To Our Shareholders

No comet flew over us in 1988. We earned $14.3 million on our average equity capital of $67.6 million, a 21.2% return on shareholders' equity. In the last three years, we have earned an average 26.1% on shareholders' equity versus 11% for the TSE 300. Operating earnings per share of $1.94 were up 29% from $1.50 in 1987, while net earnings per share of $1.94 were down 13% from $2.23 in 1987. Book value per share increased 22% to $10.13 per share.

The table below shows the sources of our net earnings:

	1988	1987	% Change
	($ millions)		
Pre-tax earnings before realized gains	13.5	9.0	+50%
Realized gains	7.8	9.2	– 15%
Total pre-tax earnings	21.3	18.2	+17%
Income taxes	5.3	5.9	– 10%
Earnings from operations	16.0	12.3	+30%
Less minority interest	1.7	1.5	–
Add gain on sale of Morden & Helwig	–	3.5	–
Add recovery of income taxes	–	1.7	–
Net earnings	14.3	16.0	– 11%

As you can see in the table, pre-tax earnings before realized gains increased 50%, mainly due to the inclusion of our share of the Shand, Morahan group's earnings. Surprisingly, in spite of lacklustre markets, realized investment gains in 1988 were about the same as in 1987. As a percentage of our average portfolio, realized gains amounted to 6%. Total earnings from operations increased by 17% pre-tax and 30% after taxes. The effective tax rate in 1988 was 25% compared to 32% last year. Unlike 1987, we did not have any unusual gains in 1988 and so net earnings were down by 11%. While shareholders had a higher total earnings return in 1987 by virtue of unusual gains, the sustainability of our present earnings level is higher currently than a year ago.

There is no question that the insurance cycle is on the downswing. Our insurance companies in 1988 had the wind against them unlike the two prior years when the wind was behind them. We have always said that our insurance companies would not write business unless there was the prospect of an underwriting profit. 1988 tested that resolve. While none of the companies achieved an underwriting profit, all the presidents are firmly committed to this objective. Our insurance companies will continue to face difficult times in 1989 and beyond until the insurance cycle turns. My partner, Steven Markel, discusses this further in his section.

Markel Insurance, led by Keith lngoe, continued to perform extremely well. The company earned 19.7% on equity in 1988 even though the combined ratio came in at 102%. As discussed in his section, Keith continues to look for better ways to serve his clients. In 1988, under the leadership of Bruce Bedford, Markel Insurance opened a first class driver training school in Guelph, Ontario to fill the need for trained truck drivers. This was a great example of synergy as Bill Andrus from Fairfax worked with Bruce Bedford and Keith to take an idea from concept to full operation in the space of nine months. Under Bruce's leadership, Markel Training Systems Inc. has plans to expand this service across the country.

Otter Dorchester had an extremely poor year in 1988 as the company suffered from losses on automobile business in Ontario and weather related losses. If you think there is no risk in insurance, read Keith's section on Otter Dorchester. Keith is currently re-evaluating Otter's business strategy.

Sphere Reinsurance, run by Rui Quintal and Bill Grant, had another excellent year in 1988, earning 20% on equity. In 1988, we purchased the minority interest from Rui and Bill, on terms acceptable to them, so as to make Sphere a wholly-owned subsidiary of Fairfax. Rui discusses Sphere's results in greater detail in his section.

The Shand, Morahan group, run by Joe Prochaska and Bob Libby, came through for us in 1988. As Joe indicates in his section, the Shand group earned a 16.4% return on equity resulting in F-M Acquisition earnings of US$13 million – a 35% return on common equity. During the year, we have come to know the people at Shand, Morahan much better and are very impressed at the professionalism we have found in the company. As discussed in our quarterly reports, we raised our interest in F-M Acquisition to 47.5% from 35% by purchasing the shares from Hees International. Our purchase of Shand, Morahan would not have been possible without the support of the management group at Hees.

Also, during the year, we renegotiated portions of F-M Acquisition's purchase contract with Alexander & Alexander at their request which basically is neutral to our position. As of December 31, 1988, we feel that reserve deterioration from the past eroded about $21 million of the note and interest owing to the previous owners.

It was a busy year for Ken Polley and his team at Morden & Helwig as the company continued to expand its operations in Canada and the U.K., and to participate in the U.S. through Lindsey & Newsom. M&H had another excellent year as revenues increased to $43 million and net income increased by 25%.

Lindsey & Newsom operations, run by Bob Irwin, are on a solid foundation. While the returns in 1988 were, for various reasons including the costs of the merger discussed below, less than anticipated, Bob and his management team have worked extremely hard during the year to merge the Gordon Boyd and National Claims Services operations, with 1988 revenues of US$11 million, into Lindsey & Newsom, with 1988 revenues of US $18 million. This merger became formally effective only on January 1, 1989 and thus has not impacted our 1988 financial statements. When you consider the dimensions of this merger (besides the added revenues described above, the number of Lindsey & Newsom offices increased from 62 to 136 and the number of employees from 350 to 775) and the fact that it was all done in the course of nine months, you can appreciate the special efforts of the management group. We now have a very sound base for expansion in the U.S. and the growth potential of our claims adjusting operations over the next few years could be very exciting. **NO** guarantees though! Shareholders should read M&H's annual report to get more details about our claims operations.

As discussed in last year's annual report, the return on equity for Morden & Helwig is still below our target of 20% because of the impact of the new capital raised in 1987 and of the lower than anticipated contribution from Lindsey & Newsom. With Ken's leadership in Canada and Bob's in the U.S., we think it is only a matter of time before we attain the 20% level.

In 1989/90 our plan is to continue with the creation of an international claims company with Morden & Helwig Limited and Lindsey & Newsom Claim Services operating as presently structured.

Late in 1988, just as we were planning our Christmas holidays, Paul Fink came across an opportunity that could be very significant over the years for Fairfax shareholders. After some negotiations, we were able to purchase a controlling (37%) interest in Walwyn Inc. from Financial Trustco for $13.4 million, with Confederation Life and Tony Arrell as partners. To our surprise, this purchase really took the press's fancy and Fairfax made the headlines more than once!!!

Walwyn is predominantly a retail stock brokerage house with 75 offices across Canada. We would not have made this purchase (a) if Tim Miller, the existing CEO, had not consented to Tony Arrell coming in as the new CEO and (b) if the shares could not have been purchased at or below book value (book value at year-end has been written down significantly.) Tony Arrell is a unique individual with an unusual combination of fine operating experience and a value-oriented investment philosophy. Under Tony's leadership, we expect Walwyn to become a first rate investment brokerage house serving the long term interests of its clients.

Concurrent with the purchase of the controlling block, we purchased $9 million of 12.5% subordinated debentures from Walwyn Inc., convertible at $4.00 per share into common shares. Fairfax's total exposure in connection with the Walwyn purchase is approximately $12.5 million.

''How about the downside?'' you ask.

The major risks in our Walwyn investment are:

a) the possibility of continuing losses because of individuals not being in the stock market,

b) the possibility of stock trading volumes declining even further, and

c) the major assets of the firm go down in the elevator every day; they may not come back up – for whatever reason!

Our thinking was that most of these negative factors were essentially discounted in the stock price, since we purchased the control block of Walwyn Inc. at about one-third of the price at which the block traded in August 1987. Also, we viewed the investment environment as being quite positive over the longer term. Finally, the stock brokerage business is very people intensive, and while this could be a negative, we believed that Walwyn could truly be a very different company in a short period of time if it could attract capable people, as we felt it could. For more information, shareholders should read the Walwyn Inc. annual report. This investment does not impact our 1988 statements but in 1989 we will be equity accounting our interest in Walwyn.

The major consequence of increasing our ownership in F-M Acquisition and investing in Walwyn is that Fairfax is now in debt. Yes, we took on more debt than we thought we would, though our balance sheet continues to be sound. We financed these major purchases through:

a) a $7.5 million private placement of 8.5% subordinated debentures, convertible into subordinate voting shares at $19 per share; and

b) borrowings of approximately $20 million which we are in the process of refinancing long term.

A few comments with regard to our financial position:

1) We consider the convertible debentures to be quasi-equity and hope they will be converted long before their maturity in 1993.

2) The borrowings finance income producing assets, i.e. 10% preferred shares of F-M Acquisition and 12.5% debentures of Walwyn.

3) Our borrowings of $20 million are modest in relation to our 1988 net income of $14.5 million and shareholders' equity of $74.2 million.

Having said all of that, we are worried! Our top priority is to get Fairfax back to a debt free position (or close to!) as soon as possible. If we have learned one thing about business, it is that too many companies fail because of excessive leverage. Suffice it to say, we are working on reducing this debt as soon as we can.

On December 31, 1988, a very sad event took place for all the original shareholders (including yours truly) who refinanced Fairfax (then Markel) Financial Holdings in its dark days of 1985. Fairfax forced conversion of its $9.3 million of 11.25% convertible preferred shares because the common was trading above $8.50 per share. The fact that Fairfax had prospered so well in three years that it was able to do this at the earliest time permitted was a triumph for all shareholders!

Further on the positive side, our balance sheet continues to be very conservatively stated. Our insurance companies appear to be well reserved. We have recognized only a portion of the amounts by which we expect that our obligations in connection with the Sphere Re and Shand, Morahan acquisitions will be ultimately reduced (in accordance with the purchase agreements). In addition, we ended the year with unrealized gains of approximately $5.2 million in our Canadian insurance companies and US$3.6 million in the U.S. insurance companies owned by F-M Acquisition.

Take the unrealized gains as seriously as we suggested you take the unrealized losses of 1987 – very lightly! In addition to comments made in last year's annual report, because of the debt we consider our balance sheet to be less strong than in 1987, but still very solid.

Fairfax continues to attract very good people – the best sign I know of success in the future. Rick Salsberg, a partner of Tory, Tory, has taken a leave of absence to join us for 1989. You may remember Rick's name in our 1987 and 1986 annual reports in connection with our stock issues. My great fortune was to have Rick's counsel in every major transaction that Fairfax has entered into since we began in 1985. Rick joins David Rooney, Bill Andrus, John Varnell and Brenda Adams at Fairfax. He will also be working with Paul Fink who will no longer be our one-man investment banking department. This is because Rob Mills has joined him as our in-house real estate expert. Rob has years of experience in the real estate business and has consistently applied a value-oriented philosophy to the real estate area.

Our investment banking department is gradually blossoming and we plan to make it a separate company soon. Paul has done three deals only, the largest by far (in terms of financial exposure) being Walwyn. The other two deals are an investment in Carbovan (a vanadium extraction plant) and a position in Develcon Electronics that we obtained for arranging the restructuring and refinancing of that company. While the returns from this area are still insignificant, with Paul and Rob and the others at Fairfax, we think future returns could be very attractive. Please remember that our investment banking department also operates under our overall investment philosophy of downside protection first before looking at potential gain.

Our investment results in 1988 were excellent. Looking back over the past 15 months, we find that the ''value'' approach has continued to be a reliable guide for us. In 1987's annual report (just after the crash) we cited Ben

Graham's words: ''Never buy a stock immediately after a substantial rise or sell one immediately after a substantial drop.'' Our own conclusion as a result of the substantial drop was that the crash had provided more opportunities for long term investment. In hindsight, we were able to take advantage of many of these opportunities.

In 1988, we benefitted significantly from the manufacturing and natural resource sectors in North America. The major contributors to realized investment gains in 1988 were Algoma Steel ($2.0 million), Stewart & Stevenson ($1.0 million), IPSCO ($0.5 million), Laclede Steel ($0.5 million), MRI Resources ($0.5 million), Acme Steel ($0.4 million), Gibraltar ($0.3 million), and Falconbridge ($0.5 million). Total realized losses in 1988 were $1.1 million. Also, we realized $2.0 million in exchange gains as we hedge all our U.S. stock investments against changes in the exchange rate. In fact, in 1988 we have hedged our initial investment and most of our future income for the next five years from Shand, Morahan (U.S.), L&N (U.S.) and Hamkin Holdings (U.K.). Our U.S. and U.K. assets and income are protected from a rising Canadian dollar and will not benefit from a declining dollar. We discuss this further in Note 14 to the financial statements.

In past annual reports we have detailed our long term, value-oriented philosophy. Our insurance company portfolios are skewed toward stocks and convertible securities which we feel will provide good returns over time. How much do we invest in stocks? We have developed guidelines based on excellent work done by David Rooney and John Varnell that limit our exposure to common stocks so that a 50% drop in the stock market and a 20% drop in convertibles and preferreds will not have any impact on our ability to continue to write insurance. Our approach was partially tested during the crash of 1987, but stood the test well. We are not looking forward to a full trial!

We expressed some concern last year about the Japanese stock market. We predicted ''a collapse in the highly speculative Japanese stock market'' just as it exploded by 40% in 1988. So much for our expertise in Japanese stocks! If this continues, Japan will be the only equity market of consequence. Count me among the skeptics. However, we continue to find long term values in the Canadian and U.S. stock markets.

At the end of 1988 we had $13.3 million invested in banks, $10.5 million in insurance company stocks and $14.5 million in industrial products.

During 1988, Fairfax shares traded in a range of $11.75 to $15.125. At the lower end of the range, we felt our shares were an excellent investment for the company and instituted a buyback of 10% of the float. We managed to purchase only 14,200 shares at an average price of $12.94 per share. We will continue to repurchase our shares if we consider that to be the best investment available for your company.

For your information, over 60% of the shares of Fairfax are owned by The Sixty Two Investment Company Limited, Markel Corporation and the officers and directors of the company. Fairfax's share prices are of interest to us! However, we do not pay much attention to short term fluctuations in share prices – other companies' or our own. Short term fluctuations are driven by the twin emotions of fear and greed while underlying value is always reflected in the long term. At Fairfax, we concentrate on building long term value for all shareholders.

It often amazes us how most people forget the power of compounding. If Fairfax were to achieve an ROE of 20% for the next five years, book value would rise to $25 per share. If this rate continued for the next ten years (which will be extremely challenging to do), book value would increase to $63 per share. Given appropriate premiums to book value, you can see how long term shareholders can do very well if Fairfax achieves a consistent 20% on equity over time. The trick is to achieve the 20% return! Warren Buffett, the Wizard from Omaha, from whom we have learned a lot, has compounded book value of Berkshire Hathaway at 23.5% annually over a 23-year period. Book value increased from $19.46 per share at the end of 1964 to $2,477.47 per share at the end of 1987 while Berkshire's stock price rose from $14 to $2,950 per share over the same period (it is currently $4,825). As we have stated in earlier annual reports, for Buffett and Berkshire Hathaway this record is a fact. For you and us at Fairfax, it is still only a hope!

We face many challenges in 1989 including a downswing in the insurance cycle, an uncertain stock market, growing pains as Morden & Helwig expands through Lindsey & Newsom in the U.S. and possible losses in Walwyn. These factors should make it much more difficult for us to achieve our 20% return on equity objective in 1989. While the short term is uncertain, the long term future of the company continues to be very good due to the excellent people Fairfax has been able to attract.

Before signing off, I want to take time out to particularly thank one of our directors, Robbert Hartog, who is chairman of our Audit Committee and a member of our Executive Committee. Robbert retired from an extremely successful business career by selling the company he founded, Waltec, to Emco Ltd.

He was one of the key founders of Sixty Two who backed me when we made our investment in Fairfax in 1985. Since that time we have made no major decision without Robbert's counsel. Even in retirement, Robbert's schedule would tire a thirty year old, let alone a seventy year old! His unfailing commitment to Fairfax has been, and continues to be, a major reason for our success.

We also thank Fred Kaneb, Robert McDowell and Jim Martin, three directors who have served the company for many years, for their support and contribution, particularly during the company's difficult times. We wish them well as they retire from our Board. We welcome Winslow Bennett, Peter Bloemen and Tony Arrell to our Board and look forward to working with them.

Again, on your behalf, we would like to thank the Board, the management and the employees of our subsidiaries for making 1988 another very good year.

March 31, 1989

V. P. Watsa

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