To Our Shareholders:

Halley's Comet flew over us in 1987. We earned $16 million after taxes on an average equity base of $52 million – a 31% return on shareholders equity. Given the return on equity earned by the average company in Canada and the U.S. of 13-14% and our own objective of 20%, it is not likely that this return will be repeated in the future. Net earnings per share of $2.15 were up 60% from 1986. Book value per share increased 41% to $8.32 per share.

The table below shows the sources of our net earnings:

	1987	**1986**	**% Change**
	($ millions)		
Pre-tax earnings before realized gains	9.0	8.1	+11%
Realized investment gains	9.2	1.0	+820%
Total pre-tax earnings	18.2	9.1	+100%
Income taxes	5.9	4.2	+40%
Net earnings before minority interest and extraordinary item	12.3	4.9	+151%
Less minority interest	1.5	0.1	–
Add gain on sale of Morden & Helwig shares	3.5	–	–
Add recovery of income taxes	1.7	1.7	–
Net earnings	16.0	6.5	+146%

As you can see from the table, the major source of our earnings gains in 1987 was two fold:

a) Realized security gains of $9.2 million (after tax – $6.8 million)

b) After-tax gain of $3.5 million on the sale of Morden & Helwig Group Inc. shares.

These two sources accounted for 64% of our reported earnings. While the timing of (a) is uncertain, we fully expect to continue to increase book value over the longer term with these types of gains. Gains like (b) are not likely to be repeated again. All of (a) and most of (b) though are cash earnings and do legitimately increase book value.

As far as realized gains are concerned you should note that we could easily increase our future investment income by selling stocks and buying bonds or preferred stock. However, we invest for total return and thus have no plans on changing our bias towards stocks. Realized gains in 1987 amounted to approximately 8% on the average portfolio.

While earnings before realized gains only increased 11%, our companies are in excellent shape. Markel Insurance had an excellent year under the leadership of Keith Ingoe, earning an underwriting profit even after a significant build-up in reserves. As you can see in Keith's section, Markel Insurance earned a very attractive return on its equity for the second year in a row.

In spite of significant competition, Keith and his team are building a reputation as the best trucking (and lately, transportation) insurance company in Canada. We are excited to be shareholders. In August 1987, Markel Insurance acquired Otter Dorchester Insurance Company, a property and casualty company specializing in the agricultural industry. Otter Dorchester writes $11 million in gross premium (net premium: $3.7 million). We purchased Otter Dorchester for $2.6 million, a 35% premium to its book value of $2 million. Otter Dorchester is run by Reg Black. We welcome Reg and his team to the Fairfax group and look forward to participating in the company's growth as it expands its service to rural communities throughout Ontario.

Sphere Reinsurance, run by Rui Quintal and Bill Grant, had a very good year in 1987, earning 20% on average equity. On our invested capital of $4 million, the returns are exceptional. Based on current actuarial projections, it appears that part of the note of $2.8 million to the former shareholder of Sphere may not be paid due to reserve development prior to our purchase. However, we continue to show the note on our balance sheet at the full $2.8 million. Rui discusses the operations in further detail in his section.

As discussed in our 1986 annual report, we took Morden & Helwig (M&H) public in 1987 to take advantage of the tremendous growth potential in Canada and abroad. The same group that raised $20 million for Fairfax in 1986, did a public offering of $20 million for M&H in 1987 – $15 million for the treasury and $5 million for Fairfax. On your behalf, we again thank Dick Falconer, Jim Hinds and Joe Brosseau from Wood Gundy; Bryan Smith and Rob Bell from Dean Witter Reynolds; and Rick Salsberg and Bob Karp from Tory, Tory for their hard work in completing this issue. We don’t plan on this being an annual feature!!!

After months of preparation for this issue; Ken Polley and his team could again concentrate on business at hand. As you will note in Ken’s section, M&H had an excellent year in 1987, completing 13 acquisitions in Canada. The share capital raised reduced the company’s return on equity in 1987. As M&H is the largest claims adjusting company in Canada, with 679 employees and 153 branches, we fully expect it to earn our targeted 20% return over time.

Prior to the public issue, all Morden & Helwig employees had the opportunity to acquire shares, with the result that a substantial number of employees are shareholders once again.

Late in 1987, M&H and Markel Corporation (U.S.) each acquired 50% of Lindsey & Newsom (L&N). L&N is the largest independent claims adjusting company in Texas with 44 offices and 310 employees. Also acquired was Vale National Training Centers, a school for training adjusters. Total purchase price was US $14 million, approximately 8.6 times earnings for this company; being a service business, book value at US $2.8 million, was not significant.

Bob Irwin runs this fine company with Terry Grant as his first mate. Under Bob’s leadership, we see tremendous growth potential in the U.S. We are planning a merger of M&H, Markel Corporation’s U.S. claims business and L&N in 1988/89 as a first step in building an international claims adjusting company. In any merger, particularly an across-the-border one, there are many hurdles to be overcome. However, I am very optimistic about the growth opportunities of this company because of the fine people we have to manage it. As shareholders, I would recommend that all of you read M&H’s annual report to better understand the business. We look forward to working with Bob Irwin.

The name Fairfax, as we suggested in our last annual report, comes from **Fair**, **F**riendly, **Ac**quisitions. I have already discussed two acquisitions made in 1987 – Otter Dorchester and Lindsey & Newsom. On December 29, 1987, after months of negotiation, Fairfax, Markel Corporation and an investment banker purchased the shares of Shand, Morahan and Evanston Services lnc. from Alexander & Alexander, Kansa General Insurance and C. J. Coleman Holdings. Fairfax is the controlling shareholder but as in our other ventures, we consider Markel Corporation to be our equal partner. At closing, Fairfax has a 35% interest, Markel Corporation 35%, investment banker 20%, Management 5% and Coleman 5% – with Fairfax having the votes and the first call on the investment banker’s 20%. This is the biggest deal we have done to date! Shand, Morahan/Evanston is an insurance company specializing in underwriting professional liability. In 1987, it earned premiums of US $105 million, had assets of US $535 million and common equity of approximately US $80 million.

The total purchase price consisted of US $30 million cash and a five year note of US $47 million with almost no interest and no principal payment for five years. Also the note is subject to offset from reserve development and reinsurance uncollectibles associated with insurance written prior to December 31, 1986. The company is run by Joe Prochaska and his team. Joe discusses the company further in his section. We are very impressed with the high quality of the people in this company and under Joe’s leadership – we are excited about the potential returns for shareholders from this investment. The downside to this investment is (a) it is in the “long tail” end of the business and so reserves are always uncertain, (b) the judicial system in the U.S. is still largely a lottery, and (c), any losses in this company would significantly impact Fairfax.

We are more optimistic (are managements ever **not**!!) about Shand, Morahan because of the very significant changes that have taken place in their business in the past four years as shown below:

– an increase in premium levels averaging in excess of 400%

– a tenfold reduction in exposure limits from $20-30 million per policy to $2-3 million per policy

– a slowing of growth in the size of court liability awards

– a dramatic increase in selectivity on policy coverage

– a majority of policies written on a ''claims made'' basis

– the guarantees of A&A, Kansa and Coleman to reimburse adverse development and reinsurance unrecoverables arising out of the 1986 and prior book of business to an amount of US $44.6 million plus interest.

Finally, the investment portfolio at Evanston is in excess of US $280 million which, if managed well, could provide additional returns to shareholders.

As shareholders, we welcome Joe Prochaska and the employees of Shand/Evanston and Bob Irwin and the employees of Lindsey & Newsom to our team. We look forward to a long association.

Fairfax has always prided itself on a strong balance sheet. At year end 1987, a few comments are in order. As in the past, the reserves of all our insurance and reinsurance companies including Evanston Services have been certified by The Wyatt Company, independent actuarial consultants. Goodwill of $3.4 million on the balance sheet is from M&H ($2.8 million) and Otter Dorchester ($0.6 million). Unfortunately, accounting conventions do not allow us to write these items off. Because of very low capital requirements, strong free cash flow and low book values, M&H will always have goodwill arising from acquisitions. We think this may be a valid asset over time. The Shand, Morahan/Evanston acquisition has resulted in significant off balance sheet debt to Fairfax as discussed in note 14 to the financial statements. Most of this debt is due in five years and is subject to offset from reserve deterioration and reinsurance uncollectibles. This debt is very similar to the $2.8 million note we assumed in connection with the Sphere Re purchase. We think you should know about these even though we think our share of these payments will be quite comfortably met in the future. Our balance sheet is less strong though because of these payments. Also at year end, we had unrealized losses in our portfolio of approximately $7 million. We consider unrealized losses and gains as temporary fluctuations and only measure them when they are realized. Obviously, if we had to liquidate the portfolio at year end 1987, common equity would be reduced by approximately $5 million (after tax impact of unrealized losses). On the plus side, we have been extremely conservative and have provided for additional reserves as and when we could.

Many of you probably realize this already, but as the years go by, it seems to me that all business is, is people. As the CEO of a very successful high technology company recently said, ''It is not the processes, technology, etc. that distinguish this company but the ability to attract the best in the business.'' In 1987, this was certainly true for Fairfax. In last year's annual report, I mentioned that David Rooney joined us as CEO. David's experience and creativity will be one of the major reasons for our success in the future. Later in the year, John Varnell, after many years of experience in private industry and public practice, joined David as Controller. Bill Andrus, with many years' experience as a consulting actuary and publisher of the TRAC Report, joined us as Vice President, Corporate Development. He was instrumental in our making the initial investment in Fairfax (then Markel Financial) in 1985. Paul Fink, with years of experience in investment research and structuring deals, joined us as our one-man Investment Banking Department. Over the years, we expect this area to continue to grow and perhaps become a separate company. Finally, Brenda Adams, who invented our company name, joined us as Corporate Secretary after years of experience at Markel Insurance. Fairfax, as a holding company, has now taken shape. As shareholders (myself included), you should be extremely happy that these people have decided to work for Fairfax. Our future success will be largely dependent on their efforts.

In 1987, we issued 330,000 subordinate voting shares at $14.50 per share to the directors and officers of Fairfax and key officers of independent operating units. These people were given five-year interest free loans to buy these shares. Unlike options, these shares are owned by the individuals and the positive or negative impact of share fluctuations is fully reflected in their economic net worth – just as it is for any of you. The after-tax cost to the shareholders of the interest free loan works out to approximately $260,000 annually. As you probably know, Steven and I do not get paid a salary but we do own 75,000 shares each in this program. Also, both of us have a very significant interest in Fairfax; through Sixty Two Investment Company for me and through Markel Corporation (U.S.) for Steven. All of us at Fairfax have the same interest as yours – maximize shareholder value over the long term.

Also in 1987, we have instituted significant bonus plans and share ownership plans for our insurance companies (M&H already had these in place). These plans are mainly based on underwriting profit with additional bonuses for achieving our targeted 20% return on equity. These plans are unlimited in amounts and flow down through the whole organization. Thus based on performance, it is very possible for management as well as clerical staff in our companies to have significant bonuses. Bonuses at Fairfax, the holding company, are based on returns on equity achieved by the total company.

We have been asked many times as to what the vision for Fairfax is. What are its long term plans? While our independent operating units do have a ''vision'' and a ''mission'' statement, at Fairfax, ours is simply to achieve a 20% + return on common equity over the long term. We have no long term plans other than to react to opportunities on a day by day basis. Our operating companies are run independently by the president of each company. He runs it as he wants except for four areas:

1) **Performance evaluation:** He runs it but we evaluate his performance.

2) **Choosing his successor:** As we run our companies with a hands-off style, we need to be comfortable with his successor.

3) **Acquisitions/Change in business strategy:** Acquisitions are a Fairfax responsibility – particularly price. Also, if Markel went from insuring trucks to insuring satellites, we would like to know!

4) **Financings:** All financings and capital decisions are a Fairfax responsibility.

With these exceptions, each of our presidents runs his operation completely independently.

In the 1985 and 1986 annual reports, we discussed our investment philosophy and guidelines in detail. We manage the insurance company portfolios with a long term value oriented philosophy. Realized gains are the key to long term performance as unrealized gains can disappear at any time. During 1987, we benefitted greatly from the fact that we sold more than 50% of the stock portfolio and realized significant capital gains for the company. However, in the ''melt down'' on October 19, our cheap stocks went down with the market. An unrealized gain of approximately $10 million as of September 30, 1987 became an unrealized loss of $7 million as of December 31, 1987.

Many have suggested that the crash in October could lead to a depression. Can this be 1929 repeated all over again? Unfortunately, we don't know the answer to these questions. What we do know is that short term fluctuations in the market have always resulted from the twin emotions of fear and greed and have **nothing** to do with the underlying business fundamentals of the country or company. As Ben Graham, dean of security analysts, stated a long time ago in his book ''The Intelligent Investor,''

> ''The investor with a portfolio of sound stocks should expect their prices to fluctuate and should neither be concerned by sizeable declines nor become excited by sizeable advances. He should always remember that market quotations are there for his convenience, either to be taken advantage of or to be ignored. He should never buy a stock because it has gone up or sell because it has gone down. He would not be far wrong if this motto read more simply: 'Never buy a stock immediately after a substantial rise or sell one immediately after a substantial drop.' ''

In 1987, we benefitted significantly from our investment in the natural resource sector. We realized $8.6 million or 80% of our realized profits from this sector. Other significant contributors to realized profits in 1987 were Rothmans ($0.8 million), Ford US ($0.3 million) and American President ($0.2 million). Total realized losses in 1987 were less than $100,000. Our position in the banks hurt our performance in 1987.

As detailed in the 1986 annual report, we continue to be quite optimistic about the long term values available in the U.S. and Canadian markets. The major risk we see is a collapse in the highly speculative Japanese stock and real estate markets. If any of you know when that will happen, please let me know! In the meantime, we continue to focus on identifying long term values and investing in them as and when we find them. At year end 1987, we had $14.8 million invested in industrial products, $13.7 million in the banks and $6.8 million in the mines.

Since we began in September 1985, Fairfax has increased its book value from $1.84 per share to $8.32 per share, earnings from a loss to $2.23 per share, total assets from $28 million to $193 million and common equity from $1 million to $61 million. The stock price has reacted accordingly and increased from $3.25 in September 1985 to $12.38 as of December 31, 1987. In September 1985, we had one operating unit; today we have five. Fairfax now has its own offices and has been able to attract extremely capable people. While you should be cautious about extrapolating the past, we think the long term future of the company continues to be attractive. On your behalf, we would like to thank the Board and the management and employees of our subsidiaries for making 1987 another very successful year.

March 31, 1988

V. P. Watsa

V. Prem Watsa
Chairman of the Board and
Chief Executive Officer.