MARKEL FINANCIAL HOLDINGS LIMITED

TO OUR SHAREHOLDERS:

1986 was a year of significant achievement for your company. Net income after-tax (including tax loss carryforwards) amounted to $6.5 million compared to a loss of $0.9 million in 1985. The company has never earned more than $1.0 million in the past. Total assets increased to $130 million vs $41 million in 1985 while shareholders' equity increased to $41 million from $10 million in 1985. Fully diluted book value per common share increased by 183% to $5.89 from $2.08 in 1985. After-tax return on average common shareholders' equity was 25.4%. This figure includes the tax loss carryforwards in income, assumes all convertible preferreds are converted into common shares (as they most likely will be) and is based on the average common equity during the year as common equity expanded considerably because of the public issue.

The major reasons for this significant performance in 1986 were three fold:

1) A tremendous increase in Markel's trucking insurance business.

2) A common stock issue of $20 million.

3) Acquisitions.

Keith Ingoe discusses in greater detail in his report the reasons for the superb year that Markel Insurance had in 1986. While the company benefitted from the demise of a major competitor, Keith and his staff have done an outstanding job in managing the company as its business more than doubled during the year.

The business potential that Markel Insurance faced allowed us to complete a public financing of $20 million led by Wood Gundy and Dean Witter Reynolds. We sold 2 million subordinate voting shares from treasury at $10 share in July 1986. The issue was successful because we were very fortunate in having people of the calibre of Dick Falconer, Jim Hinds and Joe Brosseau from Wood Gundy and Bryan Smith and Rob Bell from Dean Witter Reynolds working on our behalf. Rick Salsberg from Tory & Tory, together with Bob Karp, were invaluable in navigating us through the legal maze. It all culminated in a well crafted prospectus which all shareholders should review to better understand our business. We thank these gentlemen for their great effort and welcome our new shareholders. After months of work, we were extremely gratified to receive a cheque for $20 million from small and large investors across Canada. We appreciate the vote of confidence and will do our best to continue to earn it. The common stock issue was a significant milestone for Markel Financial as it placed the company on a very firm financial footing.

Why did we sell subordinate voting shares which have only one vote and retain multiple voting shares (10 votes) for ourselves? Mainly because we wanted to control Markel Financial and manage the company to provide an above average long term return to shareholders. Our multiple voting shares are not traded and can be sold in the public markets only as subordinate voting shares. Also, a takeover offer for our shares, if accepted, immediately triggers a similar offer for all the common shares outstanding. A Canadian Tire type situation, which we find very distasteful, cannot and will not happen with Markel Financial. However, we must add that it is extremely unlikely that we would sell our multiple voting shares even if an offer came in at 100% above the current market price. Thus, our multiple voting shares prevent an investor from getting an attractive one time bonanza. Our feeling though, is that for this short term pain, there could be some excellent long term gains. Berkshire Hathaway, for example, has experienced an unbelievable increase in its share price from $20 in 1965 to $3,500 currently. Any takeover offer for Berkshire Hathaway, though attractive in the short run, would be hard pressed to match the long term returns that have been achieved. For Berkshire Hathaway, this is a fact. For us it is only a goal!

The public issue provided us with $18.4 million after expenses. After providing $5 million in additional capital to Markel Insurance, we had $13.5 million available for acquisitions. Fortunately, we were able to complete two acquisitions in late 1986. We purchased Sphere Reinsurance Company of Canada on September 2, 1986 and Morden & Helwig Ltd., the largest claims adjusting firm in Canada, on October 27, 1986. We purchased Sphere for $4 million cash plus a five year note of $2.8 million which is adjustable based on loss reserves development until 1990. Rui Quintal and his team have run the company for over five years. In the extremely risky business of reinsurance their experience and conservative underwriting policy will hold us in good stead in the future. We amalgamated with Morden & Helwig by paying its shareholders $2.0 million in cash and $6.9 million in Markel Financial stock. The amalgamation was supported by over 99% of the more than 200 Morden & Helwig shareholders. The company is run by a fine management team led by Ken Polley. Under Ken's leadership, Morden & Helwig has tremendous growth potential in Canada and abroad and we are excited to be shareholders. To take advantage of the growth opportunities and also to allow its employees to become shareholders again, Morden & Helwig is planning an initial public offering of subordinate voting shares and has filed the preliminary prospectus on March 16, 1987. We welcome the employees of Sphere Re and Morden & Helwig to our team and look forward to a long association.

My partner, Steven Markel, in his report discusses these acquisitions in greater detail and shows how they provide further diversification. Rui and Ken have reports on their own operations that follow.

The two acquisitions made in 1986 illustrate some of the principles that will guide us in the future.

1) We will acquire companies with good management already in place.

2) We will not acquire companies unless we believe they can achieve a 20% return on capital.

3) Each company will be run independently and be measured against the targeted return of 20% on capital invested.

4) We consider our stock as good as cash. We will not issue stock indiscriminately. When we issue stock, as we did for Morden & Helwig, we will ensure that we get as much value as we give.

When we began our association with Markel Financial in September 1985, Markel Financial was a holding company with only one subsidiary, Markel Insurance. In fact, Markel Financial was synonymous with Markel Insurance. Remarkably, in a little more than a year, Markel Financial is now operating in three different businesses. We think this creates some confusion between the holding company and Markel Insurance. With your approval, we are proposing to change the name of Markel Financial to Fairfax Financial Holdings Limited. If you are wondering where ''Fairfax'' came from, you may be surprised to know that it did not come from a ''name'' consultant or from the Board of Directors but from Brenda Adams who is Keith Ingoe's secretary. Brenda's logic for Fairfax – *Fair*, *f*riendly, *ac*quisition*s* – made sense to us and thus the name. Markel Insurance will always use the ''Markel'' name under which it has done business for more than 35 years.

Markel Financial will be soon moving to 95 Wellington Street West in Toronto. David Rooney has recently joined us as Vice-President, Finance and chief Financial Officer for Markel Financial. David comes to us after 11 years as Chief Financial Officer of Ault Foods (a subsidiary of John Labatt) during which time Ault achieved a significant compound rate of growth in sales and earnings.

Since September 1985, we have developed a number of new investment guidelines and policies for the management of our Insurance Company portfolios. First the operating requirements of Markel Insurance and more recently Sphere Reinsurance were reviewed and all excess funds were earmarked for potential long term investment. Cash and short term deposits at Markel Insurance for example have fallen from 47% of the investment portfolio at December 31, 1984 to 14% as of December 31, 1986. Second, we have restricted the term to maturity of the bond portfolio to less than five years unless unusual opportunities exist. Finally, we have increased the proportion of investments in common shares and convertible securities. As of December 31, 1986, we had $43.8 million in common stocks and convertible securities.

For the benefit of new investors we reiterate our investment philosophy from last year's annual report – ''Our investment philosophy is based on the value approach as laid out by Ben Graham and practised by his famous disciple, Warren Buffett. This means we buy stocks of financially sound companies at prices below their underlying long term values. We expect to make money over time, not in the next month or two. In fact, in the short term, stock prices could go well below our cost. In our purchases, we are always trying to first protect your capital from long term losses (as opposed to short term price fluctuations) before attempting to make money. We do not speculate with your money and thus, do not buy options, commodities, futures, gold and other short term trading instruments. Over time, our investment philosophy has served us well and we plan to stick with it.''

In 1986, Markel Financial realized about $1 million from capital gains vs $0.5 million in 1985. Unrealized gains amounted to $1.0 million at December 31, 1986 vs $1.3 million in 1985. The total investment portfolio for Markel Insurance was up 10.4% which was a mediocre result. Common stocks did well for us in 1986 but convertible securities did poorly. Over time, we expect our common stock and convertible positions to contribute significantly to consolidated profits of Markel Financial. As of December 31, 1986, we had $13.2 million in Natural Resources (particularly Mines) and $3.4 million in the Banks.

Where does the stock market go from here? We don't know but if we had to guess we think there are many long term secular forces that could result in the stock market experience of the 1950's being repeated. While the Dow Jones has more than doubled in the past four years, we should point out that in the fifties and sixties this index increased five-fold from 200 in 1950 to 1000 in 1965. We think there will be ups and downs in the market, as there always have been, but we think there is a good possibility of the Dow Jones rising significantly in the next five years. We continue to find good long term values that meet our criteria.

We have one change among our Directors this year. Jack Herbert will be resigning from the Board to pursue other interests while Ken Polley will be joining the Board. We thank Jack for his support and contribution during the year. Also, on your behalf, we would like to thank the Board and the Management and Employees of our subsidiaries for their significant contributions in 1986. Without their help, 1986 would not have been as successful as it was.

April 5, 1987

V. P. Watsa

V. Prem Watsa
Chairman of the Board