To Our Shareholders

We were optimistic. We thought 1989 was going to be a difficult year; it was much worse as you will soon find out. While we earned $16.7 million and did earn 20.3% on common equity (vs 11% for the TSE 300), it was mainly due to very significant realized gains in 1989. In 1989 E.P.S. increased 16% to $2.25 while book value per share increased 22% to $12.41 per share.

The table below shows the sources of our net earnings:

	1989	1988	% Change
	($ millions)		
Operating earnings before realized gains	8.9	15.7	– 4.3%
Realized gains on investments	15.5	7.8	+99%
Operating earnings	24.4	23.5	+4%
Interest expense	5.2	2.2	+136%
Earnings before income taxes	19.2	21.3	– 10%
Income taxes	1.2	5.3	– 77%
Net earnings before minority interest	18.0	16.0	+12%
Less: minority interest	1.3	1.7	– 24%
Net earnings	16.7	14.3	+16%

As you can see in the table, operating earnings before realized gains dropped by 43%. This was largely due to a huge underwriting loss in Markel Insurance Company. More on this later. Realized gains almost doubled during 1989, resulting in earnings before income taxes dropping by 10%. Realized gains amounted to about 12% of the portfolio. Interest expense increased 136% or $3 million. Our tax provision dropped very significantly because certain sources of income are exempt from tax or are taxed at lower rates. As a result net earnings increased by 16% during 1989.

Since we began in 1985, we have said that our insurance companies would be run to achieve an underwriting profit. We emphasized that our companies would rather write significantly reduced business than write it at unprofitable rates. In 1986 and 1987 we were able to achieve this objective because the insurance cycle was on the upswing. As the insurance cycle began its downswing in 1988, we seemed to be holding to our objective. The true test of our approach was in 1989. While we continued to practise what we preached in Shand, Morahan and Otter Dorchester, we failed miserably in Markel.

Markel had an unbelievable combined ratio of 133.6% in 1989 – a far cry from our target of 100%. We had an underwriting loss of $14 million as compared to our expectation of a loss of $1 million. Why did this happen? As Rick Salsberg explains in his section on Markel's operations, the losses were mainly due to unprofitable diversification (taxis and surety) – the grass is greener on the other side – and accepting trucking risks at unprofitable prices – something we said we would not do!

What is particularly worrisome is that the underwriting loss in 1989 was mainly due to 1989 business as opposed to reserve development on past business. Things can change very quickly in the insurance business.

We have emphasized in the past that our companies are run independently by our presidents. While the advantages of this approach are many, the downside is that things can happen in any of our companies of which we may not be aware. This happened to us in Markel in 1989. Again, as Rick discusses in his section, we found out that Markel's surety operations were being run in a very loose manner. Performance bonds were being issued in excess of reinsurance limits. Financial guarantee bonds, for which we have no reinsurance, were being issued and claims were not fully disclosed. We have made proper provisions for surety operations which resulted in a combined ratio of 343% in 1989.

You can be sure that if additional information indicates that more reserves are required, we will provide for them immediately. Rick Salsberg has spent virtually all of the first quarter of 1990 identifying and fixing this problem for us.

Why did this happen at Markel? Could Fairfax have reacted sooner? Do we need to be more centralized, more hands-on in our operations? All good questions. On reflection, I think the major reason for the problem was that while our individual companies were run in a decentralized manner, they were still all reporting to me. We recognized this early in 1989 and reorganized Fairfax so that David Rooney and Rick Salsberg became responsible for Shand, Markel and Morden & Helwig at the Fairfax level. We continue to believe strongly in decentralized operations with Fairfax responsible for performance measurement, succession planning, acquisitions and financing. For performance measurement, each of our companies submits annual business plans which are reviewed and signed off by the person responsible for the individual company. This method of operation we feel will make it unlikely that our experience at Markel will be repeated and if it were necessary, we would be able to react much sooner. We continue however to run on a decentralized basis and let the presidents manage their companies.

Otter Dorchester, while profitable, continued to suffer from weather-related losses. We are in the process of determining an acceptable business strategy for Otter.

Early in 1989 we made the decision to sell Sphere's book of reinsurance business to Skandia Re for $5.75 million. This was an extremely difficult decision for us. We decided to sell the company because we did not have any niche in this business and because the industry is dominated by very large participants. In this sale we ensured that our partners, Rui and Bill, were well looked after and all the employees of Sphere were treated fairly. Led by Rick Salsberg and John Varnell, we ensured that the interests of Sphere Re's customers, employees and shareholders were looked after in this transaction. We initially estimated our realized proceeds on this sale to be $23 million. This comprised Sphere Re's book value of $14 million, the value of its loss reserves of $3.25 million, and the $5.75 million consideration by Skandia.

Since then, mainly due to significant realized gains in 1989, we estimate the proceeds to be well in excess of our original expectations. We are amortizing the gain on the transaction ($2.3 million) over the life of the reserve run-off to protect against unexpected reserve development. As discussed in Note 8, Sphere Re's contingent note of $1.12 million has been completely eroded due to reserve development, and we have written this off in 1989.

After the sale of Sphere's reinsurance business, we changed the name of the company to Chequers and obtained a new insurance licence. Chequers will specialize in unique niches. Bill Andrus is President of this company and will be working with David, Rick and John to identify and develop new insurance products or distribution methods. The first project, only begun in October 1989, will be selling personal lines insurance through the Laurentian Financial Services network in Eaton stores across Canada. It is still too early to tell how this project will work out but we will know by year-end 1990.

Joe Prochaska and Bob Libby continued to produce good results at the Shand, Morahan group. As explained by Joe in his section, Shand's combined ratio increased to 118.6% from 104.6% in 1988 due to higher expense ratios associated with running off business written in the past. Higher investment income resulted in the Shand group earning a 13% return on equity in 1989 (27.4% for F-M Acquisition). Since we acquired the Shand group in 1987 for US $30 million plus a five year contingent note for US $47 million, the company has earned a total of US $26.4 million, and the contingent note and accrued interest has decreased to US $23.5 million due to reserve development. Though Shand's business is primarily long tail in nature, we feel we have conservatively provided for the reserves.

Morden & Helwig, our claims operation, under Ken Polley's leadership, has come a long way since we acquired it in 1986. In three years, revenues in Canada have increased from $30.9 million to $46.7 million, the number of branches from 135 to 147 and net income from $2.2 million to $2.8 million. In the same period, shareholders' equity has increased from $6.2 million to $27.3 million, mainly due to a share issue of $15 million in 1987. Through the acquisition of a 50% interest in Lindsey & Newsom Claim Services, Inc. in 1987 and the merger with National Claims and Gordon Boyd in 1989, Morden & Helwig has revenues of $49.1 (US $40.9) million in the U.S. through 151 branches. Also in 1988 Morden & Helwig acquired Hamkin Holdings Limited which has seven branches in the U.K. Total revenues in 1989 were $2.4 (£1.2) million. Over a three year period this is very dramatic growth! Also, this was accomplished while maintaining a sound balance sheet with little debt. Profitability though has suffered. While the Canadian operations have been very profitable and have earned close to 20% on equity capital invested in Canada, the U.S. and the U.K. operations have been barely profitable. Bob Irwin and Terry Grant have had their hands full consolidating the National Claims and Gordon Boyd operations under the Lindsey & Newsom name. This has required a tremendous amount of time and effort. While 1989 was a disappointment, we fully expect improved returns from our U.S. and U.K. operations in the years to come. Shareholders should read Morden & Helwig's annual report to get more details about our claims operations.

As discussed in last year's annual report, we are proceeding with the creation of an international claims company.

1989 was the first year for Walwyn Inc. under Tony Arrell's leadership. When we purchased a major position in late 1988, we expected to lose money in our first year. We were not disappointed! This was mainly because the individual investors had not returned to the stock market even though investment returns were excellent last year. What is not obvious is the significant improvement in Walwyn's underlying operations under Tony's leadership. Walwyn has attracted many capable investment professionals recently and its research product has improved significantly. While the risks mentioned in last year's annual report continue to be significant, we believe that over the long term Walwyn will be an excellent investment for Fairfax. In 1989 Walwyn's loss was $5.3 million, and Fairfax reflected a $1 million loss as its equity pick up in its financial statements. This was less than our proportionate share of the loss because of the provision of $1.1 million set up as of December 31, 1988. Interest costs to finance the Faircross purchase of the Walwyn shares amounted to $0.9 million in 1989 (see Note 4). For further details on Walwyn's operations, please read Walwyn's annual report.

In last year's annual report, we said we were concerned about the debt on our balance sheet and were working to reduce it. In 1989 we replaced our short term debt with long term debt, and reduced our total debt by $7.6 million to $14.4 million. This consists of a five year committed loan facility as described in Note 8. We have already received $6.2 million in dividends from Chequers and expect to receive an additional $4 million in early 1990. With additional dividends from Markel, we expect to have further reduced the debt we had as of December 31, 1989. With almost $100 million in equity capital (including $7.5 million in convertible debentures) and little debt, we are in a strong financial position and we feel that our insurance companies are well reserved. At the end of the year, we had unrealized losses of $1.1 million in our Canadian insurance companies and US $0.5 million in our U.S. insurance companies. You know my feelings on unrealized gains or losses!

In 1988's annual report, we suggested that our investment banking department was likely to become a separate company. We have done that in 1989 and called the company Fairbridge Inc. It is run by Paul Fink. A major plus for Fairbridge and Fairfax was that Tony Griffiths joined Fairbridge as Chairman in early 1989. Tony brings his great business experience, contacts and most importantly, his sense of humour to our company. We have already benefitted greatly from his association. As discussed last year, Fairbridge had done three deals only (including Walwyn). Carbovan Inc., in partnership with Agra Industries Limited, completed the building of the vanadium extraction plant and it should be in production early in 1990. We continue to expect this project to earn good returns even though it was over budget in construction costs. Develcon Electronics Ltd. continues to plod along in spite of much effort by Paul and Tony. Our exposure is quite minimal.

Fairfax Realty Inc., the real estate subsidiary of Fairbridge, is run by Rob Mills who made our first real estate investment – a small shopping mall in Calgary. We have invested $1.5 million in this project, net of a non-recourse mortgage on the mall of $2.9 million. All of these investments are discussed in greater detail in Note 4. Currently, Paul is not planning any significant additional investments in Fairbridge until the present ones mature.

Fairfax continues to attract good people. Ronald Schokking and Sam Chan joined us during 1989 to help John Varnell and Bill Andrus in the finance and actuarial functions respectively. As we grow, it is key that we are able to attract hardworking, talented people like Ronald and Sam.

Our investment results in 1989 again were excellent though they did not match the respective indices in Canada and the U.S. Since we began in 1985, Fairfax's Canadian equity portfolios (at Markel Insurance) have compounded at 20.7% (vs 11.7% for the TSE 300) and 24.6% for the U.S. portfolio (vs 17.7% for the S&P 500). The other insurance company portfolios have done as well since they have been acquired. This record, albeit only four years long, was accomplished in the 1980's, a decade of great pessimism. Fears of recession, government and trade deficits, international debt crises, etc., etc. dominated the news every year of the decade. Surprisingly though, we have had stable economic growth with low rates of inflation since the decade began after the recession of 1981/82. This experience of *low* expectations vs *excellent* results was also experienced in the 1950's. And like the 1950's, the stock market was a great place to be in the 1980's. The S&P 500 compounded at 17.6% per year during the 1980's second only, out of the last six decades, to the 19.4% in the 1950's. As an aside, the Wall Street Journal recently noted that Mr. Kandel's book "How to Cash in on the Coming Stock Market Boom", published in 1982, sold 15,000 copies, while Mr. Batra's "The Great Depression of 1990" sold some 500,000 copies! The time to worry is when books like Mr. Kandel's become best sellers. We continue to be optimistic about long term prospects for stocks in Canada and the U.S.

We have expressed some skepticism about the Japanese market for a few years now. This unfortunately did not stop it from increasing 20% in 1989. However, after 40% in 1988, the momentum definitely seems to be slowing down!! Nippon Telephone, the Bell Telephone of Japan, presently sells at 81 times earnings, but at its high in 1987 and 1988 it had a market value in excess of the whole stock market in Canada. While speculation in Japan appears to be rampant it is nothing like in Taiwan. According to Grant's, a publication that monitors financial excesses, there are more brokerage firms (250) in Taiwan than listed companies (172).

In 1989 we benefitted strongly from the financial services, mining and manufacturing sectors in North America. The major contributors to realized gains in 1989 were Royal Bank ($2.7 million), Princeton Mining ($2.1 million), The Progressive Corporation ($1.7 million), Bank of Commerce ($1.6 million), Loews Corp ($1.5 million), Deere & Co. ($0.6 million), Gordon Jewelry ($0.6 million), Northern Telecom ($0.4 million), Shaw Industries ($0.4 million), and Hudson's Bay ($0.3 million). Total realized losses in 1989 amounted to $0.8 million. Since 1985 realized gains have amounted to $33.4 million in our Canadian operations or $4.33 per share before tax. We fully expect to earn realized gains in the next four years comparable to the last four even though the timing on an annual basis is not predictable.

At the end of 1989 we had $21.1 million invested in banks and insurance company stocks, $13.4 million in industrial products and $6.3 million in mining stocks.

Late 1989 we made two significant purchases which we should discuss with you. The first was the acquisition of Federal Insurance Holdings of Canada Ltd. for which we signed a letter of intent in November 1989 and are now in the process of closing. Federated provides life and property-casualty insurance to commercial accounts across Canada. It is a direct insurer (as opposed to agents) and has done business in Canada for 65 years. In 1989 it had $50 million in gross premiums written.

As discussed in Note 18, we are buying Federated for approximately $28 million of which $20 million is in two 10% contingent notes maturing in five and ten years respectively, and the rest is cash. Federated's book value is approximately $26 million with acquisition adjustments that take it significantly higher. We are really excited about this acquisition and would like to welcome all the Federated employees to the Fairfax Group. We look forward to a long and mutually profitable association. David Rooney has done a tremendous job in working to close this transaction and he has ongoing responsibility for Federated.

The second purchase we made at the end of the year was a major position in FCA International Ltd., one of the two largest collection companies in North America. We have followed FCA for many years and have been very impressed by its successful track record since the mid-60's. FCA has earned returns on equity in excess of 20% with the exception of the last few years. When Mark Lubotta phoned and said his family could be sellers, we purchased the block. We look forward to a long association with Mark Lubotta and Steve Levy, Chairman and President respectively of FCA. The purchase is described more fully in Note 15. We consider FCA to be a long term passive investment, and are currently working towards bringing in a financial partner with us, not unlike our investment in Walwyn.

In last year's annual report we discussed the power of compounding. Recently we analyzed another great example in Canada. Laidlaw, run by its founder Michael Degroote, has had a track record few companies can match. In 1969, when it went public, Laidlaw had sales of $5.7 million, net income of $0.3 million and common equity of $1.4 million. Twenty years later in 1989, Laidlaw's sales were $1.7 billion, net income $285 million and common equity $1.8 billion. Earnings and common equity compounded at rates in excess of 40% while sales compounded at 33%. Not surprisingly, Laidlaw's stock price compounded at 40% also! The issue price of $3 per share in 1969 is equivalent to $2,606 today – adjusting for stock splits. A purchase of 1,000 shares of Laidlaw at a cost of $3,000 would today be worth $2.6 million. The long term is where it's at and that's our focus too!

As we enter 1990 and the last decade of the twentieth century, your company faces many challenges. The immediate ones are the continuing downswing in the insurance cycle and its impact on our insurance companies, the problems we have encountered at Markel, continued growing pains at Lindsey & Newsom, potential losses in Walwyn and an uncertain stock market environment. As I look back to 1989, with the exception of Markel, these were the same fears we faced as we began the year. While we managed to earn 20% last year, it is quite possible that we will not achieve it in 1990. Remember our objective is to achieve 20%+ returns over the long term but not particularly every year. The short term outlook is ever so uncertain but, as in the past, with good people on board at Fairfax we believe the long term future will be excellent. Since we began in September 1985, Fairfax has earned an average return on common equity of 24.6% vs 11.4% for the TSE 300, book value has grown from $1.84 per share to $12.41 per share and share prices have risen from $3 per share to $18.75 per share. We hope that we can continue to maintain these growth rates in the future.

George Christoff will be retiring this year as a director of Fairfax but will continue to serve our company as a director of Markel Insurance Company. We thank George for his support and contribution over the many years he has served Fairfax, particularly during the company's difficult times.

On your behalf, I would like to thank the Board, the management and employees of all our companies for making 1989 another excellent year.

March 30, 1990

V. P. Watsa

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