To Our Shareholders

1990 was the best of times, it was the worst of times. We earned a record $21.3 million, all of it from the sale of F-M Acquisition to our partners in Richmond, Virginia. Our operations, after losses from investment banking, were unprofitable. Return on common equity in 1990 was 23% (vs 7.9% for the TSE 300) while earnings per share at $2.92, increased 30% from 1989. More importantly, because of the decrease in common shares outstanding, book value per share increased by 39% to $17.29 from $12.41. The most significant event in 1990 was the restructuring of our partnership interests with Markel Corporation to allow both companies greater freedom to pursue growth. The past five years have been excellent years for both Fairfax and Markel Corporation as each company expanded from a capital base of less than $10 million to approximately $100 million currently. However, more recently, Steven Markel and I have felt that in the long term, the existing structure was unlikely to continue to be the best one and that Fairfax and Markel should either be put together or be separated. The opportunity for us to purchase Commonwealth Insurance was the catalyst for the restructuring whereby Fairfax transferred its 47.5% interest in F-M Acquisition Corporation to Markel Corporation in exchange for:

a) US $45 million cash,

b) l.65 million shares of Fairfax, and

c) the preferred shares of Lindsey & Newsom Claim Services, Inc. with a par value of US $7 million.

Also, Markel Corporation transferred its common shares and debt interest in Lindsey & Newsom to Morden & Helwig Group for US $8.3 million. Due to dramatic changes in the financial markets since the announcement of these transactions on September 4, 1990, US $11.5 million (Cdn $13.6 million) of the US $45 million cash component became contingent on a recovery of the financial markets in the next two and a half years. With this restructuring, Markel Corporation's 23% ownership of Fairfax was eliminated; Fairfax through Morden & Helwig owns 100% of Lindsey & Newsom; and Fairfax purchased Commonwealth Insurance with the cash proceeds. Why did we do this restructuring? As discussed in the information circular of November 8, 1990, the major reasons were as follows:

(a) It separated the business interests of Fairfax and Markel Corporation to allow both companies greater freedom to pursue growth;

(b) Fairfax realized a very significant profit on the transfer of its F-M Acquisition shares;

(c) Fairfax retired 23% of its shares at a favorable price. This significantly increased the book value per share and should also increase future earnings per share;

(d) Morden & Helwig became the sole owner of Lindsey & Newsom and now has the opportunity to expand significantly under the leadership of Ken Polley and Terry Grant; and

(e) The cash received on the transfer of F-M facilitated the acquisition of Commonwealth Insurance, which Fairfax purchased at a significant discount to book value.

You will be happy to know that this restructuring was done in a fair and friendly manner and to the complete satisfaction of the Fairfax, Markel Corporation and Morden & Helwig boards of directors. Also the transaction was overwhelmingly approved by Fairfax and Morden & Helwig shareholders at special meetings held on December 14, 1990. Moreover, we feel this restructuring will be positive for the long term success of F-M Acquisition, Morden & Helwig and Lindsey & Newsom.

We wish Joe Prochaska and the Shand, Morahan companies owned by F-M Acquisition great success under the Markel Corporation umbrella. While it made sense to separate Fairfax's and Markel Corporation's business interests, Steven Markel and I will continue to be on each others' boards.

The table below shows the sources of our net earnings:

	1990	**1989**	**% Change**
	($ millions)		
Insurance underwriting	(12.4)	(11.9)	(4)%
Interest and dividends	19.3	9.2	110%
Realized gains	4.2	14.5	(71)%
Total insurance pre-tax	11.1	11.8	(6)%
Claims adjusting (Fairfax portion)	1.7	1.5	13%
Investment banking (including Midland Walwyn)	(6.4)	(1.4)	(357)%
Fairfax entity	(9.9)	(4.0)	(148)%
Equity earnings	4.8	7.3	(34)%
Income before taxes and provisions	1.3	15.2	(91)%
Less: provisions for future potential losses	(7.9)	0	
Total pre-tax income	(6.6)	15.2	(143)%
Less: Goodwill amortization and taxes	0.9	1.5	(40)%
Net earnings after taxes	(5.7)	16.7	(134)%
Gain on sale of F-M	27.0	0	
Net Earnings	21.3	16.7	28%

We have decided to use this new format as it shows you more clearly what our results have been from our insurance operations (underwriting and investments) and our non-insurance operations. We have segregated provisions for future potential losses as well as minority interest, goodwill amortization and taxes, so you can better understand the earnings from our operating companies. In the interests of better disclosure, on page 32 we have included the unaudited statements of our insurance operations, and a summary of Morden & Helwig's audited financial statements is included in Note 3. Fairfax entity includes interest expense (of $8.9 million) and corporate overhead while equity earnings are derived from F-M Acquisition (no longer there in 1991). Provision for future potential losses includes an investment reserve of $2.9 million and general provisions of $5 million.

Insurance Underwriting

As a group, our insurance companies continued to have underwriting losses reflecting the downturn in the insurance cycle and the surety problems discussed in last year's annual report. Unfortunately our estimate for surety losses as of December 31, 1989 proved to be light. Early in 1990 we provided for an additional $5 million and effectively stopped writing surety business. Since we began the surety program in 1988 we collected premiums of $7 million and had gross losses of $21 million. Our overall combined ratio for the surety program at Markel was 330% – a far cry from the 100% that we said was our target. Our surety book will be largely run off by the end of 1991 and we feel we are properly reserved at year-end (again!). Excluding surety losses, Fairfax's underwriting losses in 1990 amounted to $3 million.

Chequers' initial project of selling personal lines through Eaton's stores presently operates at an underwriting loss. A decision will be made in 1991 about the future of this program.

Late in 1990 the management of Markel Insurance, Otter Dorchester and Chequers was amalgamated into one company under the Markel name to take advantage of administrative efficiencies. Markel will be run by Bill Grant who, if you will remember, was one of our partners at Sphere Reinsurance. We welcome Bill back to the Fairfax fold and look forward to Markel's growth under his leadership. The management group at Markel has done a tremendous job of cleaning up the problems of the past at Markel.

Federated Insurance, under John Paisley's leadership, has achieved much in the first year under Fairfax ownership. Having been a branch operation of Federated Mutual (U.S.), Federated Insurance has gone a long way in 1990 to becoming a self-sufficient, independent operation with its own systems, underwriting guidelines, etc. John's team has done an excellent job in the past year (combined ratio 106%) and is working diligently to produce combined ratios below 100%.

On November 14, 1990 we acquired Commonwealth Insurance Company from The Home Insurance Company for $57.5 million – a discount from its book value of $67.8 million. Commonwealth underwrites commercial property and casualty insurance and has been in business since 1965. Based in Vancouver, B.C., Commonwealth has been run by John Watson since 1978. Excluding a book of business that has been in run-off since 1983, Commonwealth has been able to achieve underwriting profits in the past five years. Gross revenues written in 1990 amounted to $141 million and total assets were $183 million at December 31, 1990. We welcome John Watson and the employees of Commonwealth Insurance to Fairfax and look forward to participating in the company's growth. It is our expectation that Commonwealth will compensate for the sale of our interest in F-M in earnings and assets. The $10.3 million purchase price discount to book value will be added to reserves as discussed in Note 18 of the audited financial statements.

In spite of a continued downcycle in the insurance business, it is likely that our underwriting results will improve from 1990 because surety should not continue to be a problem.

Claims Adjusting

With the restructuring discussed earlier, Morden & Helwig has become an international claims adjusting company with 100% owned operations in Canada, the U.S. and the U.K.

Pro forma sales in 1990 with Lindsey & Newsom fully consolidated amounted to $117 million. Morden & Helwig now has 159 branches in Canada, 176 in the U.S. and 7 in the U.K. As discussed in last year's annual report, this is a tremendous growth record, under Ken Polley's leadership, since we acquired it in 1986 with revenues of $30.9 million from 135 branches in Canada.

While revenues have almost quadrupled since 1986, net income has increased only by about 40% from $2.2 million. This is largely because the U.S. operations have yet to contribute to profitability. The Canadian operations continue to perform extremely well.

After more than 40 years with Lindsey & Newsom, Bob Irwin retired from the company and his chosen successor, Terry Grant, took over running the U.S. operations. Bob Irwin has led Lindsey & Newsom for eighteen years and leaves Terry Grant with a great foundation to build on. We thank Bob for his great efforts in the past three years and wish him a happy retirement.

We continue to expect improved profitability from the U.S. operations. Morden & Helwig financed its acquisition of Markel Corporation's 50% interest in Lindsey & Newsom with five-year bank debt and common shares (issued at $8.00 per share) in equal proportions. At year-end, Morden & Helwig had a strong balance sheet (though not as strong as 1989) with total debt (including Lindsey & Newsom's debt) of $23 million vs common equity of $34 million.

All of the increased goodwill on our balance sheet comes from the consolidation of Lindsey & Newsom into Morden & Helwig. In a service business, tangible assets are minimal and goodwill reflects the earnings capacity of the firm. In 1990 Lindsey & Newsom generated US $47.4 million in revenues through 170 branches with 900 employees. When it was acquired in 1987, Lindsey & Newsom had sales of US $17 million in 38 branches with 268 employees. Our expectations are that this goodwill is fully justified.

Shareholders should read Morden & Helwig's Annual Report to get more details about our claims operations. You can get a copy by phoning Don House at (416) 362-6762.

Investment banking

We are no longer in the high profile stock brokerage business. During 1990 Walwyn merged with Midland Doherty backed by a capital infusion from Mackenzie Financial. The merger was very well managed but late in the year Tony Arrell, who continued to have our total support, decided to resign from Midland Walwyn. Given Tony's resignation and Confederation Life's continuing interest in the business, we decided to transfer our interest to Confederation Life. By September 30, 1990 we had already written off our investment in Midland Walwyn, so this sale did not and will not have any further impact on our financial statements. However, our venture into the stock brokerage business cost our shareholders $3.5 million plus the opportunity cost on this capital for two years. We continue to hold our $8.7 million in 12.5% convertible debentures due in December 1993. With the capital raised recently by Midland Walwyn, we are comfortable valuing these debentures at par. We are confident that Midland Walwyn will continue to be very successful under the guidance of Mackenzie Financial and Confederation Life and wish them well in the future. It is highly likely (and personally much appreciated) that you will not see your Chairman's name in the local newspapers soon!

We said in last year's report that Paul Fink was not planning any further investments until the current ones mature. And did they mature! We have written off our investment in Carbovan (cost $5 million) – I was too optimistic last year – and our minor investment in Develcon continues to plod along.

Our real estate investments, run by Rob Mills, consist mainly of a small shopping mall in Calgary. During 1990 the mall was substantially leased and it is expected to produce a positive cash flow in 1991 on our investment of $3 million, net of a non-recourse mortgage of $3 million.

The investment banking losses were mainly due to your Chairman's bright ideas! To date, investment banking has cost our shareholders $8.5 million ($1.55 per share) pre-tax excluding opportunity costs. We are reviewing the investment banking operation to take advantage of the talents of Tony Griffiths, Paul Fink and Rick Salsberg and minimize the losses from your Chairman. It is fair to say we will not do any more venture capital deals and will be extremely cautious of "turnaround" opportunities. Like Warren Buffett, we have found that when good management tackles an industry with poor prospects, it is the industry's reputation that remains intact.

The 1990 losses from investment banking shown in the table on page 8 come from the write-off of the Carbovan investment of $5 million and losses from Midland Walwyn of $1.5 million.

Financial position

Since we began in September 1985, we stated that our objective was to achieve returns on shareholders' equity in excess of 20% while maintaining a sound financial position. For the past few years we have been concerned about bringing our debt position down. While we made progress in 1989, in 1990 it seems that our situation worsened. To further understand our financial position, it is best to look at the unaudited statements shown on page 34 with Morden & Helwig equity accounted. Here's what our capital position looks like:

	$ million
Short and long term debt	31.5
Contingent debt (Note 8)	
– Federated contingent debt	20.4
– Markel Corp contingent debt	13.6
	34.0
Convertible debentures	7.5
Common equity	94.7
	167.7

Some points on the above:

1) *Contingent Debt*

   The Markel Corporation debt will be extinguished with interest if the financial markets recover in the next two and a half years as described in Note 8. As of March 8, 1991 the market recovery has resulted in the note being reduced by $9 million. However, as we can reduce the note only once, we have to wait until the securities fully recover to extinguish the note. Our expectation though is that this will happen. It should be noted that when this debt is extinguished, common equity is increased accordingly as we have not included the contingent purchase price on our books (Note 3).

   Federated contingent debt is subject to offset to the extent of adverse development in 1989 and prior reserves – very comparable to the debt on F-M Acquisition's balance sheet. Through the sale of F-M Acquisition, we have eliminated our liability for F-M's debt (which was not included on Fairfax's 1989 balance sheet) and added comparable contingent debt (which is included on Fairfax's 1990 balance sheet) through the purchase of Federated.

2) We expect the convertible debentures to be converted to equity at $19 per share prior to April 30, 1993 – though it is debt until then.

3) We sold Sphere Reinsurance for a price in excess of $21 million but have had access to only $8 million of the proceeds to date. The remaining $13 million is in Chequers where we wrote only $2 million in net premiums in 1990. With the planned amalgamation of Markel, Otter Dorchester and Chequers, it is likely that we will be writing only $l of premium for every $2 of equity capital as opposed to the more normal $2 of premium for every $1 of capital. Excess capital in the merged Markel will likely be more than $20 million which, subject to regulatory approval, will be used to reduce our borrowings in the future.

4) We retired 1.84 million shares or 25% of the shares outstanding in 1990. We felt this was an excellent investment for Fairfax in relation to potential earnings and current book value per share.

   However, if we had not retired these shares but had resold them at market prices, our equity capital would have been $22 million higher (at $12 per share) and our borrowings would have been reduced by a similar amount.

   Thus our financial position has not changed as significantly as first impressions would indicate. However, we have decided not to make any more acquisitions until we have reduced our short and long term debt to less than $10 million.

Investments

1990 was the worst year we have experienced in terms of investment results – particularly for value oriented investors like ourselves. The stocks that were cheap collapsed in the third quarter of 1990. Unlike past markets where the value oriented approach provided downside protection (at least vs the market), this did not happen in 1990. The unrealized loss in our portfolios increased significantly from $1.1 million at December 31, 1989 to $34 million at December 31, 1990.

As emphasized in the past, we run our insurance businesses so that (a) unrealized losses do not affect our insurance company operations, and (b) we are not forced to sell securities at inappropriate times. In our 1988 Annual Report we discussed the guidelines "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". When combined with reserve hits, stock market declines can be particularly dangerous. We are taking another look early in 1991 at our guidelines to better protect us on the downside.

The unrealized loss for our portfolios is broken down by major categories below:

	Cost	**Market**	**Unrealized loss**
		($ millions)	
Cash and short term investments	$ 54.0	$ 54.0	$ –
Bonds	165.9	157.6	(8.3)
Preferred stocks	58.9	50.5	(8.4)
Common stocks	63.1	45.8	(17.3)
	$341.9	$307.9	$(34.0)

As shown, the total unrealized loss is about 10% of the total portfolio. About half the loss is in common stocks and the rest is in fixed income securities.

As you know, Hamblin Watsa Investment Counsel (HWIC) manages Fairfax's insurance portfolios. Occasionally, an investment that HWIC buys for its clients, of which Fairfax is one, becomes a matter of public record. This is sometimes confused in the press as a Fairfax investment as opposed to an investment distributed across all Hamblin Watsa client portfolios. In the table following, we show holdings of common and convertible bonds in Fairfax insurance portfolios of the three names disclosed publicly by HWIC (Magna, Woodward's and Repap) and that have been reported in the press.

	Cost	**Market**	**Unrealized gain (loss)**
		($ millions)	
Magna International Inc.			
384,300 common shares	3.4	1.1	(2.3)
$4,785,000 conv. debs 7% due 1993	3.4	2.5	(0.9)
Total	6.8	3.6	(3.2)
Woodward's Limited			
698,388 common shares	2.4	0.9	(1.5)
$776,000 conv. debs. 10% due 2004	0.8	0.6	(0.2)
$200,000 conv. debs. 9% due 2000	0.2	0.1	(0.1)
Total	3.4	1.6	(1.8)
Repap Enterprises Inc.			
105,000 common shares	0.9	0.5	(0.4)
$4,100,000 conv. debs. 9% due 1998	4.0	2.2	(1.8)
Total	4.9	2.7	(2.2)
Total (Magna, Woodward's, Repap)	15.1	7.9	(7.2)

Thus, $7.2 million of the $34 million unrealized losses are in the three names mentioned above. The remaining unrealized losses are in a broadly diversified group of common stocks, preferreds and bonds.

We continue to feel that over the long term these unrealized losses will disappear and in fact, become realized gains.

Common shares in late 1990 were extraordinarily cheap in relation to earnings, assets and revenues and should provide good returns over time. As of March 5, 1991, unrealized losses in the total portfolio had declined to $16 million and for the three securities shown above to $3.1 million.

Realized gains of $2.3 million in 1990 were net of realized losses of $1.1 million and a reserve for potential losses of $2.9 million. Gross realized gains were $6.3 million.

The major contributors to realized gains in 1990 were Nikkei Puts ($2.4 million) and Bank of Commerce ($0.4 million). The major realized losses included Bank of Montreal ($0.7 million).

No trees grow to the sky. Finally, in 1990 the Japanese market declined by 38.7%. The Taiwan market, where there was much more speculation, declined by 52.9% in 1990. As noted earlier, we benefitted by the decline in the Japanese market through the purchase of Nikkei Puts (not exactly value oriented?!). The Japanese and Taiwanese markets continue to sell at high price/earnings ratios of 38 and 29 times respectively.

At the end of 1990 we had $29.7 million invested in banks, insurance and financial service companies, $13.8 million in industrial products and $8.8 million in mining stocks.

In the 1987 Annual Report we discussed the interest free, five-year loans given to directors and officers of Fairfax and key officers of independent operating units. We said "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 you." In Note 6 we show that we have loans of $9.6 million outstanding as of December 31, 1990 that were used to buy 664,982 Fairfax shares at an average price of $14.48 per share. At a 10% interest rate, the annual after tax cost to you is $536,000 or 10¢ per share. When the stock traded at $10 per share in 1990, the directors and officers of Fairfax and subsidiaries were not exactly smiling!

It is now a little more than five years since we took control of this company. It is very humbling to look back at the $9 million that we raised in September 1985 and to consider all the problems that this company has faced since then. We have had two stock market crashes in the last five years, a downcycle in insurance for at least half the period, surety losses of $21 million at Markel Insurance, losses from Midland Walwyn and other investment banking projects, and continued growing pains at Lindsey & Newsom. To add to this, you had a company undergoing a transition from being very small to medium sized and all that that entails for the organization.

With good people, much work and our share of fortune, book value has grown from $2.08 per share in December 1985 to $17.29 per share in December 1990 – a compounded growth rate of 53% annually. You know that cannot be repeated. Return on common equity has averaged 24% during this period – somewhat higher than our long term goal of 20%. By comparison, the TSE 300 group of companies earned 10.3% on average during the last five years. As an aside, our five-year average return on common equity of 24% places us among the top 5% of all the companies in the TSE 300. Shareholders' equity increased from $10 million as of December 31, 1985 to $95 million on December 31, 1990 – with very little new capital, as we retired 1.84 million of the 2 million new shares issued in May 1986. Prior to September 1985, the company had never made $1 million in net income; last year it made $21.3 million.

Our share price though has only risen from $3.00 in 1985 to $11.00 at year-end – a compounded rate of 30% annually, but much less than the growth of underlying book value.

At year-end 1990 our shares were selling at a 36% discount to book value per share as opposed to a 50% premium when we refinanced the company in September 1985. In early 1991 the discount decreased significantly. While these fluctuations in premiums or discounts to book value result in shareholder returns being greater or lower than returns earned by the company, in the long term these two returns should converge.

We expect to encounter as many problems in the future as in the past – and perhaps more – but we hope to continue to compound book value per share at rates in excess of 20% over the long term.

Tony Markel will be retiring this year as a director of Fairfax. Along with Steve Markel, Tony was instrumental in turning the company around in 1985 and since then has provided constant support and encouragement on our Board. Peter Bloemen retired from Trucena in 1990 and his successor, John Puddington will be joining us on the Board. Like Tony, Peter has been a pleasure to work with and has always been very supportive of the company and its interests. We wish both Tony and Peter all the very best and welcome John to our Board.

On your behalf, I would like to thank the Board, the management and employees of all our companies for making 1990 another excellent year under very challenging circumstances.

March 30, 1991

V. P. Watsa

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