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**FAIRFAX**  
FINANCIAL HOLDINGS LIMITED

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**1998 Annual Report**

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**1998 Annual Report**

**Five Year Financial Highlights**

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

	<b>1998</b>	<b>1997</b>	<b>1996</b>	<b>1995</b>	<b>1994</b>
Revenue	3,574.3	2,088.3	1,475.8	1,145.5	634.9
Net earnings	387.5	232.5	150.8	87.5	38.1
Total assets	20,886.7	10,207.3	5,778.4	2,873.5	2,173.4
Shareholders' equity	2,238.9*	1,395.7	911.1	472.6	391.9
Shares outstanding – year-end <i>(mil.)</i>	12.1*	11.1	10.5	8.9	9.0
Return on average equity	20.1%	20.4%	21.4%	20.1%	12.1%
<i>Per share</i>					
Net earnings	32.63	21.59	15.36	9.79	4.66
Shareholders' equity	184.54	125.38	87.05	53.28	43.77
<i>Market prices per share</i>					
High	603.00	403.00	310.00	100.00	76.00
Low	253.00	285.00	98.00	66.25	52.00
Close	540.00	320.00	290.00	98.00	67.00

\* not including share subscription receipts issued December 22, 1998 or their proceeds – see note 6 to the consolidated financial statements

## 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.

### *Insurance subsidiaries*

**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 1998, Commonwealth's net premiums written were \$72.8 million. Commonwealth has been in business since 1947. At year-end, the company had capital and surplus of \$152.9 million and there were 125 employees.

**Crum & Forster**, based in Morristown, New Jersey, is a national commercial lines property and casualty insurance group in the United States that operates on a regional basis and produces business through a limited number of preferred independent agents and brokers. In 1998, Crum & Forster's net premiums written were US\$779.7 million. The company has been in business since 1896. At year-end, the company had capital and surplus of US\$949.0 million and there were 1,494 employees. Crum & Forster was acquired on August 13, 1998.

**Falcon Insurance**, based in Hong Kong, writes property and casualty insurance to niche markets in Hong Kong. In 1998, Falcon's net premiums written were HK\$4.4 million (approximately HK\$5 = C\$1). At year-end, the company had capital and surplus of HK\$260.2 million and there were 34 employees. The company was acquired on January 16, 1998.

**Federated Insurance**, based in Winnipeg, markets a broad range of insurance products in Canada primarily for commercial customers. In 1998, Federated's net premiums written were \$67.0 million, consisting of \$53.9 million of property and casualty business and \$13.1 million of life and group health and disability products. Federated has been in business since 1920. At year-end, the company had capital and surplus of \$42.2 million and there were 257 employees.

**Lombard Insurance**, based in Toronto, writes a complete range of commercial and personal insurance products in Canada. The company has been in business since 1904. In 1998, Lombard's net premiums written were \$381.2 million. At year-end, the company had capital and surplus of \$174.9 million and there were 651 employees.

**Markel Insurance**, based in Toronto, 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. In 1998, net premiums written were \$59.0 million. At year-end, the company had capital and surplus of \$46.2 million and there were 108 employees.

**Ranger Insurance**, based in Houston, Texas, specializes in writing property and casualty insurance in the United States to niche markets such as propane distributors and agri-products. The company has been in business since 1923. In 1998, net premiums written were US\$129.0 million. At year-end, the company had capital and surplus of US\$108.7 million and there were 301 employees.

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### ***Reinsurance subsidiaries***

**CRC (Bermuda) Reinsurance**, based in Bermuda, continues to be a major reinsurer of Lombard Insurance. In 1998, net premiums written were \$103.3 million. At year-end, the company had capital and surplus of \$115.1 million.

**Wentworth Insurance**, based in Barbados, was incorporated in 1990. In 1998, Wentworth's net premiums written were US\$3.2 million. At year-end, the company had capital and surplus of US\$175.5 million and there were 7 employees.

### **Odyssey Re Group**

The company's international reinsurance operations are carried out through Odyssey Re Group with subsidiaries in New York, London, Bermuda, Paris, Stockholm, Toronto and Dublin, with a branch in Singapore. In 1998, net premiums written were US\$665.1 million. At year-end, the Group had consolidated capital and surplus of US\$1,156.4 million. Odyssey Re Group has the following operating subsidiaries:

**Odyssey Reinsurance**, based in New York, writes property and casualty reinsurance in the United States and Canada. The company was established in 1918 and in 1998, net premiums written were US\$212.8 million. At year-end, the company had capital and surplus of US\$448.9 million and there were 152 employees.

**Odyssey Re London** and **Odyssey Re Bermuda** (formerly Sphere Drake) write traditional and alternative reinsurance and specialized insurance. The company was established in 1948 and in 1998, net premiums written were US\$216.0 million. At year-end, the company had capital and surplus of US\$324.6 million and there were 219 employees.

**Compagnie Transcontinentale de Réassurance (CTR)**, based in Paris (with a branch in Singapore), writes primarily property, casualty and some life reinsurance internationally. The company was established in 1951 and in 1998, net premiums written were FF1,172.7 million (approximately FF4 = C\$1). At year-end, the company had capital and surplus of FF1,130.5 million and there were 154 employees.

**Odyssey Re Stockholm** writes property and casualty reinsurance in the Nordic countries and Latin America and manages a runoff reinsurance portfolio retained when the company (then called Skandia International) was acquired. At year-end, the company had capital and surplus of SEK1,029.9 million (approximately SEK5 = C\$1) and there were 19 employees. Odyssey Re Stockholm was acquired on September 4, 1998.

**ORC Re**, based in Dublin, Ireland, was established in 1997 and writes selected long term property and casualty reinsurance. At year-end, the company had capital and surplus of US\$1,048.0 million and there were 4 employees.

***Claims adjusting subsidiary***

**Lindsey Morden Group** is engaged in providing claims adjusting, appraisal and loss management services to a wide variety of insurance companies and self-insured organizations in Canada, the United States, the United Kingdom, continental Europe, the Far East, Latin America and the Middle East. In 1998, revenue totalled \$294.8 million. The company was established in 1923, and at year-end the group had 4,767 employees located in 460 offices.

***Investment management subsidiary***

**Hamblin Watsa Investment Counsel** provides discretionary investment management, primarily to pension funds and insurance companies, including the insurance and reinsurance company subsidiaries of Fairfax. Hamblin Watsa was founded in 1984, and at year-end managed approximately \$12 billion.

*Note: All companies are wholly owned except Lindsey Morden Group, a public company of which Fairfax owns 53% of the equity and 82% of the votes.*

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## **To Our Shareholders**

With the help of strong financial markets *again*, we earned 20.1% on average shareholders' equity in 1998 (versus approximately 3.2% for the TSE 300). Net income after tax increased by 67% to \$388 million. After a 9% increase in shares outstanding, earnings per share increased by 51% to \$32.63 per share. Book value per share increased by 47% to \$185 per share and our share price followed suit, increasing 69% to \$540 per share. Given the number of catastrophes we faced in 1998 and our poor underwriting results, we were very fortunate to report the results we did.

Since we began in 1985, thirteen years ago, our book value per share has compounded at 41% annually, while our stock price has compounded at 48% (both not repeatable in the future). During this time period, Fairfax has averaged a return on average equity of 20.4%, in excess of our objective and in excess of all but 3 companies on the TSE 300 and 57 companies on the S&P 500. So you can see, earning 20% on equity over time is very difficult – particularly with a much larger equity base. You may be interested to know that over the last thirteen years, there is only one Canadian company and two U.S. companies whose stock price has compounded at a rate faster than ours. That's one for the history books and will not help you in the future – as we will be very pleased if we can compound at rates less than half our historical rates.

While we are very gratified by these results, we are even more grateful for the fact that they were achieved by treating our customers, employees and shareholders – and others that we deal with – in a fair and friendly way. As we said in our 1995 Annual Report, “This approach to business may penalize our results in the short term, but it is the only one we feel comfortable with and the way you can expect us to behave in the future.” However, I would caution certain readers of this report not to mistake our approach to business as a sign of weakness – as it definitely is not!

In terms of growth, Fairfax had one of those jet-propelled years that we have had only twice before (1986 and 1990). Investments and net premiums written on an annualized pro forma basis just about tripled in 1998 because of the acquisitions of Skandia International, Crum & Forster (CFI) and TIG. You may well be suspicious that we mistake frenetic activity for results!

In our letter to you on May 19, 1998, we discussed the purchase of CFI and Skandia International and, in case some of you missed it, we have reprinted it for you in the Appendix. Please read it carefully as it not only outlines the reasons for our purchase but also the risks involved. The risks are many at CFI but with the strong leadership of Bob Rich and Jim Stark, we feel comfortable that this will be a very significant opportunity for us.

By the way, Jan Wangård, the President of Skandia International, was the Chief Financial Officer of Skandia Insurance, Sweden when we purchased its subsidiary, Skandia America (now Odyssey Reinsurance, New York). We very much liked Jan when he was on the opposite side of the negotiating table but much prefer to have him on our side. We welcome Bob Rich, Jim Stark and the employees of CFI as well as Jan Wangård and the employees of Skandia International (now named Odyssey Re Stockholm) to the Fairfax Group.

Late in 1998, we announced the purchase of TIG Holdings, Inc., a NYSE-listed insurance holding company, for US\$16.50 per share in cash or US\$847 million for the whole company. TIG Holdings owns two main subsidiaries: TIG Insurance, based in Dallas, Texas, which writes

primarily commercial insurance of US\$1 billion net, and TIG Reinsurance which writes approximately US\$0.4 billion net. TIG Holdings has investment assets of approximately US\$3.9 billion and book value of US\$1.1 billion (approximately US\$22.10 per share). TIG Holdings will be the second public company that Fairfax has purchased.

So why are we buying TIG Holdings? The major reasons are:

- 1) The addition of TIG Re to the Odyssey Re Group makes our reinsurance operations among the largest in the U.S. broker reinsurance market. With capital in excess of US\$1.6 billion and net premiums written in excess of US\$1.1 billion worldwide, Odyssey Re has become one of the largest reinsurance groups in the world. TIG Re's business is primarily in the U.S. but it does have a branch in the U.K., two Lloyds syndicates and a small Latin American operation with an office in Chile. Also, TIG Insurance adds approximately US\$1 billion in premiums to our approximately US\$0.9 billion base of U.S. commercial insurance premiums, putting Fairfax among the 15 largest commercial insurance groups in the U.S. Both TIG Re and TIG Insurance have many specialized commercial lines (though in this soft market it does not make much difference!) that will be a long term benefit to us. Both TIG Re and TIG Insurance are currently rated A by both A.M. Best and S&P.
- 2) We very much like the management of the subsidiaries of TIG Holdings. Michael Wacek, President and Chief Executive Officer of TIG Re, and Roland Jackson, Chief Financial Officer, have been at TIG Re for less than a year but have excellent long term records with their previous employers. As TIG Insurance was managed by the holding company in New York and the President decided not to join us, Courtney Smith will be the new President of TIG Insurance. Courtney comes to TIG Insurance with a very successful track record of underwriting profitability with Coregis.
- 3) Similar to our other acquisitions, TIG Holdings provides Fairfax with business and investment diversification.
- 4) The discount to book value of US\$5.60 per share or US\$280 million provides significant downside protection from reserve development or reinsurance recoverable bad debt. TIG insurance also has a US\$90 million indemnity from Transamerica for environmental and asbestosis exposure which has yet to be used. Unlike our other recent acquisitions, TIG has very little exposure to these long tail liabilities. I hope you are not disappointed!!
- 5) With a combined ratio of about 105% and TIG's investment portfolio of US\$3.9 billion, Fairfax should achieve its 20% objective on its purchase price of US\$847 million.
- 6) We were able to raise financing for the purchase of TIG on fair terms which made Fairfax's financial position even stronger.

As with any acquisition, there are risks and the main ones are discussed below:

- 1) TIG Holdings has a mediocre track record with a combined ratio of 108.5% since going public in 1993. Excluding the onetime US\$145 million increase in reserves in 1997 though, TIG Holdings has had a combined ratio of 106.6% (107.7% at TIG Insurance

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and 104.3% at TIG Re). All in all, return on shareholders' equity from 1994 to 1998 has averaged only 6.8%.

- 2) TIG Insurance does its business through managing general agents who have the ability to bind the company. In insurance jargon, we have "given the pen" to our key agents. This can be very risky as the agent perhaps has less incentive to focus on underwriting profit. TIG Insurance minimizes this risk by being very selective in the choice of agents and by having very strong controls to ensure underwriting profitability.
- 3) In the insurance and reinsurance business there is always the possibility of reserve development from the past and reinsurance recoverable bad debt coming to haunt us. Our analysis of TIG's reserves and reinsurance recoverable suggests that we have more than adequate protection from worst case events from the discount to book value but what else would a buyer say? Again, only time will tell and sometimes, as you will read later, it is not a good story!
- 4) There is always the risk of growing too quickly. We think not, because of the excellent people who will be joining the Fairfax group through the purchase of TIG Holdings and also because of additions to the head office (reluctantly!) – but it's something we are very conscious of!

We raised financing for the purchase of TIG Holdings by the issue of 2 million shares of Fairfax at \$500 per share to raise \$1 billion or \$960 million net. To put this financing in perspective, the 2 million shares we sold in 1986 raised us only \$20 million! It took us months to raise the \$20 million in 1986 while the \$1 billion took us a week from the announcement of our purchase of TIG Holdings (\$800 million the next day!) – and perhaps rightly so, because our shares were a lot more risky at \$10 than at \$500 per share. We have always said that we considered our shares as good as cash and this was demonstrated again in 1998. Since that issue in 1986, that they perhaps should not have done, Dick Falconer and CIBC Wood Gundy have led our equity issues, ably supported by Nesbitt Burns, ScotiaMcLeod, RBC Dominion Securities, Merrill Lynch, TD Securities, First Marathon, Deutsche Morgan Grenfell and Newcrest Capital.

Our bond issue for the purchase of CFI was led by CS First Boston and strongly supported by Deutsche Morgan Grenfell, Citicorp and Salomon Smith Barney. We thank our Canadian and U.S. investment dealers for doing an excellent job for us again and welcome our new shareholders and bondholders to the company. We received our first A- rating for our senior debt in 1998 from DBRS. As emphasized in the past, *ad nauseam*, our company is run for the *long term* benefit of our shareholders while maintaining a very strong financial position which will benefit our bondholders. The emphasis though is 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.

Please don't forget what we said in our 1996 Annual Report, "We have been fortunate not to have had any short term (read quarterly) surprises but I'm sure they will come one of these days!" And, unlike prevailing practice in the financial markets, you will *not* get a "profits warning" announcement from us. To further dampen your expectations, we suggest you read

our old Annual Reports that list all the mistakes we have made in the past (even I don't do that with a full stomach!).

By way of perspective, the table below shows you how significantly we have grown in the past five years:

<b>As of December 31</b>	<b>1993</b>	<b>1998*</b>	<b>Increase</b>
	<i>(\$ billions except share and per share data)</i>		
Net premiums written	0.15	5.5	37x
Investment portfolio	0.80	18.0	23x
Shareholders' equity	0.30	3.2	11x
Net debt	0.10	1.5	15x
Shares outstanding (millions)	8.0	14.1	2x
Investments per share (\$)	107	1,300	12x
Book value per share (\$)	35	225	6x

*\* Pro forma for CFI and TIG*

While this growth is mind-boggling even for us, the bad news is that it was not based on a "vision" statement or long term plan that we have at Fairfax (I have checked but have yet to find it!). This, of course, means that this growth *cannot* be extrapolated in the future (we will own the world if it is!). However, it does mean that with a premium base of \$5.5 billion, an investment portfolio of \$18 billion and excellent management at our operating subsidiaries, we have a sound base of operations to deliver 20%+ return on equity to our shareholders in the long term with no acquisitions. I'm not saying we won't make any more though if the stars and the moon are all in alignment!

While all this activity took place in the past five years, there have been no additions to our small staff at Fairfax (with the one exception of Francis Chou in 1996) since 1989! Isn't that difficult to believe? Fortunately, John Varnell and Rick Salsberg decided to add Trevor Ambridge and Brad Martin in 1998. Trevor Ambridge was a partner at Coopers & Lybrand for thirteen years and more importantly had been the partner on our account for ten years, while Brad Martin was a partner at Tory Tory (our lawyers) for four years and on our account for five years. We are extremely fortunate that these two individuals have joined Fairfax and, along with Rick Salsberg, John Varnell, Brenda Harvey, Sam Chan, Ronald Schokking and Francis Chou, rest assured we have significant unused capacity for growth if it comes our way!

After being Chief Financial Officer for the past ten years, John Varnell decided to pass the mantle on to Trevor Ambridge as he spearheaded a new initiative for Fairfax. During 1998, The Hub Group Ltd. was created which owns eleven insurance brokers in Canada with 50 offices, 700 employees and approximately \$60 million in commission revenues. The company raised \$50 million in early 1999 through an IPO and private warrant issue with Fairfax having a 45% interest. John Varnell is the Chairman of The Hub Group, representing our interests, while Rick Gulliver is the President and Chief Executive Officer of the company. This is a very strategic holding (i.e. forever) for us and the company has excellent long term growth prospects with John and Rick at the helm. John will continue to oversee our Canadian operations while Trevor and Francis watch over our non-Canadian operations. I continue to be amazed at what

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a few capable, hardworking, trusted individuals can accomplish working together as a team with no egos.

Over the years, I have mentioned many times (1986, 1995 and 1997) that you have a major short term disadvantage by my controlling all the multiple voting shares. You cannot grow rich quickly by buying Fairfax shares as my shares (should I say votes!) are not for sale as we are building our company over the next 20+ years. Also, we have said that none of our subsidiaries is for sale, irrespective of price. This major negative for you is a very significant positive for our subsidiaries, as today we are one of the very few companies in the P&C industry (for that matter, any industry!) that can escape the trauma of being swallowed up in the current merger and acquisitions activity which is not limited by size. Thus, many of our much larger competitors in the U.S. (and elsewhere) are fearful for their independence and sometimes, as a defensive move, make uneconomic acquisitions. We will not *knowingly* make uneconomic acquisitions and our managements can truly build for the long term unencumbered by fears about their company being sold.

Also rest assured that the experience at Oshawa Group will never take place at Fairfax. When that company was taken over in 1998, the multiple voting shares were purchased at \$116 per share while the non-voting shares received \$36 per share (a 69% discount). We continue to be surprised at the atrocities that take place in the marketplace.

The table below shows the sources of our net earnings.

	<b>1998</b>	<b>1997</b>
	<i>(\$ millions)</i>	
Insurance underwriting	(311.4)	(56.2)
Interest and dividends	<u>432.0</u>	<u>242.3</u>
<i>Total</i>	120.6	186.1
Realized gains	440.8	206.8
Claims adjusting (Fairfax portion)	12.4	1.8
Interest expense	(84.4)	(43.2)
Goodwill and other amortization	(5.0)	(4.8)
Corporate overhead and other	<u>(15.9)</u>	<u>(15.0)</u>
Pre-tax income	468.5	331.7
Less: taxes	<u>81.0</u>	<u>99.2</u>
Net earnings	<u>387.5</u>	<u>232.5</u>

The table shows you the results from our insurance (underwriting and investments) and non-insurance operations. *In this report, insurance operations include reinsurance operations.* Claims adjusting shows you our share of Lindsey Morden's after-tax income. Goodwill and other amortization includes Hamblin Watsa goodwill (\$1.4 million) and amortization from Ranger (\$3.6 million). The corporate overhead expense is net of Hamblin Watsa's pre-tax income and interest income on Fairfax cash balances and includes one time expenses associated with our acquisitions and our issues of securities (don't worry – overhead at Fairfax has not increased much). Shown separately are realized gains so that you can better understand our earnings from our operating companies. Also, please note the unaudited financial statements of our

combined insurance operations and of Fairfax with Lindsey Morden equity accounted, as well as Lindsey Morden's financial statements, shown on pages 68 to 73.

The increase in underwriting losses in 1998 was largely due to Ranger (\$114.3 million) again as well as Odyssey Re Group (\$154.6 million). Catastrophes significantly impacted us in 1998 as Hurricanes Georges and Mitch cost us \$28 million and the Quebec ice storm \$16 million. Interest and dividend income, as well as interest expense, increased because of the Odyssey Re London and Bermuda acquisition late in 1997 and the CFI acquisition in 1998. Lindsey Morden's contribution was at a record level while corporate overhead and other increased slightly. Realized gains were more than twice the record 1997 levels, more than offsetting the increase in underwriting losses, and were the main reason for the increase in earnings in 1998. Fairfax's effective tax rate was 18% in 1998 mainly reflecting tax-free Canadian dividend income and international operations and capital gains with lower tax rates.

Book value per share increased from \$125.38 to \$184.54 per share, approximately half from earnings and half from our share issue.

### **Insurance operations**

The table below shows the combined ratios of each of our companies for 1997 and 1998. As you can see, 1998 was a very poor year for our underwriting operations. Even Commonwealth had a difficult year! Our Canadian insurance operations had a combined ratio higher than the 100.0% in 1997. Ranger was a disaster with a combined ratio before internal stop loss of 156.8% (146.0% after an internal stop loss treaty). CFI, excluding accounting adjustments, was running at 116.6% for the approximately five months since we acquired it. Odyssey Re Group also had a poor year with a combined ratio of 115.6%. While the insurance industry was as competitive as ever, our performance in 1998 was significantly worse than the industry.

	<b>1998</b>	<b>1997</b>
	%	%
Commonwealth	108.5	88.8
Federated	100.1	97.4
Lombard	102.8	102.8
Markel	106.8	103.0
<i>Total Canadian insurance</i>	<i>105.2</i>	<i>100.0</i>
Ranger	146.0	112.1
CFI	116.6	-
<i>Total U.S. insurance</i>	<i>123.2</i>	<i>112.1</i>
Odyssey Re Group*	115.6	104.7
<i>Total reinsurance</i>	<i>115.6</i>	<i>104.7</i>
<i>Total</i>	<i>113.0</i>	<i>103.8</i>

\* includes Odyssey Re London and Bermuda for one month in 1997

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Commonwealth, led by John Watson, hit an air pocket in 1998, mainly due to an oil drillers'/ operators' extra expense program that had gross losses of \$30 million for a net impact of \$12.6 million. Commonwealth had a combined ratio of 108.5%. Hurricane Georges also cost the company \$5 million net.

In 1998, Commonwealth's gross premiums written dropped by 17% to \$196 million, while net premiums written dropped by 12% to \$73 million. Commonwealth earned \$15.6 million after taxes.

Federated, under John Paisley's leadership, had another excellent year in 1998 with a combined ratio of 98.0% for the property and casualty company (100.1% including the life operations). John and his management team have had combined ratios of less than 100% in eight of the last nine years in the property and casualty company.

In spite of the soft market, Federated's property and casualty company increased gross premiums written by 3% to \$62 million while net premiums written increased 3% to \$54 million. During the year, Federated's property and casualty company obtained four additional trade association recommendations for its target markets and retained over 90% of its commercial policyholders while reducing its expense ratio to 29.9% (from 31.4% in 1997). Federated Life also had a fine year with a 17% growth in premiums written. All in all, an excellent year for Federated. The company earned \$8.1 million after taxes in 1998 versus \$7.7 million in 1997.

In spite of the Quebec ice storm (\$8 million net), Byron Messier and his management team at Lombard had another very good year in 1998 – even though they just missed the 100% objective! Including the continuing high marketing costs for the Privilege 50 program, Lombard had a combined ratio of 102.8%. Excluding these marketing costs, Lombard had a combined ratio of 101.4% – commercial lines at 101.1% and personal lines at 104.4%.

Net premiums written from the Privilege 50 program increased by 79% to \$25 million in 1998 (versus \$14 million in 1997). While the loss ratio on the business was slightly higher in the 77% area, high marketing costs resulted in a combined ratio of 159% for this program. We continue to expect this to be a good program for Lombard and its customers in the future.

Lombard's gross premiums written (including CRC (Bermuda)) increased by 4% in 1998 to \$523 million, while net premiums written increased by 5% to \$485 million. Net income after taxes dropped by 37% to \$52 million due to lower realized gains.

As mentioned in last year's Annual Report, Falcon, our Hong Kong company, was established in January 1998 with Kenneth Kwok at the helm. With an A- rating from S&P, Falcon should gradually begin to establish itself in the Hong Kong marketplace. Kenneth works closely with Byron Messier and Kim Tan from Lombard.

Markel's combined ratio of 106.8% in 1998 was slightly higher than in recent years due mainly to an extraordinary frequency of large losses and also due to its trucking line's very competitive market conditions. Excluding the impact of these extraordinary losses, Markel's portfolio continued to run smoothly with a normalized combined ratio of 101.6% for 1998. Overall frequency remained consistent with prior years. While gross premiums written increased by

5% to \$77 million, net premiums earned decreased 15% to \$56 million. Net income after taxes decreased by 21% to \$5.9 million because of lower realized gains.

Over the past four years under the leadership of Mark Ram's team, Markel has written \$350 million of business at a cumulative combined ratio of 103.8%. The company continues to post conservative reserves. Although Markel's niche has never been an easy one, the company continues to lead the Canadian long-haul trucking insurance market with an unparalleled level of service and the highest combination of ratings of any insurer in the line. Once again, Markel's insureds agreed with the Markel philosophy, as over 88% chose to remain with the company in 1998. Markel remains focused on the long term, working to define Canadian transportation insurance for the next decade.

Ranger had a disastrous year in 1998 – the worst year in its history and the worst results of any company under our stewardship over the past 13 years! Ranger had a combined ratio before internal stop loss of 156.8% (146.0% after an internal stop loss treaty) – and after I said last year that I thought they were close to 100%! The company had the largest single fire loss in its history (gross US\$46 million; net US\$5 million) in 1998 and case under-reserving problems surfaced *again*. We increased case reserves by US\$48 million in 1998 – after my comment to you that we felt we were well reserved at year-end 1997.

Bob Rich has made many significant management changes at Ranger and hired Phil Broughton as President as he moved on to join CFI as Chairman and CEO.

Ranger's underwriting loss in 1998 was \$114.3 million; after investment income, the company lost \$58 million after taxes – another record that Fairfax could well do without! Ranger and I have been more optimistic about loss ratios than warranted as results of the company have clearly demonstrated. Ranger has been a problem child for us for five years now – it shows you that in spite of good intentions, insurance can be a very tough business! In 1999, Ranger will be downsizing significantly as Phil Broughton focuses on product lines that clearly have prospects for underwriting profit. I have said to you in the past that only time will tell – and in the case of Ranger, it is clearly not a good story! No predictions from me on Ranger – I will wait for the results to speak for themselves!

We closed our purchase of CFI on August 13, 1998. While the combined ratio in the second half for CFI was in excess of 115%, significant realized gains resulted in net income after taxes of \$185 million. Early in 1999, CFI announced a re-organization to better serve clients and reduce costs as it reduced the number of operating regions from 20 to 6. All affected associates of CFI will be well looked after in this reorganization. Bob Rich and Jim Stark are clearly focused on achieving a combined ratio of 110% in 1999, 106% in 2000 and 104% in the following year.

Odyssey Re Group completed its first full year of operation in 1998 with Jim Dowd as Chairman and Andy Barnard as President and CEO. Michael Watson was named Executive Vice President and Chief Operating Officer of the Group while Jan Wangård was appointed President and CEO of Odyssey Re London and Bermuda. Early in 1999, Michael Wacek from TIG Re became President and CEO of Odyssey Reinsurance (New York) as well, and Roland Jackson (CFO of TIG Re) became Group CFO. We have an excellent management team at

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Odyssey Re Group under Andy Barnard's leadership, which will focus on underwriting profit and building the company in the years to come.

In 1998, Odyssey Re Group had a combined ratio of 115.6% mainly because of Odyssey Re London and Bermuda's combined ratio of 129.2%. Excluding hurricanes and some extraordinary satellite losses, Odyssey Re Group had a combined ratio of 110.4%. Net income after taxes from the Group amounted to \$178 million. Andy is focused on steadily reducing the combined ratio of the Group.

During 1998, Odyssey Re Group added offices in Stockholm, Mexico City and Cologne (Germany). As well, our operations in Asia have advanced despite turbulent conditions in the region. Also during the year, North American Programs Division was created which realigns four underwriting divisions from three companies under common strategic management.

Our insurance companies are all well capitalized as shown on page 62. As suggested last year, "We continue to have significant unused capacity and it will continue to be unused as long as current conditions prevail."

As you know, it is our policy to have our reserves set at a level that results in redundancies in future years. How did we do in 1998? We provide extensive disclosure on our claims reserves beginning on page 44 in the MD&A. In Canada, our insurance companies had redundancies of \$2.5 million in 1998 while in the U.S. Ranger had a deficiency of US\$44 million. Our reinsurance companies had unfavourable development of US\$26 million, principally due to Odyssey Re London and Bermuda.

### **Claims adjusting**

Lindsey Morden was transformed in 1998 into one of the very few global loss adjusters in the world. Looking back, it is quite amazing what happened in 1998.

Let me give you a blow-by-blow account:

- 1) On May 8, 1998, Lindsey Morden announced the purchase of Hambro Insurance Services Group (HIS) for £88 million, a company with which, in 1994, it had created a worldwide loss adjusting and claims management network. In 1997, HIS had revenue of £111 million and pre-tax profit of £10.9 million. HIS owned:
  - (a) Cunningham Group, loss adjusters with 140 offices in the United Kingdom, Continental Europe, the Far East, the Middle East and Latin America;
  - (b) Hambro Assistance, one of the largest telephone help line services in the U.K.; and
  - (c) a one third interest in Oracle (a similar business to Hambro Assistance operating in Canada).

The purchase was financed through the issue of 4 million subordinate voting shares of Lindsey Morden (of which Fairfax took 2.5 million shares) at \$20 per share to raise \$78.1 million (net of commissions and expenses of issue) in equity capital and a \$125 million, 10 year unsecured debenture issue with a coupon of 7%, which realized net proceeds of \$123 million.

- 2) Hambro Assistance and Oracle were businesses in which Lindsey Morden had no experience and so they were sold for £51 million (£48 million in cash and £3 million in a 2 year note) and £8 million in Sykes' (the acquirer) shares respectively.
- 3) On October 30, 1998, Lindsey Morden purchased Ellis & Buckle, another premier adjuster in the U.K., owned by Rutland Trust, for £15 million in Lindsey Morden subordinate voting shares at \$20 per share and £45.75 million in unsecured notes. These notes were repaid by the cash from the Hambro Assistance sale. Ellis & Buckle has one of the best ten-year track records of any business that we have come across and is run by Gerry Loughney. Ellis & Buckle has been merged with the U.K. operations of Cunningham Group under Gerry's leadership.

Wow! Just writing that was difficult! While the whole management team at Lindsey Morden has done a wonderful job with strong support from Fairfax, these transactions would not have happened if not for Ken Polley, Ferd Roibas and Francis Chou from Fairfax. Ken Polley and Ferd Roibas have had to juggle many roles to get this transformation done and deserve a standing ovation from all shareholders. Francis Chou continues to help focus Lindsey Morden employees on free cash flow and the results are very dramatic. In 1998, Lindsey Morden's North American Operations generated a record free cash flow of \$8 million, a total of \$22 million in the three years since Francis got involved.

We now have a very strong management team at Lindsey Morden with Ken Polley, Ferd Roibas, Don Smith (North American Operations), Gerry Loughney and Andrew Lund (U.K.), Pim Polak Schoute (Europe) and Jim Grant (International). We welcome all of the employees of Cunningham Group and Ellis & Buckle indirectly to the Fairfax family. We also welcome Christopher Sporborg, formerly Chairman of HIS, Michael Langdon, Chairman of Rutland Trust, and Francis Chou to the Board of Lindsey Morden.

Because of record free cash flow and a very strong financial position, the Board of Lindsey Morden has decided to increase the dividend from \$0.60 per share in 1998 to \$1.00 per share in 1999. With very strong management, annualized revenues in excess of \$500 million, 460 branches all over the world and 4,767 employees, the best is yet to come from Lindsey Morden.

For shareholders who have been with the company since it went public in 1987 at \$10 per share, your patience is being (and will continue to be) rewarded. At \$30 per share, long term shareholders (i.e. since going public) have had capital appreciation of approximately 11% per year plus dividends. While this is less than our long term objective of 20%, it is much higher than the 4.5% capital return from the TSE 300 during the same period. For further information on the company, please read the annual report of Lindsey Morden, which you can obtain by phoning Ferd Roibas at (903) 561-6700 or (416) 596-8020.

### **Investment management**

While 1998 was another good year in the U.S. equity markets and marginally down in the Canadian equity markets, our equity results did not keep pace. Our bond results in 1998 continued to be excellent on both a relative and absolute basis.

The key, of course, is long term and as shown in the table below, HWIC has produced excellent results in all of the areas in which it provides investment management — Canadian and U.S. equities and Canadian and U.S. bonds. HWIC now shows 20 year results as the investment team, consisting of five partners, have worked together for over 24 years.

*Annualized rates of return (%)*

*Cumulative periods ended December 31, 1998*

	<b>5 years</b>	<b>10 years</b>	<b>15 years</b>	<b>20 years</b>
Canadian Equities	8.4	9.2	12.1	14.1
TSE 300	10.7	9.7	9.6	11.9
U.S. Equities	25.6	24.3	21.6	21.4
S&P 500	27.8	22.2	19.6	19.3
Canadian Bonds	11.2	13.4	—	—
SM Index	9.2	11.6	—	—
U.S. Bonds	7.9	10.8	—	—
ML Index	6.5	8.3	—	—
Balanced Fund	11.8	12.8	—	—

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

Total fees in 1998 were \$12.3 million, up from \$9.8 million in 1997 mainly because of the addition of Odyssey Re London and Bermuda and CFI. Fairfax earned a 49% pre-tax cash return in 1998 on its \$14 million investment in HWIC.

### **Financial position**

As mentioned in previous reports, we feel our unaudited balance sheet with Lindsey Morden equity accounted (shown on page 70 is the best way to understand our financial position. Here is what our year-end financial position looks like compared to the end of 1997. We have also shown our financial position with TIG on a pro forma basis (which does not reflect the approximately \$300 million of additional financing which will be raised to complete this acquisition).

	<b>1998 Pro Forma (with TIG)</b>	<b>1998</b>	<b>1997</b>
		<i>(\$ millions)</i>	
Cash and short term investments	305.4	305.4	207.1
Long term debentures	1,444.4	1,444.4	718.4
TIG obligations	375.0 <sup>(1)</sup>	—	—
Net debt	1,514.0	1,139.0	511.3
Common shareholders' equity	3,198.6	2,238.9 <sup>(2)</sup>	1,395.7
Net debt/equity	47%	51% <sup>(2)</sup>	37%
Net debt/total capital	32%	34% <sup>(2)</sup>	27%

*(1) Includes notes payable US\$100 million, capital preferred securities US\$125 million and preferred stock US\$25 million as debt (aggregate C\$375 million).*

*(2) Excludes \$959.7 million of equity raised by December 1998 stock issue in trust.*

As shown, common shareholders' equity, our capital, increased by \$843 million, \$455 million from a stock issue and \$388 million from net income. Long term debentures increased due to the US\$400 million debenture issue in connection with the purchase of CFI and the weakening of the Canadian dollar versus the U.S. dollar (this translation effect has no economic impact as our exposures are hedged). Our cash position at Fairfax increased significantly to \$305 million because of our earnings and because we reduced some of our excess capital at our insurance companies. Our net debt to equity and net debt to total capital ratios increased in 1998 because of two very significant acquisitions and the weakening of the Canadian dollar (as discussed above) but remained at acceptable levels.

As mentioned in last year's Annual Report, a very significant element of financial conservatism on our balance sheet is the negative goodwill (or as the accountants call it, excess of net assets acquired over purchase price) that is shown on our balance sheet. This item (\$227.8 million), together with additional provisions arising from our recent acquisitions (\$220 million), results in our "rainy day" cushion of \$447.8 million. With TIG, our "rainy day" cushion may well increase above \$900 million. These cushions, together with the remaining \$957 million of reserve/reinsurance unrecoverable protection that is not on our balance sheet, significantly protect our shareholders' equity from asset or liability deficiencies that may occur in the future.

As discussed in last year's Annual Report, we are required to amortize the excess of net assets acquired over their purchase price into income. We have reduced the amortization period from thirty to ten years and used this amortization (\$23 million) to offset the amortization of the cost of our S&P puts (\$36 million) discussed later in the Investments section.

Our financial position continues to be very strong for the same reasons that we discussed in our 1997 Annual Report. Briefly they are:

- 1) We have no bank debt. Our debt consists of six public debentures with a long term to maturity (5 years to 39 years) and low interest rates ( $6\frac{7}{8}\%$  to 8.30%) and three small 2 year, 5 year and 8 year debentures issued to vendors with STIBOR\*,  $7\frac{3}{4}\%$  and  $2\frac{1}{2}\%$  coupons respectively. All of this debt (except the STIBOR and  $2\frac{1}{2}\%$  debentures, which have comparable terms to the other debt) was issued under a single trust indenture containing no restrictive covenants, thus providing us with great flexibility. We have swapped the fixed interest rates on most of the public debentures (with the exception of the ones maturing in less than 10 years) into floating rates, saving approximately 71 basis points on average currently. Also, we swapped US\$125 million of our 7.375% debentures due April 15, 2018 for Japanese yen denominated debt of the same maturity with a fixed rate of 3.48% per annum (see note 5).
- 2) We have unused, unsecured, committed, long term bank lines in excess of \$1.3 billion with excellent covenants. These bank lines are with five Canadian, five U.S. and three European banks. In addition, we have LOC facilities in excess of \$100 million.

\* *Swedish interbank offered rate*

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- 3) Our net long term debt is less than three times our earnings base. Also, our earnings base is well diversified among many insurance and reinsurance companies, Lindsey Morden and HWIC and geographically from Canadian, U.S. and international sources of income.
  - 4) Available cash flow at the Fairfax (holding company) level from dividends, management fees and interest covers our expenses (administrative and interest) by about two times. This is based on normal dividend payouts from our insurance companies which are much less than our maximum dividend-paying capacity. Note Fairfax's parent company-only income statement on page 75.
  - 5) With \$305 million in cash in the holding company, we can pay our administrative and interest expenses at Fairfax, with *no* dividends from any of our insurance or reinsurance companies, for five to six years – our management holding company survival ratio!
  - 6) As discussed in the MD&A, our insurance companies are all over-capitalized with significant solvency margins in excess of mandated regulatory levels.
  - 7) Our foreign exchange exposure from our U.S. insurance and reinsurance companies has been fully hedged by the U.S. debenture issues and the purchase of foreign exchange contracts. We have done the same for CTR (in French Francs) and Odyssey Re London and Bermuda (in U.S. dollars).

### **Investments**

While 1997 was the best ever for realized gains, 1998 was even better! The unrealized gains as of year-end are shown below:

	<b>1998</b>	<b>1997</b>
	<i>(\$ millions)</i>	
Bonds	28.0	116.6
Preferred stocks	4.4	25.5
Common stocks	<u>(26.9)</u>	<u>(19.4)</u>
	<u>5.5</u>	<u>122.7</u>

We realized an amazing \$441 million in gains in 1998 – more than double the \$207 million in 1997 – and thank goodness we did because we would not have made our 20% return objective without it!! To put the realized gains in perspective, it took us 12 years to achieve cumulative realized gains of \$500 million – we achieved 88% of it in 1998 alone! While these realized gains are significant, they are less than 4% of our \$12 billion portfolio (excluding TIG). While some of you may look at the unrealized gains of less than \$6 million at year end 1998 and probably think that we have exhausted our realized gains potential, you may want to note that:

- (1) We have \$797 million invested in common stock on which we expect to make significant gains;
- (2) We have in excess of \$4 billion in “put” bonds (described in our 1997 Annual Report) that have significant upside potential if interest rates decline (limited downside if interest rates increase); and

- (3) We have US\$700 million in S&P Index puts that can result in large profits if the U.S. stock market declines significantly (please note: our letter to shareholders dated October 2, 1998 which describes these puts has been included in the Appendix).

As in the past, the timing of these potential realized gains is very uncertain but we very much expect to make them in the future. The approximately \$1 billion in realized gains that Fairfax has achieved over the past 13 years is one of the key reasons we entered the insurance business many years ago. We come to the insurance business with an investment mindset as opposed to an insurance mindset (focused on increasing market share), a key long term positive for Fairfax. With \$18 billion in investments after the acquisition of TIG Holdings (all marketable!) and an experienced investment team focused on identifying long term values wherever they are, we continue to expect to achieve significant realized gains in the long term.

The table on page 58 shows the return on our investment portfolio. Investment income (interest and dividends) increased again in 1998 due to Odyssey Re London and Bermuda and the purchase of CFI. Pre-tax investment income per share has increased from \$23.64 per share in 1997 to \$37.37 per share in 1998 and should increase again to about \$69 per share in 1999 because of CFI and TIG.

Gross realized gains totalled \$456 million. After realized losses of \$2 million and increased provisions of \$13 million, net realized gains were \$441 million. Net gains from fixed income securities were \$347 million while net gains from common stock were \$107 million.

The major contributors to stock realized gains were Kookmin Bank (\$26.2 million), FCA (\$12.8 million), Rothmans (\$8.5 million), Korea International Fund (\$4.0 million), Reitmans (\$3.5 million), Washington Post (\$3.1 million), St. Lawrence Cement (\$1.9 million), TransAlta (\$1.6 million) and Jannock (\$1.5 million).

I would rather not comment on one of my major mistakes in the past decade, but as full disclosure is one of our objectives, here are the gory details. In 1989, we purchased 2.2 million shares at \$10.25 per share of FCA, one of the largest credit collection companies in North America at that time. FCA had an excellent long term track record just prior to our purchase. Since our purchase, FCA never regained its position in the industry – in spite of our best intentions. We were fortunate to sell our position to NCO Group under their offer to all shareholders at \$9.60 per share – about the same price we paid for them almost a decade ago. We showed realized gains because we had written down our original cost of FCA. Another great investment by your Chairman! If I had invested that \$22.5 million in 1989 in Coca Cola shares at \$7.22 per share (adjusted for splits), your company would have \$236 million today as opposed to the same \$22.5 million. A very costly mistake, as you can see! We thank Ted Jarman, who became Chairman of FCA a few years ago, for his hard work at FCA and his help in the sale process. We wish John Moynan, Bob DiSante and the management and employees of FCA the very best in the future.

We continue to be very concerned about the level of the U.S. stock market as discussed in our 1996 and 1997 Annual Reports – even though the S&P 500 increased again by 26.7% in 1998. The possibility of deflation, mindless long term investing in mutual funds and a lack of investment “values” in the North American stock markets do not appear to bother most investors. In fact, speculation is rampant in the U.S. markets as demonstrated by the “internet”

stocks. America Online has a market cap that exceeds the total market cap of the five largest Canadian banks even though AOL has been a public company for only six years. Amazon.com has a market cap that is in excess of Sears (U.S.) even though Sears annually earns more than twice Amazon.com's revenues. Finally, Yahoo! has a market cap in excess of Boeing even though the latter has revenues of \$55 billion compared to Yahoo!'s \$190 million. The speculative juices are flowing freely in the U.S. but the music will stop and many investors (speculators!) will not have any chairs to sit on. *Caveat emptor!*

The following table from Barron's summarizes the key "Vital and Fatal" signs for the U.S. stock market.

<b>Vital and Fatal Signs</b>		
	<b>1982</b>	<b>1998</b>
Dividend yield	6.3%	1.6%
Price/book	1.1	5.0
Price/earnings	7	25
Value of NYSE/GDP	0.3	1.2
No. of equity mutual funds	320	2,500
No. of investment clubs	4,000	32,000

*Source: Barron's, October 12, 1998*

It is interesting to note that in 1982, with the market at seven times earnings and yielding 6.3%, there were very few "long term" investors. Currently, with the market at 25 times earnings (or higher!) and a dividend yield of less than 2%, there are masses of "long term" investors in the U.S. Please note again, the increase in equity mutual funds and the number of investment clubs. The U.S. equity market is "priced for perfection". There is virtually no margin of safety should there be any negative developments. Count us among the skeptics!!

We continue to have less than 7% of our investment portfolios in common shares and 93%+ of the portfolios in cash and good quality marketable bonds (92% of the bond portfolio in bonds rated A or above). By country, our common stock investments at December 31, 1998 were as follows:

	<b>Book value</b>	<b>Market value</b>
	<i>(\$ millions)</i>	
United States	195	198
Canada	182	155
Korea	168	213
Japan	158	137
Other Emerging Markets	94	68
	<u>797</u>	<u>771</u>

As shown, most of our common stock investments are outside North America — i.e. in Asia and Latin America — where we think the long term investment values are. Francis Chou, Chandran Ratnaswami and Paul Fink have been responsible for identifying the investment values outside North America and we expect to benefit greatly from these investments.

The “doomsday test” of violent market fluctuations on regulatory capital that we do monthly at Fairfax continues to show that all our companies meet this test. As previous comments indicate, we are concerned that our “doomsday” scenario may be tested some time soon.

### **Miscellaneous**

In 1998, Fairfax and its subsidiaries donated \$5.0 million (1% of pre-tax income) to a variety of charities across North America. When we began this policy in 1991, our annual donations amounted to \$200,000.

In the past two years, each of our Canadian subsidiaries has made a one-time significant donation to the charity of its choice in its community. This one-time gift will spread each year to the other communities where Fairfax operates across the world. Also, in 1999, Fairfax will fund 60 scholarships (based on merit and means) for university and community college education in Canada. We are very privileged to be able to invest in the communities in which we live.

Please review page 74 which is an unaudited unconsolidated balance sheet showing you where your money is invested. As you can see, we have \$1.8 billion invested in our insurance companies, \$1.6 billion invested in our reinsurance companies, \$8 million invested in Lindsey Morden (not including 6.2 million common shares with a carrying value of \$14.98 per share that are held by our reinsurance companies), \$5 million in HWIC and \$305 million in cash. Rumour has it that our investment in Noro is worth a lot more than shown on our books but unfortunately it is not for sale!

Our insurance and reinsurance companies and Lindsey Morden are carried at their underlying book value, i.e. very conservatively stated. Unfortunately, you will not see any short term bonanza as none of them is for sale — at any price! As we said last year, “As long term shareholders of Fairfax, you benefit greatly from the fact that all our presidents run their companies as their own with a loyalty and commitment that is unmatched in the industry. Any short term sale for a one time gain would destabilize this loyalty and commitment, ultimately resulting in lower long term returns for Fairfax.”

As you know, we have never had options at Fairfax but we have provided key officers of our companies with interest free loans to buy Fairfax shares in the marketplace (not treasury stock). At December 31, 1998, as note 10 shows, we had loans of \$28 million to purchase 409,142 shares at an average cost of \$68 per share. At a 6% interest rate, the annual after-tax cost to you is about \$1 million or 8¢ per share. Also, as described in our 1996 Annual Report, we have a very successful employee share purchase plan that allows employees to contribute up to 10% of their salary and the company matches 30% automatically, with a further 20% if Fairfax achieves its 20% ROE objective. If an employee with a salary of only \$20,000 had participated fully in the plan over the 11 years of its existence, he or she would have approximately 789 shares worth \$426,060 at the end of 1998! We like our management and employees to be owners of the company so as to benefit from that ownership over the long term.

We said in our 1995 Annual Report that you should sell Fairfax if we ever made the TSE options list. In 1998, we continued to have very few shares traded on the TSE compared to other listed

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companies. During 1998, 3.5 million shares of Fairfax were traded on the TSE or 33% of the float. When compared to all companies listed on the TSE 300, Fairfax's turnover (shares traded as a percentage of the float) continued to rank in the bottom 10%. Interestingly enough, compared to the companies listed on the S&P 500, Fairfax's turnover ranked in the bottom 3%. Thus, even though we are the 25th largest company in Canada, we did not make the S&P/TSE 60 – a happy occurrence! The other measure that indicates to us that we have attracted shareholders with a long term horizon is that I have yet to see Fairfax appear in the monthly listing of shares that are sold “short” on The Toronto Stock Exchange. Our focus continues to be on the long term.

The strengths that Fairfax has to achieve its 20% return on equity objective over time have not changed since we listed them for you last year. Neither have the risks – that we have again listed for you on page 64.

In late 1998, Steven Markel and I, to neither of our surprise, decided that the time had come to step off each other's boards as our companies were running into each other in the U.S. Steven Markel has been on the Fairfax board even longer than I have as his family began the business in Canada in 1951. Markel Corporation has been hugely successful in the U.S. and we consider Steven Markel one of the founders of our company. Steven's integrity, experience and strong support were among the key reasons for the birth of Fairfax in 1985 and its continued success in the 13 years following. While Steven and I continue to be very good friends, we will miss his wise counsel at our board meetings. We wish Steven and Markel Corporation great success in the future – unless they are competing against our companies!

Robbert Hartog, Chairman of the Audit Committee, turned 80 early in 1999. Trevor Ambridge and John Varnell are waiting for Robbert to slow down so they can keep up! I wouldn't bet on it!

Our Annual Meeting last year at the Metro Toronto Convention Centre worked out well because many of you came and your questions benefitted all shareholders. While we cannot answer your questions on the telephone, we look forward to answering them all at our Annual Meeting – which will be held at 4:30 p.m. on Tuesday, April 13, 1999 in Room 106 at the Metro Toronto Convention Centre. Again, on your behalf, I would like to thank the board and the management and employees of all of our companies for another 20% year.

March 1, 1999



**V. Prem Watsa (signed)**  
*Chairman and  
Chief Executive Officer*

## Consolidated Financial Statements

for the years ended December 31, 1998 and 1997

### Consolidated Balance Sheets

as at December 31, 1998 and 1997

	<b>1998</b>	<b>1997</b>
	(\$000)	(\$000)
<b>Assets</b>		
Cash and short term investments .....	245,999	207,104
Marketable securities .....	59,366	-
Share subscription receipts cash in trust (note 6) .....	959,700	-
Accounts receivable and other .....	2,777,788	1,706,536
Recoverable from reinsurers (note 7) .....	3,820,426	2,164,466
Income taxes refundable .....	7,109	31,448
	<u>7,870,388</u>	<u>4,109,554</u>
<i>Portfolio investments (note 2)</i>		
Subsidiary cash and short term investments (market value - \$896,248; 1997 - \$823,762) .....	896,248	823,762
Bonds (market value - \$9,887,952; 1997 - \$3,970,151) .....	9,859,921	3,853,505
Preferred stocks (market value - \$159,337; 1997 - \$297,101) .....	154,980	271,642
Common stocks (market value - \$770,512; 1997 - \$565,627) .....	797,400	585,063
Real estate (market value - \$94,460; 1997 - \$54,627) .....	94,460	54,627
Total (market value - \$11,808,509; 1997 - \$5,711,268) ....	<u>11,803,009</u>	<u>5,588,599</u>
Deferred premium acquisition costs .....	277,292	220,113
Deferred income taxes (note 8) .....	523,977	169,445
Capital assets .....	94,588	54,434
Goodwill .....	276,400	41,320
Other assets .....	41,040	23,804
	<u>20,886,694</u>	<u>10,207,269</u>

Signed on behalf of the Board

*V. P. Watsa*

V. Prem Watsa (signed), Director

*Robert Hartog*

Robert Hartog (signed), Director

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	<b>1998</b> (\$000)	<b>1997</b> (\$000)
<b>Liabilities</b>		
Bank indebtedness .....	–	594
Share subscription receipts (note 6) .....	959,700	–
Accounts payable and accrued liabilities .....	880,211	282,516
Premium deposits .....	97,443	105,708
	<u>1,937,354</u>	<u>388,818</u>
Provision for claims (note 3) .....	13,161,215	6,322,737
Unearned premiums .....	1,651,498	1,113,842
Contingent value rights (note 4) .....	–	45,988
Long term debt (note 5) .....	1,582,066	735,563
	<u>16,394,779</u>	<u>8,218,130</u>
Non-controlling interest .....	87,908	20,509
Excess of net assets acquired over purchase price .....	227,803	184,097
 <b>Shareholders' Equity</b>		
Capital stock (note 6) .....	1,222,339	766,739
Retained earnings .....	1,016,511	628,976
	<u>2,238,850</u>	<u>1,395,715</u>
	<u>20,886,694</u>	<u>10,207,269</u>

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**Consolidated Statements of Earnings***for the years ended December 31, 1998 and 1997*

	<b>1998</b> (\$000)	<b>1997</b> (\$000)
<b>Revenue</b>		
Gross premiums written .....	2,966,376	1,883,560
Net premiums written .....	2,276,607	1,392,627
Net premiums earned .....	2,394,851	1,460,641
Interest and dividends (note 2) .....	443,838	254,562
Realized gains on investments (note 2) .....	440,785	206,773
Claims fees .....	294,843	166,331
	<u>3,574,317</u>	<u>2,088,307</u>
<b>Expenses</b>		
Losses on claims .....	1,889,412	1,034,665
Operating expenses .....	667,950	408,187
Commissions, net .....	442,205	264,790
Interest expense .....	89,966	44,703
	<u>3,089,533</u>	<u>1,752,345</u>
<b>Earnings before income taxes</b> .....	484,784	335,962
Provision for income taxes (note 8) .....	86,362	102,261
Earnings from operations .....	398,422	233,701
Non-controlling interest .....	(10,887)	(1,203)
<b>Net earnings</b> .....	<u>387,535</u>	<u>232,498</u>
<b>Net earnings per share</b> (note 12) .....	\$ 32.63	\$ 21.59

**Consolidated Statements of Retained Earnings***for the years ended December 31, 1998 and 1997*

	<b>1998</b> (\$000)	<b>1997</b> (\$000)
<b>Retained earnings – beginning of year</b> .....	628,976	397,672
Net earnings for the year .....	387,535	232,498
Excess over stated value of shares purchased for cancellation (note 6) .....	–	(1,194)
<b>Retained earnings – end of year</b> .....	<u>1,016,511</u>	<u>628,976</u>

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## Consolidated Statements of Changes in Cash Resources

for the years ended December 31, 1998 and 1997

	<b>1998</b> (\$000)	<b>1997</b> (\$000)
<b>Operating activities</b>		
Earnings from operations .....	398,422	233,701
Amortization .....	8,975	6,578
Deferred income taxes .....	10,555	24,704
Gains on investments .....	(440,785)	(206,773)
	(22,833)	58,210
Increase (decrease) in:		
Provision for claims .....	935,536	143,792
Unearned premiums .....	(109,050)	22,006
Marketable securities .....	(59,366)	-
Accounts receivable and other .....	(53,266)	(99,732)
Recoverable from reinsurers .....	(491,954)	(66,141)
Income tax refundable .....	24,339	(5,791)
Accounts payable and accrued liabilities .....	169,837	28,923
Other .....	(40,702)	153,272
Cash provided by operating activities .....	352,541	234,539
<b>Investing activities</b>		
Investments – purchases .....	(8,983,257)	(2,046,201)
– sales .....	8,277,759	2,029,078
Purchase of capital assets .....	(12,467)	(25,326)
Purchase of subsidiaries, net of cash acquired .....	(774,936)	(215,199)
Cash used in investing activities .....	(1,492,901)	(257,648)
<b>Financing activities</b>		
Capital stock transactions (note 6) .....	455,600	244,783
Increase in long term debt (note 5) .....	740,223	198,414
Change in non-controlling interest .....	56,512	(1,694)
Cash provided by financing activities .....	1,252,335	441,503
<b>Increase in cash resources</b> .....	111,975	418,394
<b>Cash resources – beginning of year</b> .....	1,030,272	611,878
<b>Cash resources – end of year</b> .....	1,142,247	1,030,272

Cash resources consist of cash and short term deposits.

February 3, 1999

**Auditors' Report to the Shareholders**

We have audited the consolidated balance sheets of Fairfax Financial Holdings Limited as at December 31, 1998 and 1997 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 in Canada. 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, 1998 and 1997 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 in Canada.



PricewaterhouseCoopers LLP (signed)  
Chartered Accountants  
Toronto, Ontario

February 3, 1999

**Valuation Actuary's Report**

PricewaterhouseCoopers LLP has reviewed management's valuation, including management's selection of appropriate assumptions and methods, of the policy liabilities of the subsidiary insurance and reinsurance companies of Fairfax Financial Holdings Limited in its consolidated balance sheet at December 31, 1998 and their change as reflected in its consolidated statement of earnings for the year then ended, in accordance with accepted actuarial practice.

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

Under accepted actuarial practice, the valuation of policy liabilities reflects the time value of money. Management has chosen not to reflect the time value of money in its valuation of the policy liabilities.



PricewaterhouseCoopers LLP (signed)  
Richard Gauthier, FCIA, FCAS  
Toronto, Ontario

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## Notes To Consolidated Financial Statements

for the years ended December 31, 1998 and 1997

(in \$000s except per share amounts and as otherwise indicated)

### 1. Summary of Significant Accounting Policies

The preparation of financial statements in accordance with generally accepted accounting principles requires management to make estimates and assumptions that affect reported amounts of assets and liabilities and disclosures of contingent assets and liabilities as at the date of the financial statements and the reported amounts of revenue and expenses during the periods covered by the financial statements. Actual results could differ from those estimates.

#### *Business operations*

The company is a financial services holding company which, through its subsidiaries, is principally engaged in property and casualty insurance conducted on a direct and reinsurance basis, investment management and insurance claims management.

#### *Principles of consolidation*

The consolidated financial statements include the accounts of the company and all of its subsidiaries:

#### **Insurance**

Commonwealth Insurance Company  
Crum & Forster Holdings, Inc.  
Falcon Insurance Company Limited  
Federated Insurance Holdings of Canada Ltd.  
Lombard General Insurance Company  
of Canada  
Markel Insurance Company of Canada  
Ranger Insurance Company

#### **Reinsurance**

CRC (Bermuda) Reinsurance Limited  
Odyssey Re Group Ltd., consisting of:  
Odyssey Reinsurance Corporation  
Compagnie Transcontinentale de  
Réassurance  
Odyssey Re (London) Limited  
Odyssey Re (Bermuda) Limited  
Odyssey Re (Stockholm) Insurance  
Corporation (publ)  
ORC Re Limited  
Wentworth Insurance Company Ltd.

#### **Other**

Hamblin Watsa Investment Counsel Ltd. (investment management)  
Lindsey Morden Group Inc. (insurance claims management)

All subsidiaries are wholly-owned except for Lindsey Morden with a 53% equity and 82% 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 and reinsurance premiums are taken into income evenly throughout the terms of the related policies.

*Deferred premium acquisition costs*

Certain costs, consisting of brokers' commissions and premium taxes, of acquiring insurance premiums are deferred, to the extent that they are considered recoverable, and charged to income as the premiums are earned. The ultimate recoverability of deferred premium acquisition costs is determined without regard to investment income.

*Investments*

Bonds are carried at amortized cost providing for the amortization of the discount or premium on a straight line basis to maturity. Bonds are classified at the earliest of the available maturity dates. Preferred and common stocks are carried at cost. Real estate is carried at book value. 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, 1998, the aggregate provision for losses on investments was \$22.9 million (1997 – \$27.8 million).

The company purchases foreign currency forward contracts to hedge its foreign equity portfolio. At December 31, 1998, the company held JPY 22.4 billion of such contracts, maturing in 2002 and 2003. The unrealized gain or loss on these contracts is included in the determination of the unrealized gain or loss on the foreign equity portfolio. Once the securities are sold, the contracts are closed out and any gain or loss is then included in realized gain or loss on sale of investments.

*Provision for claims*

Claim provisions are established by the case method as claims are reported. For reinsurance, the provision for claims is based on reports and individual case estimates received from ceding companies. The estimates are regularly reviewed and updated as additional information on the estimated claims becomes known and any resulting adjustments are included in income. 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.

*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 transactions are recognized in the statements of earnings.

The operations of the company's subsidiaries (principally in the United States, France and the U.K.) are self-sustaining. As a result, the assets and liabilities of these subsidiaries are translated at the year-end rates of exchange. Revenue and expenses are translated at the average rate of exchange for the years. The company enters into foreign currency contracts from time to time to hedge the foreign currency exposure related to its net investments in self-sustaining foreign operations. Such contracts are translated at the year-end rates of exchange. The net unrealized gains or losses, if material, which result from translation, less related hedging gains or losses, are deferred and included in shareholders' equity under a caption "currency translation adjustment".

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At December 31, 1998, the company had net foreign currency contracts hedging its self-sustaining subsidiaries, maturing as follows:

	<b>Notional Value</b>		
	<b>\$US</b>	<b>FF</b>	<b>£</b>
1999	277	-	-
2001	350	-	-
2002	20	-	-
2003	675	-	-
2004	-	-	82
2006	370	800	-
2007	470	300	-
2008	75	-	-
	<u>2,237</u>	<u>1,100</u>	<u>82</u>

#### *Goodwill*

The excesses of purchase cost over the fair value of the net assets of acquired businesses are amortized on the straight line basis over their estimated useful lives which range from 10 years for Hamblin Watsa Investment Counsel Ltd. and Ranger Insurance Company to 40 years for Lindsey Morden Group Inc. The company assesses the continuing value of goodwill based on the underlying undiscounted cash flows and operating results of the subsidiaries.

The excess of net assets acquired over purchase price paid for acquired businesses is amortized to earnings on the straight line basis over 10 years.

#### *Reinsurance*

The company reflects third party reinsurance balances on the balance sheet on a gross basis to indicate the extent of credit risk related to third party reinsurance and its obligations to policyholders and on a net basis in the statement of earnings to indicate the results of its retention of premiums written.

#### *Income taxes*

Income taxes reflect the expected future tax consequences of temporary differences between the carrying amounts of assets and liabilities and their tax bases based on tax rates which are expected to be in effect when the asset or liability is settled.

**2. Investment Information**

	1998		1997	
	Book Value (\$000)	Estimated Fair Value (\$000)	Book Value (\$000)	Estimated Fair Value (\$000)
Subsidiary cash and short term investments	896,248	896,248	823,762	823,762
Bonds				
Canadian – government	809,281	823,428	612,618	640,957
– corporate	286,933	294,150	117,350	125,959
U.S. – government	4,288,488	4,245,512	613,747	614,564
– corporate	3,556,587	3,617,404	2,177,903	2,262,197
Other – government	702,537	696,394	230,687	234,860
– corporate	216,095	211,064	101,200	91,614
Preferred stocks				
Canadian	134,938	137,255	271,642	297,101
Foreign	20,042	22,082	–	–
Common stocks				
Canadian	181,789	155,212	167,404	167,190
U.S.	195,344	197,988	113,342	126,037
Foreign	420,267	417,312	304,317	272,400
Real estate	94,460	94,460	54,627	54,627
	<u>11,803,009</u>	<u>11,808,509</u>	<u>5,588,599</u>	<u>5,711,268</u>

The estimated fair values of preferred and common stocks and debt securities are based on quoted market values. The book value of real estate approximates fair value. Included in the U.S. common equities at December 31, 1998 are S&P put contracts, with an average strike price of 1,012 and a notional value of US\$700 million. The premiums paid to acquire these contracts are being charged to realized losses on equity investments on a straight line basis over their term to maturity, ranging from 1999 to 2001.

Management has reviewed currently available information regarding those investments whose estimated fair value is less than book value, amounting to an aggregate unrealized loss of \$289 million at December 31, 1998, and has determined that the book values are expected to be recovered. Debt securities whose book value exceeds market value can be held until maturity. Preferred and common stock investments have been reviewed to ensure that corporate performance expectations have not changed significantly to adversely affect the market value of these securities other than on a temporary basis.

**Liquidity and interest rate risk**

Maturity profile as at December 31, 1998

	Within 1 Year (\$000)	1 to 5 Years (\$000)	6 to 10 Years (\$000)	Over 10 Years (\$000)	Total (\$000)
Bonds (book value)	312,713	2,711,425	5,408,159	1,427,624	<u>9,859,921</u>
Effective interest rate					<u>5.40%</u>

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**Investment Income**

	<b>1998</b>	<b>1997</b>
	(\$000)	(\$000)
Interest and dividends:		
Cash and short term investments	54,496	31,651
Bonds	372,986	195,448
Preferred stocks	16,406	14,751
Common stocks	5,407	14,191
	<u>449,295</u>	<u>256,041</u>
Expenses	(5,457)	(1,479)
	<u>443,838</u>	<u>254,562</u>
Gain on sale of investments:		
Bonds	342,180	6,085
Preferred stocks	4,892	320
Common stocks	107,089	214,055
Other	150	(2,459)
Provision for loss	(13,526)	(11,228)
	<u>440,785</u>	<u>206,773</u>
Net investment income	<u>884,623</u>	<u>461,335</u>

**3. Provision for Claims**

The provisions for unpaid claims and adjustment expenses and for the third party reinsurers' share thereof are estimates subject to variability, and the variability could be material in the near term. The variability arises because all events affecting the ultimate settlement of claims have not taken place and may not take place for some time. Variability can be caused by receipt of additional claim information, changes in judicial interpretation of contracts or liability or significant changes in severity or frequency of claims from historical trends. The estimates are principally based on the company's historical experience. Methods of estimation have been used which the company believes produce reasonable results given current information.

Changes in claim liabilities recorded on the balance sheet for the years ended December 31, 1998 and 1997 and their impact on unpaid claims and adjustment expenses for these two years are as shown in the following table:

	<b>1998</b> (\$000)	<b>1997</b> (\$000)
Unpaid claim liabilities – beginning of year – net	4,150,386	2,192,627
Increase (decrease) in estimated losses and expenses for losses occurring in prior years	125,512	(10,823)
Provision for losses and expenses on claims occurring in the current year	1,763,900	1,045,488
Paid on claims occurring during:		
the current year	(827,333)	(479,611)
prior years	(1,030,277)	(410,226)
Unpaid claim liabilities of CTR	–	600,955
Unpaid claim liabilities of Odyssey Re London and Bermuda	–	1,211,976
Unpaid claim liabilities of Falcon	8,539	–
Unpaid claim liabilities of Crum & Forster	3,794,255	–
Unpaid claim liabilities of Odyssey Re Stockholm	684,178	–
Unpaid claim liabilities of ORC Re	<u>678,096</u>	<u>–</u>
Unpaid claim liabilities before reserve indemnification – end of year – net	9,347,256	4,150,386
Reserve indemnification	<u>(52,299)</u>	<u>(48,606)</u>
Unpaid claim liabilities – end of year – net	9,294,957	4,101,780
Reinsurance gross-up	<u>3,866,258</u>	<u>2,220,957</u>
Unpaid claim liabilities – end of year – gross	<u>13,161,215</u>	<u>6,322,737</u>

The basic assumptions made in establishing actuarial liabilities are best estimates of possible outcomes. The company presents its claims on an undiscounted basis.

The company's provision for asbestos, pollution and other hazards claims is set out in the table on page 52 of the MD&A.

As part of its acquisition strategy, the company generally obtains vendor indemnifications from adverse development in the acquired company's claims reserves and unrecoverable reinsurance. A summary of these indemnifications is set out in the table on page 55 of the MD&A.

#### **4. Contingent Value Rights**

As part of the consideration for the purchase of Sphere Drake (now Odyssey Re London and Bermuda), the company issued contingent value rights ("CVRs") bearing effectively 8% interest per annum and payable in 2007, subject to earlier redemption at the option of the company. The amount payable at maturity is subject to adjustments for the development of Sphere Drake's provision for claims as of December 31, 1996, the development of Sphere

Drake's reserves for unrecoverable receivables from reinsurers and indemnifiers as of December 31, 1996, the result of commutations and certain actuarial expenses. At December 31, 1998, adverse development has exceeded the carrying amount, including accrued interest from the date of acquisition, of the CVRs by \$16 million, which amount is included in incurred losses.

## 5. Long Term Debt

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

	<b>1998</b>	<b>1997</b>
	(\$000)	(\$000)
Fairfax unsecured note with interest based on STIBOR due September 4, 2000	60,292	-
Fairfax unsecured senior notes of US\$100 million at 7.75% due December 15, 2003	153,820	142,960
Fairfax unsecured senior note at 7.75% due December 15, 2003	25,000	25,000
Fairfax FF300 million unsecured debt at 2½% due February 27, 2007 (effectively a FF200 million debt at 8%)	59,867	50,111
Fairfax unsecured senior notes of US\$175 million at 6.875% due April 15, 2008	269,185	-
Fairfax unsecured senior notes of US\$100 million at 8.25% due October 1, 2015 <sup>(1)</sup>	153,820	142,960
Fairfax unsecured senior notes of US\$225 million at 7.375% due April 15, 2018 <sup>(1)(2)</sup>	346,095	-
Fairfax unsecured senior notes of US\$125 million at 8.30% due April 15, 2026 <sup>(1)</sup>	192,275	178,700
Fairfax unsecured senior notes of US\$125 million at 7.75% due July 15, 2037 <sup>(1)</sup>	192,275	178,700
Lindsey Morden unsecured Series B debentures at 7% due June 16, 2008	125,000	-
Other long term debt of Lindsey Morden	12,655	17,132
	<u>1,590,284</u>	<u>735,563</u>
Less: Lindsey Morden debentures held by Fairfax	(8,218)	-
	<u>1,582,066</u>	<u>735,563</u>

- (1) The company has entered into various interest rate swap agreements on the above-noted debt with an aggregate balance of \$692,190 whereby it now pays interest on that debt at a rate linked to LIBOR, saving approximately 71 basis points on average during 1998.
- (2) During 1998, the company swapped US\$125 million of its debt at 7.375%, due April 15, 2018 for Japanese yen denominated debt of the same maturity, with fixed interest at 3.48% per annum. The pre-tax unrealized loss on the yen debt swap amounted to \$18 million at December 31, 1998 and is being amortized to income over the remaining term to maturity.

Interest expense on long term debt amounted to \$89,831 (1997 – \$44,116).

Principal repayments are due as follows:

	<i>(\$000)</i>
1999	5,095
2000	63,340
2001	2,300
2002	6,115
2003	180,012
Thereafter	<u>1,325,204</u>
	<u>1,582,066</u>

## 6. 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*

	<b>1998</b>		<b>1997</b>	
	<i>number</i>	<i>(\$000)</i>	<i>number</i>	<i>(\$000)</i>
Subordinate voting shares	11,383,530	1,236,361	10,383,530	780,761
Multiple voting shares	<u>1,548,000</u>	<u>5,000</u>	<u>1,548,000</u>	<u>5,000</u>
	12,931,530	1,241,361	11,931,530	785,761
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>12,132,300</u>	<u>1,222,339</u>	<u>11,132,300</u>	<u>766,739</u>

On December 22, 1998, the company issued 2,000,000 subscription receipts, each representing the right to receive one subordinate voting share of the company from treasury, at \$500 per subscription receipt, for net proceeds of \$959,700. The proceeds from this offering will be used to finance the company's acquisition of TIG Holdings, Inc., which is expected to close in the spring of 1999. If the acquisition of TIG is not completed, the proceeds of the offering will be repaid to the holders of the subscription receipts.

On April 3, 1998, the company issued 1,000,000 subordinate voting shares at \$475 per share for net proceeds of \$455,600.

On July 14, 1997 the company issued 650,000 subordinate voting shares at \$395 per share for net proceeds of \$246,358, and on December 3, 1997 issued 21,472 subordinate voting shares at \$341.94 per share for an aggregate of \$7,342 as part of the consideration for the Sphere Drake acquisition. In 1997, under the terms of a normal course issuer bid approved by The Toronto

Stock Exchange, the company purchased and cancelled 5,100 subordinate voting shares for an aggregate cost of \$1,575 of which \$1,194 was charged to retained earnings.

## 7. Reinsurance

The company follows the policy of underwriting and reinsuring contracts of insurance and reinsurance which, depending on the type of contract, limits the liability of the individual insurance and reinsurance subsidiaries to a maximum amount on any one loss of \$4.0 million. Reinsurance is generally placed on an excess of loss basis in several layers. The company's reinsurance does not, however, relieve the company of its primary obligation to the policyholders.

The company has guidelines and a review process in place to ascertain the creditworthiness of the companies to which it cedes.

The company makes specific provisions against reinsurance recoverable from companies considered to be in financial difficulty. In addition, the company records a general allowance based upon analysis of historical recoveries, the level of allowance already in place and management's judgement. The allocation of the allowance for loss is as follows:

	<b>1998</b> <i>(\$000)</i>	<b>1997</b> <i>(\$000)</i>
Specific	86,871	74,873
General	81,553	20,451
Total	<u>168,424</u>	<u>95,324</u>

A summary of the company's major reinsurers, showing their A.M. Best rating and outstanding balance at December 31, 1998, is set out in the table on page 54 of the MD&A.

During the year, the company ceded premiums earned of \$740,318 (1997 – \$453,445) and \$817,815 (1997 – \$304,636) of claims incurred.

## 8. 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:

	<b>1998</b> <i>(\$000)</i>	<b>1997</b> <i>(\$000)</i>
Provision for taxes at statutory marginal income tax rate	213,305	149,772
Non-taxable investment income	(28,940)	(18,346)
Income earned outside Canada	(87,269)	(28,406)
Utilization of prior years' losses and other	(10,734)	(759)
Provision for income taxes	<u>86,362</u>	<u>102,261</u>

Deferred tax assets of the company under Canadian and US GAAP are as follows:

	<b>1998</b>	<b>1997</b>
	(\$000)	(\$000)
Operating and capital losses	101,385	42,690
Claims discount	320,248	115,093
Unearned premium reserve	69,827	39,282
Deferred premium acquisition cost	(76,325)	(39,391)
Investments	(36,551)	(6,057)
Allowance for doubtful accounts	5,739	16,115
Accounts payable and other	<u>139,654</u>	<u>1,713</u>
Deferred tax assets, Canadian GAAP	523,977	169,445
Unrealized gains on investments	<u>(2,090)</u>	<u>(46,615)</u>
Deferred tax assets, US GAAP	<u>521,887</u>	<u>122,830</u>

### **9. Statutory Requirements**

The company's insurance subsidiaries are subject to certain requirements and restrictions under their respective insurance company Acts including minimum asset requirements and dividend restrictions.

The company can receive up to \$331 million as dividends from insurance and reinsurance subsidiaries without obtaining the prior approval of insurance regulators.

At December 31, 1998, statutory surplus, determined in accordance with the various insurance regulations, amounted to \$1.7 billion for the insurance subsidiaries and \$1.6 billion for the reinsurance subsidiaries.

### **10. 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 to the company's operations or its financial position.

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 \$27,798 (1997 - \$14,636) for which 409,142 (1997 - 390,280) subordinate voting shares of the company with a year-end market value of \$220,937 (1997 - \$124,890) have been pledged as security.

The Year 2000 issue arises because many computerized systems use two digits rather than four to identify a year. Date-sensitive systems may recognize the year 2000 as 1900 or some other date, resulting in errors when information using year 2000 dates is processed. In addition, similar problems may arise in some systems which use certain dates in 1999 to represent something other than a date. The effects of the Year 2000 issue may be experienced before, on or after January 1, 2000 and, if not addressed, the impact on operations and financial reporting may range from minor errors to significant systems failure which could affect a company's ability to conduct normal business operations. It is not possible to be certain that all aspects of

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the Year 2000 issue affecting the company, particularly those related to the efforts of customers, suppliers or other third parties, will be fully resolved.

### **11. Operating Leases**

Aggregate future commitments at December 31, 1998 under operating leases relating to premises, automobiles and equipment for various terms up to ten years are as follows:

	<i>(\$000)</i>
1999	76,500
2000	68,400
2001	55,200
2002	44,400
2003	35,700
Thereafter (in aggregate)	49,000

### **12. Earnings per Share**

Fully diluted and basic earnings per share are the same in 1998 and 1997. The weighted average number of shares for 1998 was 11,877,505 (1997 – 10,769,865).

### **13. Acquisitions**

On December 3, 1998, the company entered into a definitive agreement to acquire TIG Holdings, Inc. of New York through a merger transaction for an aggregate value of US\$847 million. The merger transaction is subject to the receipt of satisfactory applicable regulatory approvals, approval of the merger by the shareholders of TIG and standard closing conditions. Completion of the merger is contemplated to occur in the spring of 1999. For the year ended December 31, 1998, TIG had total revenue of US\$1.7 billion. At December 31, 1998, total assets amounted to US\$7 billion and shareholders' equity amounted to US\$1.1 billion.

Effective September 4, 1998, the company purchased certain run-off reinsurance operations of Skandia International Insurance Corporation of Stockholm, Sweden for US\$75 million (\$115 million) cash and a note to the vendor, due September 4, 2000, of \$60 million. At September 4, 1998, Skandia had US\$689 million in total assets and US\$544 million in total liabilities at fair value.

Effective August 13, 1998, the company purchased Crum & Forster Holdings, Inc. of Morristown, New Jersey for US\$565 million (\$859 million) cash. At August 13, 1998 (after repayment of its US\$115 million debt), Crum & Forster had US\$5,180 million in total assets and US\$4,468 million in total liabilities (including a restructuring accrual of US\$41 million for severance, lease termination and related costs on the downsizing of CFI's regional office network) at fair value. The vendor purchased a reinsurance contract for Crum & Forster's benefit of US\$400 million for any inadequacy in Crum & Forster's provision for claims as at August 13, 1998 and for any of Crum & Forster's reinsurance receivable relating to the period up to August 13, 1998 which subsequently becomes unrecoverable.

Effective January 16, 1998, the company purchased Falcon Insurance Company Limited of Hong Kong for HK\$23 million (\$4 million) cash. At January 16, 1998, Falcon had HK\$40 million in total assets and HK\$75 million in total liabilities at fair value. The excess of

the purchase price paid over net assets acquired has been assigned to the value of the licence and is being amortized to expense on a straight line basis over ten years.

On December 3, 1997, the company purchased Sphere Drake Holdings Limited of Bermuda for US\$217 million (\$310 million) of which US\$139 million was paid in cash and Fairfax shares (note 6) and US\$78 million in contingent value rights (note 4). In addition, the company injected US\$100 million of capital into Sphere Drake to permit the repayment of Sphere Drake's US\$100 million of debt. At December 3, 1997 (after repayment of its US\$100 million of debt) Sphere Drake had US\$1,952 million in total assets and US\$1,641 million in total liabilities at fair value.

On February 27, 1997 the company purchased Compagnie Transcontinentale de Réassurance (CTR) of Paris, France for FF700 million (approximately \$175 million), of which FF300 million was financed by a 10 year 2½% borrowing (effectively FF200 million at an 8% rate). At February 27, 1997 CTR had FF4.2 billion (\$1.1 billion) in total assets and total liabilities of FF3.3 billion (\$875 million) at fair value, resulting in an excess of the fair value of net assets acquired over the effective purchase price of FF300 million. The vendor provided a secured indemnification to a maximum of FF250 million for any inadequacy in CTR's provision for claims as at December 31, 1995 and for any of CTR's reinsurance receivable relating to the period up to December 31, 1995 which subsequently becomes unrecoverable.

On June 19, 1998, Lindsey Morden Group (LMG) purchased Hambro Insurance Services (HIS) of London, England for cash of \$217 million. The purchase was primarily funded by the issuance of 4 million LMG subordinate voting shares for net proceeds of \$78.1 million and the issuance of \$125 million 7% unsecured debentures due June 16, 2008. At June 19, 1998, HIS had \$123 million in total assets and \$37 million in total liabilities, at fair value. The difference of \$131 million has been allocated to goodwill. Subsequently, on November 30, 1998, LMG sold Hambro Assistance, a unit of HIS, for \$130 million, consisting of cash of \$122 million and \$8 million (£3 million) by a subordinated loan note repayable in two years and with interest at UK Sterling LIBOR plus 2%. On December 29, 1998, HIS sold its 33% interest in Oracle Service Networks Corporation in exchange for common shares of the purchaser with a value of \$20 million. LMG has agreed to hold two-thirds of the common shares received until at least May 15, 1999 and the remainder until at least December 29, 1999. LMG recorded an after-tax gain of \$13 million on the sale of the companies.

On October 30, 1998, LMG purchased Ellis & Buckle of the UK for an aggregate purchase price of \$148 million consisting of 1,930,800 LMG subordinate voting shares, valued at \$39 million, and notes to the vendor of \$109 million (later repaid from the proceeds of sale of Hambro Assistance). At October 30, 1998, E&B had \$70 million in total assets and \$111 million in total liabilities (including a restructuring accrual of \$16 million consisting of severance, lease termination and related costs on the integration of the HIS UK operations with E&B), at fair value. The difference of \$189 million has been allocated to goodwill.

#### 14. Segmented Information

The company is a financial services holding company which, through its subsidiaries, is primarily engaged in property and casualty insurance conducted on a direct and reinsurance basis. The company also provides claims adjusting, appraisal and loss management services and investment management services.

	Canada		United States		Europe and Far East		Total	
	1998 (\$000)	1997 (\$000)	1998 (\$000)	1997 (\$000)	1998 (\$000)	1997 (\$000)	1998 (\$000)	1997 (\$000)
<b>Revenue</b>								
Insurance	801,597	785,749	1,022,163	301,105	-	-	1,823,760	1,086,854
Reinsurance	8,239	8,593	440,098	450,870	931,728	342,401	1,380,065	801,864
Claims adjusting	62,668	56,931	118,464	106,465	113,711	2,935	294,843	166,331
Corporate and other	75,649	33,258	-	-	-	-	75,649	33,258
	<u>948,153</u>	<u>884,531</u>	<u>1,580,725</u>	<u>858,440</u>	<u>1,045,439</u>	<u>345,336</u>	<u>3,574,317</u>	<u>2,088,307</u>
	26.5%	42.4%	44.2%	41.1%	29.3%	16.5%	100%	100%
<b>Earnings before income taxes</b>								
Insurance	60,312	156,335	196,737	37,930	-	-	257,049	194,265
Reinsurance	(3,115)	3,648	89,498	147,015	154,163	24,838	240,546	175,501
Claims adjusting	(1,341)	1,117	5,279	5,156	24,721	(229)	28,659	6,044
Corporate and other	(41,470)	(39,848)	-	-	-	-	(41,470)	(39,848)
	<u>14,386</u>	<u>121,252</u>	<u>291,514</u>	<u>190,101</u>	<u>178,884</u>	<u>24,609</u>	<u>484,784</u>	<u>335,962</u>
	3.0%	36.1%	60.1%	56.6%	36.9%	7.3%	100%	100%
<b>Identifiable assets</b>								
Insurance	2,132,768	1,884,079	8,543,014	1,155,915	-	-	10,675,781	3,039,994
Reinsurance	23,293	109,656	4,682,770	4,284,651	3,684,756	2,542,641	8,390,820	6,936,948
Claims adjusting	52,430	33,129	70,084	58,636	368,477	2,781	490,991	94,546
Corporate and other	1,329,102	135,781	-	-	-	-	1,329,102	135,781
	<u>3,537,593</u>	<u>2,162,645</u>	<u>13,295,868</u>	<u>5,499,202</u>	<u>4,053,233</u>	<u>2,545,422</u>	<u>20,886,694</u>	<u>10,207,269</u>
	16.9%	21.2%	63.7%	53.9%	19.4%	24.9%	100%	100%
<b>Amortization</b>	5,980	3,583	2,995	2,995	-	-	8,975	6,578
<b>Interest expense</b>	89,062	44,053	-	650	904	-	89,966	44,703

Geographic revenue is determined based on the domicile of the various subsidiaries and where they primarily derive their revenue.

CRC (Bermuda) Reinsurance is included in the Canadian segment and Wentworth Insurance is included in the United States segment.

Corporate and other revenue includes interest on the company's cash balances, management fees and other. Earnings before income taxes includes the company's interest expense and corporate overhead. Identifiable assets include the share subscription receipts and holding company cash at December 31, 1998.

**15. Fair Value**

Information on the fair values of financial instruments of the company where those values differ from their carrying values in the financial statements at December 31, 1998 include:

	<b>Note Reference</b>	<b>Book Value (\$000)</b>	<b>Estimated Fair Value (\$000)</b>
Investments	2	11,803,009	11,808,509
Long term debt	5	1,582,066	1,524,036
Foreign exchange contracts	1	0	(173,561)

The amounts do not include the fair value of underlying lines of business. While fair value amounts are designed to represent estimates of the amounts at which instruments could be exchanged in current transactions between willing parties, certain of the company's financial instruments lack an available trading market. Therefore, these instruments have been valued on a going concern basis. Fair value information on the provision for claims is not determinable.

These fair values have not been reflected on the financial statements.

**16. US GAAP Reconciliation**

The consolidated financial statements of the company have been prepared in accordance with generally accepted accounting principles ("GAAP") as applied in Canada which are different in some respects from those applicable in the United States, as described below.

*Consolidated Statements of Earnings*

There is no material difference between the consolidated net earnings as reported under Canadian GAAP for the years ended December 31, 1998 and 1997 and the consolidated net earnings which would be reported by applying US GAAP.

*Consolidated Balance Sheets*

In Canada, portfolio investments are carried at cost or amortized cost with a provision for declines in value which are considered to be other than temporary. In the U.S., such investments are classified as available for sale and marked to market through shareholders' equity.

The following shows the balance sheet amounts in accordance with US GAAP where different from the amounts reported under Canadian GAAP:

	<b>1998</b> (\$000)	<b>1997</b> (\$000)
<b>Assets</b>		
Portfolio investments		
Bonds	9,887,952	3,970,151
Preferred stocks	159,337	297,101
Common stocks	<u>770,512</u>	<u>565,627</u>
Total portfolio investments	10,817,801	4,832,879
Deferred income taxes	521,887	122,830
Other assets	<u>9,550,416</u>	<u>5,327,614</u>
Total assets	20,890,104	10,283,323
<b>Liabilities</b>		
Total liabilities	<u>18,647,844</u>	<u>8,811,554</u>
<b>Shareholders' Equity</b>		
Total shareholders' equity	<u>2,242,260</u>	<u>1,471,769</u>

The difference in consolidated shareholders' equity is as follows:

	<b>1998</b> (\$000)	<b>1997</b> (\$000)
Shareholders' equity based on Canadian GAAP	2,238,850	1,395,715
Other comprehensive income	<u>3,410</u>	<u>76,054</u>
Shareholders' equity based on US GAAP	<u>2,242,260</u>	<u>1,471,769</u>

Statement of Financial Accounting Standards No. 130 "Reporting Comprehensive Income" requires the company to disclose items of other comprehensive income in a financial statement and to disclose accumulated balances of other comprehensive income in the equity section of a financial statement. Other comprehensive income includes unrealized gains and losses on investments, as follows:

	<b>1998</b> (\$000)	<b>1997</b> (\$000)
Unrealized gains on investments available for sale	5,500	122,669
Less: related deferred income taxes	<u>(2,090)</u>	<u>(46,615)</u>
	<u>3,410</u>	<u>76,054</u>

*Disclosure of interest and taxes paid*

The aggregate amount of interest paid for the years ended December 31, 1998 and 1997 was \$80,706 and \$53,111 respectively. The aggregate amount of taxes paid for the years ended December 31, 1998 and 1997 was \$59,279 and \$43,736 respectively.

## 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 and reinsurance companies, claims adjusting fees of Lindsey Morden and other miscellaneous income for the past five years.

*Revenue by*

*Line of Business*

	<b>1998</b>	<b>1997</b>	<b>1996</b>	<b>1995</b>	<b>1994</b>
	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)
Insurance	1,823,760	1,086,854	1,026,107	985,916	476,445
Reinsurance	1,380,065	801,864	273,340	–	–
Claims adjusting	294,843	166,331	162,266	154,914	156,093
Other income	75,649	33,258	14,102	4,690	2,359
	<u>3,574,317</u>	<u>2,088,307</u>	<u>1,475,815</u>	<u>1,145,520</u>	<u>634,897</u>

The 1998 increase in insurance revenue was mainly the result of the August 13, 1998 acquisition of Crum & Forster. The increase in reinsurance revenue in 1998 over 1997 was mainly the result of the inclusion of Odyssey Re London and Bermuda for all of 1998 as opposed to one month after its acquisition in 1997. The 1998 increase in claims adjusting revenue reflects Lindsey Morden's acquisition of Hambro Insurance Services effective June 19, 1998 and Ellis & Buckle effective October 30, 1998.

On a geographic basis, the United States operations accounted for approximately 44% of total revenue and 60% of operating profits in 1998 compared with 41% of revenue and 57% of operating profits in 1997. Canadian operations accounted for approximately 27% of Fairfax's revenue and 3% of operating profits in 1998, compared with approximately 42% of revenue and 36% of operating profits in 1997. The balance of revenue and operating profits was earned in Europe and the Far East.

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## Net Earnings

Sources of net earnings with Lindsey Morden equity accounted were as follows for the past five years:

	1998 (\$000)	1997 (\$000)	1996 (\$000)	1995 (\$000)	1994 (\$000)
Underwriting					
Insurance	(156,808)	(20,370)	(45,846)	(40,883)	(16,880)
Reinsurance	(154,571)	(35,787)	(4,717)	–	–
Interest and dividends	<u>432,024</u>	<u>242,300</u>	<u>144,101</u>	<u>86,274</u>	<u>53,742</u>
Insurance and reinsurance earnings before realized gains	120,645	186,143	93,538	45,391	36,862
Realized gains	440,785	206,773	131,274	71,912	20,026
Claims adjusting (Fairfax portion)	12,388	1,824	2,298	2,098	532
Interest expense	(84,356)	(43,182)	(34,997)	(19,086)	(10,426)
Goodwill and other amortization	(4,985)	(4,817)	(4,765)	(4,765)	(1,392)
Corporate overhead and other	<u>(15,963)</u>	<u>(14,991)</u>	<u>(6,656)</u>	<u>(5,618)</u>	<u>(2,147)</u>
Pre-tax income	468,514	331,750	180,692	89,932	43,455
Less: taxes	<u>80,979</u>	<u>99,252</u>	<u>29,872</u>	<u>2,435</u>	<u>5,350</u>
Net earnings	<u>387,535</u>	<u>232,498</u>	<u>150,820</u>	<u>87,497</u>	<u>38,105</u>

Net earnings in 1998 were \$387.5 million, an increase of \$155.0 million or 67% from 1997 net earnings of \$232.5 million.

The major changes which affected net earnings were:

- Insurance and reinsurance earnings before realized gains decreased by \$65.5 million over 1997 due to higher underwriting losses from weather-related losses and adverse development from prior years for Ranger and Odyssey Re London and Bermuda
- Net realized gains increased in 1998 to \$440.8 million from \$206.8 million in 1997
- Interest expense increased in 1998 due to interest expenses from the debt issued in 1998 related to the purchases of Crum & Forster and Odyssey Re Stockholm
- The provision for income taxes was lower in 1998 due to higher income earned outside Canada at lower rates of tax.

## Insurance Underwriting

Fairfax's insurance and reinsurance 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 fourteen years for Fairfax's insurance companies and, for Fairfax's reinsurance companies, for the three years that Fairfax has owned these companies.

### Insurance

	NET PREMIUMS		RATIOS		
	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
1995	864,589	829,340	74	31	105
1996	879,687	864,169	75	31	106
1997	864,708	867,218	71	31	102
1998	1,310,141	1,402,771	78	33	111

In 1998, the combined ratio was well above 100% because of ratios of 117% for the recently acquired Crum & Forster and 146% for Ranger (our Canadian companies achieved a ratio of 105%). Since current management took over in September 1985 Fairfax has had combined ratios of less than 100% in five of the thirteen full years and greater than 100% in the remaining eight years.

### Reinsurance

	NET PREMIUMS		RATIOS		
	Written (\$000)	Earned (\$000)	Loss (%)	Expense (%)	Combined (%)
1996	163,392	166,719	62	34	96
1997	527,919	593,423	72	35	107
1998	966,466	992,080	80	36	116

In 1998, the combined ratio increased to 116% due to adverse development at Odyssey Re London and Bermuda and due to weather-related losses.

### 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

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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. 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) for the insurance and reinsurance lines of business for the past five years. As shown in the table, the sum of the provision for claims for all of Fairfax's insurance and reinsurance subsidiaries is \$13,161 million as at December 31, 1998 – the amount shown as Provision for claims on Fairfax's balance sheet on page 22. The "other" shown in the table below is the \$14 million Fairfax indemnification of Ranger reserves.

*Reconciliation of Provision for Claims  
and LAE as at December 31*

	<b>1998</b> (\$000)	<b>1997</b> (\$000)	<b>1996</b> (\$000)	<b>1995</b> (\$000)	<b>1994</b> (\$000)
Insurance subsidiaries owned throughout the year – net of indemnification	1,107,551	978,498	956,704	864,346	428,564
Insurance subsidiaries acquired during the year	<u>3,802,794</u>	<u>–</u>	<u>–</u>	<u>–</u>	<u>462,476</u>
Total insurance subsidiaries	<u>4,910,345</u>	<u>978,498</u>	<u>956,704</u>	<u>864,346</u>	<u>891,040</u>
Reinsurance subsidiaries owned throughout the year	2,981,663	1,215,130	13,363	12,095	7,659
Reinsurance subsidiaries acquired during the year	<u>1,362,274</u>	<u>1,869,526</u>	<u>1,138,865</u>	<u>–</u>	<u>–</u>
Total reinsurance subsidiaries	4,343,937	3,084,656	1,152,228	12,095	7,659
Federated Life	26,675	24,626	23,095	22,214	22,975
Other	<u>14,000</u>	<u>14,000</u>	<u>14,000</u>	<u>14,000</u>	<u>–</u>
Total provision for claims and LAE	9,294,957	4,101,780	2,146,027	912,655	<u>921,674</u>
Reinsurance gross-up	<u>3,866,258</u>	<u>2,220,957</u>	<u>1,147,422</u>	<u>414,482</u>	
Total including gross-up	<u>13,161,215</u>	<u>6,322,737</u>	<u>3,293,449</u>	<u>1,327,137</u>	

The six tables that follow show the reconciliation and the reserve development of the insurance (Canadian and U.S.) and reinsurance subsidiaries' provision for claims. Because business is done in various locations, there will necessarily be some distortions caused by foreign exchange fluctuations. The insurance subsidiaries' tables are presented in Canadian dollars for the Canadian subsidiaries and in U.S. dollars for the U.S. subsidiaries. The reinsurance subsidiaries' tables are presented in U.S. dollars as the reinsurance business is substantially transacted in that currency.

*Canadian Insurance Subsidiaries*

The following table shows for Fairfax's Canadian insurance subsidiaries the provision for claims liability for unpaid losses and LAE as originally and as ultimately estimated for the years 1994 through 1998. The favourable or unfavourable development from prior years is credited or charged to each year's earnings.

*Reconciliation of Provision for Claims –  
Canadian Insurance Subsidiaries*

	<b>1998</b> (\$000)	<b>1997</b> (\$000)	<b>1996</b> (\$000)	<b>1995</b> (\$000)	<b>1994</b> (\$000)
Provision for claims and LAE at January 1 for Commonwealth, Federated, Markel and, since 1995, for Lombard and CRC (Bermuda)	764,052	746,119	695,328	673,789	185,010
Incurring losses on claims and LAE					
Provision for current accident year's claims	545,306	553,902	482,970	456,967	139,671
Increase (decrease) in provision for prior accident years' claims	(2,464)	(11,974)	(16,692)	4,149	2,809
Total incurred losses on claims and LAE	542,842	541,928	466,278	461,116	142,480
Payments for losses on claims and LAE					
Payments on current accident year's claims	(239,426)	(285,067)	(195,604)	(205,766)	(53,222)
Payments on prior accident years' claims	(248,628)	(238,928)	(219,883)	(233,811)	(62,955)
Total payments for losses on claims and LAE	(488,054)	(523,995)	(415,487)	(439,577)	(116,177)
Provision for claims and LAE at December 31	818,840	764,052	746,119	695,328	211,313
Provision for claims and LAE for Lombard and CRC (Bermuda) at December 31	-	-	-	-	462,476
Provision for claims and LAE for Canadian insurance subsidiaries at December 31	818,840	764,052	746,119	695,328	673,789

The company strives to establish adequate provisions at the original valuation date. It is the company's objective to have favourable development from the past. The Canadian insurance subsidiaries had favourable development in 1998 of \$2.5 million. The reserves will always be subject to upward or downward development in the future.

The following table shows for Fairfax's Canadian insurance subsidiaries the original provision for claims reserves including LAE at each calendar year-end commencing in 1988 with the subsequent cumulative payments made from these years and the subsequent re-estimated amount of these reserves. The following Canadian insurance subsidiaries' reserves are included from the respective years in which they were originally acquired:

	<b>Year Acquired</b>
Markel	1985
Federated	1990
Commonwealth	1990
Lombard (including CRC (Bermuda))	1994

*Provision for Canadian Insurance Subsidiaries' Claims Reserve Development*

<b>As at December 31</b>	<b>1988 and prior</b>	<b>1989</b>	<b>1990</b>	<b>1991</b>	<b>1992</b>	<b>1993</b>	<b>1994</b>	<b>1995</b>	<b>1996</b>	<b>1997</b>	<b>1998</b>
	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)
Provision for claims including LAE	71,964	79,357	192,372	168,393	179,587	185,010	673,789	695,328	746,119	764,052	818,840
Cumulative payments as of:											
One year later	21,015	25,194	44,055	48,050	56,824	62,955	233,811	219,883	238,928	248,628	
Two years later	33,196	35,440	76,947	75,403	87,878	105,537	351,600	355,035	386,447		
Three years later	42,043	44,169	98,150	94,834	110,565	127,418	457,680	455,301			
Four years later	47,901	50,120	115,417	110,838	126,123	147,296	525,453				
Five years later	52,104	55,310	127,003	120,435	137,732	159,482					
Six years later	55,675	58,687	135,020	128,060	145,986						
Seven years later	57,855	60,422	142,082	134,465							
Eight years later	59,152	61,625	147,015								
Nine years later	60,150	62,009									
Ten year later	60,428										
Reserves re-estimated as of:											
One year later	71,673	80,602	175,138	168,001	179,948	187,819	677,938	678,636	734,145	761,588	
Two years later	69,930	73,904	173,992	157,849	174,820	191,825	676,826	692,888	743,443		
Three years later	67,676	71,810	165,753	157,671	171,833	197,833	685,675	704,431			
Four years later	64,478	67,166	166,797	156,291	177,451	198,650	688,769				
Five years later	64,395	65,414	165,625	158,366	177,370	199,317					
Six years later	62,939	65,181	167,289	161,088	177,964						
Seven years later	63,103	64,087	169,803	162,501							
Eight years later	62,250	64,196	171,625								
Nine years later	62,218	63,916									
Ten years later	61,933										
Favourable (unfavourable) development	10,031	15,441	20,747	5,892	1,623	(14,307)	(14,980)	(9,103)	2,676	2,464	

The insurance subsidiaries had a net redundancy of \$2.5 million during 1998, primarily consisting of a redundancy of \$3.3 million for Markel offset by a deficiency of \$1.3 million for Lombard. The net deficiency in 1993 resulted from the impact of U.S. floods on Commonwealth while the net deficiencies in 1994 and 1995 relate to Lombard.

Management is pleased with the generally favourable development for the Canadian insurance subsidiaries over the years. Future development could be significantly different from the past due to many unknown factors.

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*U.S. Insurance Subsidiaries*

The following table shows for Fairfax's U.S. insurance subsidiaries the provision for claims liability for unpaid losses and LAE as originally and as ultimately estimated for the years 1994 through 1998. The favourable or unfavourable development from prior years is credited or charged to each year's earnings.

*Reconciliation of Provision for Claims –  
U.S. Insurance Subsidiaries*

	<b>1998</b>	<b>1997</b>	<b>1996</b>	<b>1995</b>	<b>1994</b>
	<i>(US\$000)</i>	<i>(US\$000)</i>	<i>(US\$000)</i>	<i>(US\$000)</i>	<i>(US\$000)</i>
Provision for claims and LAE at January 1 for Ranger	184,003	187,644	157,804	154,870	173,887
Incurring losses on claims and LAE					
Provision for current accident year's claims	104,477	105,462	111,607	90,192	91,980
Increase in provision for prior accident years' claims	43,821	8,681	25,352	36,168	6,021
Total incurred losses on claims and LAE	148,298	114,143	136,959	126,360	98,001
Payment for losses on claims and LAE					
Payments on current accident year's claims	(40,477)	(37,962)	(37,767)	(34,333)	(38,474)
Payments on prior accident years' claims	(70,130)	(79,822)	(69,352)	(89,093)	(78,544)
Total payments for losses on claims and LAE	(110,607)	(117,784)	(107,119)	(123,426)	(117,018)
Provision for claims and LAE at December 31	221,694	184,003	187,644	157,804	154,870
Provision for claims and LAE for CFI at December 31	2,466,685	–	–	–	–
Provision for claims and LAE for U.S. insurance subsidiaries at December 31 before indemnification	2,688,379	184,003	187,644	157,804	154,870
Reserve indemnification	(34,000)	(34,000)	(34,000)	(34,000)	–
Provision for claims and LAE for U.S. insurance subsidiaries after indemnification	2,654,379	150,003	153,644	123,804	154,870
Exchange rate	1.5382	1.4296	1.3706	1.3652	1.4028
Converted to Canadian dollars	<u>C\$4,082,966</u>	<u>C\$214,445</u>	<u>C\$210,585</u>	<u>C\$169,017</u>	<u>C\$217,251</u>

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The company strives to establish adequate provisions at the original valuation date. It is the company's objective to have favourable development from the past. Ranger had unfavourable development in 1998 of US\$43.8 million. Its generally unfavourable development over the years has been a source of significant concern. Ranger now has a new senior management team and they are taking the necessary steps to eliminate and significantly reduce unprofitable lines of business. The reserves will always be subject to upward or downward development in the future.

The following table shows for Fairfax's U.S. insurance subsidiaries the original provision for claims reserves including LAE at each calendar year-end commencing in 1993 (the date of Ranger's acquisition) with the subsequent cumulative payments made from these years and the subsequent re-estimated amounts of these reserves.

*Provision for U.S. Insurance Subsidiaries' Claims Reserve Development*

<b>As at December 31</b>	<b>1993</b>	<b>1994</b>	<b>1995</b>	<b>1996</b>	<b>1997</b>	<b>1998</b>
	(US\$000)	(US\$000)	(US\$000)	(US\$000)	(US\$000)	(US\$000)
Provision for claims including LAE	173,887	154,870	157,804	187,644	184,003	221,694
Cumulative Payments as of:						
One year later	78,544	89,093	69,352	79,822	70,130	
Two years later	141,662	130,040	119,882	125,286		
Three years later	169,259	158,738	135,225			
Four years later	185,800	166,941				
Five years later	188,254					
Six years later						
Seven years later						
Eight years later						
Nine years later						
Ten year later						
Reserves re-estimated as of:						
One year later	171,418	191,038	183,156	195,925	227,824	
Two years later	199,586	206,856	190,861	229,083		
Three years later	214,492	216,783	210,832			
Four years later	222,191	226,006				
Five years later	227,579					
Six years later						
Seven years later						
Eight years later						
Nine years later						
Ten years later						
Favourable (unfavourable) development	(53,692)	(71,136)	(53,028)	(41,439)	(43,821)	–

Ranger had a net deficiency of US\$43.8 million during 1998. Future development could be significantly different from the past due to many unknown factors.

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*Reinsurance subsidiaries*

The following table shows for Fairfax's reinsurance subsidiaries the provision for claims liability for unpaid losses and LAE as originally and as ultimately estimated for the years 1997 and 1998. The favourable or unfavourable development from prior years is credited or charged to each year's earnings.

*Reconciliation of Provision for Claims –  
Reinsurance Subsidiaries*

	<b>1998</b> <i>(US\$000)</i>	<b>1997</b> <i>(US\$000)</i>
Provision for claims and LAE at January 1 for Odyssey Reinsurance (New York) and Wentworth and, in 1998, for CTR and Odyssey Re London and Bermuda	2,157,706	858,469
Incurring losses on claims and LAE		
Provision for current accident year's claims	504,347	150,166
Increase (decrease) in provision for prior accident years' claims	26,017	(7,901)
Total incurred losses on claims and LAE	530,364	142,265
Payments for losses on claims and LAE		
Payments on current accident year's claims	(292,325)	(31,055)
Payments on prior accident years' claims	(457,334)	(119,698)
Total payments for losses on claims and LAE	(749,659)	(150,753)
Provision for claims and LAE at December 31	1,938,411	849,981
Provision for claims and LAE for CTR and Odyssey Re London and Bermuda at December 31	–	1,307,725
Provision for claims and LAE for Odyssey Re Stockholm and ORC Re at December 31	885,628	–
Provision for claims and LAE for all reinsurance subsidiaries at December 31	2,824,039	2,157,706
<i>Exchange rate</i>	1.5382	1.4296
Converted to Canadian dollars	<u>C\$4,343,937</u>	<u>C\$3,084,656</u>

The unfavourable reserve development of US\$26.0 million in 1998 was due to additional development of reserves at Odyssey Re London and Bermuda. The reserves will always be subject to upward or downward development in the future.

The following table shows for Fairfax's reinsurance 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 reinsurance subsidiaries' reserves are included from the respective years in which they were originally acquired or were established:

Wentworth	1990
Odyssey Reinsurance (New York)	1996
CTR	1997
Odyssey Re London and Bermuda	1997
ORC Re	1998
Odyssey Re Stockholm	1998

*Provision for Reinsurance Subsidiaries' Claims Reserve Development*

<b>As at December 31</b>	<b>1996</b> <i>(US\$000)</i>	<b>1997</b> <i>(US\$000)</i>	<b>1998</b> <i>(US\$000)</i>
Provision for claims including LAE	858,469	2,157,706	1,938,411
Cumulative payments as of:			
One year later	119,698	457,334	
Two years later	229,077		
Reserves re-estimated as of:			
One year later	850,568	2,183,723	
Two years later	834,308		
Favourable (unfavourable) development	<u>24,161</u>	<u>(26,017)</u>	

**Asbestos, Pollution and Other Hazards**

Fairfax's reinsurance subsidiaries in the Odyssey Re Group, as well as Ranger and CFI, wrote reinsurance policies prior to their acquisition by Fairfax which involve asbestos related, environmental pollution and other hazards (APH) coverage, primarily in the United States. Following is an analysis of Fairfax's gross and net reserves from APH exposures at year-end and the movement in gross and net reserves for the year.

	<b>1998</b>		<b>1997</b>	
	<b>Gross</b> <i>(US\$000)</i>	<b>Net</b> <i>(US\$000)</i>	<b>Gross</b> <i>(US\$000)</i>	<b>Net</b> <i>(US\$000)</i>
Provision for APH claims and LAE at				
January 1	402,911	255,558	383,576	252,669
APH losses and LAE incurred during the				
year	48,851	32,357	59,697	25,671
APH losses and LAE paid during the year	<u>(45,648)</u>	<u>(22,357)</u>	<u>(40,362)</u>	<u>(22,782)</u>
Provision for APH claims and LAE at				
December 31	406,114	265,558	402,911	255,558
CFI provision for APH claims and LAE at				
December 31	<u>458,082</u>	<u>330,394</u>	<u>-</u>	<u>-</u>
Total provision for APH claims and LAE at				
December 31	<u>864,196</u>	<u>595,952</u>	<u>402,911</u>	<u>255,558</u>
Comprising:				
Outstanding	466,494	290,718	227,575	147,976
IBNR	397,702	305,234	175,336	107,582
Survival ratio – 3 year (before				
indemnification)		12.0		
Survival ratio – 3 year (after				
indemnification)		18.2		

The gross amount of US\$864 million is included in the C\$13,161 million shown as Provision for claims at December 31, 1998 on Fairfax's balance sheet on page 22.

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The three year survival ratio represents the outstanding APH claims and LAE at December 31 divided by the average paid APH claims for the last three years (including CFI). The survival ratio after indemnifications includes one half of the remaining indemnifications at December 31, 1998 for Odyssey Reinsurance (New York), CTR, Odyssey Re London and Bermuda and CFI.

Many insurance coverage issues and circumstantial uncertainties make the estimation of these reserves very difficult. Inconsistencies among the states with regard to coverage, occurrence definitions and Superfund reform can all affect the outcome of APH claims.

These APH reserves are continuously monitored by management and are reviewed extensively by independent consulting actuaries.

Fairfax is protected against adverse development of these reserves at Odyssey Reinsurance (New York), CTR, Odyssey Re London and Bermuda and CFI from their levels at the time of acquisition of those companies to the extent of the available indemnifications obtained in connection with those acquisitions, as discussed under Indemnifications on page 54.

#### **Other Claims**

Odyssey Re London has entered into various reinsurance contracts, principally covering personal accident and workers' compensation risks, which are in dispute on the basis that the losses ceded pursuant to such contracts are inconsistent with agreed terms. It is not yet possible to develop any reasonably based estimate of the amount of claims which might be made upon these contracts if they were enforceable, although the company believes that the likely ultimate liability in respect of these contracts will not be material to Fairfax.

#### **Reinsurance Recoverables**

Fairfax's subsidiaries purchase certain reinsurance so as to reduce their liability on the insurance and reinsurance risks which they write. Fairfax strives to minimize the credit risk of purchasing reinsurance through adherence to its internal reinsurance guidelines. To be a reinsurer of Fairfax, a company must have high A.M. Best and/or Standard & Poor's ratings and maintain capital and surplus exceeding \$100 million. The following table shows Fairfax's top fifteen active reinsurers at December 31, 1998. These fifteen reinsurers represent 47% of Fairfax's \$3,820 million in reinsurance recoverable on unpaid losses (which total is net of bad debt reserves aggregating \$168 million).

<b>Reinsurers</b>	<b>A.M. Best Rating</b>	<b>Reinsurance Recoverable</b> <i>(\$000)</i>
International Insurance	B++	313,746
Equitas	NR	307,072
Skandia Insurance Company Limited	NR	180,018
American Re/Munich	A++	122,985
Centre Reinsurance Company Limited	A	119,311
Frankona	A+	103,131
Employers Reinsurance Corporation	A++	100,798
General Reinsurance	A++	95,376
Lloyds of London Underwriters	A	89,445
TIG Reinsurance Company	A	75,219
Everest Reinsurance Company	A+	60,978
Continental Insurance Company	A-	60,022
Kemper Reinsurance Company	A	59,411
Gan Vie	BBB*	55,067
AXA Reassurance Group	A+	49,341
Other reinsurers		<u>2,196,930</u>
		3,988,850
Provision for uncollectible reinsurance		<u>168,424</u>
Total reinsurance recoverable on unpaid losses		<u>3,820,426</u>

\* S&P rating

The balance recoverable from Skandia Insurance Company Limited was commuted, effective January 1, 1999, subject to approval by applicable insurance regulatory authorities.

To support these reinsurance recoverable balances, Fairfax has the benefit of letters of credit, trust funds or offsetting balances payable totalling \$1,695.1 million. Equitas and Lloyds are also required to maintain funds in Canada and the United States which are monitored by the applicable regulatory authorities.

Reinsurance treaties typically contain provisions concerning ceding commissions, required reports to the reinsurers, responsibility for taxes and arbitration in the event of a dispute, and provisions allowing the company to demand that a reinsurer post letters of credit or assets as security if a reinsurer becomes an "unauthorized" or "unapproved" reinsurer under applicable laws and regulations.

Fairfax is protected against adverse development of the reserves for unrecoverable reinsurance at Odyssey Reinsurance (New York), CTR, Odyssey Re London and Bermuda and CFI from their levels at the time of acquisition of those companies to the extent of the available indemnifications obtained in connection with those acquisitions, as discussed under Indemnifications below.

### **Indemnifications**

Shown below are the indemnifications originally received by Fairfax on previous acquisitions. These indemnifications protect Fairfax from adverse development in the respective companies' claims reserves and unrecoverable reinsurance as at the end (or, as regards CFI, as of August 13)

of the respective original years shown. The indemnifications will be settled as of the end of the respective settlement years shown.

<b>Year</b>	<b>Company</b>	<b>Amount</b> <i>(millions)</i>	<b>Amount</b> <i>(C\$ millions)</i>	<b>Settlement Year</b>
1993	Ranger	US\$ 20	31	1998
1993	Lombard	C\$ 40	40	1998
1995	Odyssey Reinsurance (New York)	US\$ 175	269	2005
1995	CTR	FF 250	68	2005
1996	Odyssey Re London and Bermuda	US\$ 171	263	2006
1998	CFI	US\$ 400	615	None
			<u>1,286</u>	

At December 31, 1998, the company estimates that the Ranger indemnification has been exhausted and that the other indemnifications have been used to the following extent: Odyssey Reinsurance (New York) – US\$51 million (C\$78 million), CTR – FF80 million (C\$22 million), Odyssey Re London and Bermuda – US\$95 million (C\$146 million), and CFI – US\$8 million (C\$12 million), leaving remaining indemnifications for future years totalling C\$957 million.

The company is in the process of negotiating final settlement of the Ranger indemnification. Effective January 1, 1999, the company negotiated final settlement of the Odyssey Reinsurance (New York) stop loss contract, subject to approval by applicable insurance regulatory authorities.

#### **Year 2000**

The company commenced work on the “Year 2000” issue in 1995 and is planning to complete the last parts of the project such as replacement of personal computers by June 30, 1999.

The senior management and Audit Committee at Fairfax have been reviewing the progress of each subsidiary’s Year 2000 plans for the last two and a half years.

Two years ago the company completed surveys of all the services it purchases or provides where the Year 2000 Issue could have an impact on its business and believes all major issues have been addressed. As part of their renewal of insurance policies for 1999, the company’s insurance subsidiaries have notified policyholders of Year 2000 limitations and exclusions consistent with industry practice.

It is estimated that over 90% of key system modifications are now complete and that the cost of the remaining changes will be approximately \$9 million in 1999. Testing began in 1997 and 95% of the testing is expected to be complete by March 31, 1999.

Until the testing is complete, it is not possible to be certain that all aspects of the Year 2000 issue have been addressed. However, since Fairfax has a number of insurance and reinsurance subsidiaries, it is anticipated that if the system failed at one subsidiary, it would be possible to process that subsidiary’s business on another subsidiary’s system in the short term. The company’s subsidiaries are in the process of developing Year 2000 contingency plans to address potential disruptions in business arising from unforeseen circumstances.

**Insurance Environment**

The property and casualty insurance market continued to be very competitive in 1998 with combined ratios in Canada and the U.S. expected to be approximately 108% and 107% respectively, versus 103% and 105% respectively in 1997. Increased catastrophe activity in North America combined with very inadequate pricing resulted in the higher combined ratios in 1998. Significant restructuring and consolidation continues to take place in the industry. We continue to believe that over time price increases must take place to compensate for the underwriting losses combined with interest rates which are insufficient to adequately offset these losses. Currently, however, the industry continues to be highly competitive.

**Crum & Forster Acquisition**

Effective August 13, 1998, the company acquired Crum & Forster Holdings, Inc. The consolidated balance sheet of Crum & Forster upon acquisition was as follows:

	<i>(US\$ millions)</i>
Investments, including cash	3,261
Deferred premium acquisition costs	57
Accounts receivable	408
Deferred income taxes	255
Other assets	1,199
	<u>5,180</u>
Provision for claims	3,722
Unearned premiums	473
Other liabilities	273
Shareholders' equity	712
	<u>5,180</u>

The purchase price of US\$565 million (approximately \$859 million) was paid in cash. In addition, the company injected US\$115 million of capital into Crum & Forster to permit the repayment of Crum & Forster's US\$115 million of debt to the vendor.

Crum & Forster is a national commercial lines property and casualty insurance group that operates on a regional basis and produces business through a limited number of preferred independent agents and brokers. Its net premiums written for 1998 were US\$780 million.

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### **Odyssey Re Stockholm Acquisition**

Effective September 4, 1998, the company acquired Odyssey Re Stockholm (then named Skandia International Insurance Corporation). The consolidated balance sheet of Odyssey Re Stockholm upon acquisition was as follows:

	<i>(US\$millions)</i>
Investments, including cash	543
Deferred premium acquisition costs	2
Accounts receivable	131
Other assets	<u>13</u>
	<u>689</u>
Provision for claims	509
Unearned premiums	9
Other liabilities	26
Shareholders' equity	<u>145</u>
	<u>689</u>

The acquisition price was US\$115 million (\$175 million), consisting of cash of US\$75 million and a note to the vendor of US\$40 million.

Odyssey Re Stockholm writes selected reinsurance coverages in the Nordic countries and manages a runoff portfolio.

### **Interest and Dividend Income**

The majority of interest and dividend income is earned by the insurance and reinsurance companies. Major acquisitions added to the portfolios in the following years:

<b>Acquisition Date</b>		<b>Portfolio</b> <i>(\$millions)</i>
March 21, 1990	Federated	101
November 14, 1990	Commonwealth	130
December 31, 1993	Ranger	400
November 30, 1994	Lombard (including CRC (Bermuda))	684
May 31, 1996	Odyssey Reinsurance (New York)	1,490
February 27, 1997	CTR	764
December 3, 1997	Odyssey Re London and Bermuda	1,068
August 13, 1998	Crum & Forster	4,955
September 4, 1998	Odyssey Re Stockholm	831

	<b>Average Investments at Book Value</b> (\$000)	<b>Interest and Dividend Income</b>					
		<b>Pre-Tax</b>			<b>After Tax</b>		
		<b>Amount</b> (\$000)	<b>Yield</b> (%)	<b>Per Share</b> (\$)	<b>Amount</b> (\$000)	<b>Yield</b> (%)	<b>Per Share</b> (\$)
1985	29,060	2,455	8.45	0.87	1,271	4.37	0.45
1986	64,181	4,678	7.29	0.96	2,522	3.93	0.52
1987	109,825	8,042	7.32	1.10	5,499	5.01	0.77
1988	130,782	8,922	6.82	1.22	6,618	5.06	0.90
1989	135,703	11,628	8.57	1.51	8,537	6.29	1.11
1990	237,868	20,704	8.70	2.75	14,017	5.89	1.86
1991	338,461	26,051	7.70	4.44	17,731	5.24	3.02
1992	366,481	23,988	6.55	4.17	17,749	4.84	3.09
1993	418,207	23,251	5.56	3.78	17,994	4.30	2.92
1994	852,010	58,219	6.83	7.12	39,608	4.65	4.85
1995	1,608,054	89,354	5.56	10.00	73,664	4.58	8.25
1996	2,548,076	151,387	5.94	15.42	111,458	4.37	11.35
1997	4,584,569	254,562	5.55	23.64	174,408	3.80	16.19
1998	8,877,495	443,838	5.00	37.37	337,519	3.80	28.42

Interest and dividend income increased in 1998 due to the inclusion of Odyssey Re London and Bermuda's portfolio for a full year versus one month in 1997, as well as the acquisitions of Crum & Forster and Odyssey Re Stockholm in 1998. As shown, the pre-tax income yield decreased in 1998 to 5.00% due to declining interest rates in 1998. The after-tax income yield was unchanged in 1998 because of more investment income earned in lower tax rate jurisdictions. Pre-tax interest and dividend income per share has compounded at 33.5% per year since 1985.

Investments for the past fourteen 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.

	<b>Cash and</b>				<b>Total Investments</b>		
	<b>Short Term</b>	<b>Bonds</b>	<b>Preferreds</b>	<b>Common</b>	<b>Average</b>	<b>Year-End</b>	<b>Per Share</b>
	<b>Investments</b>						
	<i>(\$000)</i>	<i>(\$000)</i>	<i>(\$000)</i>	<i>(\$000)</i>	<i>(\$000)</i>	<i>(\$000)</i>	<i>(\$)</i>
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
1995	297,989	796,310	157,017	356,738	1,608,054	1,668,656	188.14
1996	470,651	1,462,064	168,438	446,923	2,548,076	3,454,521	330.07
1997	822,569	2,989,063	226,936	546,001	4,584,569	5,795,703	520.62
1998	1,116,239	6,856,713	213,311	691,232	8,877,495	12,108,374	998.03

Total investments per share at year-end 1998 increased significantly due to the Crum & Forster and Odyssey Re Stockholm acquisitions. Since 1985 investments per share have compounded at 47.2% per year. Upon the acquisition of TIG, investments per share will amount to approximately \$1,300.

**Return on Investment Portfolio**

The following table shows the performance of the investment portfolio for the past fourteen 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.

	<b>Average Investments at Book Value</b> (\$000)	<b>Interest and Dividends Earned</b> (\$000)	<b>Realized Gains (Losses) after Provisions</b> (\$000)	<b>Change in Unrealized Gains (Losses)</b> (\$000)	<b>Total Return on Average Investments</b> (\$000) (%)	
1985	29,060	2,455	459	878	3,792	13
1986	64,181	4,678	952	(352)	5,278	8
1987	109,825	8,042	9,159	(7,976)	9,225	8
1988	130,782	8,922	7,802	12,131	28,855	22
1989	135,703	11,628	15,458	(6,272)	20,814	15
1990	237,868	20,704	2,278	(32,943)	(9,961)	(4)
1991	338,461	26,051	(4,512)	27,866	49,405	15
1992	366,481	23,988	3,400	(11,197)	16,191	4
1993	418,207	23,251	27,822	28,792	79,865	19
1994	852,010	58,219	20,026	(42,407)	35,838	4
1995	1,608,054	89,354	71,912	45,438	206,704	13
1996	2,548,076	151,387	131,274	112,676	395,337	16
1997	4,584,569	254,562	206,773	(4,479)	456,856	10
1998	8,877,495	443,838	440,785	(117,169)	767,454	9

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 analytic value. At December 31, 1998, the aggregate provision for losses on investments was \$22.9 million (1997 – \$27.8 million). The decrease in provisions resulted from the sale of FCA. At December 31, 1998 the Fairfax investment portfolio had an unrealized gain of \$5.5 million compared to an unrealized gain at December 31, 1997 of \$122.7 million.

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



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 and reinsurance subsidiaries of Fairfax for the past five years in the following table:

	<b>Net Premiums Written to Surplus (Common Shareholders' Equity)</b>				
	<b>1998</b>	<b>1997</b>	<b>1996</b>	<b>1995</b>	<b>1994</b>
<b>Insurance</b>					
Commonwealth	0.5	0.6	0.6	0.7	0.8
Crum & Forster	0.7	-	-	-	-
Falcon	<0.1	-	-	-	-
Federated	1.6	1.2	1.2	1.2	0.9
Lombard	1.7	1.4	1.7	2.0	2.3
Markel	1.3	0.9	1.2	1.6	1.3
Ranger	1.2	1.1	1.1	1.2	1.5
<b>Reinsurance</b>					
Odyssey Reinsurance (New York)	0.5	0.5	0.6	-	-
Odyssey Re London and Bermuda	0.7	-	-	-	-
CTR	1.0	-	-	-	-
Canadian insurance industry	1.2	1.2	1.3	1.3	1.4
U.S. insurance industry	0.9	0.9	1.0	1.1	1.3

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, 1998, Fairfax's Canadian property and casualty insurance subsidiaries had a combined Section 516 surplus of approximately \$274 million (1997 - \$442 million), in excess of minimum requirements. The reduction in surplus occurred due to the payment of dividends during 1998.

In the U.S., the National Association of Insurance Commissioners (NAIC) has 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. At the end of 1998, Ranger, Odyssey Reinsurance and Crum & Forster had capital and surplus in excess of three times the authorized control level.

Fairfax and its insurance subsidiaries are rated as follows by the respective rating agencies:

	<b>A.M. Best</b>	<b>Standard &amp; Poor's</b>	<b>Duff &amp; Phelps</b>	<b>DBRS</b>	<b>Moody's</b>
Fairfax	–	BBB+	BBB+*	A–	Baa3
Commonwealth	A	A–	A+	–	–
Crum & Forster	A–	A–	A	–	–
Falcon	–	A–	–	–	–
Federated	A	A–	–	–	–
Lombard	A–	A–	A+	–	–
Markel	A–	A–	–	–	–
Ranger	A–	–	A	–	–
CRC (Bermuda)	A–	–	–	–	–
CTR	A–	A–	A	–	–
Odyssey Reinsurance (New York)	A–	A–	A	–	–
Odyssey Re London and Bermuda	A–	A–	A	–	–
Odyssey Re Stockholm	A–	A–	A	–	–
Wentworth	A	–	–	–	–

\* *Fairfax's claims paying ability is rated a+ by Duff & Phelps.*

In 1998, DBRS raised the rating on our senior debt to A– from BBB (high).

### **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's parent company-only income statement is disclosed on page 75. As shown, Fairfax had net revenue of \$167 million in 1998, consisting of dividends from its insurance subsidiaries (\$135 million), management fees (\$16 million) and interest income (\$30 million) offset by realized losses primarily from the amortization of the S&P puts (\$14 million). After interest expense (\$81 million), operating expenses (\$17 million) and non-recurring expenses (\$10 million), the parent company (or holding company) had income of \$59 million before taxes. As inter-company dividends are tax free, the parent company paid no income taxes. After recording a recovery of deferred income taxes of \$30 million for the parent company's tax losses, net income after taxes amounted to \$89 million. This income statement shows that in 1998, Fairfax comfortably met all its obligations from internal sources.

In 1999, Fairfax continues to have access to dividends and management fees and should again comfortably meet all its obligations from internal sources.

Fairfax has a large cash and liquid investment holding of \$305 million available to meet unexpected requirements. The cash in the holding company would permit Fairfax to meet its net interest and other expenses for five to six years without access to any dividends from its insurance and reinsurance subsidiaries.

Also, Fairfax has in excess of \$1.3 billion of unused, unsecured, committed, five year bank lines. The principal covenant attached to these lines is a covenant to maintain a net debt to equity ratio not exceeding 1:1.

The company manages its debt levels based on the following financial measurements and ratios (with Lindsey Morden equity accounted):

	<b>1998</b>			
	<b>Pro Forma</b>			
	<b>(with TIG)<sup>(1)</sup></b>	<b>1998</b>	<b>1997</b>	<b>1996</b>
Net debt ( <i>\$ millions</i> )	1,514.0	1,139.0	511.3	369.4
Net debt to equity	47%	51%	37%	41%
Net debt to capital	32%	34%	27%	29%
Net debt to earnings		3.1x	2.2x	2.4x
Interest coverage		6.6x	8.7x	6.2x

<sup>(1)</sup> As explained under *Financial position* on page 15.

The company's financial position is very strong. The increase in net debt/equity and net debt/capital ratios in 1998 is principally due to the acquisitions in 1998 and also due to the translation effect of U.S. dollar-denominated debt.

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.

### **Issues and Risks**

The following issues and risks, among others, should also be considered in evaluating the outlook of the company.

#### *Claims Reserves*

The major risk that all property and casualty insurance and reinsurance companies face is that the provision for claims is an estimate and may be found to be deficient in the future for a variety of reasons including unpredictable jury verdicts, expansion of insurance coverage to include exposures not contemplated at the time of policy issue (e.g. asbestos, pollution, breast implants), or poor weather. The provision for claims amounted to \$13,161 million on Fairfax's balance sheet as at December 31, 1998.

#### *Reinsurance Recoverables*

Most insurance and reinsurance companies reduce their liability for any individual claim by reinsuring amounts in excess of the maximum they want to retain. This third party reinsurance does not relieve the company of its primary obligation to the insured. Reinsurance recoverables can become an issue mainly due to solvency credit concerns but also due to policy disputes. Fairfax had \$3,820 million recoverable from reinsurers as at December 31, 1998.

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#### *Catastrophe Exposure*

Insurance and reinsurance companies are subject to losses from catastrophes like earthquakes, windstorms or hailstorms, which are unpredictable and can be very significant.

#### *Prices*

Prices in the insurance and reinsurance industry are cyclical and can fluctuate quite dramatically. With under-reserving, competitors can price below underlying costs for many years and still survive.

#### *Foreign Exchange*

The company has assets, liabilities, revenue and costs that are subject to currency fluctuations, particularly in the U.S. dollar but also other foreign currencies. These currency fluctuations have been and can be very significant.

#### *Cost of Revenue*

Unlike most businesses, the insurance and reinsurance business can have enormous costs that bear no relation to revenue. Similar to short selling in the stock market (selling shares not owned), there is no limit to the losses that can arise from most insurance policies.

#### *Regulation*

Insurance and reinsurance companies are regulated businesses which means that Fairfax does not have access to its insurance and reinsurance subsidiaries' net income and shareholders' capital without the requisite approval of applicable insurance regulatory authorities.

#### *Common Stock Holdings*

The company has common stocks in its portfolio. As common stocks fluctuate, the company's equity (or surplus) is exposed to fluctuations in the stock market.

#### *Goodwill*

Most of the goodwill on the balance sheet comes from Lindsey Morden. Continued profitability is essential for there to be no deterioration in the carrying value of the goodwill.

#### *Ratings*

The company has excellent claims paying and debt ratings by the major rating agencies in North America. As financial stability is very important to its customers, the company is vulnerable to downgrades by the rating agencies.

#### *Holding Company*

Being a small holding company, Fairfax is very dependent on strong operating management, which makes it vulnerable to management turnover.

**Quarterly Data (unaudited)***(in \$ millions except per share data)*

<i>Years ended December 31</i>	<b>First quarter</b>	<b>Second quarter</b>	<b>Third quarter</b>	<b>Fourth quarter</b>	<b>Full year</b>
1998					
Revenue	637.2	648.2	1,157.8	1,131.1	3,574.3
Net earnings	52.8	58.1	108.7	167.9	387.5
Net earnings per share	\$4.75	\$4.79	\$9.08	\$14.01	\$32.63
1997					
Revenue	484.9	545.2	547.4	510.8	2,088.3
Net earnings	31.9	62.9	71.0	66.7	232.5
Net earnings per share	\$3.05	\$6.01	\$6.51	\$6.02	\$21.59

**Stock Prices**

Below are The Toronto Stock Exchange high, low and closing prices of subordinate voting shares of Fairfax for each quarter of 1998 and 1997.

	<b>First quarter</b>	<b>Second quarter</b>	<b>Third quarter</b>	<b>Fourth quarter</b>
	<i>(\$)</i>	<i>(\$)</i>	<i>(\$)</i>	<i>(\$)</i>
1998				
High	500.00	600.00	603.00	575.00
Low	253.00	487.00	420.00	390.00
Close	487.00	574.00	441.00	540.00
1997				
High	307.00	403.00	400.00	386.00
Low	285.00	293.00	375.00	295.00
Close	299.00	400.00	383.00	320.00

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**Fairfax Insurance and Reinsurance Companies****Combined Balance Sheets**

as at December 31, 1998 and 1997

(unaudited)

	<b>1998</b> (\$000)	<b>1997</b> (\$000)
<b>Assets</b>		
Accounts receivable and other .....	2,563,649	1,626,636
Recoverable from reinsurers .....	3,820,426	2,164,466
Income taxes refundable .....	24,243	24,766
	<u>6,408,318</u>	<u>3,815,868</u>
<i>Portfolio investments (at book value)</i>		
Cash and short term investments .....	897,728	819,010
Bonds .....	9,861,070	3,849,084
Preferred stocks .....	156,980	273,642
Common stocks .....	801,723	591,750
Real estate .....	94,012	54,324
	<u>11,811,513</u>	<u>5,587,810</u>
Deferred premium acquisition costs .....	277,292	220,113
Deferred income taxes .....	491,767	172,799
Capital assets .....	52,375	41,630
Other assets .....	25,336	18,373
	<u>19,066,601</u>	<u>9,856,593</u>
<b>Liabilities</b>		
Accounts payable and accrued liabilities .....	862,448	364,429
Premium deposits .....	97,443	105,708
	<u>959,891</u>	<u>470,137</u>
Provision for claims .....	13,161,215	6,322,737
Unearned premiums .....	1,651,498	1,113,842
	<u>14,812,713</u>	<u>7,436,579</u>
<b>Shareholders' Equity</b>		
Capital stock .....	2,511,457	1,327,912
Contributed surplus .....	21,932	21,445
Retained earnings .....	760,608	600,520
	<u>3,293,997</u>	<u>1,949,877</u>
	<u>19,066,601</u>	<u>9,856,593</u>

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**Fairfax Insurance and Reinsurance Companies****Combined Statements of Earnings***for the years ended December 31, 1998 and 1997**(unaudited)*

	<b>1998</b> <i>(\$000)</i>	<b>1997</b> <i>(\$000)</i>
<b>Revenue</b>		
Gross premiums written .....	2,966,376	1,883,560
Net premiums written .....	<u>2,276,607</u>	<u>1,392,627</u>
Net premiums earned .....	<u>2,394,851</u>	<u>1,460,641</u>
<b>Expenses</b>		
Losses on claims .....	1,889,412	1,034,665
Operating expenses .....	374,613	217,343
Commissions, net .....	<u>442,205</u>	<u>264,790</u>
	<u>2,706,230</u>	<u>1,516,798</u>
<b>Underwriting loss</b> .....	<u>(311,379)</u>	<u>(56,157)</u>
<b>Investment and other income (expense)</b>		
Interest and dividends .....	432,024	242,300
Realized gains on investments .....	<u>429,766</u>	<u>207,539</u>
	861,790	449,839
Other .....	<u>(52,816)</u>	<u>(19,104)</u>
	<u>808,974</u>	<u>430,735</u>
<b>Earnings before income taxes</b> .....	497,595	374,578
Provision for income taxes .....	<u>109,838</u>	<u>99,488</u>
<b>Net earnings</b> .....	<u>387,757</u>	<u>275,090</u>

**Fairfax Insurance and Reinsurance Companies**

Fairfax's insurance business is conducted by a number of subsidiaries. These subsidiaries underwrite a wide range of commercial and personal property, oil and gas, casualty and life insurance and property, casualty and life reinsurance in Canada, the United States and internationally.

**Fairfax with Equity Accounting of Lindsey Morden****Consolidated Balance Sheets**

as at December 31, 1998 and 1997

(unaudited)

	<b>1998</b> (\$000)	<b>1997</b> (\$000)
<b>Assets</b>		
Cash and short term investments .....	245,999	207,104
Marketable securities .....	59,366	–
Share subscription receipts cash in trust .....	959,700	–
Accounts receivable and other .....	2,609,033	1,655,320
Recoverable from reinsurers .....	3,820,426	2,164,466
Income taxes refundable .....	18,629	33,683
	<u>7,713,153</u>	<u>4,060,573</u>
<i>Portfolio investments</i>		
Subsidiary cash and short term investments (market value – \$898,975; 1997 – \$823,473) .....	898,975	823,473
Bonds (market value – \$9,879,987; 1997 – \$3,970,151) .....	9,851,956	3,853,505
Preferred stocks (market value – \$159,337; 1997 – \$297,101) .....	154,980	271,642
Common stocks (market value \$767,200; 1997 – \$565,562) .....	794,088	585,063
Real estate (market value – \$94,460; 1997 – \$54,627) .....	94,460	54,627
Total (market value – \$11,799,958; 1997 – \$5,710,980) ..	<u>11,794,459</u>	<u>5,588,310</u>
Investment in Lindsey Morden .....	101,786	31,043
Deferred premium acquisition costs .....	277,292	220,113
Deferred income taxes .....	521,834	173,029
Capital assets .....	53,990	43,584
Goodwill .....	8,974	10,784
Other assets .....	37,522	22,149
	<u>20,509,010</u>	<u>10,149,585</u>
<b>Liabilities</b>		
Share subscription receipts .....	959,700	–
Accounts payable and accrued liabilities .....	728,090	263,067
Premium deposits .....	97,443	105,708
	<u>1,785,233</u>	<u>368,775</u>
Provision for claims .....	13,161,215	6,322,737
Unearned premiums .....	1,651,498	1,113,842
Contingent value rights .....	–	45,988
Long term debt .....	1,444,411	718,431
	<u>16,257,124</u>	<u>8,200,998</u>
Excess of net assets acquired over purchase price .....	227,803	184,097
<b>Shareholders' Equity</b>		
Capital stock .....	1,222,339	766,739
Retained earnings .....	1,016,511	628,976
	<u>2,238,850</u>	<u>1,395,715</u>
	<u>20,509,010</u>	<u>10,149,585</u>

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**Fairfax with Equity Accounting of Lindsey Morden****Consolidated Statements of Earnings***for the years ended December 31, 1998 and 1997**(unaudited)*

	<b>1998</b> <i>(\$000)</i>	<b>1997</b> <i>(\$000)</i>
<b>Revenue</b>		
Gross premiums written .....	2,966,376	1,883,560
Net premiums written .....	<u>2,276,607</u>	<u>1,392,627</u>
Net premiums earned .....	2,394,851	1,460,641
Interest and dividends .....	443,838	254,562
Realized gains on investments .....	440,785	206,773
Equity earnings of Lindsey Morden, net of dividends .....	<u>12,388</u>	<u>1,832</u>
	<u>3,291,862</u>	<u>1,923,808</u>
<b>Expenses</b>		
Losses on claims .....	1,889,412	1,034,665
Operating expenses .....	407,375	249,421
Commissions, net .....	442,205	264,790
Interest expense .....	<u>84,356</u>	<u>43,182</u>
	<u>2,823,348</u>	<u>1,592,058</u>
<b>Earnings before income taxes</b> .....	468,514	331,750
Provision for income taxes .....	<u>80,979</u>	<u>99,252</u>
<b>Net earnings</b> .....	<u>387,535</u>	<u>232,498</u>
<b>Net earnings per share</b> .....	\$ 32.63	\$ 21.59

**Lindsey Morden Group Inc.****Consolidated Balance Sheets***as at December 31, 1998 and 1997*

	<b>1998</b> (\$000)	<b>1997</b> (\$000)
<b>Assets</b>		
Cash .....	8,360	290
Accounts receivable .....	91,957	30,925
Claims in process .....	61,981	14,872
Temporary investment in common shares .....	20,331	-
Prepaid expenses .....	9,011	1,344
Deferred income taxes .....	3,483	-
	<u>195,123</u>	<u>47,431</u>
Property and equipment .....	40,598	10,851
Goodwill .....	267,426	30,535
Investment in affiliates .....	3,312	-
Other assets .....	20,051	5,729
	<u>526,510</u>	<u>94,546</u>
<b>Liabilities</b>		
Bank indebtedness .....	31,824	594
Accounts payable and accrued liabilities .....	116,658	19,578
Income taxes payable .....	11,520	2,235
Current portion of long term debt .....	6,581	-
Deferred income taxes .....	3,695	3,584
	<u>170,278</u>	<u>25,991</u>
Long term debt .....	137,655	10,805
Future retirement payments .....	6,644	6,327
Pension and other liabilities .....	20,694	-
	<u>335,271</u>	<u>43,123</u>
<b>Shareholders' Equity</b>		
Capital stock .....	152,228	30,715
Retained earnings .....	39,011	20,708
	<u>191,239</u>	<u>51,423</u>
	<u>526,510</u>	<u>94,546</u>

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**Lindsey Morden Group Inc.**  
**Consolidated Statements of Earnings**  
*for the years ended December 31, 1998 and 1997*

	<b>1998</b> <i>(\$000)</i>	<b>1997</b> <i>(\$000)</i>
<b>Revenue</b> .....	294,843	166,331
<b>Cost and expenses</b>		
Cost of service .....	211,482	132,230
Selling, general and administration .....	62,145	25,469
Interest .....	5,610	1,522
Goodwill amortization .....	2,935	1,066
	<u>282,172</u>	<u>160,287</u>
<b>Earnings before income taxes</b> .....	12,671	6,044
Provision for income taxes .....	5,384	3,009
	<u>7,287</u>	<u>3,035</u>
<b>Net earnings from continuing operations</b> .....	7,287	3,035
<b>Discontinued operations</b> .....	15,988	-
	<u>23,275</u>	<u>3,035</u>

**Consolidated Statements of Retained Earnings**  
*for the years ended December 31, 1998 and 1997*

	<b>1998</b> <i>(\$000)</i>	<b>1997</b> <i>(\$000)</i>
<b>Retained earnings – beginning of year</b> .....	20,708	20,444
Net earnings for the year .....	23,275	3,035
Dividends .....	<u>(4,972)</u>	<u>(2,771)</u>
<b>Retained earnings – end of year</b> .....	<u>39,011</u>	<u>20,708</u>

*These condensed financial statements have been prepared from the Lindsey Morden Group Inc. audited consolidated financial statements as at and for the years ended December 31, 1998 and 1997, copies of which are available on request.*

**Fairfax Financial Holdings Limited****Unconsolidated Balance Sheets***as at December 31, 1998 and 1997**(unaudited)*

	<b>1998</b> <i>(\$000)</i>	<b>1997</b> <i>(\$000)</i>
<b>Assets</b>		
<i>Subsidiary companies</i>		
Insurance companies .....	1,789,263	698,976
Reinsurance companies .....	1,573,505	1,240,818
Lindsey Morden .....	8,218	30,423
Hamblin Watsa .....	5,367	6,767
Noro .....	2,027	2,031
	<u>3,378,380</u>	<u>1,979,015</u>
Cash and short term investments .....	245,999	207,104
Marketable securities .....	59,366	979
Share subscription receipts cash in trust .....	959,700	-
Other assets .....	101,875	43,441
	<u>4,745,320</u>	<u>2,230,539</u>
<b>Liabilities</b>		
Share subscription receipts .....	959,700	-
Accounts payable and other liabilities .....	102,359	70,405
Contingent value rights .....	-	45,988
Long term debt .....	1,444,411	718,431
	<u>2,506,470</u>	<u>834,824</u>
<b>Shareholders' Equity</b>		
Capital stock .....	1,222,339	766,739
Retained earnings .....	1,016,511	628,976
	<u>2,238,850</u>	<u>1,395,715</u>
	<u>4,745,320</u>	<u>2,230,539</u>

*The investments in subsidiaries are carried on the equity basis whereby they are included at their original purchase price plus Fairfax's share of the earnings less dividends.*

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**Fairfax Financial Holdings Limited**  
**Unconsolidated Statements of Earnings**

(parent company-only income statement)

for the years ended December 31, 1998 and 1997

(unaudited)

	<b>1998</b>	<b>1997</b>
	(\$000)	(\$000)
<b>Revenue</b>		
Dividend income .....	135,289	125,829
Interest income .....	29,883	13,970
Management fees .....	16,376	12,406
Realized gains (losses) .....	(14,674)	696
	<u>166,874</u>	<u>152,901</u>
<b>Expenses</b>		
Interest expense .....	80,713	42,559
Operating expenses .....	16,662	8,991
Non-recurring expenses .....	10,084	9,033
	<u>107,459</u>	<u>60,583</u>
<b>Earnings before income taxes</b> .....	59,415	92,318
Recovery of income taxes .....	30,000	0
<b>Net earnings</b> .....	<u>89,415</u>	<u>92,318</u>

## APPENDIX

To Our Shareholders:

May 19, 1998

This letter is being mailed to you with our first quarter report to provide you with additional details on our recently announced purchase of Crum & Forster (CFI) as opposed to waiting for the 1998 Annual Report.

On March 11, 1998, we announced that we had signed an unconditional definitive agreement to purchase CFI, an established commercial lines only company located in Morristown, New Jersey, for US\$565 million. As of March 31, 1998, CFI had a written down book value of US\$765 million and an investment portfolio of US\$3.3 billion. Net premiums written by CFI amounted to US\$939 million in 1997. Through a reinsurance policy issued by American Re (a large reinsurance company owned by Munich Re), the vendor, Talegen (a subsidiary of Xerox Financial Services), is providing a US\$400 million stop loss contract against adverse development in reserves and reinsurance unrecoverables.

The purchase is subject to regulatory approval and is expected to close by the third quarter of 1998. We financed the purchase price of US\$565 million (plus inter-company debt of US\$115 million) through the issue of 1 million Fairfax shares at \$475 per share and a two-tranche US\$400 million debenture issue (US\$175 million at 6<sup>7</sup>/<sub>8</sub>% for 10 years and US\$225 million at 7<sup>3</sup>/<sub>8</sub>% for 20 years). Our net debt/total capital ratio remains in the 30% range after this acquisition and by year end 1998, we expect this ratio to be similar to year end 1997. Our financial position will continue to be very strong.

So why are we buying CFI? The major reasons are not too dissimilar from previous purchases discussed in earlier reports.

- 1) CFI is a well established, commercial lines only company with an excellent brand name and a small, very select, high quality independent agency force. The company is rated A- (excellent) by A.M. Best Company and Standard & Poor's.
- 2) Management is excellent at CFI, led by Jim Stark, President and Chief Operating Officer. Bob Rich, President and Chief Executive Officer of Ranger, will be taking the place of the former Chairman and Chief Executive Officer of CFI, who determined to return to his former position at Talegen. A replacement for Bob Rich at Ranger will be announced shortly.
- 3) The company fits well with Lombard Canada. While each company will be operated independently, there are many synergies between the two companies. Also, our experience with Lombard Canada, where combined ratios dropped from 116% prior to our acquisition to the 101-103% level in 3 years, makes us comfortable that CFI can experience similar declines.
- 4) CFI provides Fairfax with an excellent platform in the United States, the largest market in the world. As CFI's agents control US\$16 billion in commercial lines business, the opportunity for growth in the long term at CFI is very significant.

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- 5) The US\$400 million stop loss contract with American Re together with the US\$200 million purchase price discount to book value provides very significant downside protection for Fairfax.
  - 6) With CFI's combined ratios expected to decline from 110% in 1998 to 104% in 2000 and an investment portfolio of US\$3.3 billion, Fairfax should achieve its 20% return objective on its purchase price of US\$565 million.
  - 7) The purchase of CFI was able to be financed at fair terms and Fairfax continues to maintain its very strong financial position. Cash in the holding company is expected to increase to \$300 million by year end 1998 and long term, *unused* bank lines should increase further from \$1.0 billion.

As with our acquisitions in the past, there are risks in any purchase and the main ones are discussed below.

- a) CFI has significant long tail liabilities (including asbestos and environmental). We feel the US\$400 million indemnification is sufficient protection but only time will tell (you may have sold your shares long before we find out!).
- b) CFI lacked parental commitment since 1993. While the impact on existing management and clients has been minimal, the ability to attract new key associates and clients has suffered.
- c) Historical results at CFI have been very poor (due mainly to adverse loss development). Adverse loss development from the past should not be a problem going forward due to the stop loss contract.
- d) CFI has reinsurance recoverables of approximately US\$1.2 billion on a net reserve base of US\$2.6 billion. The company is exposed to potential bad debts on its reinsurance recoverables. We feel comfortable with the quality of the recoverables and also the bad debt reserve of US\$75 million already in place together with the US\$400 million stop loss contract.

Similar to the acquisitions in the last few years, we feel that we have significant protection against any downside from the past at CFI and we are quite excited about the company's prospects in the future. However, please remember that managements (including us) always feel excited at the time of purchase but unfortunately there are no guarantees. In time, results will tell!

After the purchase and the financing of CFI, Fairfax's investment portfolios will increase to approximately \$11.2 billion\* or \$928 per share – up 78% from \$521 per share as at December 31, 1997. Investment income per share (only interest and dividends) from these portfolios, which ultimately drives earnings per share, book value per share and intrinsic value per share, should increase to approximately \$50 per share on an annualized basis from the annualized rate of \$30 per share at year end 1997.

As always, who knows what the short term will bring, but we are very excited about our long term prospects with the purchase of CFI.

*V. P. Watsa*

V. Prem Watsa (signed)  
*Chairman and Chief  
Executive Officer*

(\*) Includes the purchase of two Skandia subsidiaries announced on February 20, 1998 and expected to close by the third quarter. The Skandia subsidiaries, which we purchased for US\$75 million, have an investment portfolio of US\$500 million and a book value of US\$105 million. A very valuable plus in this purchase is Jan Wangård, President and Chief Executive Officer of these companies.

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To our Shareholders:

October 2, 1998

In our 1996 Annual report, we noted the many “warning lights flashing” with regard to the U.S. and Canadian stock markets. In our 1997 Annual Report, we changed the “warning lights flashing” to “red alert” and stated that “Given the levels of the market, the possibility of deflation, mindless ‘long term’ investing in mutual funds by individuals and a lack of investment ‘values’ in the North American stock markets, we have reduced our U.S. and Canadian common stock investments significantly”. As a percentage of our investment portfolios, our common stock positions at year end 1997 were the lowest in 12 years and currently, at approximately 5%, are even lower. This of course means that the other 95% (or in excess of \$10.5 billion) is largely invested in cash and high quality bonds.

In the spirit of “predicting rain doesn’t count, building an ark does”, in the past twelve months we have purchased US\$700 million of at-the-money S&P 500 Index puts. These puts have been purchased at an average index level of 1012 with maturities from August 1999 to June 2001. This means that if the S&P 500 Index declines below 1012, the value of Fairfax’s investment increases to the tune of almost US\$70 million for every 100 point drop in the index. Our cost for these puts amounted to US\$72.8 million – a premium of approximately 10.4% on the notional amount of the puts.

If the S&P 500 Index stays above the 1012 level for the next two to three years and Fairfax continues to hold the S&P 500 Index puts, those puts will be worthless and Fairfax will have lost US\$72.8 million – spread over two to three years. While this is a significant cost, on an after-tax basis it is only a reasonably small portion of our recent earnings.

Since we began in the investment business about 25 years ago, we have never seen the level of speculation that we have experienced in the past twelve months. Sadly, the mindless “long term” investing by individuals may well lead to significant pain for the average investor in the market. We have attempted to prudently protect our shareholders’ capital from this pain.

*V. P. Watsa*

V. Prem Watsa (signed)

*Chairman and Chief  
Executive Officer*

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

	Return on average share-holders' equity	Per Share		Revenue	Earnings before income taxes	Net earnings	Total assets <sup>(1)</sup>	Investments	Net debt <sup>(2)</sup>	Share-holders' equity	Shares outstanding at year-end (000)	Closing stock price
		Share-holders' equity	Net earnings – fully diluted									
<i>For the years ended December 31:</i>												
1985	–	2.08	(1.89)	17.0	(0.9)	(0.9)	41.5	32.7	–	10.4	5,000	3.25 <sup>(3)</sup>
1986	25.4%	5.89	1.35	53.7	9.1	6.5	129.8	95.6	2.8	41.3	7,007	12.75
1987	31.3%	8.32	2.23	113.0	18.2	16.0	185.4	124.0	2.8	61.0	7,337	12.37
1988	21.2%	10.13	1.94	133.6	21.3	14.4	246.8	137.5	28.2	74.2	7,322	15.00
1989	20.3%	12.41	2.25	125.8	19.2	16.7	248.1	133.9	22.0	90.8	7,316	18.75
1990	23.0%	17.29	2.92	195.4	23.2	21.3	536.0	335.7	65.9	94.7	5,477	11.00
1991	21.3%	21.41	3.94	250.0	32.5	22.5	516.6	341.2	51.3	116.8	5,455	21.25
1992	7.7%	23.76	1.76	286.8	7.0	10.0	590.5	396.2	68.2	143.8	6,055	25.00
1993	20.3%	35.13	5.42	344.0	46.7	33.3	1,200.3	848.8	132.4	279.5	7,955	61.25
1994	12.1%	43.77	4.66	634.9	46.0	38.1	2,173.4	1,551.3	218.0	391.9	8,955	67.00
1995	20.1%	53.28	9.79	1,145.5	95.9	87.5	2,873.5	1,668.1	227.7	472.6	8,869	98.00
1996	21.4%	87.05	15.36	1,475.8	187.3	150.8	5,778.4	3,454.5	369.4	911.1	10,466	290.00
1997	20.4%	125.38	21.59	2,088.3	336.0	232.5	10,207.3	5,795.7	511.3	1,395.7	11,132	320.00
1998	20.1%	184.54	32.63	3,574.3	484.8	387.5	20,886.7	12,108.4	1,139.0	2,238.9	12,132	540.00

<sup>(1)</sup> Commencing in 1995, reflects a change in accounting policy for reinsurance recoverables

<sup>(2)</sup> Total debt (beginning in 1994, net of cash in the holding company) with Lindsey Morden equity accounted

<sup>(3)</sup> When current management took over in September 1985

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

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**Directors of the Company**

- \* Winslow W. Bennett  
President, Winwood Holdings Ltd.
- \* Robbert Hartog  
President, Robhar Investments Ltd.  
Kenneth R. Polley  
President and Chief Executive Officer  
Lindsey Morden 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*  
Robert H. Rich, Chairman  
James Stark, President  
*Crum & Forster Holdings, Inc.*  
Kenneth Kwok, President  
*Falcon Insurance Company Limited*  
John M. Paisley, President  
*Federated Insurance Company of Canada*  
Anthony F. Hamblin, President  
*Hamblin Watsa Investment Counsel Ltd.*  
Richard A. Gulliver, President  
*The Hub Group Limited*  
Kenneth R. Polley, President  
*Lindsey Morden Group Inc.*  
Byron G. Messier, President  
*Lombard General Insurance Company of Canada*  
Mark J. Ram, President  
*Markel Insurance Company of Canada*  
James F. Dowd, Chairman  
Andrew A. Barnard, President  
Michael C. Watson, Executive Vice President  
*Odyssey Re Group Ltd.*  
Michael Wacek, President  
*Odyssey Reinsurance Corporation and TIG Reinsurance Company*  
Jean-Philippe Casanova, President  
*Compagnie Transcontinentale de Réassurance*  
Jan Wangård, President  
*Odyssey Re Stockholm Insurance Corporation (publ)*  
*Odyssey Re (London) Limited*

Philip Broughton, President  
*Ranger Insurance Company*  
Courtney Smith, President  
*TIG Insurance Company*

**Officers of the Company**

Trevor J. Ambridge  
Vice President and Chief Financial Officer  
Sam Chan  
Vice President  
Francis Chou  
Vice President  
J. Paul T. Fink  
Vice President  
Brenda Harvey  
Vice President and Corporate Secretary  
Bradley P. Martin  
Vice President  
Eric P. Salsberg  
Vice President, Corporate Affairs  
Ronald Schokking  
Vice President, Finance  
John C. Varnell  
Vice President  
V. Prem Watsa  
Chairman and Chief Executive Officer

**Head Office**

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Telephone (416) 367-4941  
Web site [www.fairfax.ca](http://www.fairfax.ca)

**Auditors**

PricewaterhouseCoopers LLP

**General Counsel**

Tory Tory DesLauriers & Binnington

**Transfer Agent and Registrar**

CIBC Mellon Trust Company

**Share Listing**

The Toronto Stock Exchange  
Stock Symbol FFH

**Annual Meeting**

The annual meeting of shareholders of Fairfax Financial Holdings Limited will be held on Tuesday, April 13, 1999 at 4:30 p.m. in Room 106 at the Metro Toronto Convention Centre, 255 Front Street West, Toronto.