## To Our Shareholders

The inevitable happened. For the first time since we began in 1985, we did not earn a return on shareholders' equity in excess of 20%. We earned 7.7% on shareholders' equity in 1992 (vs 1.8% for the TSE 300). Net income after taxes in 1992 was $10 million or $1.76 per share, a 56% decrease from the $22.5 million or $3.94 per share reported in 1991. Book value per share, however, increased by 11% to $23.76 per share.

While these results were disappointing, over the last seven years Fairfax has earned an average annual return on shareholders' equity of 21.5% (vs 7.5% for the TSE 300), which is in excess of our objective of 20%. Book value has increased from $2.08 in 1985 to $23.76 – a compound rate of about 40% that we do not expect to repeat.

A word about long term returns on shareholders' equity. In July of each year the Report on Business publishes a survey of the top 1,000 companies in Canada based on profits, revenue, assets and return on shareholders' equity. You may be surprised to know that in last year's issue, only 39 companies out of the top 1,000 earned in excess of 20% on equity over the previous five years. Fairfax was ranked 22nd last year. While the results to date have been gratifying, this shows that our 20% objective is not an easy hurdle. Nevertheless, we continue to have that as our objective over the next five years.

In 1992 we simplified our corporate relationships significantly by the purchase of Hamblin Watsa Investment Counsel Ltd. (HWIC) as well as a 49.9% interest in The Sixty Two Investment Company Limited (Sixty Two), the controlling shareholder of Fairfax. As I was a shareholder in both these companies and recognized the potential conflict of interest was very high, I want to make sure you understand how and why we did these transactions and why they were fair (I hope you agree!).

HWIC is an investment counselling firm that Tony Hamblin and I founded in 1984. With five partners, Tony Hamblin, Roger Lace, Brian Bradstreet, Frances Burke and me, who have worked together for 18 years, and Vito Maida, a recent addition, the firm manages approximately $1 billion in pension, corporate and individual funds. Of the $1 billion, approximately $240 million are funds that originate from Fairfax's insurance subsidiaries. From inception the firm was set up to manage a small number of portfolios with a long term value-oriented philosophy. All the clients agreed to an incentive fee, resulting in HWIC being more investment driven than marketing-oriented. The company's long term results have ranked among those of the top investment managers in Canada.

How did we value the firm? Firstly, we created an independent committee of our Board, chaired by Robbert Hartog. Secondly, we consulted Sir John Templeton, the dean of the investment counselling business and also a large shareholder of ours. After arriving at a price that both Robbert and Sir John felt was fair, we obtained written approval of this transaction from all of the more than 50% of our minority shareholders that we contacted. Thus, the valuation of $14 million ($1.85 million in cash and 433,773 Fairfax shares valued at $28 per share) was considered fair and approved by our Board of Directors, the majority of our minority shareholders and all the partners at HWIC.

Why did HWIC make sense for Fairfax? Mainly, for the following three reasons:

1) It was a very good investment for Fairfax. Under very reasonable assumptions (i.e. no incentive fees or additional funds under management), Fairfax could achieve its 20% return on investment. Also, a multiple of 3.8 times revenue and 8 times pre-tax earnings was reasonable compared to private transactions and public valuations of investment counselling firms. Furthermore, we paid for most of the purchase by issuing shares of Fairfax at a fair price of $28 per share.

2) It brought proven investment management into Fairfax.

3) It removed my perceived conflict of interest and placed all of my interests in one pot.

While we think HWIC will be an excellent investment for Fairfax, our purchase price, as Note 16 shows, was essentially all goodwill. We are amortizing this over 10 years even though we do not think there will be any decrease in goodwill over the years.

HWIC will continue to be run as a separate subsidiary with Tony Hamblin as President. We have maintained the incentives at HWIC by a fair structuring of revenue sharing. I welcome the partners and employees of HWIC to Fairfax and we look forward to some excellent long term returns from our investment.

The purchase of the 49.9% interest in Sixty Two was basically to provide liquidity to the original investors who backed me seven years ago, on terms attractive to Fairfax. Sixty Two's only asset is shares of Fairfax and it has no liabilities. The shares of Sixty Two were valued on the basis of the market price of the Fairfax shares owned by it, less a liquidity discount of 15%. As disclosed in Note 9, in essence Fairfax issued approximately 680,000 shares to acquire indirect ownership of about 800,000 of its shares. The net result was that Fairfax effectively repurchased approximately 120,000 of its shares (with a market value of over $3.3 million at $28 per share) for no cost. Book value and earnings per share will be about 2% higher because of this purchase. Sixty Two will continue to be controlled by me as it has been in the past. This purchase also was approved by our Board of Directors, the majority of our minority shareholders and all the investors in Sixty Two.

With the completion of these two transactions, Fairfax is much simplified in its relationships and perhaps more focused. Also, the purchase of the Sixty Two shares brings to an end (at least formally) the original partnership that refinanced Fairfax (then known as Markel Financial) in those early days in 1985. Looking back, these investors must have been special to have financed an almost bankrupt insurance holding company led by a chairman with no corporate experience at all. There may, after all, be some truth in the definition of an entrepreneur – ''Unreasonable conviction based on inadequate evidence''! Even though this group will continue to be shareholders for some time, I want to take this opportunity to thank them for their invaluable support, without which Fairfax would not have existed.

The table below shows the sources of our net earnings:

| | **1992** | **1991** |
|---|---|---|
| | *($ millions)* | |
| Insurance underwriting | (16.9) | 5.3 |
| Interest and dividends | 24.8 | 25.4 |
| *Total* | 7.9 | 30.7 |
| Claims adjusting (Fairfax portion) | 0.3 | 0.1 |
| Investment banking and adjustments | – | (1.1) |
| Interest expense/corporate overhead | (4.8) | (6.5) |
| Realized gains | 9.7 | 2.5 |
| *Income before taxes and provisions* | 13.1 | 25.7 |
| Less: provisions for investment losses | (6.4) | (7.0) |
| Total pre-tax income | 6.7 | 18.7 |
| Less: taxes | (3.3) | 9.8 |
| Earnings after taxes | 10.0 | 8.9 |
| Gain on sale of F-M Acquisition | – | 13.6 |
| Net earnings | 10.0 | 22.5 |

The table shows you the results from our insurance (underwriting and investments) and 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 combined insurance operations and Morden & Helwig's financial statements shown on pages 35 to 39.

Insurance earnings declined significantly due to large underwriting losses which are discussed in greater detail later, and there was only an insignificant contribution from Morden & Helwig. In spite of higher realized gains and lower interest expense and corporate overhead, this resulted in pre-tax income before provisions declining by 50% to $13.1 million. After provisions and a recovery of past income taxes, we earned $10 million, up from $8.9 million last year. In 1991, however, we benefitted from a $13.6 million gain on the sale of our interest in F-M Acquisition Corporation which resulted in net earnings of $22.5 million. Our net earnings of $10 million are at their lowest level since 1986.

## Insurance operations

We suggested last year that there were faint signs that the insurance cycle was turning and that the wind might be behind our back again. How wrong we were! Hurricane Andrew bore down on the industry with a vengeance and cost us approximately $11 million. Also, a few large losses, combined with wind storm damage at Otter Dorchester and a $1.5 million loss from the Laurentian Financial Services (LFS) program (including termination costs), resulted in Markel having an underwriting loss of $5 million. The combined underwriting loss in our insurance operations of almost $17 million was by far the largest loss we have had over the last five years (page 29). On a combined ratio basis, we came in at 114%, way above our target of 100%. That's the bad news. The good news is that in the main we could not have prevented these losses through better underwriting.

As suggested last year, Markel continues to focus on long haul trucking. By year-end Markel had disposed of its farm business in Otter Dorchester to the North Waterloo Mutual Insurance Company and cancelled its contract with LFS. Markel's business increased significantly in 1992 without any price discounting, partly because its largest competitor had financial problems. Markel had a combined ratio of about 115% excluding its discontinued lines. Bill Grant and his management team have consolidated Markel and focused it on long haul trucking. The trucking insurance business, however, continues to be very competitive.

Since we bought it in 1990, Federated Insurance, under John Paisley's leadership, has gone from a branch operation to an independent company with its own information systems. John and his management team continue to develop niche markets with a captive sales force. Federated's property-casualty and life insurance operations' combined ratio was 104% in 1992, and the company is poised for achieving consistent underwriting profitability.

Commonwealth, led by John Watson, had a difficult year in 1992 due to Hurricane Andrew which resulted in the company having a combined ratio of 122% – its worst result in over five years. If not for Hurricane Andrew, Commonwealth's combined ratio would have been 98%. Unlike Hurricane Hugo ($2.7 million) and the Oakland earthquake ($1.4 million), Hurricane Andrew cost Commonwealth approximately $11 million, even though gross losses for Hugo were somewhat larger. Commonwealth continues to realize price increases in many of its insurance lines and, barring another major hurricane or earthquake, should contribute significantly to our earnings in 1993.

As mentioned in last year's annual report, there continue to be signs of a turn in the insurance underwriting cycle. We may have the wind behind our back again after having a headwind for five long years. While our insurance companies are writing more business than in 1991, our operating leverage (net premiums to common equity) continues to be only 0.9:1 for Markel, 1:1 for Federated and 0.6:1 for Commonwealth, versus a potential of at least 2:1. Thus when the cycle turns we, unlike many insurance companies, have the capacity to increase our premiums manyfold.

As you know, since we began in 1985, we have had The Wyatt Company certify our claims reserves by company and in total. How accurate have we been in our estimation of claims reserves? Have we been consistently over-reserved or under-reserved? To help you answer these and other questions, this year, for the first time, we have provided extensive disclosure on our total claims reserves in the section "Provision for claims" beginning on page 29. While this disclosure is mandatory in the U.S., it is not a requirement in Canada. However, we feel that this information will help you better understand our insurance operations and we thus plan to disclose it annually. While there are no guarantees, we continue to feel that we are adequately reserved.

## Claims adjusting

In spite of Hurricane Andrew, Morden & Helwig had a disappointing year in 1992. While net income increased to $562,000 from $234,000 in 1991, the results are still much below expectations. Ken Polley and his management team are working diligently to deal with the situations that arose from significant expansion in the U.S. while also coping with the poor claims environment in Canada. During 1992 Ken moved to the U.S., and we continue to be very confident that Morden & Helwig will return to significant profitability soon (to date I have been wrong!).

With the acquisition of the Renaud, Préfontaine group in Quebec, large capital expenditures for computerization and poor profitability, Morden & Helwig's long term debt increased in 1992. However, with a long term debt to common equity ratio of 0.4:1, Morden & Helwig continues to have a strong balance sheet – although less strong than in the past.

Included in ''Other assets'' on the Morden & Helwig balance sheet on page 38 is goodwill amounting to $31.4 million as at December 31, 1992. This goodwill is consolidated into Fairfax's balance sheet. Most of this goodwill arose from the purchase of the original Lindsey & Newsom operations in Texas. As these operations continue to be very profitable and provide the base for the U.S. operations, we believe there is no diminution of goodwill. Also, even at its low of $6-$7 per share, Morden & Helwig sells at its book value per share of approximately $7.05, suggesting the goodwill is ''good''. We review the goodwill on Morden & Helwig's balance sheet on a regular basis and continue to feel comfortable that in a service business with 334 offices and 1,700 people, the goodwill is justified. There is nothing like improved profits, though, to make us (and you!) more comfortable.

**Investment banking**

This is the last time you will read this section in our reports – and I'm sure you are very happy (I am!). We will be closing down our investment banking area. While not obvious in the table on page 6, we had to make good on our guarantees at Carbovan for $5.75 million. We have used provisions from the past which have now proved to be unnecessary to offset the impact of this on our income statement. Including guarantees, our half of Carbovan has cost us $14 million since 1988 – and we have nothing to show for it. You can be sure we will never get into a venture capital investment again. Unfortunately, it was a costly lesson – we prefer to learn from the mistakes of others!

A management restructuring at Develcon resulted in our $1 million loan being settled for cash and Develcon shares. We have written down our Develcon shares to an insignificant amount even though we have not sold the shares. We first invested in Carbovan in 1988 and in Develcon in 1987. It took us between five and six long years to exit from these investments – proving again that it is very easy to get into something but extremely difficult to get out. On a cumulative basis, your Chairman's brilliance has cost the company about $18 million or $3.00 per share pre-tax. On the positive side, this is history and will not affect us in the future. We continue to work at liquidating our real estate investments and expect to recover our costs (please see Note 2).

**Financial position**

As mentioned in previous annual reports, the best way to understand our financial position is to look at our unaudited balance sheet with Morden & Helwig equity accounted as shown on page 37. Here is what it looks like compared to 1991:

| | **1992** | **1991** |
|---|---|---|
| | *($ millions)* | |
| Short and long term debt | 47.7 | 30.8 |
| Contingent debt Federated | 20.4 | 20.4 |
| Common shareholders' equity | 143.8 | 124.3* |
| Total capital | $211.9 | $175.5 |

* *Includes the convertible debenture that was converted into subordinate voting shares on February 14, 1992.*

Our short and long term debt increased by approximately $17 million in 1992, mainly because we took almost no dividends from our insurance companies while financing the purchase of Hamblin Watsa ($1.85 million), the repurchase of about 109,000 Fairfax shares ($2.6 million), an investment in marketable securities at the Fairfax level ($5 million), Carbovan and other miscellaneous items.

Our shareholders' equity increased by $19.5 million because of net income of $10 million and net shares issued of $9.5 million ($12.1 million for Hamblin Watsa, less $2.6 million spent to retire 109,000 shares of Fairfax at an average price of $24 per share (Note 9)).

Our short and long term debt position at year-end was higher than we expected for the reasons mentioned. In 1993 we plan to bring this debt down to about $30 million, at which point our debt level would be very comfortable in relation to our earnings and shareholders' equity base.

In 1992 we renegotiated our banking lines and raised them to $75 million, all on a revolving five year term basis. While these lines provide us with flexibility, we plan to always leave a significant portion of them undrawn.

As mentioned in last year's annual report, we have begun to finance our employee stock purchase loans at a bank (Note 4). During 1993 it is likely that almost all these loans will be financed independently in this manner. We are also looking at more efficient ways to make the key officers of Fairfax significant owners.

This is perhaps an appropriate time to discuss our share buyback philosophy. We believe that at stock prices close to book value, it benefits our shareholders if we buy back our shares and retire them, as long as this is done well within our financial capability. We do not find too many opportunities to invest at a 20% after tax rate of return – assuming that is what we earn in the future. Many companies have share buyback plans but rarely use them. Here's what we have done since we began:

| | **1988** | **1989** | **1990** | **1991** | **1992** |
|---|---|---|---|---|---|
| Shares repurchased *(000s)* | 14 | 6 | 1,839 | 21 | 109 (+120*) |
| Average price *($)* | 8 | 8 | 9½ | 19 | 24 |
| Cost *($000s)* | 112 | 48 | 17,460 | 399 | 2,616 |

* *120,000 shares effectively retired for no cost due to the Sixty Two purchase.*

On a cumulative basis, since we began we have retired approximately 2.1 million shares (including the Sixty Two purchase) at an average cost of $9.80 per share. This works out to approximately 34% of our current shares outstanding.

Given our planned reduction in debt levels in 1993, we continue to examine opportunities to expand in the insurance business. While we have examined many situations, nothing has come of them.

### Investments

1992 was among the worst years we have experienced over the past 18 years managing Canadian stocks using a value-oriented philosophy. Stocks on the TSE that were among the cheapest on a value-oriented basis declined significantly in the second half of the year. On the other hand, our U.S. stock portfolios had an excellent year. However, we have more invested in Canada.

1991's year-end unrealized losses, which almost disappeared in the first quarter of 1992, increased again at year-end as shown below:

| | **1992** | **1991** |
|---|---|---|
| | *($ millions)* | |
| Bonds | 2.4 | (0.3) |
| Preferred stocks | 1.4 | (0.8) |
| Common stocks | (21.2) | (5.0) |
| | (17.4) | (6.1) |

The unrealized losses at the end of 1992 were after an aggregate provision for losses of $16.3 million, up from $9.9 million at the end of 1991 (please see Note 1). Thus if we had not increased our provision for losses in 1992, the unrealized loss at year-end would have been $6.4 million higher. What does all this mean? In the worst case, if we had to liquidate our portfolios as at December 31, 1992, our book value would be $17.4 million (or approximately $2.90 per share pre-tax) less than what we have shown it to be. We think this is pretty drastic but that is the downside.

The trend in our unrealized gains or losses as at December 31 is shown below:

| | **1985** | **1986** | **1987** | **1988** | **1989** | **1990** | **1991** | **1992** |
|---|---|---|---|---|---|---|---|---|
| **Unrealized gains (losses)** | | | | | | | | |
| $ million | 1.4 | 1.0 | (6.9) | 5.2 | (1.1) | (34.0) | (6.1) | (17.4) |
| % of investment portfolio | 4.3 | 1.1 | (5.6) | 3.8 | (0.8) | (10.0) | (1.8) | (4.4) |

My own view, as expressed often here in these pages, is that unrealized losses or gains are fluctuations and do not have any predictive value. At the end of 1990 we had an unrealized loss of $34 million which almost disappeared in early 1992. Realized gains or losses are what count over the long term. Having said that, we have provided $16.3 million for investment losses to take the possibility of permanent impairments into account. For example, with Woodward's having filed for protection from creditors, we have written off our total investment of $2 million even though we haven't sold it. Of the $16.3 million provision, approximately $5 million is specific, the rest being provisions against potential losses. We continue to feel that this provision is conservative, but only time will tell. Unrealized losses have dropped to $7.2 million as of March 17, 1993.

The table on page 32 shows the returns on the investment portfolio. As shown, realized gains after provisions have been below par in the past three years – unlike the three years before that. We continue to believe that realized gains in the future will be significant even though we can't say when. I should note here that the TSE 300 is selling at only a 35% premium to book value while the S&P 400 sells at a 200% premium. Over the past 35 years, both markets have sold at comparable market to book value ratios. We expect this relationship to come back into balance as the TSE 300 outperforms the S&P 400.

Gross realized gains in 1992 totalled $11.8 million. After realized losses of $2.1 million and provisions of $6.4 million, net realized gains were $3.4 million. The major contributors to realized gains were Bank of Nova Scotia ($1.7 million), Magma Copper ($1.5 million), Nikkei puts ($1.4 million) and Old Republic ($0.9 million).

At the end of 1992 we had $33.4 million invested in the common shares of banks and insurance and financial service companies and $20.6 million in natural resource companies.

Finally, on page 32, you should note that over time the increase in our investment portfolio has resulted in a rising stream of dividend and interest income. The decrease in 1992 is a result of a shift towards high quality preferreds (dividends are more tax efficient). On an after tax basis, dividend and interest income continued to increase in 1992.

Please refer to our 1991 annual report for our press and/or investor relations policy. It is not long.

As discussed in our 1991 annual report, our donations policy is to donate annually at least 1% of our pre-tax income from operations to charities. Fairfax and its subsidiaries donated approximately $150,000 in 1992 to a variety of charities across the country.

I have always believed that the stock market fluctuates in the short term but always reflects economic reality in the long term. How about Fairfax? How has the market treated us? Since we began over seven years ago, Fairfax has sold below book value for only 1 year from March 1990 to September 1991 – i.e. for approximately 20% of the time. The market has been pretty fair to us.

This also means that over time, every one dollar retained by Fairfax (as against paying it out in dividends) has resulted in at least one dollar of market value, with no taxes paid by our shareholders. As long as this test continues to hold (i.e. every dollar retained resulting in a dollar of increased market value) and we continue to earn 20% on our shareholders' equity, we won't be paying any dividends because it would be contrary to the interest of long term shareholders – to whom we try to cater.

We continue to keep our holding company small. Brenda Adams, Sam Chan, Paul Fink, Rick Salsberg, Ronald Schokking and John Varnell continue to show what can be done with a small, exceptionally talented and hard working group of people.

So much for history! How about the future? It continues to be as uncertain and unpredictable as it always was. However, with good people and good fortune, we continue to labour towards our long term objective of earning in excess of 20% on shareholders' equity by running Fairfax and its subsidiaries for the long term benefit of customers, employees and shareholders.

On your behalf, I would like to thank the Board and the management and employees of all our companies for their very significant contributions throughout the challenges of 1992.

March 22, 1993

V. P. Watsa

V. Prem Watsa
*Chairman and*
*Chief Executive Officer*