

The FAIRFAX Newsletter

Welcome to the Fairfax Newsletter. This is the inaugural issue of a newsletter we will publish on a periodic basis. We seek to accomplish two major goals in publishing this newsletter. First, we intend to promote a broader base of knowledge about Fairfax to all of our employees. Second, we seek to promote and facilitate greater cooperation and interaction across our group, between companies and among employees. In future issues we intend to highlight centers of excellence within the Fairfax group, focus on interesting and novel approaches to building lines of business, and provide profiles of individuals and offices as well as conduct interviews with key executives within Fairfax.

It is our hope that you, the employees of the Fairfax group of companies, will also actively engage in developing the message of our newsletter. We welcome your comments, critiques, suggestions and ideas for stories and features. Please do not hesitate to email newsletter@fairfaxinsgroup.com at any time.

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AN INTERVIEW WITH PREM WATSA, CHAIRMAN AND CEO OF FAIRFAX FINANCIAL HOLDINGS LIMITED

Fairfax began after you had already started Hamblin Watsa Investment Counsel. Would you please tell us about how you started Hamblin Watsa?

Hamblin Watsa Investment Counsel opened its doors in 1984. After working as an investment analyst and money manager in large organizations, I teamed with my former boss from Confederation Life, Tony Hamblin, to start our own investment manager where we could run our business and manage money in our own style, answering only to our clients. We had credibility, a track record we had built managing money together at Confederation Life, and enough people who believed in our abilities and gave us enough of their own money to manage that we were able to start the business. We were soon joined by partners, most of whom we had worked with previously

– Brian Bradstreet, Frances Burke, Roger Lace, Enza LaSelva and Mary Pritchard, all of whom are still with us. With clients who understood our value-oriented investment style, our business grew nicely.

How would you describe the investment style of Hamblin Watsa?

Our investment philosophy at Hamblin Watsa rests on the principles of value investing championed by Ben Graham and practised by Warren Buffett and John Templeton. We have a long term value-oriented approach to managing money, which results in our viewing the risk of capital loss within a portfolio differently than how other investment managers may view it. We do not worry about the short term fluctuations of the market, focusing instead on the long term asset values of our investments. We look at markets declining as an opportunity to buy good assets cheaply, or in other words, an opportunity to buy one dollar for fifty cents, as my old friend Peter Cundill would say. Similarly, when market exuberance sends prices well above our estimation of value, we don't buy, and we might sell. This long term approach takes solid research and courage and conviction, because you are regularly acting differently from the prevailing market sentiment and you may initially, and sometimes for quite a while, suffer unrealized losses until the market ultimately validates your investment choice. Simply put, a clear understanding of the fundamental value of our holdings allows us to go against the crowd. It is lonely at times, but it works.

Warren Buffett is the most well-known practitioner of this brand of long term value investing. We have long admired his skill and investment returns. But the most important idea I got from Mr. Buffett – and it was Francis Chou (who later became a

young employee at Hamblin Watsa) who brought this idea to me – is that Warren Buffett, like Larry Tisch and Henry Singleton before him, realized that owning insurance companies would allow him to significantly increase the profits of those companies by exercising his investment skills on those companies' float (the "float" is basically the premiums collected but not yet used for paying claims or expenses).

And this lesson inspired you to start Fairfax?

It did. It was a defining moment for us. And we put this lesson into practice in 1985, when the opportunity to buy control of Markel Insurance Company of Canada came to us. With great luck and much hard work, we persuaded a number of our investment management clients, in particular Robbert Hartog who became a director and the Chairman of our Audit Committee, and my former employer Confederation Life, to invest \$5 million to purchase control of Markel Insurance's holding company (which I'll call Fairfax since we subsequently changed the holding company's name to Fairfax Financial). As a result, we gained investment management of the \$40 million float within Markel Insurance.

So you were now a money manager controlling an insurance company.

In my new role as Chairman and controlling shareholder of Fairfax, I was confident that we could manage Markel Insurance's investment portfolio well, but I had no background in running an insurance business. We needed an experienced person to run the insurance operations, so we hired a highly respected insurance industry veteran as CEO of Markel Insurance. Trusting in his expertise and experience, we allowed him to operate the company independently, while we retained exclusive responsibility for managing the company's investment portfolio.

Is it fair to say that this structure and philosophy underlies the Fairfax approach to running an insurance company?

Yes. We had hit upon a very powerful operating philosophy that we continue to follow today. Our goal at Fairfax is to provide long term returns for our shareholders by treating our customers well and our employees well. We realized we could achieve an excellent total return for our shareholders over time by combining disciplined underwriting in our property and casualty insurance businesses – disciplined meaning that business should be written profitably, and writings will be reduced if business cannot be written profitably – with investment management based on value investing principles.

So we permit management of each of our insurance companies to manage their insurance business without interference from head office, while managing investments is all done at head office by Hamblin Watsa. This combination of disciplined underwriting by decentralized companies and a centralized value-oriented investment management dedicated to long term total returns has made Fairfax very different from most other insurance holding companies.

Are there other elements of your investment philosophy that influence how Fairfax's insurance businesses operate?

We brought the discipline of our investment style into our insurance operations. It doesn't make sense to us, as value-oriented long term investors, to pay more for a stock or bond than a price on which, in our estimation based on its value, we should earn a good return over time. The same principle holds true for underwriting. The insurance industry as we all know is very cyclical. We focus on avoiding writing business where we are not being properly compensated for assuming the potential liability. If pricing is weak and the business cannot be written profitably, we simply decline to write the business. Similarly, in a hard market where pricing is strong and profitable, we will focus on greatly expanding the amount of business written. Management of our

companies understand clearly that they will be measured only on the profitability of their underwriting. As value investors, we focus on preserving capital and not paying too much for assets. That value philosophy drives our approach to the insurance business as well.

I think this focus on disciplined underwriting is very powerful and not all that common in the property and casualty industry. We judge our insurance companies by their profitability, not by the volume of business they write. Effectively, this is the same performance standard we use in judging our portfolio returns at Hamblin Watsa.

What is the geographic scope of the Fairfax insurance operations?

Fairfax now owns and has minority investments in a growing number of property and casualty insurance and reinsurance companies around the world. Since our first purchase in 1985, we have had the good fortune to build our presence in the industry by numerous acquisitions. We are now operating in over 100 countries around the world. We have made many "fair and friendly" acquisitions over the years and have been very fortunate indeed to have attracted top flight executives and talented people who were drawn to our decentralized approach and our culture.

Our largest insurance companies operate in the major developed markets in North America and Europe and offer a wide range of primarily commercial lines, including many specialty and niche lines of business. Our reinsurance business operates essentially worldwide. And we are also minority partners in other insurance businesses, notably in India, China and the Middle East. These parts of the world are developing rapidly, and because they have low insurance and reinsurance product penetration, these areas hold significant promise for us in the future.

Prem, you often speak about the Guiding Principles of Fairfax. What are these principles and how have

they helped shape the culture of the company?

Not too long after we started, we thought hard about the objectives, the structure and the values that constituted the culture of Fairfax – the way that everyone in Fairfax together would operate our business – and we wrote them down. They have been with us for a long time, we refer to them constantly, and we don't expect them to change. I hope that you will print them in the newsletter so that everyone can read them. They are all important, but I would particularly emphasize the first item of each of our objectives, structure and values, and our value of working cooperatively, without egos: as President Reagan once said, "Anything in the world is possible if you don't care who gets the credit".

You probably know that the name "Fairfax" was chosen as an abbreviation of "fair, friendly acquisitions". The concept of "fair and friendly" is central to our culture. We want to treat everyone we deal with well. We don't engage in hostile acquisitions. "Fair and friendly" doesn't mean that we are weak or that we are not focused on our businesses, but it establishes a way of operating businesses that is comfortable for all our employees and that gives us a reputation that over time has become a real advantage in our business dealings.

And as Fairfax has grown larger and more complex, how has the approach to managing the enterprise changed?

There are two points I would like to mention. First, we recently appointed Andy Barnard as President and COO of our Fairfax Insurance Group. In this new role, Andy will oversee all of Fairfax's insurance and reinsurance operations and work with the leaders of our companies on strategy and coordination. In Odyssey Re, Andy built one of the most successful reinsurance companies in the world over the course of the last fifteen years. He is a wonderful example of the "entrepreneur unleashed" that our decentralized model for operations successfully nurtures.

Second, we are actively considering how to make the special skills and expertise we have in various parts of our extended operations available to the benefit of other parts of the organization, and how to ensure the establishment and practice of the Fairfax culture throughout the organization, while at the same time fully maintaining our decentralized structure. This is important but not easy, so it is something that we, and we hope everyone throughout the group, will think about and work on.

You have talked about "doing good by doing well". What does that mean?

We all recognize that there are many needs in the communities in which we live that simply can't be taken care of by governments. If we operate our business profitably, we have the means to assist in taking care of those needs. Doing well in your business gives you the ability to make a significant difference by doing good in the world and within the communities in which you operate.

In order to support the communities in which we operate our businesses and live, we contribute 1% of our pre-tax profits (and we are thinking of raising that) to charitable organizations and projects.

The power of "doing good by doing well" struck me when I realized that when Fairfax started in 1985, its total worth was about \$2 million, while in 2010 alone we donated in excess of \$10 million to our communities. Isn't that unbelievable! First you have to do well in your business, and that gives you the ability to do good to help the people in our communities who need it the most. We have many heartwarming examples of where we have helped.

Can you give us a recent example?

In September of this year we visited a boarding school in Poland devoted to the education of children who were born blind. We found ourselves in a truly wonderful place where people have dedicated their lives to helping the blind children become fully functioning and

productive members of society by the time they leave the school in their early 20s. Our Polish Re subsidiary made a substantial donation to help the school continue to expand and meet the needs of even more students.

You have been outspoken with your concern about the global economy. Do you have any advice for our employees?

This is a time, I think, to be very careful. We think of the contraction and recession in 2008-2009 and what is happening now as perhaps a one in 50 or one in 100 year event. The only comparable events in recent economic history are Japan since 1990 and the U.S. in the 1930s, where nominal Gross National Product remains flat for 10 to 20 years with many bouts of deflation. Currently, there is very little flexibility in the economic systems because there has been a huge debt build-up over the recent past.

We worry that in the United States there is no ammunition left for government to counter this debt build-up and its negative impact on the economy. Interest rates are already effectively at zero percent and there is no fiscal "ammo" remaining. In 2008-2009 the United States stimulated the economy with a lot of borrowed money, with little positive effect. Further U.S. fiscal stimulus in our opinion is not likely to occur because there is no political consensus that adding more government spending will ease unemployment or otherwise impact the current economic malaise. Europe has already approved austerity budgets to deal with its debt build-up and balance its books. Finally, in China there is a possibility that a major bubble in real estate may burst.

While the 2008-2009 period was a very brief period of recession due to stimulus injected into the economy and the lowering of interest rates at the time, we think the basic problem of a weak economy and too much debt remains. The typical fiscal and monetary options are not readily available, nor do we think they would have much of an effect. So at an individual level,

we think you have to “batten down the hatches” in the face of these problems, do what you can to carry no personal debt, and be very careful as investors. These challenging economic conditions could last for some time to come.

At Fairfax, we have hedged our equity portfolio, we bought U.S. treasury bonds, and since we worry that a slow to no growth environment could tip into deflation, we own contracts that benefit from deflation. We are very conservatively positioned because we are worried. However, I do believe that companies which survive this period will thrive – and we intend to be one of those companies.

With those concerns noted, are you excited about Fairfax today?

I remain very excited and optimistic about our future. Look at what we have in place that we have built over more than twenty-five years. We have a network of wonderful insurance and reinsurance businesses and operations around the world, which are run and staffed by exceptional and talented individuals who have not sacrificed our goal of underwriting profitability simply to write business in the current softer markets, but who have the ability and the capital to increase that business dramatically and profitably in a hard market. We continue to be alert to expanding opportunistically and responsibly. We have an outstanding investment capability at Hamblin Watsa, with a sterling track record over more than twenty-five years, and our investments are excellently positioned to do well in the tough economic conditions we foresee. We are well capitalized, we have a decentralized structure, and we have a wonderful culture which has helped us build an excellent reputation. Our focus has always been on doing well over the long term, and I can't help but be excited in looking at our prospects over the next twenty-five years.

Thank you, Prem.

GUIDING PRINCIPLES

OBJECTIVES:

- » We expect to compound our mark-to-market book value per share over the long term by 15% annually by running Fairfax and its subsidiaries for the long term benefit of customers, employees and shareholders - at the expense of short term profits if necessary.
- » Our focus is long term growth in book value per share and not quarterly earnings. We plan to grow through internal means as well as through friendly acquisitions.
- » We always want to be soundly financed.
- » We provide complete disclosure annually to our shareholders.

STRUCTURE:

- » Our companies are decentralized and run by the presidents except for performance evaluation, succession planning, acquisitions and financing which are done by or with Fairfax. Cooperation among companies is encouraged to the benefit of Fairfax in total.
- » Complete and open communication between Fairfax and subsidiaries is an essential requirement at Fairfax.
- » Share ownership and large incentives are encouraged across the Group.
- » Fairfax will always be a very small holding company and not an operating company.

VALUES:

- » Honesty and integrity are essential in all our relationships and will never be compromised.
- » We are results oriented - not political.
- » We are team players – no “egos”. A confrontational style is not appropriate. We value loyalty - to Fairfax and our colleagues.
- » We are hard working but not at the expense of our families.
- » We always look at opportunities but emphasize downside protection and look for ways to minimize loss of capital.
- » We are entrepreneurial. We encourage calculated risk taking. It is all right to fail but we should learn from our mistakes.
- » We will never bet the company on any project or acquisition.
- » We believe in having fun - at work!

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POLISH RE DONATION

“DOING GOOD” FOR THE SOCIETY FOR THE CARE OF THE BLIND

On a day early in 2011, Marek Czerski, President of Polish Re, met with Katarzyna Wojciechowska, a volunteer since 2007 at The Society for the Care of the Blind located outside of Warsaw in Laski, Poland. Previously, Katarzyna had worked for 21 years in the insurance industry with ten of those years at a Polish insurance company, and so she was quite aware of the presence and success of Polish Re. Established in 1996, Polish Re in fifteen years has grown into a leading presence in the reinsurance markets in Eastern and Central Europe.

While Katarzyna and Marek shared industry ties, the meeting that day had to do with insurance of another sort, ensuring that the mission of the Society for the Care of the Blind continued, and specifically that the Society complete the construction and development of its newest center and its centerpiece property near Gdansk in northern Poland. Katarzyna recounted the story of the Society for the Care of the Blind, which was founded in 1911 by Countess Roza Czacka, a woman born into a family known for its patriotic leaders, who became blind at the age of 22. Roza came to view her circumstance as a blessing rather than an affliction and immersed herself in all of the challenges faced by the sightless. Out of this study and with relentless determination, Roza conceived of the idea of building an educational system and school that would teach sightless persons to become self supporting, thus restoring self dignity. In 1918, she founded the Order of Franciscan Sisters Servants of the Cross to secure and build a staff for carrying out the primary activities of the Society, educating and developing practical skills for blind children living in Poland. In 1922, the school, devoted to carrying out the mission of the Society for the Care of the Blind, opened in Laski, Poland.

Depending upon private donations for the bulk of its funding, the Society attracted many outstanding persons inspired to commit their time and lives to this mission. From the start, Father Wladyslaw Kornilowicz was a spiritual leader of the Society and its mission. He brought Antoni Marylski to Laski, and Antoni led the construction of the school campus and all of the school buildings, including classrooms and administrative and living quarters. By the advent of World War II, 180 children were living at and attending the school, engaged in the challenges of education and practical skill learning. World War II saw over 70% of the infrastructure of the school destroyed, but the aid of worldwide charitable organizations enabled the school to be rebuilt after the war. Mother Czacka remained an involved leader through all of this time, leading a then novel cooperative partnership between the people of Laski and the Franciscan Sisters Servants of the Cross. This partnership, really the cornerstone of the Society, remains in place today and is seen throughout all facets of life and work in Laski.

Today, the school operates three educational centers in Poland for blind children who live at and attend the school. The school serves a range of

ages from kindergarten through high school, educating roughly 300 children and another 350 very young children attend early aid centers. Additionally, there are two separate homes for the care of disabled sightless adults.

The Early Intervention Assistance House is a vital piece of the spectrum of care and education at the school. Here is where the expert teaching, guidance and early involvement in the lives of sightless children and their parents begin. Young, sightless children and their parents have unique challenges. Children learn basic life skills and social functions through repetition and interaction with others. For the sightless, some of these skills are difficult to learn. Parents play a crucial role



Mr. Watsa accepts a welcoming bouquet of flowers from two of the students at the school in Laski operated by The Society for the Care of the Blind.



From left to right, bottom to top row:

Pupil Agata, pupil Agnieszka, pupil Agata, Nun Agata, pupil Ola, Justyna Gołąb (wife of the President of the Blind Center), Władysław Gołąb (President of the Blind Center), Prem Watsa (Chairman and CEO, Fairfax Financial Holdings), Supervisory Mother Anna Maria (Vice President of the Blind Center), Jadwiga Dąbrowska (former pupil, today a librarian in the Blind Center), Nun Benita (Director of the kindergarten in the Blind Center), Nun Irmina (Director of the Boarding School in the Blind Center); Katarzyna Wojciechowska (Advisor for the Management Board of the Blind Center), Vinodh Loganadhan (Fairfax Financial Holdings), Andrew Barnard (COO, Fairfax Insurance Group), Jean Cloutier (Vice President, Fairfax Financial Holdings), Adam Kubicki (Administrative Director for the Blind Center); Marek Czernski (President and CEO, Polish Re), Tomasz Czałbowski (Vice President and CFO, Polish Re), Piotr Grocholski (Director of the Blind Center), Szymon Sławiński (Director of the Voluntary Section in the Blind Center)

in developing these skills in their sightless children. Parents need training as well in order to help their children cope with their unique circumstance. The school offers an array of specialized teaching and knowledge to help parents as well as children in developing basic life skills essential to further success, learning and integration into society.

The story of the Society for the Care of the Blind was deeply moving to Marek and the employees at Polish Re. The culture of Fairfax, and its policy of giving back to the communities in which Fairfax companies and their employees live and operate, fit perfectly with the current needs and the mission of the Society. Helping these

children and their families is truly “doing good by doing well”. Marek and Polish Re contacted Fairfax with a proposal to support the Society, and Fairfax worked expeditiously to endorse a contribution to further strengthen this institution and its mission.

Mr. Watsa, along with other executives within Fairfax and Polish Re, visited the school in Laski in early September of 2011. It was a day filled with meeting children and the dedicated staff of the school, highlighted by the Society and school thanking Fairfax and Polish Re and its employees for their donation of US\$150,000. Władysław Golab, the President of the Blind Center, presented

Mr. Watsa, on behalf of the employees of Polish Re, with The Society’s highest honor, a medal inscribed with the words of Mother Czacka: *Pax et Gaudium in Cruce* (Peace and Joy in the Cross).

Polish Re’s donation will ensure completion of the building of the Early Intervention Assistance House for blind children in Sobieszewo near Gdansk. The house is already serving approximately 150 students and their families in the area of Gdansk. Through the generosity of all of the employees at Polish Re and Fairfax, the Society will continue its mission and reach out to even more of those in need.