAL HOLDINGS LIMITED

1994 Annual Report

Ten Year Financial Highlights

(in \$ millions except share and per share data)

	1994	1993	1992	1991	1990	1989	1988	1987	1986	1985
Total revenue	634.9	344.0	286.8	250.0	195.4	125.8	133.6	113.0	53.7	17.0
Net earnings	38.1	33.3	10.0	22.5	21.3	16.7	14.4	16.0	6.5	(0.9)
Total assets	2,173.4	1,200.3	590.5	516.6	536.0	248.1	246.8	185.4	129.8	41.5
Shareholders' equity	391.9	279.5	143.8	116.8	94.7	90.8	74.2	61.0	41.3	10.4
Shares outstanding										
year-end (<i>mil.</i>)	9.0	8.0	6.1	5.5	5.5	7.3	7.3	7.3	7.0	5.0
Return on average equity	12.1%	20.3%	7.7%	21.3%	23.0%	20.3%	21.2%	31.3%	25.4%	
<i>Per share</i>										
Net earnings fully diluted	4.66	5.42	1.76	3.94	2.92	2.25	1.94	2.23	1.35	(1.89)
Shareholders' equity	43.77	35.13	23.76	21.41	17.29	12.41	10.13	8.32	5.89	2.08
<i>Market prices per share</i>										
High	76.00	61.25	30.00	22.50	21.63	19.00	15.13	17.50	14.13	6.00
Low	50.00	24.00	21.75	10.75	8.88	14.00	11.75	10.50	6.00	3.00
Close	67.00	61.25	25.00	21.25	11.00	18.75	15.00	12.37	12.75	6.00

CORPORATE PROFILE

Fairfax Financial Holdings Limited is a financial services holding company whose corporate objective is to achieve a high rate of return on invested capital and build long term shareholder value. The company has been under present management since September 1985.

Commonwealth Insurance, based in Vancouver, offers commercial property and oil and gas insurance in Canada, the United States and internationally, and commercial casualty insurance in Canada. In 1994 Commonwealth's net premiums written totalled \$90.4 million. Commonwealth has been in business since 1947 and at year-end there were 126 employees.

Continental Insurance, based in Toronto, writes a complete range of commercial and personal insurance products. The company has been in business since 1904. In 1994 Continental's net premiums written were \$373 million. At year-end there were 740 employees.

Federated Insurance is based in Winnipeg. Its two companies market a broad range of insurance products primarily for commercial customers. In 1994 Federated's net premiums written totalled \$50.4 million, consisting of \$39.8 million of property and casualty business and \$10.6 million of life and group health and disability products. Federated has been in business since 1920 and at the end of 1994 had 251 employees.

Markel Insurance is one of the largest trucking insurance companies in Canada and has provided the Canadian trucking industry with a continuous market for this class of insurance since 1951. The company also insures small amounts of property and casualty risks. In 1994 net premiums written were \$55.9 million and the company had 87 employees at year-end.

Ranger Insurance, based in Houston, Texas, specializes in writing property and casualty insurance to niche markets in the United States such as propane distributors, petroleum and gas marketers, long haul trucking and agri-products. The company has been in business since 1923. In 1994 Ranger's net premiums written were US\$128.4 million. At year-end there were 307 employees.

Wentworth Insurance was incorporated in 1990 as an insurance company domiciled in Barbados. In 1994 Wentworth's net premiums written were \$8.7 million.

Morden & Helwig Group is engaged in providing claims adjusting, appraisal and loss management services to a wide variety of insurance companies and self-insured organizations across Canada and the United States. In 1994 revenue totalled \$156.1 million. The company was established in 1923, and at year-end the group had 1,686 employees located in 304 offices.

Hamblin Watsa Investment Counsel provides discretionary investment management, primarily to pension funds and insurance companies, including the insurance company subsidiaries of Fairfax. Hamblin Watsa was founded in 1984 and at year-end managed approximately \$2.1 billion.

Note: (1) All companies are wholly owned except Morden & Helwig Group, a public company of which Fairfax owns 56% of the equity and 91% of the votes.

To Our Shareholders

It happened again! For the second time since we began in 1985, we did not earn a return on equity in excess of 20%. We earned 12.1% on shareholders' equity in 1994 (versus 9.5% for the TSE 300). Net income after taxes in 1994 increased by 14% to \$38.1 million, while earnings per share decreased by 14% to \$4.66 per share because of the 33% increase in the average number of shares outstanding. Book value per share, however, increased by 25% to \$43.77 while our share price increased by 9% to \$67.00.

While these results were disappointing, over the last nine years Fairfax has earned an average annual return on shareholders' equity of 20.3% (versus 7.3% for the TSE 300), which is just above our objective of 20%. Book value though has increased from \$2.08 in 1985 to \$43.77 in 1994 a compound rate of 40.3%. Our stock price has followed the growth in book value over the long term and has increased from \$3.25 in September 1985 when we began to \$67.00 in 1994 both up by more than twenty times since 1985. We are very gratified about this record, but as emphasized in past annual reports, this record of book value growth is not sustainable.

In the July 1994 issue of Report on Business Magazine, Fairfax's five year return on equity of 17.6% (or, according to our calculations, 18.5%) ranked 43rd (or, based on our calculations, 34th) out of the top 1,000 companies listed on the Canadian stock exchanges, i.e. in the top 4% of all companies in Canada. While this shows that our 20% goal is not an easy hurdle, nevertheless, we continue to have that as our objective over the next five years.

Sidestepping our financial results in 1994 for a moment (you can understand why!), we purchased Continental Canada, our largest acquisition yet, late in 1994. We bought it from Continental U.S. for \$155 million of which \$25 million was paid by Fairfax's issue of an unsecured 7.75% debenture due December 15, 2003 containing the same terms as our publicly issued 7.75% debentures due December 15, 2003. We financed the balance with the issue of one million treasury shares through a private placement at effectively \$76 per share and a \$60 million unsecured, five year bank loan. This bank loan is in addition to our unused, committed, long term bank lines of approximately \$105 million. An additional \$10 million will be payable to Continental U.S. if Continental Canada achieves a combined ratio of 100.4% or less over the next five years. Also, Continental U.S. has provided us with a \$40 million, five year indemnification against adverse development in loss reserves and reinsurance recoverables, secured by marketable bonds.

We are excited (we always seem to be!) about our purchase of Continental Canada because it is predominantly a commercial lines insurance company led by Byron Messier who is committed to underwriting profits and the company was available at a fair price. We paid \$155 million for

Continental Canada with a book value of approximately \$163 million and after-tax earnings of \$19 million in 1993. Because of higher interest rates and mark-to-market purchase accounting, Continental Canada's book value has been written down for accounting purposes to approximately our purchase price. This adjustment consists of an unrealized loss in a predominantly government bond portfolio with an average term of approximately three years. In three years, or if interest rates decline in the interim, we will recoup this writedown. Together with the indemnification discussed earlier, we felt that Continental Canada was available at a price and on terms that would meet our long term objectives.

After not issuing shares for seven years, we have been great supporters of the investment dealer industry recently. We did a public issue of 2 million shares at \$55 per share in 1993, and in 1994 we completed a private placement of 1 million shares at \$76 per share led again by Dick Falconer and Jim Hinds from Wood Gundy and ably supported by RBC Dominion Securities, ScotiaMcLeod, Nesbitt Burns and Richardson Greenshields. We thank them all again for an excellent job and request them not to extrapolate this recent frenetic activity in their future plans! We welcome our new shareholders and emphasize again, as we did in 1993, that our company is run for the long term. So don't be too concerned about short term results as we will accept short term volatility in our earnings for better long term results.

We should note here that we are very careful about issuing shares. We shun companies which make acquisitions at twice book value and finance them by issuing their own shares at discounts to book value. If our shares were not selling at fair prices, we would not have issued them and thus, would not have purchased Continental Canada. You will remember, we have never been interested in becoming bigger only in earning attractive long term returns on shareholders' capital by treating customers, employees and shareholders fairly.

Our recent stock issue at \$76 was unusual as it was about twelve dollars above the previous day's trade. Most participants in the financial markets consider the last trade as the fair value of a company even though only 200 shares may have traded at that price. Our view is different. We felt that a fair price for our shares was \$76, particularly given the pending purchase of Continental Canada. Fortunately many investors agreed with our view. Most stock issues in the financial markets are priced to go up in the short term to provide buyers with a warm comfort factor even though their experience in the long term may be just the opposite. While we would be pleased if our shares went up after an issue, we are more concerned with making our investors look good in the long term.

Prior to the purchase of Continental Canada, we had approximately \$107 of investments (cash,

bonds, preferreds and common shares) per share of Fairfax. After the purchase of Continental Canada and the share issue described above, you have approximately \$173 of investments working for you for every share you own (we began with \$7 of investments per share of Fairfax in 1985). Investments per share have grown at 44% per year since 1985 as shown on page xx. In the long run, this will be of significant benefit to you by increasing our ability to achieve our long term 20% return on equity objective.

By way of perspective, the table below shows how significantly we have grown in a little more than a year.

	<i>(millions)</i>		
Increase	September 30, 1993	December 31, 1994	
Net premiums written	\$ 164	\$ 850 *	5.2 times
Investment portfolio	\$ 404	\$ 1,551	3.8 times
Shareholders' equity	\$ 161	\$ 392	2.4 times
Long term debt	\$ 71	\$ 225	3.2 times
Shares outstanding	6	9	1.5 times

** Including annualized net premiums written of Continental Canada which was acquired effective November 30, 1994*

As shown, net premiums written have grown by about 5 times, the investment portfolio by 4 times, and shareholders' equity and long term debt by approximately 3 times, but shares outstanding have grown by only 1.5 times. If our acquisitions of Ranger and Continental Canada work out, and that's a big *if*, you can see our shareholders will benefit very significantly in the future as they have more investments and insurance premiums for each share held. However, if either or both of these acquisitions don't work out, our returns will be reduced significantly our returns, not our viability as a company, because we have never bet our company on an acquisition. Like Ranger and each of our operating companies, Continental Canada will be run separately no synergies at Fairfax!

In spite of our significant growth discussed earlier, there were no changes in the small Fairfax head office. Rick Salsberg and John Varnell, ably supported by Brenda Adams, Sam Chan, Paul Fink and Ronald Schokking, continued to work miracles.

The table below shows the sources of our net earnings:

	(\$ millions)	
	1994	1993
Insurance underwriting	(16.9)	2.1
Interest and dividends	<u>56.6</u>	<u>23.0</u>
<i>Total</i>	39.7	25.1
Claims adjusting (Fairfax portion)	0.5	0.4
Interest expense	(10.4)	(4.2)
Goodwill amortization	(1.4)	(1.4)
Corporate overhead and other	(4.9)	(2.9)
Realized gains	<u>20.0</u>	<u>27.8</u>
<i>Income before taxes and provisions</i>	43.5	44.8
Less: provisions for investment losses	—	—
Total pre-tax income	43.5	44.8
Less: taxes	<u>5.4</u>	<u>11.5</u>
Net earnings	<u>38.1</u>	<u>33.3</u>

The table shows you the results from our insurance (underwriting and investments) and non-insurance operations. Claims adjusting shows you our share of Morden & Helwig's after-tax income. The corporate overhead expense includes Hamblin Watsa's pre-tax income. Shown separately are realized gains so that you can better understand our earnings from our operating companies. There have been no provisions for potential losses in the past two years. Also please note the unaudited financial statements of our combined insurance operations and of Fairfax with Morden & Helwig equity accounted, as well as Morden & Helwig's financial statements, shown on pages **xx** to **xx**.

Our underwriting performance in 1994 was dismal and was the major reason for our not achieving our 20% objective in 1994 (more on this later). However, investment income more than doubled from 1993 levels, mainly because of the addition of Ranger's portfolio resulting in higher insurance earnings in 1994. Morden & Helwig made a slightly higher contribution. Interest expense more than doubled because of last year's U.S. debenture issue and goodwill amortization from Hamblin Watsa remained the same. Realized gains, even though significant, were less than last year. With no net additional provisions for investment losses and with lower taxes (see Note 7), after-tax income in 1994 was somewhat higher than 1993. Book value per share increased from \$35.13 to \$43.77, about equally from earnings and from our share issue at \$76 per share.

Insurance Operations

Although there were some real successes, 1994 was overall a difficult year for our insurance operations with a combined ratio of 104.2% versus 98.6% in 1993. Since 1985, we have achieved our target combined ratio of 100% or less in only five of the last nine years.

Commonwealth, led by John Watson, had another excellent year with a combined ratio of 97.8% in spite of the Northridge earthquake which cost the company \$9.2 million. Excluding Northridge, Commonwealth's combined ratio would have been 92.2%. With the exception of 1992 (Hurricane Andrew), Commonwealth has shown underwriting profits every year since we purchased it in 1990. During the year Commonwealth was upgraded to an A (excellent) by A.M. Best Company and continued to be rated A by S&P.

Commonwealth's gross premiums written increased to \$263 million from \$207 million in 1993 and \$129 million in 1991, while net premiums written increased to \$90 million from \$71 million in 1993 and \$33 million in 1991. As you can see, gross premiums have doubled in the last three years, while net premiums have almost trebled. Premium growth has been fuelled by the oil, gas and petroleum and U.S. commercial property divisions and, to a lesser extent, by the Canadian property and casualty divisions. Commonwealth's major advantage continues to be excellent underwriting combined with a consistently low expense ratio. The company earned \$17.5 million after taxes in 1994, slightly less than the record \$19.4 million in 1993.

Commonwealth has implemented the Insurance Risk Assessment System (IRAS) program to supplement its in-house systems which monitor its exposure to earthquakes in California and B.C. and windstorms across the U.S. Approximately 80,000 locations insured by the company are in the program. Worst case exposures and probable maximum losses are modelled and quantified by IRAS. Inasmuch as catastrophe modelling is not an exact science, we remain exposed to the unlikely possibility of a major event significantly impacting our income statement but not, we feel, our balance sheet. All of our other insurance companies will be on IRAS by year-end 1995.

Federated, under John Paisley's leadership, also had an excellent year in 1994 with a combined ratio of 99.5%. Since our purchase in 1990, Federated has averaged a combined ratio of 99.3% annually. With its specialty focus, the company continues to dominate its markets with its direct marketing representatives, underwriters, claims and support staff and should continue to achieve consistent underwriting profitability. The company enjoys customer retention rates in excess of 90% and many of its industry association relationships exceed twenty years. Federated earned \$9.0 million after taxes in 1994, slightly less than the record \$10.2 million in 1993.

Markel had another difficult year in 1994, with a combined ratio of 115%. We have had cumulative underwriting losses in Markel of \$18 million over the last three years. You can see it is not easy to make an underwriting profit, in spite of our focus. We look forward to much improved results under Mark Ram's leadership which began only in the middle of the year. Mark moved to Markel after spending four years at Fairfax. In 1994 Markel earned \$2.9 million after taxes, slightly higher than the \$1.7 million in 1993.

1994 was the first year for Ranger under Fairfax's ownership. Early in the year, A.M. Best upgraded Ranger to an A from A-. The company, however, had a poor year with a combined ratio of 114% (108% after eliminating reserve development for which we have been indemnified by the vendor). The results were poor because of some unexpected losses and worse than expected experience in certain lines; also, our IBNR provisions may prove to be conservative. Tom Friedberg has reacted quickly to these problems by reducing overhead, discontinuing the poor performing lines and reducing reinsurance costs significantly. We are confident that Tom and his management team will achieve underwriting profitability soon. In 1994 after credit for reserve development from the past, Ranger earned \$12 million significantly below our expectations.

Wentworth, our Barbados company, continues to be very small (net premiums written of \$8.7 million) and selectively participates in a few catastrophe reinsurance contracts. Because of the Northridge earthquake and no realized gains, Wentworth earned only \$0.5 million in 1994 significantly less than the \$4.2 million of 1993.

Our purchase of Continental Canada was effective November 30, 1994 and is thus included in our balance sheet and income statement for 1994. Continental Canada contributed \$26.9 million in net premium earned and \$4.0 million in net income to our results in 1994. Continental Canada, whose history goes back to 1904, writes a complete range of commercial and personal insurance products across all provinces in Canada. In 1994 its net premiums written were \$373 million of which about 70% were generated from commercial lines. At November 30, 1994 Continental Canada had total assets of \$904 million with about 740 employees.

The key reason for our purchase of Continental Canada was Byron Messier and his commitment to underwriting profits. Byron had been with Continental Canada for twenty years before leaving to run another insurance company for two years. He returned to Continental Canada in 1991 and has effectively been running the company for three years. Since rejoining Continental Canada he has reduced the combined ratio from 122% in 1991 to approximately 107% in 1994 (excluding extraordinary expenses). With savings from reinsurance and management fees to the parent, we

believe he has an excellent opportunity to achieve consistent underwriting profitability. Please review the MD&A (page **xx**) and Note 12 for additional details on Continental Canada. We welcome Byron Messier and the employees of Continental Canada to Fairfax and we look forward to participating in the company's growth.

Similar to Ranger, our due diligence of Continental Canada was done almost exclusively by our insurance subsidiaries. As mentioned last year, we have the resources internally to evaluate any potential insurance acquisition.

We continued to have low operating leverage (net premiums to common equity) in 1994. Operating leverage at Markel was 1.3:1, Federated 0.9:1, Commonwealth 0.8:1 and Ranger 1.5:1 versus a potential of at least 2:1. Thus, in an improved insurance environment, we have the capacity to increase our premiums significantly. Continental Canada, however, does not have this opportunity. Given Continental Canada's current operating leverage of 2.3:1, premium growth will be a function of retained earnings growth or additional capital invested.

While a low premiums to common equity ratio is generally considered conservative, this isn't always the case, as Emerson Reid's Insurance Observer noted recently. To quote from their January 1995 issue, "20th Century Insurance, which had \$564 million in surplus (or common equity), wrote \$21 million of earthquake premiums, but its Northridge earthquake losses exceeded \$900 million. During soft markets, when rates are depressed, insurance companies may have low premium to surplus ratios even though they are actually taking on more risk than they are in hard markets, when ratios tend to be higher." A good point, and one we try to watch very carefully!

Since 1992, I have been suggesting to you that a turn in the insurance cycle may happen soon. While some of our lines at Commonwealth are experiencing good pricing, the insurance environment continues to be very competitive. The cycle should turn but with my record, don't ask me when!

Our reserves continued to be certified at the individual insurance company level by Joe Cheng, Ron Miller and KPMG for Commonwealth, Federated and Markel, and Ranger respectively. They are then reviewed and certified by Coopers & Lybrand. This sounds impressive but unfortunately there are no guarantees that we will be right.

We provide extensive disclosure on our total claims reserves beginning on page **xx** which will help you appraise our past reserving accuracy. In 1994 we had adverse development of \$2.8 million at our Canadian insurance subsidiaries not pleasant and US\$8.5 million at Ranger, for which we

are indemnified. While we are not pleased with our reserving record in 1994, our experience over the last nine years has been good. We continue to spend much time on making sure that our reserves are conservatively stated.

Claims Adjusting

1994 was a much improved year for Morden & Helwig as earnings before income taxes and unusual items increased significantly to \$5.0 million from \$2.9 million in 1993. However, late in the year, the company decided to sell its U.K. operations to Cunningham Hart, one of the U.K.'s leading insurance claims organizations with whom it simultaneously created a worldwide loss adjusting and claims management network. The sale of its U.K. operations cost Morden & Helwig \$1.2 million. Additional one time costs reduced earnings after taxes to \$1.0 million.

While we have yet to earn an adequate return on our investment in Morden & Helwig, we are convinced that Ken Polley, Don Cain, Mark Cloutier and Duncan Smith are doing their very best and that results will improve soon. To put our money where our mouth is, we purchased an additional 241,900 shares in Morden & Helwig during the year. Also, Morden & Helwig repurchased 64,100 shares in 1994. Our investment in Morden & Helwig consists of a \$7.9 million, 10% debenture (convertible into stock at \$11 per share) and 2.69 million shares at a cost of \$6.74 per share. You didn't expect the long term to be so long, did you? We didn't either!

Morden & Helwig's balance sheet improved in 1994 with a total debt to equity ratio of 0.55:1 versus 0.59:1 in 1993. Our comments on Morden & Helwig's goodwill, discussed in 1992's annual report, are still valid. For further information on Morden & Helwig, please read its latest annual report. You can get a copy by telephoning Don House at (416) 362-6762.

Investment Management

Hamblin Watsa Investment Counsel (HWIC) continued to produce excellent investment results for its managed funds in 1994. The partners of HWIC should be congratulated for the very impressive long term results achieved in each of the areas in which they provide investment management Canadian equities, U.S. equities, Canadian bonds and balanced funds, as shown in the table below.

*Annualized rates of return (%)**Cumulative periods ended December 31, 1994*

	5 years	10 years	15 years
Canadian Equities	9.915.2	15.2	
	TSE 3004.5	9.2	9.5
U.S. Equities	21.318.3	19.0	
	S&P 50012.9	15.1	15.9
Canadian Bonds	12.312.4		
	SM Index10.3	11.3	
Balanced Fund	12.415.3		

Source: Representative balanced fund managed by HWIC for ten years. Equity results for an additional five years are from the organization for which the principals previously worked.

As far as the business of HWIC is concerned, 1994 was another record year as incentive fees were earned from most clients, including Fairfax's insurance subsidiaries. Incentive fees are paid by HWIC's clients only if their results exceed the hurdle rate on both a one year and from inception basis.

For example, for clients that have a Canadian common stock portfolio managed by HWIC, the hurdle rate is the TSE 300 return plus 200 basis points, i.e., before the client pays incentive fees, the client's results, net of all fees, must exceed the TSE 300 return plus 200 basis points for both 1994 and from inception. Incentive fees payable are 10% of any return in the past year above the hurdle rate (90% remains with the client) up to a maximum of 1.75% of assets. All the non-Fairfax related clients have considered this a very fair fee and have been happy to pay incentive fees in the past two years.

Fairfax's insurance subsidiaries were charged incentive fees by HWIC for the first time in 1994. Insurance subsidiaries did not qualify for incentive fees in 1993 mainly because of a block of FCA shares purchased for them by your Chairman in 1989. Some more details about investment management fees paid by Fairfax's insurance subsidiaries to HWIC:

- 1) Incentive fees are paid only on common stock portfolios. Results are measured against the TSE 300 return plus 200 basis points for Canadian stocks and the S&P 500 return plus 200 basis points for U.S. stocks.
- 2) The inception date for Canadian common stock portfolios is January 1, 1990, the date incentive fees were first instituted by HWIC for its clients. The inception date for U.S. common stock

portfolios is March 31, 1994, the first quarterly date on which HWIC managed a U.S. common stock portfolio for a U.S. subsidiary of Fairfax (Ranger). The common stocks of any subsequently acquired insurance subsidiary will be included in the appropriate portfolio for measurement purposes essentially from the date of acquisition.

- 3) The average base fee paid by Fairfax's insurance subsidiaries to HWIC for investment management is 0.25% of assets significantly less than the average base fee paid by HWIC's pension clients. Reflecting the Continental Canada purchase and a reduction in the base fee, the average base fee in 1995 for Fairfax's insurance subsidiaries will drop to 0.17% of assets.

Just to refresh your memory, when Fairfax purchased HWIC in 1992, a fair revenue sharing mechanism was instituted at HWIC. This is how it works. The revenue base for HWIC in 1992 was \$3.7 million of which \$2.0 million covered expenses, including salaries and overhead, and \$1.7 million was pre-tax profit. In each year after the sale, HWIC retains \$2.0 million of the first \$3.7 million of revenue to pay expenses, while Fairfax gets the remaining \$1.7 million. Any revenue above \$3.7 million in any year is split 50/50 between Fairfax and HWIC Fairfax's 50% being additional profit (to the \$1.7 million), while HWIC's 50% covers any incremental expenses beyond \$2.0 million and thereafter constitutes a profit pool to be shared among its partners and employees.

This is an excellent way to provide attractive returns for Fairfax while keeping the incentives at HWIC.

In 1994 HWIC had revenue from base fees of approximately \$4.6 million. Incentive fees totalled \$4.9 million of which \$1.6 million was from Fairfax insurance subsidiaries. Through the revenue sharing mechanism discussed earlier, Fairfax earned a 33% pre-tax return on its \$14 million investment in HWIC. These returns are all cash and, of course, there is no additional capital investment needed at HWIC. As mentioned last year, while returns after goodwill amortization (of \$1.4 million annually) will be less than those mentioned above, we think the returns we have shown are the best measure of HWIC's performance.

This is perhaps an appropriate point to mention where my compensation comes from. I get a straight salary of \$250,000 from Fairfax with no bonuses, director's fees or other payments from Fairfax or any of its subsidiaries (other than HWIC). From HWIC, like all partners there, I get a \$200,000 salary and participate in the profit sharing pool (up to 30%) described earlier. Any bonus that is shown for me in the proxy circular comes from this profit participation. Because my compensation can be significant depending on investment results, I wanted to make sure you understood exactly where it comes from.

While discussing my compensation, for the first seven years of Fairfax's history, I did not take any salary, bonus or other payment from the company but I did participate in the share purchase program. During 1995 I plan to sell my shares in the plan either to the plan or into the market and will no longer have an interest free loan from the company (our directors, senior officers and presidents will continue to have this arrangement). Thus I will be free to determine how the plan should work as I will no longer have an interest in it.

Financial Position

As mentioned in previous annual reports, the best way to understand our financial position is to look at our unaudited balance sheet with Morden & Helwig equity accounted as shown on page **xx**. Here's what it looks like compared to 1993.

	(\$ millions)	
	1994	1993
Short term bank debt		
Long term bank debt	60.0	
Debenture issue	165.3	132.4
Common shareholders' equity	391.9	279.5

As shown, common shareholders' equity increased by \$112 million \$74 million net from the share issue and \$38 million from net income. We used the share issue proceeds together with \$25 million of the increase in the debenture issue (the remaining increase in these debentures is due to exchange rate fluctuations) and the \$60 million in five year unsecured term loans from two Canadian banks to purchase Continental Canada, and we had \$8 million in cash at year-end. Currently, we have unused, unsecured, committed, long term bank lines of \$105 million from five major Canadian and U.S. banks. As discussed last year, these are unused bank lines and provide us with flexibility on an emergency basis we certainly will not use them to make an acquisition (as we did not with Continental Canada). We also have a letter of credit (LOC) facility of US\$40 million from a U.S. bank for use in the ordinary course of our insurance businesses.

Our debt to equity ratio and debt to total capital ratio increased only slightly to 0.57:1 and 0.37:1 respectively even after the purchase of Continental Canada. As mentioned last year, these ratios are close to the maximum with which we would feel comfortable. Our financial position continues to be extremely strong for the following reasons:

- 1) Our debenture issue has an interest rate fixed at 7.75% and

has a long term to maturity (another nine years). The bank loan has a five year term with floating interest rates (we could fix these rates if we wanted). We went with a term bank loan as opposed to another public U.S. debenture issue because we did not want to fix interest rates at these levels. Both debt instruments have a covenant package that provides us with great flexibility.

- 2) We have unused, unsecured, committed, long term bank lines of \$105 million with excellent covenants with Canadian and U.S. banks. In addition, we have an LOC facility of US\$40 million with a U.S. bank.
- 3) Our total long term debt is less than three times our expected earnings base with Continental Canada included. We expect to be able to pay the bank loan long before maturity if that is what we want to do. The expected earnings base is not, please note, is *not*, an earnings forecast for 1995. It is just another way of looking at our debt levels!
- 4) Cash flow in 1995 at the holding company level should be more than sufficient to fund the interest costs on all of our outstanding debt. Cash flow from HWIC should continue to pay the overhead at Fairfax. In addition, we have cash and investments in the holding company of over \$14 million as at year-end 1994.
- 5) As discussed in the MD&A, the solvency margins of all of our insurance subsidiaries, with the exception of Continental Canada, are well above the levels mandated by the applicable insurance regulatory authorities.
- 6) Our foreign exchange exposure with respect to the balance sheet has been mostly hedged by last year's U.S. debenture issue. As mentioned last year, we purchased a US\$50 million, five year foreign exchange contract at C\$1.37 to US\$1.00 to hedge the remaining net balance sheet exposure (of US\$17.4 million) and future Ranger earnings. We added to this hedge in 1994 by purchasing an additional US\$25 million, five year foreign exchange contract at C\$1.50 to US\$1.00 to hedge future earnings from Ranger. The additional foreign exchange contracts mentioned in Note 9 hedge U.S. portfolio investments in Canadian insurance subsidiaries.

Investments

1994 was a down year for the stock and bond markets with the TSE 300, the S&P 500 and the ScotiaMcLeod Bond Index showing losses on a capital only basis. On a relative basis, our Canadian common stock and bond results were excellent. After many outstanding years, our U.S. results took a breather. All in all, 1994 was another good year.

The change in unrealized gains or losses is shown below:

	(\$ millions)	
	1994	1993
Bonds	(17.5)	3.1
Preferred stocks	(1.4)	8.8
Common stocks	<u>(12.1)</u>	<u>(0.5)</u>
	<u>(31.0)</u>	<u>11.4</u>

Higher interest rates and a declining stock market resulted in \$11.4 million of unrealized gains at the end of 1993 being transformed into an unrealized loss of \$31.0 million at the end of 1994, after not insignificant realized gains of \$20.0 million during 1994 (2.4% of the average portfolio). The unrealized loss of \$31.0 million is 2.0% of the portfolio at year-end.

Our aggregate provisions for losses as at December 31, 1993 of \$11.5 million dropped to \$6.9 million at the end of 1994 mainly because we realized losses in two investments for which we had made provisions. We feel that our remaining provisions will be adequate to provide against unexpected events.

You are probably getting tired of my harping about realized gains or losses being important in the long run while unrealized gains or losses are fluctuations that have no predictive value. Fortunately, I asked you not to get excited about the unrealized gains at year-end 1993 because they certainly disappeared in a hurry!

This is probably an appropriate time to mention the Canadian government's intent to annually tax unrealized stock gains in financial institutions' investment portfolios. We believe this is seriously wrong in principle and unjustly harmful both to the companies affected and the operation of the capital markets. We have come across no other country in the world that taxes unrealized gains, and consider this to be a significant disincentive (if passed into law) to long term capital investment in Canada by financial institutions. We hope that sanity will prevail as our government begins to recognize the importance of encouraging investors to make substantial long term capital commitments to Canadian enterprises.

The table on page **xx** shows the returns on our investment portfolios. Investment income (interest and dividends) has increased dramatically because of the Ranger investment portfolio. Realized

gains in 1993 and 1994 have gone a long way to making up for the drought in the three prior years.

Total realized gains since 1985 amount to \$83 million. After-tax investment income per share has increased to \$4.85 per share in 1994 from \$2.92 in 1993 as shown on page xx. After-tax investment income per share has compounded at 30% per year since we began in 1985. Continental Canada will result in another significant increase in investment income per share in 1995.

Gross realized gains in 1994 totalled \$23.2 million. After realized losses (net of provisions) of \$3.2 million, net realized gains were \$20.0 million. The major contributors to realized gains were Gibraltar Mines (\$5.0 million), Repap (\$3.6 million), St. Lawrence Cement (\$3.0 million), Stelco (\$2.2 million), Noranda (\$1.9 million), Philip Morris (\$1.9 million), Dofasco (\$1.3 million) and Phelps Dodge (\$1.0 million). Realized losses resulted mainly from the sale of bonds at Ranger; these losses were substantially offset by realized gains from other sales of bonds at Ranger.

At the end of 1994 we had \$134 million invested in common shares of banks, insurance and financial service companies, \$89 million in natural resource companies and \$49 million in industrial products companies.

At year-end 1994 Fairfax had \$326 million invested in common shares of Canadian and U.S. companies (approximately \$36 per share). You may be interested to know that in the U.S., in the late 60s and early 70s, the average property and casualty insurance company had approximately 100% of its surplus (common shareholders' equity) invested in common shares. This happened to be when the stock market was at historically high levels and P/E ratios were in the twenty times area. Since then, common stock holdings as a percentage of surplus for the average property and casualty insurance company has been coming down (currently at 40%) even though stocks have been great investments after the crash of 1973/74. We continue to feel that there are many attractive common stock holdings in North America that meet our long term value-oriented standards thus, our relatively high exposure to common shares.

Another tidbit on common stock holdings that you may be interested in is an A.M. Best study of the hundred largest companies in the property and casualty insurance industry found that the ten companies that held the highest common stock holdings (greater than 20% of their assets) all had the highest A.M. Best ratings (A+/A++). We hope this works for us too!

Our "nuclear bomb" testing on insurance regulatory capital of a simultaneous decline of 50% in our common stock holdings and 30% in our preferred and bond holdings continues on a monthly basis. Our companies continue to meet this test, with the exception of Continental Canada. We are

working to make sure that Continental Canada will also soon meet this test.

Miscellaneous

In May 1994 we disposed of our real estate investment in Calgary (the Village Square shopping mall) for approximately our cost of \$8.0 million. We have taken back a \$2 million first mortgage on the property at 7 % due on June 1, 1996. As this mortgage is secured by a first charge on the shopping mall, we expect to be paid. We have two small remaining real estate investments, valued at approximately \$1.2 million, which we plan to dispose of in 1995.

In 1994 Fairfax and its subsidiaries donated approximately \$760,000 (1.7% of pre-tax income) to a variety of charities across North America.

On page **xx**, we have included an unaudited unconsolidated balance sheet on an equity accounted basis showing where your money is invested. As you can see, we have \$560.7 million invested in our insurance companies, \$26.0 million in Morden & Helwig and \$14.1 million in Hamblin Watsa. Our insurance companies and Morden & Helwig are shown at their underlying book values. Our insurance companies particularly are very conservatively valued. We felt this disclosure could help you when you think about our company and so we plan to disclose this every year.

Last year, we listed many short term risks that your company faces. These have not changed. The future continues to be as uncertain and unpredictable as it was when we began nine years ago. However, with good people at Fairfax and our subsidiaries, significant sustainable investment income that has taken many years to achieve and our share of good fortune, our long term prospects are excellent for achieving a return on shareholders' equity in excess of 20% by running Fairfax for the benefit of customers, employees and shareholders.

In 1994 one of our directors celebrated his 75th birthday. As I mentioned in our 1988 annual report, Fairfax has benefitted greatly from Robbert Hartog's wisdom. He has yet to slow down and we have yet to catch up with him. We look forward to Robbert's advice for a great many years to come.

As we appear to have outgrown the facilities at the new Toronto Stock Exchange, our annual meeting will be held at 4:30 p.m. on Wednesday, May 3, 1995 at the old Toronto Stock Exchange building on Bay Street. While this appears to be a step backward, it appeals to our contrarian instincts!

On your behalf, I would like to thank the Board and the management and employees of all our companies for their very valuable contributions in 1994.

March 15, 1995

V. Prem Watsa

Chairman and Chief Executive Officer

Consolidated Financial Statements
for the years ended December 31, 1994 and 1993

Consolidated Balance Sheets
as at December 31, 1994 and 1993

	1994	1993
	(\$000)	(\$000)
Assets		
Accounts receivable	365,430	184,976
Claims in process	14,842	14,719
Income taxes refundable	9,845	
Prepaid expenses	<u>10,189</u>	<u>6,845</u>
.....	<u>400,306</u>	<u>206,540</u>
<i>Portfolio investments</i>		
Cash and short term investments	271,026	287,880
Bonds		
(market value \$775,564; 1993 \$308,498)	793,113	305,375
Preferred stocks		
(market value \$158,053; 1993 \$142,201)	159,388	133,343
Common stocks		
(market value \$314,484; 1993 \$117,435)	326,568	117,976
Other investments	<u>1,248</u>	<u>4,200</u>
Total		
(market value \$1,520,375; 1993 \$860,214)	<u>1,551,343</u>	<u>848,774</u>
Deferred premium acquisition costs	82,656	25,404
Deferred income taxes	39,908	25,778
Capital assets (note 2)	29,832	24,919
Goodwill (note 12)	51,388	50,465
Other assets	<u>17,978</u>	<u>18,395</u>
.....	<u>2,173,411</u>	<u>1,200,275</u>

Signed on behalf of the Board

Director

Director

	1994	1993
	(\$000)	(\$000)
Liabilities		
Bank indebtedness (note 3)	8,875	10,463
Accounts payable and accrued liabilities	161,194	84,299
Future pension commitments	7,051	6,804
Premium deposits	7,541	5,664
Income taxes payable	—	<u>20,247</u>
.....	<u>184,661</u>	<u>127,477</u>
Provision for claims	921,674	444,846
Unearned premiums	417,318	184,277
Long term debt (note 4)	<u>240,494</u>	<u>146,750</u>
.....	<u>1,579,486</u>	<u>775,873</u>
Non-controlling interest	<u>17,315</u>	<u>17,446</u>
Shareholders' Equity		
Capital stock (note 5)	227,803	153,438
Retained earnings	<u>164,146</u>	<u>126,041</u>
.....	<u>391,949</u>	<u>279,479</u>
.....	<u>2,173,411</u>	<u>1,200,275</u>

Consolidated Statements of Earnings
for the years ended December 31, 1994 and 1993

	1994	1993
	(\$000)	(\$000)
Revenue		
Premiums earned	400,559	150,844
Claims fees	156,093	142,105
Interest and dividends	58,219	23,251
Realized gains on investments	<u>20,026</u>	<u>27,822</u>
.....	<u>634,897</u>	<u>344,022</u>
Expenses		
Losses on claims	296,641	109,419
Operating expenses	240,695	174,906
Interest expense	13,195	6,409
Commissions, net	<u>38,407</u>	<u>6,625</u>
.....	<u>588,938</u>	<u>297,359</u>
Earnings before income taxes	45,959	46,663
Provision for income taxes (note 7)	<u>7,347</u>	<u>12,936</u>
Earnings from operations	38,612	33,727
Non-controlling interest	<u>(507)</u>	<u>(387)</u>
Net earnings	<u>38,105</u>	<u>33,340</u>
Net earnings per share (note 11).....	\$4.66	\$5.42

Consolidated Statements of Retained Earnings
for the years ended December 31, 1994 and 1993

	1994	1993
	(\$000)	(\$000)
Retained earnings beginning of year	126,041	93,977
Net earnings for the year	38,105	33,340
Excess over stated value of shares purchased for cancellation (note 5)	<u> </u>	<u>(1,276)</u>
Retained earnings end of year	<u>164,146</u>	<u>126,041</u>

Consolidated Statements of Changes in Cash Resources
for the years ended December 31, 1994 and 1993

	1994	1993
	(\$000)	(\$000)
Operating activities		
Earnings from operations	38,612	33,727
Amortization	9,429	7,537
Deferred income taxes	4,219	(16,551)
Gains on investments	<u>(20,026)</u>	<u>(27,822)</u>
.....	32,234	(3,109)
Increase in provision for claims	15,825	507
Increase in unearned premiums	15,048	24,740
Increase (decrease) in cash funds resulting from changes in other operating working capital items	<u>(46,619)</u>	<u>37,698</u>
Cash resources provided by operating activities	<u>16,488</u>	<u>59,836</u>
Investing activities		
Investments net purchases	(139,151)	(29,307)
Purchase of capital assets	(5,118)	(9,858)
Purchase of subsidiaries, net of cash acquired (note 12)	<u>(54,956)</u>	<u>9,975</u>
.....	<u>(199,225)</u>	<u>(29,190)</u>
Financing activities		
Net capital stock transactions	74,365	103,597
Increase in long term debt, net	93,744	64,813
Change in non-controlling interest	<u>(638)</u>	<u>(342)</u>
.....	<u>167,471</u>	<u>168,068</u>
Increase (decrease) in cash resources	(15,266)	198,714
Cash resources beginning of year	<u>277,417</u>	<u>78,703</u>
Cash resources end of year	<u>262,151</u>	<u>277,417</u>

Cash resources consist of cash and short term investments less bank indebtedness.

Notes To Consolidated Financial Statements
for the years ended December 31, 1994 and 1993
(in \$000s except per share amounts and as otherwise indicated)

1. Summary of Significant Accounting Policies

Business operations

The company is a financial services holding company which through its subsidiaries ^[and affiliates] ~~DELETE THESE WORDS IN THE 1995 ANN REP~~ is engaged in the insurance of commercial property, oil and gas, casualty and life risks, investment management and the provision of claims adjusting, appraisal and loss management services in Canada and the United States.

Principles of consolidation

The consolidated financial statements include the accounts of the company and all of its subsidiaries: Markel Insurance Company of Canada, Federated Insurance Holdings of Canada Ltd., Commonwealth Insurance Company, Wentworth Insurance Company Ltd., Ranger Insurance Company, The Continental Insurance Company of Canada and Hamblin Watsa Investment Counsel Ltd., all 100% owned; and Morden & Helwig Group Inc., 56% equity and 91% voting interest. Acquisitions are accounted for by the purchase method, whereby the results of acquired companies are included only from the date of acquisition. Divestitures are included up to the date of disposal.

Premiums

Insurance premiums are taken into income evenly throughout the terms of the related policies. As premium deposits secure the payment of premiums and are refundable, they are not taken into income unless default in payment of premiums occurs.

Claims in process

The company records its inventory of claims in process at its estimated value at year-end, based on a determination of the claims in process at year-end through a complete physical count of related files. Claims adjustment fees arising therefrom are accounted for on an estimated percentage-of-completion basis.

Deferred premium acquisition costs

The costs incurred in acquiring insurance premiums are deferred, to the extent that they are considered recoverable, and amortized over the same period as the related premiums are taken into income.

Investments

Bonds are carried at amortized cost providing for the amortization of the discount or premium on a straight line basis to maturity. Preferred and common stocks are carried at cost. When there has been a loss in value of an investment that is other than temporary, the investment is written down to its estimated net realizable value. Such writedowns are reflected in realized gains (losses) on investments. At December 31, 1994 the aggregate provision for losses on investments was \$6.9 million (1993 \$11.5 million).

Investment income

Investment income is recorded as it accrues. Dividends are recorded as income on the record date. Gains and losses realized on the disposal of investments are taken into income on the date of disposal.

Provision for claims

Claim provisions are established by the case method as claims are reported. The provisions are subsequently adjusted as additional information on the estimated amount of a claim becomes known during the course of its settlement. A provision is also made for management's calculation of the future development of claims including claims incurred but not reported based on the volume of business currently in force and the historical experience on claims.

Translation of foreign currencies

Assets and liabilities in foreign currencies are translated into Canadian dollars at year-end exchange rates. Income and expenses are translated at the exchange rates in effect at the date incurred. Realized gains and losses on foreign exchange are recognized in the statements of earnings.

As a subsidiary, the assets and liabilities of Ranger are translated at the year-end rate of exchange. Revenue and expenses are translated at the average rate of exchange for the year.

Goodwill

The difference between purchase cost and the fair value of the net assets of acquired businesses is amortized on a straight line basis over their estimated useful life which ranges from ten years for Hamblin Watsa Investment Counsel Ltd. and Ranger Insurance Company to 40 years for Morden & Helwig Group Inc.

2. Capital Assets

	1994 (\$000)	1993 (\$000)
Land and buildings	5,360	4,735
Furniture and equipment	45,197	34,135
Leasehold improvements	4,147	2,761
Automobiles under capital lease	<u>1,044</u>	<u>1,274</u>
	55,748	42,905
Accumulated amortization	<u>25,916</u>	<u>17,986</u>
	<u>29,832</u>	<u>24,919</u>

3. Bank Indebtedness

Bank indebtedness is \$8,875 (1993 \$10,463) for which a general assignment of accounts receivable and claims in process of subsidiaries of Morden & Helwig Group Inc. have been pledged as security. Interest expense on bank indebtedness amounted to \$1,071 (1993 \$1,168).

4. Long Term Debt

The long term debt at December 31 consists of the following balances:

	1994 (\$000)	1993 (\$000)
Fairfax unsecured senior notes of US\$100 million at 7.75% due December 15, 2003	140,280	132,400
Fairfax unsecured senior note at 7.75% due December 15, 2003	25,000	
Fairfax unsecured bank term credits due December 30, 1999 at short term BA rates of 6.10% per annum at December 31, 1994	60,000	
Long term debt of Morden & Helwig Group Inc. at an average annual rate of 7.25% during 1994 (1993 6.08%)	<u>15,214</u>	<u>14,350</u>
	<u>240,494</u>	<u>146,750</u>

Interest expense on long term debt amounted to \$12,124 (1993 \$3,273).

Principal repayments on these loans are due as follows:

	(\$000)
1995	898
1996	1,664
1997	12,839
1998	123
1999	60,000
Thereafter	<u>165,868</u>
	241,392
Less: current portion	<u>898</u>
	<u>240,494</u>

5. Capital Stock

Authorized capital

The authorized share capital of the company consists of an unlimited number of preferred shares issuable in series, an unlimited number of multiple voting shares carrying ten votes per share and an unlimited number of subordinate voting shares carrying one vote per share.

Issued capital

	1994		1993	
	<i>number</i>	<i>(\$000)</i>	<i>number</i>	<i>(\$000)</i>
Subordinate voting shares	8,205,758	241,825	7,205,758	167,460
Multiple voting shares	<u>1,548,000</u>	<u>5,000</u>	<u>1,548,000</u>	<u>5,000</u>
	<u>9,753,758</u>	<u>246,825</u>	<u>8,753,758</u>	<u>172,460</u>
Interest in shares held through ownership interest in shareholder	<u>(799,230)</u>	<u>(19,022)</u>	<u>(799,230)</u>	<u>(19,022)</u>
Net effectively outstanding	<u>8,954,528</u>	<u>227,803</u>	<u>7,954,528</u>	<u>153,438</u>

On October 12, 1994 the company issued 1,000,000 subordinate voting shares at \$76 per share, for net proceeds of \$74,365.

On November 26, 1993 the company issued 2,000,000 subordinate voting shares at \$55 per share, for net proceeds of \$104,800. In 1993, under the terms of a normal course issuer bid approved by The Toronto Stock Exchange, the company purchased and cancelled 100,000 subordinate voting shares for an aggregate cost of \$2,479, of which \$1,276 was charged to retained earnings.

6. Reinsurance

The company follows the policy of underwriting and reinsuring contracts of insurance which generally limits the liability of the individual insurance companies to a maximum amount on any one loss of \$500 to \$2,500, varying by line of business. Reinsurance is generally placed on an excess of loss basis in several layers. This reinsurance does not relieve the company of its primary obligation to the policyholders. As at December 31, 1994 provision for claims reflects recoveries from reinsurers of \$308,566 (1993 \$257,320). During the year the company ceded \$188,740 (1993 \$137,484) of premium income and \$227,929 (1993 \$144,521) of claims incurred.

7. Income Taxes

The provision for income taxes differs from the statutory marginal rate as certain sources of income are exempt from tax or are taxed at other than the marginal rate.

A reconciliation of income tax calculated at the statutory marginal tax rate with the income tax provision at the effective tax rate in the financial statements is summarized in the following table:

	1994 (\$000)	1993 (\$000)
Provision for taxes at statutory marginal income tax rate	21,798	20,438
Non-taxable investment income	(9,743)	(4,740)
Recovery of claims on non-taxable purchase price adjustment	(3,732)	
Income earned outside Canada	(246)	(1,835)
Utilization of prior years' losses and other	<u>(730)</u>	<u>(927)</u>
Provision for income taxes	<u>7,347</u>	<u>12,936</u>

As at December 31, 1994 tax losses amounting to approximately \$27 million, expiring in 1998, 1999 and 2000, are available to reduce future years' taxable income. The benefit of these losses is not recorded in the financial statements.

8. Statutory Requirements Insurance Subsidiaries

Payments of dividends by the company's insurance subsidiaries are governed by insurance statutes and regulations.

9. Contingencies and Commitments

Subsidiaries of the company are defendants in several damage suits and have been named as third party in other suits. The uninsured exposure to the company is not considered to be material.

The company may under certain circumstances be obligated to purchase loans to officers and directors of the company and its subsidiaries from a Canadian chartered bank totalling \$8,728 (1993 \$4,923) for which 478,292 (1993 339,400) subordinate voting shares of the company with a year-end market value of \$32,045 (1993 \$20,788) have been pledged as security.

At December 31, 1994 the company had net foreign currency contracts outstanding to sell the equivalent of US\$110 million, primarily to hedge subsidiary investments denominated in U.S. dollars.

10. Operating Leases

Aggregate future commitments at December 31, 1994 under operating leases relating to premises, automobiles and equipment for various terms up to ten years are as follows:

	(\$000)
1995	23,700
1996	20,700
1997	16,900
1998	12,700
1999	9,000
Thereafter	<u>15,300</u>
	<u>98,300</u>

11. Earnings per Share

Earnings per share on the consolidated statements of earnings have been presented on a fully diluted basis. Basic earnings per share are \$4.66 for 1994 and \$5.42 for 1993. The weighted average number of shares for 1994 was 8,173,706 (1993 6,154,254).

12. Acquisitions

Effective November 30, 1994 the company purchased The Continental Insurance Company of Canada of Toronto, Ontario. The purchase price of \$155 million was paid \$130 million cash and a \$25 million 7.75% note due December 15, 2003. At November 30, 1994 Continental had \$904 million in total assets and \$741 million in total liabilities, at fair values. The vendor has agreed to indemnify Fairfax, to a maximum of \$40 million, for any inadequacy in Continental's provision for claims as at December 31, 1993, any of Continental's reinsurance relating to the period up to December 31, 1993 which subsequently becomes unrecoverable, and any defaults under the purchase agreement. Certain of the vendor's marketable bonds have been pledged as security for this indemnity. Continental may be entitled to additional consideration of up to \$10 million based on future years' results and 50% of any redundancy in Continental's provision for claims as at December 31, 1993.

Continental is engaged in the property and casualty insurance business in Canada. Net premiums earned for the year ended December 31, 1994 amounted to \$390 million.

Effective December 31, 1993 the company purchased Ranger Insurance Company of Houston, Texas. The purchase price of US\$125 million was paid US\$117.4 million cash and a five year insurance consulting contract valued at US\$7.6 million. At December 31, 1993 Ranger Insurance Company had US\$378 million in total assets and US\$273 million in total liabilities. The excess of the purchase price paid over the fair value of net assets acquired of US\$20 million was allocated US\$10 million to a five year non-competition agreement (recorded in other assets), US\$7.6 million to the consulting contract and the balance of US\$2.4 million to goodwill (which will be amortized to income over ten years). The vendor has agreed to indemnify Fairfax, to a maximum of US\$20 million, for any inadequacy in Ranger's provision for claims as at December 31, 1993, any of Ranger's reinsurance relating to the period up to December 31, 1993 which subsequently becomes unrecoverable, and any defaults under the purchase agreement. Certain of the vendor's assets have been pledged as security for this indemnity.

Ranger is engaged in the property and casualty insurance business in the United States. Net premiums earned for the year ended December 31, 1993 amounted to US\$132 million.

13. Segmented Information

The company is a financial services holding company which through its subsidiaries is engaged in the insurance of commercial property, oil and gas, casualty and life risks, investment management (included in "Corporate") and the provision of claims adjusting and appraisal and loss management services in Canada and the United States.

(a) Industry segments

	Insurance		Claims Adjusting, Appraisal and Loss Management		Corporate and Consolidation Adjustments		Consolidated	
	1994	1993	1994	1993	1994	1993	1994	1993
	<u>(\$000)</u>	<u>(\$000)</u>	<u>(\$000)</u>	<u>(\$000)</u>	<u>(\$000)</u>	<u>(\$000)</u>	<u>(\$000)</u>	<u>(\$000)</u>
<u>(\$000)</u>								
Revenue	476,445	201,402	156,093	142,105	2,359	515	634,897	344,022
Earnings before								
income taxes	56,387	52,623	3,036	2,253	(13,464)	(8,213)	45,959	46,663
Identifiable assets	2,053,699	1,070,538	95,908	92,795	23,804	36,942	2,173,411	1,200,275
Amortization	4,357	2,877	3,682	3,168	1,390	1,492	9,429	7,537
Interest expense			2,822	2,181	10,373	4,228	13,195	6,409

(b) Geographic segments

	Canada		United States		Total	
	1994	1993	1994	1993	1994	1993
	<u>(\$000)</u>	<u>(\$000)</u>	<u>(\$000)</u>	<u>(\$000)</u>	<u>(\$000)</u>	<u>(\$000)</u>
<u>(\$000)</u>						
Revenue	278,562	220,729	356,335	123,293	634,897	344,022
Earnings before income taxes	27,108	22,751	18,851	23,912	45,959	46,663
Identifiable assets	1,454,668	485,701	718,743	714,574	2,173,411	1,200,275
Amortization	7,348	5,782	2,081	1,755	9,429	7,537
Interest expense	12,408	4,909	787	1,500	13,195	6,409

February 8, 1995

Auditors' Report to the Shareholders

We have audited the consolidated balance sheets of Fairfax Financial Holdings Limited as at December 31, 1994 and 1993 and the consolidated statements of earnings, retained earnings and changes in cash resources for the years then ended. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the company as at December 31, 1994 and 1993 and the results of its operations and the changes in its financial position for the years then ended in accordance with generally accepted accounting principles.

Coopers & Lybrand
Chartered Accountants
Toronto, Ontario

February 8, 1995

Valuation Actuary's Report

Coopers & Lybrand has valued the policy liabilities of the subsidiary insurance companies of Fairfax Financial Holdings Limited in its consolidated balance sheet at December 31, 1994 and their change as reflected in its consolidated statement of earnings for the year then ended in accordance with accepted actuarial practice except as described in the following paragraph.

Under accepted actuarial practice, the valuation of policy liabilities reflects the time value of money. Pursuant to the authority granted by the Insurance Companies Act, the Superintendent of Financial Institutions has directed that the valuation of some policy liabilities not reflect the time value of money. Our valuation complies with that directive.

In our opinion the valuation is appropriate, except as noted in the previous paragraph, and the consolidated financial statements fairly present its results.

Coopers & Lybrand
Richard Gauthier, FCIA, FCAS
Toronto, Ontario

Management's Discussion and Analysis of Financial Condition and Results of Operations

Sources of Revenue

Revenue reflected in the consolidated financial statements includes premiums earned and investment income of the insurance companies, claims adjusting fees of Morden & Helwig and other miscellaneous income. The following table summarizes the total revenue derived from these categories from the date of acquisition of each company for the past ten years:

	1994	1993	1992	1991	1990	1989	1988	1987	1986	1985
	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)
<i>Revenue by</i>										
<i>Line of Business</i>										
Insurance	476,445	201,402	143,915	116,038	101,639	74,975	88,512	73,241	46,515	16,963
Claims adjusting	156,093	142,105	139,782	122,982	58,449	49,414	44,157	39,316	6,850	
Other income	<u>2,359</u>	<u>515</u>	<u>3,133</u>	<u>10,982</u>	<u>35,342</u>	<u>1,365</u>	<u>980</u>	<u>414</u>	<u>368</u>	<u>52</u>
	<u>634,897</u>	<u>344,022</u>	<u>286,830</u>	<u>250,002</u>	<u>195,430</u>	<u>125,754</u>	<u>133,649</u>	<u>112,971</u>	<u>53,733</u>	<u>17,015</u>

The insurance revenue increase in 1994 over 1993 was mainly the result of the 1993 year-end acquisition of Ranger and the November 30, 1994 effective acquisition of Continental, as well as increased investment income and increased pricing and volume increases at Commonwealth and Markel.

Claims adjusting revenue increased in 1994 over 1993 by \$14.0 million due largely to increased claims fees as a result of the Northridge earthquake.

On a geographic basis, Canadian operations accounted for approximately 44% of group revenue and 59% of group operating profits in 1994, compared with 64% of revenue and 49% of operating profits in 1993.

Canadian insurance operations accounted for approximately 45% of group insurance revenue in 1994. For 1995, with the inclusion of Continental Canada, Canadian insurance revenue is expected to be approximately 70% of group insurance revenue.

Net Earnings

Sources of net earnings on a pre-tax basis, with the total tax effect to the company and its consolidated subsidiaries shown as a separate item, were as follows for the past ten years:

	1994	1993	1992	1991	1990	1989	1988	1987	1986	1985
	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)
<i>Sources of Net Earnings by Line of Business</i>										
Insurance	39,745	25,071	7,880	30,680	6,786	(3,370)	6,468	8,539	9,594	(1,122)
Equity accounted										
F-M Acquisition	_____	_____	_____	<u>13,636</u>	<u>31,530</u>	<u>7,240</u>	<u>6,729</u>	<u>18</u>	_____	_____
Total	39,745	25,071	7,880	44,316	38,316	3,870	13,197	8,557	9,594	(1,122)
Claims adjusting										
(Fairfax portion)	1,553	395	282	117	1,688	1,543	1,454	5,849	539	
Investment banking										
and adjustments			29	(1,058)	(6,370)	(1,439)				
Interest and										
corporate										
expenses	(15,872)	(7,012)	(4,898)	(6,516)	(9,061)	(1,499)	(2,799)	(1,668)	(353)	(277)
Realized	20,026	27,822	9,720	2,488	5,178	15,458	7,802	9,159	952	459
investment gains										
Provisions for										
investment and										
other losses	_____	_____	<u>(6,320)</u>	<u>(7,000)</u>	<u>(7,900)</u>	_____	_____	_____	_____	_____
Net earnings	45,452	46,276	6,693	32,347	21,851	17,933	19,654	21,897	10,732	(940)
before taxes										
Provision for	<u>7,347</u>	<u>12,936</u>	<u>(3,352)</u>	<u>9,832</u>	<u>545</u>	<u>1,192</u>	<u>5,297</u>	<u>5,878</u>	<u>4,184</u>	<u>(30)</u>
income taxes										
Net earnings	<u>38,105</u>	<u>33,340</u>	<u>10,045</u>	<u>22,515</u>	<u>21,306</u>	<u>16,741</u>	<u>14,357</u>	<u>16,019</u>	<u>6,548</u>	<u>(910)</u>

Net earnings in 1994 were \$38.1 million, an increase of \$4.8 million or 14% from 1993 net earnings of \$33.3 million.

The major changes which affected net earnings were:

Insurance earnings improved by \$14.7 million from 1993

Net realized gains decreased in 1994 by \$7.8 million from \$27.8 million in 1993

In 1994 the provision for income taxes decreased to \$7.3 million (effective rate 16.2%) based on slightly lower pre-tax earnings compared to a 1993 provision of \$12.9 million

Interest and corporate expenses increased in 1994 due to higher interest expenses

from the U.S. debenture issue at the end of 1993.

Insurance Underwriting

Fairfax's insurance companies employ disciplined underwriting practices with the objective of rejecting underpriced risks. The combined loss and expense ratio is the traditional measure of underwriting results of property and casualty companies. In any year when the ratio exceeds 100%, it generally indicates that unprofitable business has been underwritten.

A summary follows of the net premiums written and earned, and the loss, expense and combined ratios, for the past ten years:

	<u>NET PREMIUMS</u>		<u>RATIOS</u>		
	Written (\$000)	Earned (\$000)	Loss (%)	Expense (%)	Combined (%)
1985	23,415	14,049	96	30	126
1986	55,992	40,885	72	23	95
1987	71,378	62,012	73	25	98
1988	68,224	66,265	73	19	92
1989	35,477	40,444	100	40	140
1990	74,487	78,427	82	31	113
1991	93,450	90,507	60	34	94
1992	128,664	118,854	79	35	114
1993	163,508	150,844	73	26	99
1994	411,570	400,559	74	30	104

In 1994 the combined ratio increased due to poor results at Ranger and at Markel.

Net premiums written and earned by company for the past five years are shown in the following table:

		1994	1993	1992	1991	1990
		(\$000)	(\$000)	(\$000)	(\$000)	(\$000)
Markel	Written	55,937	44,896	38,422	23,159	26,047
	Earned	52,149	43,749	33,760	20,594	30,225
Federated	Written	50,396	41,629	38,923	37,249	40,012
	Earned	47,376	40,436	38,776	38,838	40,858
Commonwealth	Written	90,403	71,181	51,319	33,042	8,428
	Earned	86,520	61,855	46,318	31,075	7,344
Ranger	Written	175,410				
	Earned	179,345				
Continental	Written	30,727				
	Earned	26,869				
Wentworth and other	Written	8,697	5,802			
	Earned	8,300	4,804			
Totals	Written	411,570	163,508	128,664	93,450	74,487
	Earned	400,559	150,844	118,854	90,507	78,427

Net premiums written increased at Markel, Federated and Commonwealth in 1994 due to price increases and additional accounts written. Ranger and Continental were included in Fairfax's income statements for the first time in 1994 for a year and for one month respectively.

The total underwriting profit (loss) for the individual insurance companies for the past five years is shown in the following table:

	1994	1993	1992	1991	1990
	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)
Markel	(7,965)	(5,088)	(5,000)	4,940	(9,035)
Federated	257	(1,320)	(1,294)	951	(2,303)
Commonwealth	1,867	5,126	(9,959)	196	(997)
Ranger	(15,061)				
Continental	(143)				
Wentworth and other	<u>4,165</u>	<u>3,347</u>	<u>(630)</u>	<u>(767)</u>	<u>(169)</u>
Totals	<u>(16,880)</u>	<u>2,065</u>	<u>(16,883)</u>	<u>5,320</u>	<u>(12,504)</u>

As shown, in 1994 the underwriting losses at Ranger and Markel more than offset the underwriting profits at Commonwealth and Federated. The Wentworth and other underwriting profit includes a \$4 million consolidation adjustment in 1994 related to a previous acquisition and miscellaneous adjustments from 1990 to 1992. Historically, the underwriting loss in 1992 at Commonwealth was

due to Hurricane Andrew and the loss in 1990 at Markel was from the surety business.

Provision for Claims

Claim provisions are established by the case method as claims are reported. The provisions are subsequently adjusted as additional information on the estimated amount of a claim becomes known during the course of its settlement. A provision is also made for management's calculation of factors affecting the future development of claims including claims incurred but not reported (IBNR) based on the volume of business currently in force and the historical experience on claims.

As time passes, more information about the claims becomes known and provision estimates are appropriately adjusted upward or downward. Because of the estimation elements encompassed in this process, and the time it takes to settle many of the more substantial claims, several years are required before a meaningful comparison of actual losses to the original provisions can be developed.

The development of the provision for claims is shown by the difference between estimates of reserves as of the initial year-end and the re-estimated liability at each subsequent year-end. This is based on actual payments in full or partial settlement of claims, plus re-estimates of the reserves required for claims still open or claims still unreported. Favourable development means that the original reserve estimates were higher than subsequently indicated. Unfavourable development means that the original reserve estimates were lower than subsequently indicated.

The following table presents a reconciliation of the provision for claims and loss adjustment expense (LAE) by company for the years 1991 through 1994. As shown in the table, the sum of the provision for claims for each of Fairfax's insurance subsidiaries is \$921.7 million as at December 31, 1994 the amount shown as "Provision for claims" on Fairfax's balance sheet on page **xx**.

Reconciliation of Provision for Claims and LAE

as at December 31

	1994 (\$000)	1993 (\$000)	1992 (\$000)	1991 (\$000)
Commonwealth, Federated and Markel	211,313	185,010	179,588	168,394
Continental	462,476			
Ranger	217,251	235,525		
Federated Life	22,975	22,825	22,794	21,337
Wentworth	7,659	1,486	6,381	5,196
Other	_____	_____	53	7,193
Total provision for claims and LAE at December 31	<u>921,674</u>	<u>444,846</u>	<u>208,816</u>	<u>202,120</u>

The four tables that follow show the reconciliation and the reserve development of the insurance companies' provisions for claims. In order to avoid the distortions caused by foreign exchange fluctuations, separate tables are provided for the Canadian and U.S. subsidiaries of Fairfax. Wentworth is included in the U.S. operations.

The following table shows for Fairfax's Canadian subsidiaries the provision for claims liability for unpaid losses and LAE as originally estimated for the years 1991 through 1994, the amounts paid with respect to the reserves for each subsequent year, the re-estimated liability at the end of each year, and the resulting development from prior years. The favourable or unfavourable development from prior years is credited or charged to each year's earnings.

*Reconciliation of Provision for Claims
Canadian Subsidiaries (C\$)*

	1994 (\$000)	1993 (\$000)	1992 (\$000)	1991 (\$000)
Provision for claims and LAE at January 1 for Commonwealth, Federated and Markel	<u>185,010</u>	<u>179,588</u>	<u>168,394</u>	<u>192,372</u>
Incurred losses on claims and LAE				
Provision for current accident year's claims	139,671	102,582	94,177	63,163
Increase (decrease) in provision for prior accident years' claims	<u>2,809</u>	<u>360</u>	<u>(393)</u>	<u>(17,234)</u>
Total incurred losses on claims and LAE	<u>142,480</u>	<u>102,942</u>	<u>93,784</u>	<u>45,929</u>
Payments for losses and LAE				
Payments on current accident year's claims	(53,222)	(40,696)	(34,540)	(25,852)
Payments on prior accident years' claims	<u>(62,955)</u>	<u>(56,824)</u>	<u>(48,050)</u>	<u>(44,055)</u>
Total payments for losses and LAE	<u>(116,177)</u>	<u>(97,520)</u>	<u>(82,590)</u>	<u>(69,907)</u>
Provision for claims and LAE at December 31 for Commonwealth, Federated and Markel	<u>211,313</u>	<u>185,010</u>	<u>179,588</u>	<u>168,394</u>

The company strives to establish adequate provisions at the original valuation date. While the company hopes favourable development will result from the past, in 1993 and 1994 there was unfavourable development. The company will always be subject to upward or downward development in the future.

The following table shows for Fairfax's Canadian subsidiaries the original provision for claims reserves including LAE at each calendar year-end with the subsequent cumulative payments made from these years and the subsequent re-estimated amount of these reserves. The following insurance subsidiaries' reserves are included from the respective years in which they were originally acquired:

Subsidiary	Year Acquired
Markel Insurance Company of Canada	1985
Federated Insurance Company of Canada	1990
Commonwealth Insurance Company	1990

*Provision for Canadian Subsidiaries' Claims Reserve Development
(including Commonwealth, Federated and Markel)*

As at December 31	1985 and prior	1986	1987	1988	1989	1990	1991	1992	1993	1994
(\$000)		(\$000)	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)
Provision for claims including LAE	17,517	39,522	59,400	71,964	79,357	192,372	168,394	179,588	185,010	211,313
Cumulative payments as of:										
One year later	8,069	13,940	18,752	21,015	25,194	44,055	48,050	56,824	62,955	
Two years later	11,822	22,613	27,154	33,196	35,440	76,947	75,402	87,878		
Three years later	15,514	27,295	32,919	42,043	44,169	98,149	94,834			
Four years later	16,313	30,156	37,784	47,901	50,119	115,417				
Five years later	16,989	33,256	41,128	52,103	55,310					
Six years later	16,989	34,928	43,991	55,675						
Seven years later	16,989	36,598	45,654							
Eight years later	17,185	37,261								
Nine years later	17,536									
Reserves re-estimated as of:										
One year later	18,596	42,907	56,920	71,673	80,602	175,138	168,001	179,948	187,819	
Two years later	18,352	43,397	54,920	69,930	73,904	173,992	157,848	174,820		
Three years later	19,210	43,148	53,004	67,676	71,810	165,752	157,671			
Four years later	19,079	41,448	52,295	64,478	67,165	166,797				
Five years later	18,613	41,730	50,235	64,394	65,414					
Six years later	16,989	40,280	50,822	62,939						
Seven years later	16,989	41,094	49,198							
Eight years later	17,424	39,752								
Nine years later	17,899									
Favourable (unfavourable) development	<u>(382)</u>	<u>(230)</u>	<u>10,202</u>	<u>9,025</u>	<u>13,943</u>	<u>25,575</u>	<u>10,723</u>	<u>4,768</u>	<u>(2,809)</u>	

While management is pleased with the generally favourable development over the years (in 1993 there was a small unfavourable development), future development could be significantly different from the past due to many unknown factors.

The following table shows for Fairfax's U.S. subsidiaries the provision for claims liability for unpaid losses and LAE as originally estimated for the years 1993 and 1994, the amounts paid with respect to the reserves for each subsequent year, the re-estimated liability at the end of each year, and the resulting development from prior years. The favourable or unfavourable development from prior years is credited or charged to each year's earnings.

*Reconciliation of Provision for Claims**U.S. Subsidiaries (US\$)*

	1994	1993
	<i>(US\$000)</i>	<i>(US\$000)</i>
Provision for claims and LAE at January 1		
for Ranger and Wentworth	179,001	5,020
Plus reserves of Ranger purchased		
December 31, 1993	<u> </u>	<u>177,887</u>
	<u>179,001</u>	<u>182,907</u>
Incurring losses on claims and LAE		
Provision for current accident year's claims	97,899	410
Increase in provision for prior accident years' claims	<u>8,202</u>	<u> </u>
Total incurred losses on claims and LAE	<u>106,101</u>	<u>410</u>
Payments for losses and LAE		
Payments on current accident year's claims	(39,277)	
Payments on prior accident years' claims	<u>(85,494)</u>	<u>(4,316)</u>
Total payments for losses and LAE	<u>(124,771)</u>	<u>(4,316)</u>
Provision for claims and LAE at December 31		
for Ranger and Wentworth	<u>160,331</u>	<u>179,001</u>
Exchange rate	1.4028	1.3241
Converted to Canadian dollars	C\$ <u>224,910</u>	C\$ <u>237,011</u>

The unfavourable reserve development of US\$8.2 million in the U.S. operations in 1994 derived from adverse development in periods prior to Fairfax's acquisition of Ranger, for which indemnification is provided under the purchase agreement (as shown in the following table).

The following table shows for Fairfax's U.S. subsidiaries the original provision for claims reserves including LAE at each calendar year-end with the subsequent cumulative payments made from these years and the subsequent re-estimated amount of these reserves. The following insurance subsidiaries' reserves are included from the respective years in which they were originally acquired (Wentworth from January 1, 1993 as its operations were minor prior to that):

Subsidiary

Wentworth Insurance Company Ltd.
Ranger Insurance Company

Commenced business 1990
Acquired 1993

*Provision for U.S. Subsidiaries' Claims Reserve Development
(including Ranger and Wentworth)*

As at December 31	1993 <i>(US\$000)</i>	1994 <i>(US\$000)</i>
Provision for claims including LAE	179,001	160,330
Cumulative payments as of: One year later	85,494	
Reserves re-estimated as of: One year later	187,203	
Favourable (unfavourable) development	(8,202)	
Offset by right to indemnification	8,490	
Favourable (unfavourable) development after indemnification	<u>288</u>	

Insurance Environment

The property and casualty insurance market in general experienced another year of poor underwriting results with combined ratios in Canada and the U.S. expected to be approximately 109% in 1994. Many insurance companies continue to write insurance at inadequate prices. Following the large catastrophic losses in 1992 and 1994 in the U.S. and Europe, we felt price adjustments were inevitable. We continue to believe price increases must take place as a result of large underwriting losses combined with interest rates which are insufficient to adequately offset these losses. However, the industry continues to be very competitive.

Continental Acquisition

Effective November 30, 1994 the company acquired The Continental Insurance Company of Canada for \$155 million. The combined balance sheet of Continental upon acquisition was as follows:

	(\$000)
Investments, including cash	684,198
Deferred premium acquisition costs	52,362
Accounts receivable	145,218
Other assets	<u>21,983</u>
	<u>903,761</u>
Provision for claims	461,003
Unearned premiums	217,993
Other liabilities	62,068
Shareholders' equity	<u>162,697</u>
	<u>903,761</u>

The purchase price of \$155 million was paid \$130 million in cash and the remainder by the issue of a \$25 million nine year unsecured debenture. The \$7.7 million excess of the shareholders' equity over the purchase price relates essentially to an unrealized loss in a predominantly government bond portfolio with an average term of approximately three years.

Continental underwrites a complete range of commercial and personal insurance products in Canada. Continental's net premiums written for 1994 were \$373 million.

Interest and Dividend Income

The majority of interest and dividend income is earned by the insurance companies. The Commonwealth and Federated acquisitions added \$130 million and \$101 million respectively to the investment portfolio at the end of 1990, and interest and dividend income for Commonwealth was included for only two months in 1990. Ranger's \$400 million investment portfolio acquired effective December 31, 1993, and Continental's \$684 million portfolio acquired effective November 30, 1994, are included in the following tables only as indicated.

Dividend Income Tax	Average	Pre-Tax		Interest and		After
	Investments					
	at Book Value	Amount	Yield	Amount	Yield	
Per Share	(\$000)	(\$000)	(%)	(\$000)	(%)	(\$)
1985	29,060	2,455	8.45	1,271	4.37	0.45
1986	64,181	4,678	7.29	2,522	3.93	0.52
1987	109,825	8,042	7.32	5,499	5.01	0.77
1988	130,782	8,922	6.82	6,618	5.06	0.90
1989	135,703	11,628	8.57	8,537	6.29	1.11
1990	237,868	20,704	8.70	14,017	5.89	1.86
1991	338,461	26,051	7.70	17,731	5.24	3.02
1992	366,481	23,988	6.55	17,749	4.84	3.09
1993 *	418,207	23,251	5.56	17,994	4.30	2.92
1994 **	852,010	58,219	6.83	39,608	4.65	4.85

* *Ranger is not included in this line.*

** *Continental is not included in this table.*

Interest and dividend income increased in 1994 due mainly to the inclusion of Ranger's portfolio. As shown, the after-tax income yield increased in 1994 to 4.7% as a result of a more favourable interest and dividend mix. After-tax interest and dividend income per share has compounded at 30% per year since 1985.

Investments for the past ten years are shown in the following table, the first five columns of which show them at the average of their carrying values at the beginning and end of each year, and the final two columns of which show them at year-end.

Investments Share	Cash and Short Term Investments				Total		
	Investments	Bonds	Preferreds	Common	Average	Year-End	Per
	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)	(\$)
1985	10,526	15,388	732	2,414	29,060	32,728	6.55
1986	16,605	24,523	7,979	15,074	64,181	95,633	13.65
1987	28,025	26,242	16,516	39,042	109,825	124,016	16.90
1988	29,843	23,575	25,191	52,173	130,782	137,548	18.79
1989	20,623	28,528	32,212	54,340	135,703	133,858	18.30
1990	33,596	99,220	45,652	59,400	237,868	335,740	61.30
1991	60,099	140,177	75,685	62,500	338,461	341,180	62.54
1992	77,929	108,818	99,821	79,913	366,481	396,240	65.44
1993 *	102,968	90,682	118,604	105,953	418,207	848,774	106.70
1994 **	226,205	303,859	132,138	189,808	852,010	1,551,343	173.25

* *Ranger Insurance is not included in the first five columns in this line.*

** *Continental Insurance is not included in the first five columns in this line.*

Total investments per share at year-end increased significantly in 1994 due to the Continental Canada acquisition. Since 1985 investments per share have compounded at 44% per year.

Return on Investment Portfolio

The following table shows the performance of the investment portfolio for the past ten years. The total return includes all interest and dividend income, gains (losses) on the disposal of securities and the change in the unrealized gains (losses) during the year.

Year	Average Investments at Book	Interest and Dividends Earned	Realized Gains (Losses) after Provisions	Change in Unrealized Gains (Losses)	Total Return Average
	(\$000)	(\$000)	(\$000)	(\$000)	(%)
1985	29,060	2,455	459	878	13
1986	64,181	4,678	952	(352)	8
1987	109,825	8,042	9,159	(7,976)	8
1988	130,782	8,922	7,802	12,131	22
1989	135,703	11,628	15,458	(6,272)	15
1990	237,868	20,704	2,278	(32,943)	(4)
1991	338,461	26,051	(4,512)	27,866	15
1992	366,481	23,988	3,400	(11,197)	4
1993 *	418,207	23,251	27,822	28,792	19
1994 **	852,010	58,219	20,026	(42,407)	4

* *Ranger is not included in this line.*

** *Continental is not included in this table.*

Investment gains (losses) have been an important component of Fairfax's net earnings since 1985. The amount has fluctuated significantly from period to period, but the amount of investment gains (losses) for any period has no predictive value and variations in amount from period to period have no practical analytical value. At December 31, 1994 the aggregate provision for losses on investments was \$6.9 million (1993 \$11.5 million). At December 31, 1994 the Fairfax investment portfolio had an unrealized loss of \$31.0 million compared to an unrealized gain at December 31, 1993 of \$11.4 million.

The company has a long term value-oriented investment philosophy. It continues to expect fluctuations in the stock market.

Capital Resources

At December 31, 1994 total capital, comprising shareholders' equity and non-controlling (minority) interest, was \$409.2 million, compared to \$296.9 million at December 31, 1993.

The following table shows the level of capital as at December 31 for the last five years:

	<i>(\$ millions)</i>				
	1994	1993	1992	1991	1990
Non-controlling interest	17.3	17.4	17.4	17.0	16.7
Subordinated convertible debenture				7.5	7.5
Shareholders' equity	<u>391.9</u>	<u>279.5</u>	<u>143.8</u>	<u>116.8</u>	<u>94.7</u>
	409.2	296.9	161.2	141.3	118.9

Fairfax's consolidated balance sheet as at December 31, 1994 continues to reflect significant financial strength. Fairfax's shareholders' equity has increased from \$279.5 million at December 31, 1993 to \$391.9 million at December 31, 1994.

In 1993 the company purchased and cancelled 100,000 subordinate voting shares at an average price of \$24.79 per share.

On October 12, 1994 the company issued 1,000,000 subordinate voting shares at \$76 per share, raising net proceeds of \$74.4 million. Average net outstanding shares increased as a result of this issue from 6,154,254 in 1993 to 8,173,706 in 1994. On November 26, 1993 the company issued 2,000,000 subordinate voting shares at \$55 per share, raising net proceeds of \$104.8 million. Fairfax's indirect ownership of its own shares through The Sixty Two Investment Company Limited results in an effective reduction of shares outstanding by 799,230, and this reduction has been reflected in the earnings per share and book value per share figures.

A common measure of capital adequacy in the property and casualty industry is the premiums to surplus (or common shareholders' equity) ratio. This is shown for the insurance subsidiaries of Fairfax for the last five years in the following table:

Written to Surplus Shareholders' Equity)	Net Premiums (Common				
	1994	1993	1992	1991	1990
Markel 1.2:1	1.1:1	1.0:1	0.4:1	0.6:1	
Federated	0.9:1	1.1:1	1.1:1	1.1:1	1.3:1
Commonwealth	0.8:1	0.7:1	0.6:1	0.4:1	0.4:1
Ranger	1.5:1	1.6:1			
Continental	2.3:1				
Canadian insurance industry	1.4:1	1.4:1	1.4:1	1.3:1	1.3:1
U.S. insurance industry	1.4:1	1.3:1	1.4:1	1.4:1	1.6:1

In Canada, property and casualty companies are regulated by the Office of the Superintendent of Financial Institutions on the basis of their Section 516 surplus. At December 31, 1994 Fairfax's Canadian property and casualty insurance subsidiaries had a consolidated Section 516 surplus of \$172 million (1993 \$125 million), significantly in excess of minimum requirements.

In the U.S., the National Association of Insurance Commissioners (NAIC) developed a model law and risk-based capital (RBC) formula designed to help regulators identify property/casualty insurers that may be inadequately capitalized. Under the NAIC's requirements an insurer must maintain total capital and surplus above a calculated threshold or face varying levels of regulatory action. The threshold is based on a formula that attempts to quantify the risk of a company's insurance, investment and other business activities. Fairfax does not anticipate any adverse effects of such requirements because of the strong capitalization of Ranger. At the end of 1994 Ranger had capital and surplus in excess of 4.6 times the authorized control level.

In 1994 A.M. Best upgraded Commonwealth and Ranger to an A (Excellent), while maintaining Federated at a rating of A (Excellent). Standard & Poor's has provided an A claims paying rating to Commonwealth. Fairfax's senior unsecured debt is rated BBB by S&P and Duff & Phelps, and BBB+ by Dominion Bond Rating Service.

Liquidity

The purpose of liquidity management is to ensure that there is sufficient cash to meet all financial commitments and obligations as they fall due.

Fairfax has the financial flexibility to obtain from internal or external sources the funds needed to

fulfil its cash requirements during the current financial year. In 1995 cash requirements for Fairfax at the holding company level will include gross debt servicing of about \$18 million and net administration expense of approximately \$3 million. Management fees charged will generate over \$7 million, while dividends available from Fairfax's insurance companies will exceed \$30 million. In addition, Fairfax has over \$14 million of cash and marketable securities (see page xx).

Also, Fairfax has \$105 million of unused, unsecured, committed, long term bank lines. The principal covenants attached to these lines and the bank term debt described below are covenants to maintain a debt to equity ratio not exceeding 1:1 and shareholders' equity of at least \$250 million.

During 1994 Fairfax raised \$74.4 million through the share issue referred to above under "Capital Resources". A further \$60 million in five year unsecured bank loans provided the balance of the cash component of the purchase price of Continental. Payment of the purchase price was completed by the issue of an unsecured \$25 million 7.75% debenture due December 15, 2003 containing the same terms as the publicly issued debentures described in the following paragraph.

During 1993 Fairfax raised US\$100 million in unsecured 7.75% debentures due December 15, 2003 through a public issue in the United States and \$104.8 million through the share issue referred to above under "Capital Resources". These funds were applied towards the Ranger acquisition (US\$117.4 million), paying off the then existing bank indebtedness (\$51 million) and repayment of the long term debt owed to Federated Mutual Insurance Company (\$20.4 million).

The debt to equity ratio with Morden & Helwig equity accounted was 0.57:1 at December 31, 1994, up from 0.47:1 at December 31, 1993 as a result of financing the Continental acquisition. This ratio is close to the maximum with which Fairfax feels comfortable.

The company has not paid and does not intend to pay dividends as long as it can reinvest its funds and earn a 20% return on equity over time.

Fairfax Insurance Companies**Combined Balance Sheets**

as at December 31, 1994 and 1993
(unaudited)

	1994	1993
	(\$000)	(\$000)
Assets		
Accounts receivable	334,407	154,401
Prepaid expenses	<u>5,392</u>	<u>2,420</u>
.....	<u>339,799</u>	<u>156,821</u>
Cash and short term investments	261,092	283,839
Bonds at book value	793,113	305,375
Preferred stocks at book value	158,941	132,862
Common stocks at book value	<u>320,739</u>	<u>112,690</u>
.....	<u>1,533,885</u>	<u>834,766</u>
Deferred premium acquisition costs	82,656	29,422
Deferred income taxes	42,875	27,720
Capital assets	18,113	12,558
Other assets	<u>24,286</u>	<u>19,249</u>
.....	<u>2,041,614</u>	<u>1,080,536</u>
Liabilities		
Accounts payable and accrued liabilities	151,274	79,775
Premium deposits	7,541	5,664
Income taxes payable	<u>5,244</u>	<u>19,320</u>
.....	<u>164,059</u>	<u>104,759</u>
Provision for claims	921,674	444,846
Unearned premiums	<u>417,318</u>	<u>184,277</u>
.....	<u>1,338,992</u>	<u>629,123</u>
Shareholders' Equity		
Capital stock	313,746	225,795
Contributed surplus	12,571	6,062
Retained earnings	<u>212,246</u>	<u>114,797</u>
.....	<u>538,563</u>	<u>346,654</u>
.....	<u>2,041,614</u>	<u>1,080,536</u>

Fairfax Insurance Companies**Combined Statements of Earnings**

for the years ended December 31, 1994 and 1993
(unaudited)

	1994 (\$000)	1993 (\$000)
Revenue		
Premiums earned	400,559	150,844
Interest and dividends	56,625	23,006
Realized gains on investments	<u>19,261</u>	<u>27,552</u>
.....	<u>476,445</u>	<u>201,402</u>
Expenses		
Losses on claims	296,641	109,419
Operating expenses	82,391	32,735
Commissions, net	<u>38,407</u>	<u>6,625</u>
.....	<u>417,439</u>	<u>148,779</u>
Earnings before income taxes	59,006	52,623
Provision for income taxes	<u>5,350</u>	<u>17,150</u>
Net earnings	<u>53,656</u>	<u>35,473</u>

Fairfax Insurance Companies

Fairfax's insurance business is conducted by six subsidiaries. The companies underwrite a wide range of commercial property, oil and gas, commercial casualty, commercial truck and personal lines insurance and smaller amounts of other property, other casualty, life, health and disability insurance, in Canada, the United States and internationally.

Fairfax with Equity Accounting of Morden & Helwig**Consolidated Balance Sheets**

as at December 31, 1994 and 1993
(unaudited)

	1994 (\$000)	1993 (\$000)
Assets		
Accounts receivable	338,261	160,056
Income taxes refundable	8,129	
Prepaid expenses	<u>5,512</u>	<u>2,452</u>
.....	<u>351,902</u>	<u>162,508</u>
<i>Portfolio investments</i>		
Cash and short term investments	269,732	286,247
Bonds		
(market value \$775,564; 1993 \$308,498)	793,113	305,375
Preferred stocks		
(market value \$157,623; 1993 \$141,676)	158,941	132,862
Common stocks		
(market value \$314,484; 1993 \$117,435)	326,568	117,976
Other investments	<u>1,248</u>	<u>4,200</u>
Total (market value \$1,518,651; 1993 \$858,056)	<u>1,549,602</u>	<u>846,660</u>
Investment in Morden & Helwig	26,036	25,689
Deferred premium acquisition costs	82,656	25,404
Deferred income taxes	42,875	27,715
Capital assets	18,113	12,558
Goodwill	18,297	17,167
Other assets	<u>17,836</u>	<u>18,162</u>
.....	<u>2,107,317</u>	<u>1,135,863</u>
Liabilities		
Accounts payable and accrued liabilities	143,555	69,196
Premium deposits	7,541	5,664
Income taxes payable	_____	<u>20,001</u>
.....	<u>151,096</u>	<u>94,861</u>
Provision for claims	921,674	444,846

Unearned premiums	417,318	
Long term debt.....	<u>225,280</u>	<u>132,400</u>
.....	<u>1,564,272</u>	<u>761,523</u>

Shareholders' Equity

Capital stock	227,803	153,438
Retained earnings.....	<u>164,146</u>	<u>126,041</u>
.....	<u>391,949</u>	<u>279,479</u>
.....	<u>2,107,317</u>	<u>1,135,863</u>

Fairfax with Equity Accounting of Morden & Helwig**Consolidated Statements of Earnings**

for the years ended December 31, 1994 and 1993
(unaudited)

.....	1994	1993
.....	(\$000)	(\$000)
Revenue		
Premiums earned	400,559	150,844
Interest and dividends	57,973	23,006
Realized gains on investments	20,026	27,822
Equity earnings of Morden & Helwig, net of dividends	<u>285</u>	<u>149</u>
.....	<u>478,843</u>	<u>201,821</u>
Expenses		
Losses on claims	296,641	109,419
Operating expenses	89,914	36,743
Interest expense	10,426	4,228
Commissions, net	<u>38,407</u>	<u>6,625</u>
.....	<u>435,388</u>	<u>157,015</u>
Earnings before income taxes	43,455	44,806
Provision for income taxes	<u>5,350</u>	<u>11,466</u>
Net earnings	<u>38,105</u>	<u>33,340</u>
Net earnings per share	\$4.66	\$5.42

Morden & Helwig Group Inc.**Consolidated Balance Sheets***as at December 31, 1994 and 1993*

	1994	1993
	(\$000)	(\$000)
Assets		
Cash	1,295	1,634
Accounts receivable	25,673	23,661
Claims in process	14,842	14,719
Prepaid expenses	<u>1,604</u>	<u>1,664</u>
.....	<u>43,414</u>	<u>41,678</u>
Capital assets	11,719	12,361
Other assets	<u>40,775</u>	<u>38,510</u>
.....	<u>95,908</u>	<u>92,549</u>
Liabilities		
Bank indebtedness	8,875	10,463
Accounts payable and accrued liabilities	16,744	13,593
Long term debt - current portion	898	1,269
Deferred income taxes	<u>3,777</u>	<u>2,934</u>
.....	<u>30,294</u>	<u>28,259</u>
Long term debt	14,626	14,076

Future retirement payments	<u>7,021</u>	<u>6,804</u>
.....	<u>21,647</u>	<u>20,880</u>
Subordinated convertible debenture	<u>8,519</u>	<u>8,174</u>

Shareholders' Equity

Capital stock	22,527	22,871
Retained earnings	<u>12,921</u>	<u>12,365</u>
.....	<u>35,448</u>	<u>35,236</u>
.....	<u>95,908</u>	<u>92,549</u>

Morden & Helwig Group Inc.**Consolidated Statements of Earnings***for the years ended December 31, 1994 and 1993*

	1994	1993
	(\$000)	(\$000)
Revenue	<u>156,093</u>	<u>142,105</u>
Cost and expenses		
Cost of service	116,846	110,020
Selling, general and administration	31,475	27,652
Interest	2,770	2,181
Loss on disposal of assets	<u>1,967</u>	<u> </u>
.....	<u>153,058</u>	<u>139,853</u>
Earnings before income taxes	3,035	2,252
Income taxes	<u>1,997</u>	<u>1,470</u>
Net earnings	<u><u>1,038</u></u>	<u><u>782</u></u>
.....		

Consolidated Statements of Retained Earnings*for the years ended December 31, 1994 and 1993*

	1994	1993
	(\$000)	(\$000)
Retained earnings - beginning of year	12,364	12,069
Net earnings for the year	1,038	782

Dividends	<u>(481)</u>	<u>(487)</u>
Retained earnings - end of year	<u>12,921</u>	<u>12,364</u>
.....		

These condensed financial statements have been prepared from the Morden & Helwig Group Inc. audited consolidated financial statements for the years ended December 31, 1994 and 1993, copies of which are available on request.

Fairfax Financial Holdings Limited
Unconsolidated Balance Sheet (equity accounted)
as at December 31, 1994 and 1993
(unaudited)

	1994	1993
	(\$000)	(\$000)
Assets		
Insurance		
Continental	158,997	
Ranger	178,102	154,002
Commonwealth 113,862	104,421	
Federated	51,528	47,269
Markel	42,502	40,887
Wentworth	9,302	11,286
Other	<u>6,453</u>	<u> </u>
.....	560,746	357,865
Morden & Helwig - common shares	18,136	17,789
- debentures	<u>7,900</u>	<u>7,900</u>
.....	26,036	25,689
Hamblin Watsa	14,129	15,727
Real estate	1,248	5,287
Cash and portfolio investments	<u>14,229</u>	<u>4,956</u>
.....	616,388	409,524
Other assets	<u>1,996</u>	<u>2,950</u>
.....	<u>618,384</u>	<u>412,474</u>
Liabilities		
Accounts payable 1,155	595	
Long term debt	<u>225,280</u>	<u>132,400</u>
.....	<u>226,435</u>	<u>132,995</u>
Shareholders' Equity		
Capital stock	227,803	153,438
Retained earnings 164,146	<u>126,041</u>	
.....	<u>391,949</u>	<u>279,479</u>
.....	<u>618,384</u>	<u>412,474</u>

Consolidated Financial Summary (in \$ millions except share and per share data)

	<i>For the years ended December 31</i>									
	1994	1993	1992	1991	1990	1989	1988	1987	1986	1985
Operating Results										
Premiums earned	400.6	150.8	118.9	90.5	78.4	40.4	66.3	62.0	40.9	14.0
Claims fees	156.1	142.1	139.8	123.0	58.3	49.1	43.3	33.5	6.9	
Interest and dividends	58.2	23.3	24.0	26.1	20.7	11.6	8.9	8.0	4.7	2.5
Realized gains (losses)										
on investments	20.0	27.8	3.4	(4.5)	2.3	15.5	7.8	9.2	1.0	0.5
Other income			0.8	15.0	35.7	9.1	7.3	0.2	0.4	0.1
Total revenue	634.9	344.0	286.8	250.0	195.4	125.8	133.6	113.0	53.7	17.0
Earnings before										
income taxes	46.0	46.7	7.0	32.5	23.2	19.2	21.3	18.2	9.1	(0.9)
Extraordinary items								1.7	1.7	
Net earnings	38.1	33.3	10.0	22.5	21.3	16.7	14.4	16.0	6.5	(0.9)
<hr/>										
Per Common Share										
Net earnings										
fully diluted	4.66	5.42	1.76	3.94	2.92	2.25	1.94	2.23	1.35	(1.89)
Shareholders' equity	43.77	35.13	23.76	21.41	17.29	12.41	10.13	8.32	5.89	2.08
Number of shares outstanding year-end (000)	8,955	7,955	6,055	5,455	5,477	7,316	7,322	7,337	7,007	5,000
<hr/>										
Financial Condition										
Total assets	2,173.4	1,200.3	590.5	516.6	536.0	248.1	246.8	185.4	129.8	41.5
Cash and investments	1,551.3	848.8	396.2	341.2	335.7	133.9	137.5	124.0	95.6	32.7
Total debt *	225.3	132.4	68.2	51.3	65.9	22.0	28.2	2.8	2.8	
Shareholders' equity	391.9	279.5	143.8	116.8	94.7	90.8	74.2	61.0	41.3	10.4
<hr/>										
Return on Average Shareholders' Equity	12.1%	20.3%	7.7%	21.3%	23.0%	20.3%	21.2%	31.3%	25.4%	

Numbers may not add due to rounding

* Total debt with Morden & Helwig equity accounted

Readers of the Management's Discussion and Analysis should review the entire annual report for additional commentary and information.

Directors of the Company

Winslow W. Bennett
President, Winwood Holdings Ltd.

Robbert Hartog
President, Robhar Investments Ltd.

Steven A. Markel
Vice Chairman
Markel Corporation

Kenneth R. Polley
President and Chief Executive Officer
Morden & Helwig Group Inc.

John C. Puddington
President, Trilwood Investments Limited

V. Prem Watsa
Chairman and
Chief Executive Officer

Audit Committee Member

Operating Management

John B. O. Watson
President
Commonwealth Insurance Company

Byron G. Messier
President
The Continental Insurance Company of Canada Inc.

John M. Paisley
President
Federated Insurance Company of Canada and
Federated Life Insurance Company of Canada

Anthony F. Hamblin
President
Hamblin Watsa Investment Counsel Ltd.

Mark J. Ram
President
Markel Insurance Company of Canada

Kenneth R. Polley
President
Morden & Helwig Group Inc.

Thomas H. Friedberg
President
Ranger Insurance Company

Officers of the Company

Brenda Adams
Corporate Secretary

Sam Chan
Vice President

J. Paul T. Fink
Vice President

Eric P. Salsberg
Vice President, Corporate Affairs

Ronald Schokking
Vice President, Finance

John C. Varnell
Vice President and
Chief Financial Officer

V. Prem Watsa
Chairman and Chief Executive Officer

Head Office

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Transfer Agent and Registrar
The R-M Trust Company

Share Listing
The Toronto Stock Exchange
Exchange Symbol FFH

General Counsel
Tory Tory DesLauriers & Binnington

Auditors
Coopers & Lybrand

Annual Meeting
The annual meeting of shareholders of Fairfax Financial Holdings Limited will be held on Wednesday, May 3, 1995 at 4.30 p.m. at the Design Exchange (the old Toronto Stock Exchange building), 234 Bay Street, Toronto.