To Our Shareholders

1991 worked out to be a better year than we expected. We earned a record $22.5 million of which $13.6 million was from the 1990 sale of F-M Acquisition. After tax earnings increased 6% while earnings per share increased 35% to $3.94 because of the 25% decrease in the average number of shares outstanding. Return on common equity in 1991 was 21.3% (vs 2.9% for the TSE 300) making it the sixth year we have achieved our objective of earning in excess of 20% after tax on common shareholders' equity. Book value per share increased 24% to $21.41. Our per share figures have benefitted greatly in 1991 (and will also in the future) by the significant decrease in the shares outstanding in 1990. This, of course, means that the intrinsic value per share of our company has increased significantly.

Looking back, the restructuring in 1990 of our partnership interests with Markel Corporation worked out very well for both companies. Both Markel Corporation and Fairfax are selling at historical highs in the stock market and have greater freedom for unhampered growth in the future.

As we enter the seventh year since present management took over the company, we thought it appropriate to reiterate, for the benefit of new shareholders, the objectives that we set out in our 1985 annual report. Surprisingly they have not changed since, although we have expressed them a little differently. Our objectives are as follows:

1) We expect to earn long term returns on shareholders' equity in excess of 20% annually by running Fairfax and its subsidiaries for the long term benefit of customers, employees and shareholders – at the expense of short term profits if necessary.

   Our focus is long term growth in book value per share and not quarterly earnings. We plan to grow through internal means as well as through friendly acquisitions.

2) We always want to be soundly financed.

3) We provide complete disclosure annually to our shareholders.

Some observations on our objectives. While we try to achieve a 20%+ return annually and have achieved this in the past six years, this will likely not be the case every year in the future. However, over any longer period (say five years), we would be very disappointed if we had not achieved an average return in excess of 20%. We place no importance on quarterly results. While we report results as they fall, we are conservative in our accounting policies and in our reserving, always providing for the proverbial "rainy day".

You should understand that 20% after tax is an extremely challenging objective and that very few companies achieve this objective over time. In the July 1991 issue of Report on Business magazine, Fairfax's five year return on common equity was ranked 30th out of the top 1,000 companies listed on Canadian stock exchanges. This means that only 3% of the top 1,000 companies in Canada have earned more on equity than we have over the past five years. By retaining all our income (and not paying any dividends) the 20% hurdle becomes more difficult as the years go by. However, over the next five years, we continue to expect to achieve this 20%+ objective.

Over the past six years we have always maintained a strong financial position. Our experience in 1990/91, when our financial position was less strong, has only underlined the importance of this objective. We will always sacrifice return if it endangers our financial health. It is interesting to observe the dramatic collapses of Campeau and First City Financial – both companies with track records extending over 20 years. Campeau's common shareholders' equity, built over 19 years to $141 million in 1986, turned negative in only 12 months due to losses of $254 million in 1987. While this ending may have been a foregone conclusion once Campeau bought Allied Stores and Federated Department Stores, First City's demise was much less predictable although equally dramatic. Shareholders' equity, again built over 21 years to $465 million in 1989, turned negative in only 18 months due to cumulative losses of $549 million.

Both these examples show how lethal financial leverage can be to a company's viability. Decades of growth in retained earnings can disappear in months. While we are very conscious of these failures and others like them that stem from financial excess, please remember that as Warren Buffett commented about Noah, building arks counts, not predicting rain.

Finally, we continue to report to you, once a year, the pluses and minuses about our company. We do this so that you can get a balanced view of our results but also to keep ourselves honest. Managements that fool their shareholders tend to fool themselves. Every year we work on improving your understanding of our company and we will always be receptive to ideas you may have about further disclosure.

The table below shows the sources of our net earnings:

	1991	**1990**
	($ millions)	
Insurance underwriting	5.3	(12.5)
Interest and dividends	25.4	19.3
Total insurance	30.7	6.8
Claims adjusting (Fairfax portion)	0.1	1.7
Investment banking (including Midland Walwyn)	(1.1)	(6.4)
Interest expense/corporate overhead	(6.5)	(9.1)
Realized gains	2.5	5.2
Equity earnings	–	4.5
Income before taxes and provisions	25.7	2.7
Less: provisions for future potential losses	(7.0)	(7.9)
Total pre-tax income (loss)	18.7	(5.2)
Less: taxes	9.8	0.5
Earnings (loss) after taxes	8.9	(5.7)
Gain on sale of F-M Acquisition	13.6	27.0
Net earnings	22.5	21.3

The table shows you our results from our insurance operations (underwriting and investments) and our non-insurance operations. Shown separately are realized gains and provisions for potential losses so that you can better understand our earnings from our operating companies. Also, please note the unaudited statements of our insurance operations and Morden & Helwig's financial statements shown on pages 34 to 38. Equity earnings in 1990 were from F-M Acquisition which was sold at the end of 1990.

Insurance earnings rebounded significantly in 1991 because of profits from insurance underwriting and higher dividend and interest income. In spite of a minor contribution from Morden & Helwig, continued losses from investment banking and a high level of interest expenses, pre-tax income before provisions increased significantly from $2.7 million in 1990 to $25.7 million in 1991. To be conservative, we provided $7 million in 1991 for provisions for potential investment losses. After provisions and taxes Fairfax earned $8.9 million versus a loss of $5.7 million in 1990. Because of portfolio appreciation in F-M Acquisition, described in detail in our 1990 annual report, Markel Corporation paid us an additional $13.6 million for F-M which was used to extinguish the contingent note. With this additional gain, our net earnings increased to $22.5 million from $21.3 million last year. In 1990 and 1991 our net gain on F-M totalled $40.6 million and contributed significantly to our performance in those years.

While each of our operations is discussed in more detail below, it is fair to say that the sustainability of our current earnings base is greater today than it has ever been.

Insurance operations

In last year's annual report we said that our underwriting results should improve in 1991 because surety would not continue to be a problem. In fact, because of significant recoveries in surety, our underwriting results turned positive in 1991. Our surety problem is now behind us and may perhaps continue to be a minor positive because of further recoveries. We are gratified at having conservatively reserved for surety in 1990 and would prefer to have similar reserving errors in the future. Excluding surety recoveries our insurance operations had a breakeven year in 1991 – a terrific achievement in a down cycle. Our insurance company managements deserve to be congratulated on this fine performance.

We completed the amalgamation of Markel, Otter Dorchester and Chequers in 1991 under Bill Grant's leadership. Markel is concentrating again on its expertise of the last 40 years – long haul trucking. We plan to be leaders in this industry again.

Federated Insurance, led by John Paisley, continued to make excellent progress in becoming a self-standing, independent operation. In 1991 John and his team achieved a combined ratio of 99% much improved from the 106% of 1990. Federated should have its own information systems in place by 1992 and is poised for achieving consistent underwriting profitability.

Commonwealth, led by John Watson, had an excellent year in 1991. In spite of the competitive environment, John and his team achieved a combined ratio of 99%. In last year's annual report, we said that we expected the earnings from Commonwealth to compensate for the sale of our interest in F-M. In 1991 Commonwealth earned $8.6 million after taxes versus our highest contribution from F-M of $7.2 million in 1989. As some of Commonwealth's insurance lines have recently had significant price increases and because of higher retentions, it is likely that the contribution from Commonwealth will be much higher in 1992.

There are two important points that you should note about our insurance business:

1) We have been operating for four years with the wind against us as the insurance cycle has been on the downswing. There are now faint signs that the cycle is turning. It may still be a year or two before it turns but our expectation is that sooner rather than later we will have the wind behind our back again for perhaps a few years.

2) Our insurance operating leverage is very low. Thus in 1991 we wrote only $21 million of net premiums in Markel against common equity of $35 million – an operating leverage of 0.6:1 versus a potential of at least 2:1. At Federated, our operating leverage is 1.1:1 and at Commonwealth only 0.4:1. When the cycle turns, unlike many insurance companies, we have the capacity to write many times the premiums we presently write.

Claims adjusting

1991 was a very disappointing year for Morden & Helwig, mainly because of the losses in its U.S. operations (please note statements on pages 37 and 38). Excluding losses from discontinued operations of US $1.7 million after tax, the continuing U.S. operations lost US $10,000 on revenue of US $54.8 million. This is not acceptable to management and they are focused on turning this around in 1992.

Morden & Helwig's Canadian operations, in spite of difficult industry conditions, continued to perform well, earning $2.2 million after tax in 1991, resulting in a respectable 16% return on equity supporting the Canadian operations.

Since January 1, 1992 the Canadian and U.S. claims operations of Morden & Helwig have been operating under the new name of Lindsey Morden Claim Services. The group has over 340 offices throughout Canada, the United States and the United Kingdom, with over 1,800 employees. We continue to be excited about the potential of the Morden & Helwig group under Ken Polley's overall leadership.

Morden & Helwig strengthened its balance sheet in 1991 as short and long term debt decreased significantly. Shareholders should read Morden & Helwig's annual report to get more details about our claims adjusting operations. You can get a copy by telephoning Don House at (416) 362-6762.

During 1991 Morden & Helwig exchanged Fairfax's US $7 million 9% convertible preferred shares in Lindsey & Newsom for a $7.9 million 10% debenture, convertible into common shares of Morden & Helwig at $11 per share. Fairfax's interest in Morden & Helwig now consists of this convertible debenture plus 2.45 million common shares carried at a cost (including our share of earnings) of $6.88 per share on our unconsolidated balance sheet.

Investment banking

As mentioned in last year's annual report, your Chairman's bright ideas have cost your company dearly. Although we do not intend to commit any more capital to investment banking, I should report, in the interest of fair disclosure (some of you may want to skip this section), that cumulative investment banking losses from inception increased by $1.1 million to $9.6 million ($1.65 per share). The increase was mainly due to the closure costs at Carbovan. We hope to dispose of our investment in Carbovan in 1992 (which is already written off); however, as disclosed in Note 13, we are still jointly and severally liable for $11.5 million in guarantees. We continue to have $1 million exposed to Develcon, and we are hoping to resolve this situation in 1992.

Last year we sold our convertible debentures at par in Midland Walwyn and now only have a portfolio investment in common shares. It is interesting to note that if we had not sold our interest to Confederation Life last year but maintained our interest by subscribing pro-rata to the rights issue, our all-in cost for the shares would be approximately $7.20 per share. At current prices of $9 per share for Midland Walwyn, this means we would have had an unrealized gain of approximately $3 million or a 25% return on cost as opposed to the $3.5 million loss taken in 1990. In spite of this opportunity cost, we feel we made the right decision last year as detailed in 1990's annual report.

There were no major changes in our real estate investments and we continue to expect profits on disposition.

Paul Fink, Tony Griffiths and Rob Mills are working hard to liquidate our investments in this area.

Financial position

To best understand our financial position, it is appropriate to look at the unaudited statements shown on page 36 with Morden & Helwig equity accounted. Here is what our capital position looks like compared to 1990:

	1991	**1990**
	($ millions)	
Short and long term debt	30.8	31.5
Contingent debt:		
Federated	20.4	20.4
Markel Corporation	0	13.6
	20.4	34.0
Convertible debentures	0	7.5
Common equity	124.3*	94.7
Total capital	175.5	167.7

* *Includes the convertible debentures which were converted into subordinate voting shares on February 14, 1992.*

Our financial position strengthened considerably in 1991. As discussed in last year's annual report, the Markel Corporation contingent debt was extinguished, the convertible debenture was converted into common shares early in 1992 and excess capital of approximately $10 million was released as a result of the Markel Group amalgamation. As an aside, the 1.84 million shares retired in 1990, worth $22 million then, would be worth $46 million today at $25 per share.

Also, you should be aware that we have financed employee stock purchase plans totalling $9.3 million which are included as other assets on our balance sheet (Note 4). These loans are secured by approximately 650,000 shares of Fairfax with a market value at $25 per share of approximately $16 million. If these loans were financed independently at a bank, Fairfax would have an additional $9.3 million available for debt reduction. We are exploring this possibility.

We continue to feel that we are adequately reserved. Our insurance reserves have been certified by The Wyatt Company by company and in total (note page 27). Reserve development in 1991 was minimal.

Thus, while we continue to focus on reducing long and short term debt to levels below $10 million as discussed in last year's annual report, we are very comfortable with our current financial position. In fact, we could be expanding again in 1992 if the right opportunity presents itself.

Investments

Since inception in 1985 we have always maintained that unrealized losses are not meaningful in the short term as they do not necessarily indicate permanent impairment. Unrealized losses (like unrealized gains) reflect fluctuations in the market and have no predictive value. What matters over time are the realized gains or losses.

This point is perhaps dramatically illustrated by our investment in Magna as shown below:

	Cost	**Unrealized loss as at Dec. 31/90**	**Realized gain**
		($ millions)	
Magna shares and convertible debentures	6.8	3.2	5.4

While we were unhappy about the unrealized loss of $3.2 million as of December 31, 1990, it did not affect our pocket book. What mattered was the *realized* gain of $5.4 million when we ultimately eliminated our position in October 1991. The 79% return on our cost was achieved over approximately two years.

Most fluctuations in stock and bond prices are not as dramatic, but it is fair to say that we continue to expect, in the main, to earn significant realized gains in the long term from our stock and bond investments even though some of them currently show unrealized losses.

The unrealized loss for our portfolios as at year-end is broken down by major categories below:

	1991	**1990**
	($ millions)	
Bonds	(0.3)	(8.3)
Preferred stocks	(0.8)	(8.4)
Common stocks	(5.0)	(17.3)
	(6.1)	(34.0)

The total unrealized loss dropped dramatically in 1991 from $34 million at the beginning of the year to $6 million at the close. The unrealized loss in bonds and preferred stock dropped significantly because of declining interest rates while rising stock markets helped reduce the common stock losses. Also, the unrealized loss shown is after a $7 million provision (mainly common stocks) that we took in 1991 just to be conservative. We do not expect this provision to be realized! By the end of February 1992 the unrealized loss was below $1 million.

Gross realized gains in 1991 totalled $9.1 million. After realized losses of $6.6 million and provisions of $7 million, we reported a capital loss in our income statements for the first time since we began of $4.5 million. The major contributors to realized gains were Magna ($5.4 million) and Bank of Montreal ($1.2 million). Realized losses arose in conjunction with the amalgamation of Chequers Insurance Company.

In our 1990 annual report, we disclosed our holdings in Magna, Woodwards and Repap because of the confusion in the press. As already mentioned, we sold Magna. We continue to hold the bulk of our positions in Woodwards and Repap.

Please note the tables on pages 31 and 32 for additional information on our investments.

A word about our press and/or investor relations department. We have none. We believe in making full disclosure through our annual report, our annual meeting, our interim financial statements and, when appropriate, periodic announcements. Further public comment is rarely necessary or constructive. We believe that Fairfax and each company within the group should be judged by its long term results and not by ''good'' or ''bad'' press. This is why we regularly have a ''no comment'' for the press.

We formalized a charitable donations policy in 1991 that committed us to donate at least 1% of pre-tax income from operations annually. We donated approximately $200,000 last year to a variety of charities across the country.

As you know our companies are decentralized and run by the presidents except for performance evaluation, succession planning, acquisitions and financings which are done at Fairfax. From the very beginning we have emphasized that Fairfax is a holding company and *not* an operating company. In 1991 we re-emphasized this aspect of our organization structure. Our holding company consists of only fourteen people including support staff and we plan to keep it this way. At Fairfax, John Varnell is responsible for all our insurance operations while Rick Salsberg is responsible for our non-insurance operations. Ronald Schokking is our V.P. Finance, Sam Chan our V.P. and Actuary and Brenda Adams our Corporate Secretary. It is because of their exceptional talent and hard work that we can continue to keep Fairfax small.

Since we began in 1985, book value per share has grown tenfold from $2.08 per share to $21.41 – a compounded growth rate of 46% that *cannot* be repeated. We are humbled by this experience because it is much greater than we ever expected. Our return on shareholders' equity over the past six years has averaged 23.8% (vs 9.1% for the TSE 300). Total shareholders' capital has increased to $124 million (including the conversion of the 8.5% convertible debentures in February 1992) from $10 million in December 1985.

So much for the past. What about the future?

The future continues to be very uncertain and not predictable. However, our company enters the new year in a far better position than it has had in the past. The insurance down cycle which has negatively impacted us for the last four years is showing signs of changing for the better. Our financial position is very strong and prospects are good for significant capital gains. On the negative side, Morden & Helwig continues to face a challenge in making its U.S. operations profitable. Also, we have not totally divested our investment banking projects. All in all though, it may be a little easier to meet our objectives in 1992.

Our stock price increased by 98% in 1991, going from a 38% discount to book value (of $17.29) at the beginning of the year to book value (of $21.41) at the end of the year. Since September 1985 our stock price has compounded at 37% annually – a very high rate but still less than the growth of underlying book value. As mentioned in last year's annual report, fluctuations in premiums or discounts to book value cause shareholder returns to be greater or lower than returns earned by the company in the short term but in the long term these returns should converge.

On your behalf I would like to thank the Board and the management and employees of all our companies for making 1991 another excellent year in spite of the very difficult economic environment.

March 23, 1992

V. P. Watsa

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