To Our Shareholders

WOW! What a year! In many ways 1993 was the best year we have had since we began in September 1985. We earned 20.3% on shareholders' equity, book value per share increased by 48% to $35.13 and our company has never been in a stronger financial position. Net income after taxes was a record $33.3 million or $5.42 per share, more than three times what was earned in 1992. Even the stock market obliged and our shares increased by 145% to $61.25. I will really have to work hard to achieve our last objective – balanced reporting to you in this annual report!

While these results by themselves would have given us an excellent year, in the last three months of 1993 we purchased Ranger Insurance Company for effectively US$125 million and financed it with the issue of two million treasury shares at $55 per share and a US$100 million 7.75% ten year debenture issue. These financings also helped retire all our bank financing and the Federated contingent debt – and so, we ended the year with $75 million in unused, committed, long term bank lines.

We are excited about our purchase of Ranger because it is a niche-oriented company, led by Tom Friedberg who has an excellent track record, and it was available at a fair price. Fair price, of course, like beauty, lies in the eyes of the beholder. We effectively paid US$125 million for Ranger with a book value of approximately US$105 million, a premium we feel that Tom and his management team will justify. Unlike our past acquisitions in which we generally had the vendor provide financing whose repayment was contingent upon reserve indemnification, in the case of Ranger we financed the acquisition in the capital markets, and the vendor's US$20 million reserve indemnification is fully secured by real estate assets.

Our equity issue was led by Dick Falconer and Jim Hinds from Wood Gundy, the very same people who led our two million share issue at $10.00 per share in 1986. They were ably supported by RBC Dominion Securities, ScotiaMcLeod, Burns Fry and Richardson Greenshields. We thank them all for an excellent job and we welcome our new shareholders. We hope your results will not be too dissimilar to the shareholders who purchased our stock issue in 1986! We hasten to emphasize that our company is run for the long term. With some trepidation, we recommend that our new (and old!) shareholders review our old annual reports to get some perspective on our company. I hope that won't make you change your mind.

While we have acquired companies and have done a stock issue in the past, we have never done a public debenture issue before. Our U.S. debt financing, which was led by J.P. Morgan and First Boston, was a significant milestone for our company and we thank them for their sponsorship of our first debenture issue. While we were happy with the absolute rate of 7.75%, we paid 210 basis points (or 2.10 percentage points) above comparable U.S. treasuries – significantly higher than we expected. The rating agencies (Standard & Poor's, Duff & Phelps and Dominion Bond Rating Service) have given us a BBB. We welcome our debenture investors and want to reassure them that we run our company at much higher standards than a BBB – and plan to convince the rating agencies of that soon.

Our common stock issue of two million shares has increased our net shares outstanding by 33%, effectively reissuing the shares that we had repurchased in the past five years. This we did not do lightly. As mentioned in our 1986 annual report, ''We consider our stock as good as cash. When we issue stock we will ensure that we get as much value as we give.''

Prior to the purchase of Ranger we had approximately $65 of investments (cash, bonds, preferreds and common stocks) per share of Fairfax. After the purchase of Ranger, and the stock and debenture financing, you will have approximately $107 of investments working for you for every share you own. By way of perspective, in September 1985 there were approximately $7 of investments per share of Fairfax. In the long run, we think this will be of significant benefit to you, our shareholders. We think Ranger provides us with excellent diversification (almost 63% of our expected 1994 insurance business will now be written in the U.S.) and enhances our ability to achieve our long term 20% return on equity objective.

This is perhaps a good time to reiterate what we said about Fairfax's vision in our 1987 annual report. We said, ''We have no long term plans other than to react to opportunities on a day by day basis.'' We had barely heard of Ranger prior to October 1993; we had no plans to issue any shares and would have salivated if told about a public debenture issue. When these opportunities came our way, our small, exceptionally talented and hardworking group of people, led by Rick Salsberg and John Varnell, and ably supported by Brenda Adams, Sam Chan, Paul Fink and Ronald Schokking, did the impossible. To do any one of these three transactions in three months would have been quite an achievement. To do all three shows you why I am so excited about our long term future.

The table below shows the sources of our net earnings:

	1993	1992
	($ millions)	
Insurance underwriting	2.1	(16.9)
Interest and dividends	23.0	24.8
Total	25.1	7.9
Claims adjusting (Fairfax portion)	0.4	0.3
Interest expense	(5.0)	(5.6)
Goodwill amortization	(1.4)	(0.2)
Corporate overhead and other	(0.7)	0.9
Realized gains	27.8	9.7
Income before taxes and provisions	46.2	13.0
Less: provisions for investment losses	–	6.3
Total pre-tax income	46.2	6.7
Less: taxes	12.9	(3.3)
Net earnings	33.3	10.0

Insurance earnings improved significantly in 1993 due to the small underwriting profit earned in the year compared to the large underwriting loss in 1992. Morden & Helwig continued to make a very insignificant contribution. Interest expense decreased due to lower rates and goodwill amortization increased due to the Hamblin Watsa acquisition occurring late in 1992. The corporate overhead expense includes Hamblin Watsa pre-tax income as well as the new debenture issue costs. Large realized gains, combined with no net additional provisions for investment losses, resulted in pre-tax income increasing seven times from 1992, and after-tax income, three times. The timing of our realized gains is totally unpredictable and thus we place no importance on quarterly earnings trends. We accept short term variability for long term gains. Book value per share increased from $23.76 to $35.13, about equally from earnings and from the share issue at $55 per share.

Insurance operations

1993 was a good year for our insurance operations with a combined ratio of 99% versus 114% last year. Since 1985, we have achieved our target of 100% or less in five of the last eight years.

Commonwealth, led by John Watson, had a record year with a combined ratio of 92% versus a Hurricane Andrew-impacted 122% last year. During the year, Commonwealth was upgraded to an A- by A.M. Best Company and was also rated A- (claims paying ability) by Standard & Poor's. Gross premiums written increased to $207 million from $161 million in 1992 and $129 million in 1991. Net premiums written have increased to $71 million from $51 million in 1992 and $33 million in 1991.

Commonwealth has experienced a firming in many of its lines and has experienced significant price increases in the oil and gas area. Commonwealth earned a record $19.4 million after taxes – about a 34% return on our purchase price of $57.5 million in 1990. While we have reduced our risk to hurricanes and earthquakes and continue to monitor our exposures carefully, Commonwealth can still be significantly impacted by catastrophes such as Hurricane Andrew in 1992.

Federated also had an excellent year in 1993 with a combined ratio in its property and casualty business of 98%. Under John Paisley's leadership, Federated dominates many of its market segments including farm equipment dealerships, tire dealers, and service contractors. With the specialty focus of its direct marketing representatives, underwriters and claims staff, we continue to feel that the company will achieve consistent underwriting profitability. A.M. Best Company rated Federated an A-, its first Best rating. In 1993 Federated earned $10.2 million after taxes – a 36% return on our purchase price of $28 million in 1990. During the year, we settled the Federated contingent debt of $20.4 million to the mutual satisfaction of Federated Mutual Insurance Company and Fairfax. We have had an excellent working relationship with Federated Mutual and wish them the very best in the future.

Markel had another difficult year in 1993 with a combined ratio of 112%. In long haul trucking, our focus at Markel, we had a 115% combined ratio. Obviously, this is not acceptable and Bill Grant and his management team continue to work hard to correct the situation. In spite of these results, or because of them, the trucking insurance industry continues to be very competitive.

Our Barbados company, Wentworth Insurance, had an excellent year in 1993. It is still very small. We have participated in two catastrophe reinsurance contracts with a reinsurer we admire and respect. In 1993 Wentworth had gross premiums written of $5.8 million and net income of $4.2 million.

After three years of inactivity on the acquisitions front, effective December 31, 1993 we acquired Ranger Insurance Company for a price of US$125 million (consolidated into our balance sheet as of December 31, 1993). The company specializes in niche markets like propane distributors, petroleum and gas marketers, long haul trucking and agri-products. Since 1987, under Tom Friedberg's leadership, the company has achieved a combined ratio in the 106% area in spite of soft markets. It is our expectation that Tom and his management team will soon be able to achieve combined ratios of 100% or better. The purchase price of US$125 million included approximately US$90 million cash that was used by the vendor to purchase all of the real estate investments from Ranger at their underlying book values. Please review the MD&A (page 25) and Note 14 for additional details on Ranger. Under Tom's leadership the company has earned an average of approximately US$13 million after tax each year in the past five years after adjusting for the lack of income from real estate investments. We welcome Tom Friedberg and the employees of Ranger Insurance to Fairfax and look forward to participating in the company's growth.

As an aside, our due diligence of Ranger was done almost exclusively by our insurance subsidiaries. We now feel we have the resources internally to evaluate any potential insurance acquisition.

Our insurance companies continue to have low operating leverage (net premiums written to common equity) in spite of writing more business in 1993. Operating leverage in 1993 for Markel was 1.1:1, Federated 1.1:1, Commonwealth 0.7:1 (and Ranger 1.6:1), versus a potential of at least 2:1. Thus, in an improved insurance environment, we have the capacity to increase our premiums significantly.

Since 1985 we have had our reserves certified by The Wyatt Company. In 1993, due to Wyatt's changed business objectives, we have decided to use the casualty-actuarial practice of our auditors, Coopers & Lybrand, to also certify our reserves. Ron Miller, who was Wyatt's actuary, will continue to certify Markel and Federated's reserves, and Joe Cheng will certify Commonwealth's reserves, as he has done for the past five years. All of these reserves will then be reviewed by Coopers & Lybrand and certified by them. Sam Chan will continue to monitor our reserves internally at Fairfax. As always, in spite of these precautions, there is no guarantee that we will be adequately reserved. However, rest assured that, as in the past, we will react immediately if we find we are under-reserved. We continue to provide extensive disclosure on our total claims reserves, beginning on page 28, which will help you appraise our past reserving accuracy. While we continue to feel that our reserves are adequate, the recent settlement with Fibreboard Corporation, where two insurance companies have had asbestosis claims in excess of US$3.25 billion for premiums of approximately US$100,000 in the 1950s, always keeps us on our guard.

Claims adjusting

1993 was another poor year for Morden & Helwig and very frustrating for Ken Polley, its President. While operations have significantly improved because of tight expense control, improved branch management and more efficient computer systems, we have yet to earn an adequate profit on our investment in the past few years. Ken has appointed Frank Semancik (over 30 year's experience in the industry) in charge of U.S. operations and Don Cain (Regional Vice President for the Atlantic Provinces) in charge of Canadian operations. With Ken, Frank, Don and Duncan Smith, Vice President, Finance, we continue to expect Morden & Helwig to earn adequate returns for its patient shareholders (many public shareholders are not as patient!).

Because of almost no profitability in the last few years, Morden & Helwig's balance sheet has deteriorated. Total debt to equity is now at 0.59 – not great but still adequate.

Investment management

1993 was the first year for Hamblin Watsa Investment Counsel under the Fairfax banner. HWIC's investment results were its highest ever for Canadian equities and bonds. Long term results continue to be excellent as shown below:

Annualized rates of return (%)
Cumulative periods ended December 31, 1993

	5 year	**10 year**	**15 year**
Canadian Equities	10.0	14.1	16.1
TSE 300	8.6	8.9	12.2
U.S. Equities	23.1	19.6	20.0
S&P 500	16.9	15.6	16.6
Canadian Bonds	15.4	13.9*	–
SM Index	14.0	13.2*	–
Total Fund	13.8	16.3*	–

* *Nine years only*
Source: Representative balanced fund managed by HWIC for nine years. Equity results for an additional six years are from the organization for which the principals previously worked.

We congratulate Tony Hamblin, Roger Lace, Brian Bradstreet, Frances Burke and Vito Maida on the excellent results – short and long term. Also, it should be noted that Roger Lace and Brian Bradstreet have had excellent long term results managing U.S. stocks and U.S. bonds respectively. Thus, HWIC has the capacity to manage Ranger's portfolios.

Despite the loss of a few pension accounts, HWIC had a record year due to approximately $3.3 million in performance-based incentive fees which were earned for the first time in 1993 (a pooled fund for individuals had earned incentive fees before). In spite of great investment results in 1993, Fairfax's insurance subsidiaries did not pay an incentive fee as cumulative results from inception were not higher than the hurdle rate. Because of these incentive fees, Fairfax earned approximately a 22% pre-tax return or 16% after-tax return on its $14 million investment in HWIC. While returns after goodwill amortization (of $1.4 million annually) will be less than those mentioned above, we think the returns we have shown are the best measure of HWIC's performance.

HWIC partners, with participation in the incentive fees and as large shareholders of Fairfax (at $28 per share), have much to smile about! As suggested in our 1992 annual report, we think HWIC will be an excellent investment for Fairfax.

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 1992:

	1993	**1992**
	($ millions)	
Short and long term bank debt	–	47.7
U.S. debenture issue	132.4	–
Contingent debt – Federated	–	20.4
Common shareholders' equity	279.5	143.8
Total capital	411.9	211.9

As shown, common shareholders' equity increased by $135.7 million – $104.8 million net from the share issue and $33.3 million from net income, less the cost of 100,000 shares repurchased at $24.80 per share. Together with the US$100 million 7.75% ten year debenture issue (C$132.4 million), we purchased Ranger and also paid back our bank debt and the Federated contingent debt. Currently we have unused, unsecured, committed, long term bank lines of

$75 million from four major Canadian and U.S. banks. These are unused bank lines and provide us with flexibility – we certainly do not plan to use them other than on an emergency basis.

Our debt to equity ratio of approximately 0.47:1 or debt to total capital of 0.32:1 is close to the maximum with which we would feel comfortable. Even though this ratio is comparable to the one in 1992, I think we are in the strongest financial position we have ever been in for the following reasons:

1) The interest rate on our debt is fixed at 7.75% and the debt has a long (ten year) term. The covenant package provides us with great flexibility.

2) We have unused, unsecured, committed, long term bank lines of $75 million with excellent covenants.

3) Our long term debt is less than three times our expected earnings base with Ranger included. Note the word *expected*! We have been wrong before!

4) Due to consolidated tax accounting in the U.S., our interest costs will now be currently tax deductible (in Canada they would just have added to our large tax loss carry forward balances of $18 million). Our after-tax interest cost will be approximately US$5 million. Ranger itself has paid dividends of approximately US$10 million each year for the last three years, and our Canadian insurance companies can pay dividends of approximately $15 million in 1994. As cash flow from HWIC pays for most of the overhead at Fairfax (it is small!), our only net expense at Fairfax is our annual interest cost of US$5 million after tax.

5) There is very little foreign exchange risk as we have almost matched the purchase price of Ranger with the U.S. debt issue. We have also hedged our remaining net U.S. dollar exposure (US$17.4 million) and future Ranger earnings (in U.S. dollars) by purchasing a US$50 million, five year foreign exchange contract at C$1.37 to US$1.00.

Investments

Last year I wrote to you that "1992 was among the worst years we have experienced over the past 18 years managing Canadian stocks using a value-oriented philosophy." Well, 1993 was the best year we have ever had – both absolute and relative to the TSE 300. Our U.S. results continued to be excellent and our bond results were outstanding. All in all, a year very unlikely to be repeated!

1992's year-end unrealized losses disappeared and, in fact, we had an unrealized gain of $11.4 million as of December 31, 1993 as shown below:

	1993	**1992**
	($ millions)	
Bonds	3.1	2.4
Preferred stocks	8.8	1.4
Common stocks	(0.5)	(21.2)
	11.4	(17.4)

The change in the unrealized position was even more dramatic as it was after $27.8 million of realized gains in 1993. The total change in our market values in the past year amounted to approximately $56.6 million. You can understand why we said it was an outstanding year!!

Our aggregate provision for losses of $16.3 million as of December 31, 1992 dropped to $11.5 million at the end of 1993, mainly because we had realized losses of $4.3 million in two investments for which we had made provisions. We feel that our provisions continue to be conservative.

We have said for some time that "unrealized losses or gains are fluctuations and do not have any predictive value. Realized gains or losses are what count over the long term." 1993 was a dramatic illustration of the fluctuations that markets undergo from time to time. The key is to treat them as fluctuations and focus on the underlying long term intrinsic values. Thus, do not get particularly excited about the unrealized gains of $11.4 million as of December 31, 1993 or about their increase to over $26 million as of March 15, 1994.

The table on page 32 shows the return on our investment portfolios. While realized gains for the three years prior to 1993 have been below par, 1993 certainly went a long way to making up. Total pre-tax realized gains since we assumed management in 1985 have amounted to $62.8 million or $10 per share. Realized gains in 1993 amounted to 9% of the average portfolio, excluding cash.

Gross realized gains in 1993 totalled $35 million. After realized losses of $7.2 million, net realized gains were $27.8 million. The major contributors to realized gains were Lone Star Technologies convertible bonds ($4.4 million), Mackenzie Financial ($4 million), Nowsco Well Service ($3.7 million), Midland Walwyn ($3.6 million), Bank of Montreal ($3.2 million), Rio Algom ($2.6 million), Bank of Nova Scotia ($2.2 million), Conwest Exploration ($1.7 million) and Toronto-Dominion Bank ($1.6 million). The major realized loss was in Gentra (formerly Royal Trust). Approximately 60% of the common stock portfolio was sold to take advantage of the significant increase in stock prices. While we are pleased with the large gains in 1993, we should mention that had we been really smart and not sold Magna in 1991 but sold it at $65 in 1993, our realized gains in 1993 would have been $32 million higher!!

At the end of 1993 we had $45.3 million invested in the common shares of banks and insurance and financial services companies, $28.1 million in natural resource companies, and $16.2 million in industrial products companies.

In last year's annual report, I commented on the discrepancy between the TSE 300 and the S&P 400 market/book value ratios and the fact that over time they have sold at comparable ratios. The discrepancy narrowed in 1993 and the TSE 300 currently sells at 1.9 times book value versus the S&P 400 at 3.9 times book value. It seems to us that this narrowing will continue in 1994. We should note that book values have recently been distorted by significant accounting write-offs, and perhaps are no longer as useful as they were in the past. Having said that, there is no question that the stock markets in Canada and the U.S. are at much higher levels than in the past 20 years, reflecting the fact that inflation and interest rates are at levels that were common in the 1960s. Mutual fund mania prevails. The number of mutual funds in the U.S. (about 4,500) is greater than the number of stocks that are listed on the NYSE (2,391). Speculation is quite rampant on Wall Street and Bay Street as shown by the number of IPOs that are being completed.

We recognize the environment we are in but continue to own stocks that meet our long term value-oriented standards. We have never tried to forecast the economy or the stock markets but only try to buy common shares that protect us on the downside and earn acceptable long term returns.

You will remember that we test our portfolios monthly to check the effects of simultaneous declines of 50% in our common stock holdings, 30% in our preferreds and 20% in our bonds. We check to see if, after applying this test, the regulatory capital of our insurance companies would have been sufficiently impacted to require additional capital. You will be pleased to know that as of December 31, 1993, after this test our insurance companies would still have met the statutory capital requirements. We continue to focus on the downside!

We are working at disposing of our real estate investments ($4.2 million) by the end of 1994. We will be pleased to get our money back – I was too optimistic in the past!

In 1993 Fairfax and its subsidiaries donated approximately $400,000 or 1% of pre-tax income to a variety of charities across the country.

Please refer to our 1992 annual report for our dividend policy. Nothing has changed!

Since we began in 1985, book value has compounded at 42.4% annually, a rate we have emphasized cannot be repeated in the future. Our average annual return on equity over the past eight years is 21.3%, slightly in excess of our target of 20% (the TSE 300 averaged 7% over the same period). In the July 1993 issue of Report on Business Magazine, Fairfax's five year return on equity was ranked 39th out of the top 1,000 companies listed on Canadian stock exchanges, i.e. in the top 4% of all companies in Canada. Our stock price has compounded at 43% annually since we began in September 1985, a rate slightly higher than the growth in book value and impossible to repeat. Currently our shares are selling at twice book value of $35 per share close to the highest multiple they have sold at in the past. Obviously, we are gratified by this record.

However, it is a good time to emphasize, perhaps over-emphasize, the short term risks that your company faces. Above all is the insurance cycle and the fact that it is still a very competitive market, and Markel particularly has yet to achieve a combined ratio of 100%. We face catastrophe risks at Commonwealth, particularly a California earthquake (like the one that occurred in January 1994). The "big one" will impact our earnings significantly although our balance sheet should continue to be strong. In insurance there is always the possibility that something from the past (like asbestosis for many companies) can come to haunt you. In the case of Fairfax, we think not, but only time will tell. Morden & Helwig has yet to earn acceptable returns and, although I think it will, you can't be certain. The stock markets have been very good to us in 1993. If the markets decline significantly, this would, of course, have an impact on our 1994 earnings. I can go on and on but you can see that business is always uncertain and unpredictable. While we think we are in the best position we have ever been in and are excited about our *long term* prospects, the short term is as unpredictable and uncertain as it ever was. Our focus continues to be to earn in excess of 20% over the long term by running Fairfax and its subsidiaries for the long term benefit of its customers, employees and shareholders.

Tony Arrell retired in September 1993 as a director of Fairfax. Tony has been a good friend and a strong supporter of our company. We wish him all the very best in the future.

On your behalf, I would like to thank the Board and the management and employees of all our companies for their major contributions in 1993.

March 16, 1994

V.P. Watsa

V. Prem Watsa
Chairman and
Chief Executive Officer