To Our Shareholders

It happened again! For the second time since we began in 1985, we did not earn a return on equity in excess of 20%. We earned 12.1% on shareholders' equity in 1994 (versus 9.5% for the TSE 300). Net income after taxes in 1994 increased by 14% to $38.1 million, while earnings per share decreased by 14% to $4.66 per share because of the 33% increase in the average number of shares outstanding. Book value per share, however, increased by 25% to $43.77 while our share price increased by 9% to $67.00.

While these results were disappointing, over the last nine years Fairfax has earned an average annual return on shareholders' equity of 20.3% (versus 7.3% for the TSE 300), which is just above our objective of 20%. Book value though has increased from $2.08 in 1985 to $43.77 in 1994 – a compound rate of 40.3%. Our stock price has followed the growth in book value over the long term and has increased from $3.25 in September 1985 when we began to $67.00 in 1994 – both up by more than twenty times since 1985. We are very gratified about this record, but as emphasized in past annual reports, this record of book value growth is not sustainable.

In the July 1994 issue of Report on Business Magazine, Fairfax's five year return on equity of 17.6% (or, according to our calculations, 18.5%) ranked 43rd (or, based on our calculations, 34th) out of the top 1,000 companies listed on the Canadian stock exchanges, i.e. in the top 4% of all companies in Canada. While this shows that our 20% goal is not an easy hurdle, nevertheless, we continue to have that as our objective over the next five years.

Sidestepping our financial results in 1994 for a moment (you can understand why!), we purchased Continental Canada, our largest acquisition yet, late in 1994. We bought it from Continental U.S. for $155 million of which $25 million was paid by Fairfax's issue of an unsecured 7.75% debenture due December 15, 2003 containing the same terms as our publicly issued 7.75% debentures due December 15, 2003. We financed the balance with the issue of one million treasury shares through a private placement at effectively $76 per share and a $60 million unsecured, five year bank loan. This bank loan is in addition to our unused, committed, long term bank lines of approximately $105 million. An additional $10 million will be payable to Continental U.S. if Continental Canada achieves a combined ratio of 100.4% or less over the next five years. Also, Continental U.S. has provided us with a $40 million, five year indemnification against adverse development in loss reserves and reinsurance recoverables, secured by marketable bonds.

We are excited (we always seem to be!) about our purchase of Continental Canada because it is predominantly a commercial lines insurance company led by Byron Messier who is committed to underwriting profits – and the company was available at a fair price. We paid $155 million for Continental Canada with a book value of approximately $163 million and after-tax earnings of $19 million in 1993. Because of higher interest rates and mark-to-market purchase accounting, Continental Canada's book value has been written down for accounting purposes to approximately our purchase price. This adjustment consists of an unrealized loss in a predominantly government bond portfolio with an average term of approximately three years. In three years, or if interest rates decline in the interim, we will recoup this writedown. Together with the indemnification discussed earlier, we felt that Continental Canada was available at a price and on terms that would meet our long term objectives.

After not issuing shares for seven years, we have been great supporters of the investment dealer industry recently. We did a public issue of 2 million shares at $55 per share in 1993, and in 1994 we completed a private placement of 1 million shares at $76 per share led again by Dick Falconer and Jim Hinds from Wood Gundy and ably supported by RBC Dominion Securities, ScotiaMcLeod, Nesbitt Burns and Richardson Greenshields. We thank them all again for an excellent job and request them not to extrapolate this recent frenetic activity in their future plans! We welcome our new shareholders and emphasize again, as we did in 1993, that our company is run for the long term. So don't be too concerned about short term results as we will accept short term volatility in our earnings for better long term results.

We should note here that we are very careful about issuing shares. We shun companies which make acquisitions at twice book value and finance them by issuing their own shares at discounts to book value. If our shares were not selling at fair prices, we would not have issued them and thus, would not have purchased Continental Canada. You will remember, we have never been interested in becoming bigger – only in earning attractive long term returns on shareholders' capital by treating customers, employees and shareholders fairly.

Our recent stock issue at $76 was unusual as it was about twelve dollars above the previous day's trade. Most participants in the financial markets consider the last trade as the fair value of a company even though only 200 shares may have traded at that price. Our view is different. We felt that a fair price for our shares was $76, particularly given the pending purchase of Continental Canada. Fortunately many investors agreed with our view.

Most stock issues in the financial markets are priced to go up in the short term to provide buyers with a warm comfort factor – even though their experience in the long term may be just the opposite. While we would be pleased if our shares went up after an issue, we are more concerned with making our investors look good in the long term.

Prior to the purchase of Continental Canada, we had approximately $107 of investments (cash, bonds, preferreds and common shares) per share of Fairfax. After the purchase of Continental Canada and the share issue described above, you have approximately $173 of investments working for you for every share you own (we began with $7 of investments per share of Fairfax in 1985). Investments per share have grown at 44% per year since 1985 as shown on page 40. In the long run, this will be of significant benefit to you by increasing our ability to achieve our long term 20% return on equity objective.

By way of perspective, the table below shows how significantly we have grown in a little more than a year.

	September 30, 1993	**December 31, 1994**	**Increase**
	(millions)		
Net premiums written	$164	$ 850*	5.2 times
Investment portfolio	$404	$1,551	3.8 times
Shareholders' equity	$161	$ 392	2.4 times
Long term debt	$ 71	$ 225	3.2 times
Shares outstanding	6	9	1.5 times

* *Including annualized net premiums written of Continental Canada which was acquired effective November 30, 1994*

As shown, net premiums written have grown by about 5 times, the investment portfolio by 4 times, and shareholders' equity and long term debt by approximately 3 times, but shares outstanding have grown by only 1.5 times. If our acquisitions of Ranger and Continental Canada work out, and that's a big *if*, you can see our shareholders will benefit very significantly in the future as they have more investments and insurance premiums for each share held. However, if either or both of these acquisitions don't work out, our returns will be reduced significantly – our returns, not our viability as a company, because we have never bet our company on an acquisition. Like Ranger and each of our operating companies, Continental Canada will be run separately – no synergies at Fairfax!

In spite of our significant growth discussed earlier, there were no changes in the small Fairfax head office. Rick Salsberg and John Varnell, ably supported by Brenda Adams, Sam Chan, Paul Fink and Ronald Schokking, continued to work miracles.

The table below shows the sources of our net earnings:

	1994	**1993**
	($ millions)	
Insurance underwriting	(16.9)	2.1
Interest and dividends	56.6	23.0
Total	39.7	25.1
Claims adjusting (Fairfax portion)	0.5	0.4
Interest expense	(10.4)	(4.2)
Goodwill amortization	(1.4)	(1.4)
Corporate overhead and other	(4.9)	(2.9)
Realized gains	20.0	27.8
Income before taxes and provisions	43.5	44.8
Less: provisions for investment losses	–	–
Total pre-tax income	43.5	44.8
Less: taxes	5.4	11.5
Net earnings	38.1	33.3

The table shows you the results from our insurance (underwriting and investments) and non-insurance operations. Claims adjusting shows you our share of Morden & Helwig's after-tax income. The corporate overhead expense includes Hamblin Watsa's pre-tax income. Shown separately are realized gains so that you can better understand our earnings from our operating companies. There have been no provisions for potential losses in the past two years. Also please note the unaudited financial statements of our combined insurance operations and of Fairfax with Morden & Helwig equity accounted, as well as Morden & Helwig's financial statements, shown on pages 44 to 49.

Our underwriting performance in 1994 was dismal and was the major reason for our not achieving our 20% objective in 1994 (more on this later). However, investment income more than doubled from 1993 levels, mainly because of the addition of Ranger's portfolio – resulting in higher insurance earnings in 1994. Morden & Helwig made a slightly higher contribution. Interest expense more than doubled because of last year's U.S. debenture issue and goodwill amortization from Hamblin Watsa remained the same. Realized gains, even though significant, were less than last year. With no net additional provisions for investment losses and with lower taxes (see Note 7), after-tax income in 1994 was somewhat higher than 1993. Book value per share increased from $35.13 to $43.77, about equally from earnings and from our share issue at $76 per share.

Insurance Operations

Although there were some real successes, 1994 was overall a difficult year for our insurance operations with a combined ratio of 104.2% versus 98.6% in 1993. Since 1985, we have achieved our target combined ratio of 100% or less in only five of the last nine years.

Commonwealth, led by John Watson, had another excellent year with a combined ratio of 97.8% in spite of the Northridge earthquake which cost the company $9.2 million. Excluding Northridge, Commonwealth's combined ratio would have been 87.2%. With the exception of 1992 (Hurricane Andrew), Commonwealth has shown underwriting profits every year since we purchased it in 1990. During the year, Commonwealth was upgraded to an A (excellent) by A.M. Best Company and continued to be rated A- by S&P.

Commonwealth's gross premiums increased to $263 million from $207 million in 1993 and $129 million in 1991, while net premiums written increased to $90 million from $71 million in 1993 and $33 million in 1991. As you can see, gross premiums have doubled in the last three years, while net premiums have almost trebled. Premium growth has been fuelled by the oil and gas and petroleum and U.S. commercial property divisions and, to a lesser extent, by the Canadian property and casualty divisions. Commonwealth's major advantage continues to be excellent underwriting combined with a consistently low expense ratio. The company earned $17.5 million after taxes in 1994, slightly less than the record $19.4 million in 1993.

Commonwealth has implemented the Insurance Risk Assessment System (IRAS) program to supplement its in-house systems which monitor its exposure to earthquakes in California and B.C. and windstorms across the U.S. Approximately 80,000 locations insured by the company are in the program. Worst case exposures and probable maximum losses are modelled and quantified by IRAS. Inasmuch as catastrophe modelling is not an exact science, we remain exposed to the unlikely possibility of a major event significantly impacting our income statement but not, we feel, our balance sheet. All of our other insurance companies will be on IRAS by year-end 1995.

Federated, under John Paisley's leadership, also had an excellent year in 1994 with a combined ratio of 99.5%. Since our purchase in 1990, Federated has averaged a combined ratio of 99.3% annually. With its specialty focus, the company continues to dominate its markets with its direct marketing representatives, underwriters, claims and support staff and should continue to achieve consistent underwriting profitability. The company enjoys customer retention rates in excess of 90% and many of its industry association relationships exceed twenty years. Federated earned $9.0 million after taxes in 1994, slightly less than the record $10.2 million in 1993.

Markel had another difficult year in 1994, with a combined ratio of 115%. We have had cumulative underwriting losses in Markel of $18 million over the last three years. You can see it is not easy to make an underwriting profit, in spite of our focus. We look forward to much improved results under Mark Ram's leadership which began only in the middle of the year. Mark moved to Markel after spending four years at Fairfax. In 1994 Markel earned $2.9 million after taxes, slightly higher than the $1.7 million in 1993.

1994 was the first year for Ranger under Fairfax's ownership. Early in the year, A.M. Best upgraded Ranger to an A from A –. The company, however, had a poor year with a combined ratio of 114% (108% after eliminating reserve development for which we have been indemnified by the vendor). The results were poor because of some unexpected losses and worse than expected experience in certain lines; also, our IBNR provisions may prove to be conservative.

Tom Friedberg has reacted quickly to these problems by reducing overhead, discontinuing the poor performing lines and reducing reinsurance costs significantly. We are confident that Tom and his management team will achieve underwriting profitability soon. In 1994 after credit for reserve development from the past, Ranger earned $12 million – significantly below our expectations.

Wentworth, our Barbados company, continues to be very small (net premiums written of $8.7 million) and selectively participates in a few catastrophe reinsurance contracts. Because of the Northridge earthquake and no realized gains, Wentworth earned only $0.5 million in 1994 – significantly less than the $4.2 million of 1993.

Our purchase of Continental Canada was effective November 30, 1994 and is thus included in our balance sheet and income statement for 1994. Continental Canada contributed $26.9 million in net premium earned and $4.0 million in net income to our results in 1994. Continental Canada, whose history goes back to 1904, writes a complete range of commercial and personal insurance products across all provinces in Canada. In 1994 its net premiums written were $373 million of which about 70% were generated from commercial lines. At November 30, 1994 Continental Canada had total assets of $904 million with about 740 employees.

The key reason for our purchase of Continental Canada was Byron Messier and his commitment to underwriting profits. Byron had been with Continental Canada for twenty years before leaving to run another insurance company for two years. He returned to Continental Canada in 1991 and has effectively been running the company for three years. Since rejoining Continental Canada he has reduced the combined ratio from 122% in 1991 to approximately 107% in 1994 (excluding extraordinary expenses). With savings from reinsurance and management fees to the parent, we believe he has an excellent opportunity to achieve consistent underwriting profitability. Please review the MD&A (page 38) and Note 12 for additional details on Continental Canada. We welcome Byron Messier and the employees of Continental Canada to Fairfax and we look forward to participating in the company's growth.

Similar to Ranger, our due diligence of Continental Canada was done almost exclusively by our insurance subsidiaries. As mentioned last year, we have the resources internally to evaluate any potential insurance acquisition.

We continued to have low operating leverage (net premiums to common equity) in 1994. Operating leverage at Markel was 1.3:1, Federated 0.9:1, Commonwealth 0.8:1 and Ranger 1.5:1 versus a potential of at least 2:1. Thus, in an improved insurance environment, we have the capacity to increase our premiums significantly. Continental Canada, however, does not have this opportunity. Given Continental Canada's current operating leverage of 2.3:1, premium growth will be a function of retained earnings growth or additional capital invested.

While a low premiums to common equity ratio is generally considered conservative, this isn't always the case, as Emerson Reid's Insurance Observer noted recently. To quote from their January 1995 issue, "20th Century Insurance, which had $564 million in surplus (or common equity), wrote $21 million of earthquake premiums, but its Northridge earthquake losses exceeded $900 million. During soft markets, when rates are depressed, insurance companies may have low premium to surplus ratios even though they are actually taking on more risk than they are in hard markets, when ratios tend to be higher." A good point, and one we try to watch very carefully!

Since 1992 I have been suggesting to you that a turn in the insurance cycle may happen soon. While some of our lines at Commonwealth are experiencing good pricing, the insurance environment continues to be very competitive. The cycle should turn but with my record, don't ask me when!

Our reserves continued to be certified at the individual insurance company level by Joe Cheng, Ron Miller and KPMG for Commonwealth, Federated and Markel, and Ranger respectively. They are then reviewed and certified by Coopers & Lybrand. This sounds impressive but unfortunately there are no guarantees that we will be right.

We provide extensive disclosure on our total claims reserves beginning on page 34 which will help you appraise our past reserving accuracy. In 1994 we had adverse development of $2.8 million at our Canadian insurance subsidiaries – not pleasant – and US$8.5 million at Ranger, for which we are indemnified. While we are not pleased with our reserving record in 1994, our experience over the last nine years has been good. We continue to spend much time on making sure that our reserves are conservatively stated.

Claims Adjusting

1994 was a much improved year for Morden & Helwig as earnings before income taxes and unusual items increased significantly to $5.0 million from $2.9 million in 1993. However, late in the year, the company decided to sell its U.K. operations to Cunningham Hart, one of the U.K.'s leading insurance claims organizations with whom it simultaneously created a worldwide loss adjusting and claims management network. The sale of its U.K. operations cost Morden & Helwig $1.2 million. Additional one time costs reduced earnings after taxes to $1.0 million.

While we have yet to earn an adequate return on our investment in Morden & Helwig, we are convinced that Ken Polley, Don Cain, Mark Cloutier and Duncan Smith are doing their very best and that results will improve soon. To put our money where our mouth is, we purchased an additional 241,900 shares in Morden & Helwig during the year. Also, Morden & Helwig repurchased 64,100 shares in 1994. Our investment in Morden & Helwig consists of a $7.9 million, 10% debenture (convertible into stock at $11 per share) and 2.69 million shares at a cost of $6.74 per share. You didn't expect the long term to be so long, did you? We didn't either!

Morden & Helwig's balance sheet improved in 1994 with a total debt to equity ratio of 0.55:1 versus 0.59:1 in 1993. Our comments on Morden & Helwig's goodwill, discussed in 1992's annual report, are still valid. For further information on Morden & Helwig, please read its latest annual report. You can get a copy by telephoning Don House at (416) 362-6762.

Investment Management

Hamblin Watsa Investment Counsel (HWIC) continued to produce excellent investment results for its managed funds in 1994. The partners of HWIC should be congratulated for the very impressive long term results achieved in each of the areas in which they provide investment management – Canadian equities, U.S. equities, Canadian bonds and balanced funds, as shown in the table below.

Annualized rates of return (%)

Cumulative periods ended December 31, 1994

	5 years	**10 years**	**15 years**
Canadian Equities	9.9	15.2	15.2
TSE 300	4.5	9.2	9.5
U.S. Equities	21.3	18.3	19.0
S&P 500	12.9	15.1	15.9
Canadian Bonds	12.3	12.4	–
SM Index	10.3	11.3	–
Balanced Fund	12.4	15.3	–

Source: Representative balanced fund managed by HWIC for ten years. Equity results for an additional five years are from the organization for which the principals previously worked.

As far as the business of HWIC is concerned, 1994 was another record year as incentive fees were earned from most clients, including Fairfax's insurance subsidiaries. Incentive fees are paid by HWIC's clients only if their results exceed the hurdle rate on both a one year and from inception basis.

For example, for clients that have a Canadian common stock portfolio managed by HWIC, the hurdle rate is the TSE 300 return plus 200 basis points, i.e., before the client pays incentive fees, the client's results, net of all fees, must exceed the TSE 300 return plus 200 basis points for both 1994 and from inception. Incentive fees payable are 10% of any return in the past year above the hurdle rate (90% remains with the client) up to a maximum of 1.75% of assets. All the non-Fairfax related clients have considered this a very fair fee and have been happy to pay incentive fees in the past two years.

Fairfax's insurance subsidiaries were charged incentive fees by HWIC for the first time in 1994. Insurance subsidiaries did not qualify for incentive fees in 1993 mainly because of a block of FCA shares purchased for them by your Chairman in 1989. Some more details about investment management fees paid by Fairfax's insurance subsidiaries to HWIC:

1) Incentive fees are paid only on common stock portfolios. Results are measured against the TSE 300 return plus 200 basis points for Canadian stocks and the S&P 500 return plus 200 basis points for U.S. stocks.

2) The inception date for Canadian common stock portfolios is January 1, 1990, the date incentive fees were first instituted by HWIC for its clients. The inception date for U.S. common stock portfolios is March 31, 1994, the first quarterly date on which HWIC managed a U.S. common stock portfolio for a U.S. subsidiary

of Fairfax (Ranger). The common stocks of any subsequently acquired insurance subsidiary will be included in the appropriate portfolio for measurement purposes essentially from the date of acquisition.

3) The average base fee paid by Fairfax's insurance subsidiaries to HWIC for investment management is 0.25% of assets – significantly less than the average base fee paid by HWIC's pension clients. Reflecting the Continental Canada purchase and a reduction in the base fee, the average base fee in 1995 for Fairfax's insurance subsidiaries will drop to 0.17% of assets.

Just to refresh your memory, when Fairfax purchased HWIC in 1992, a fair revenue sharing mechanism was instituted at HWIC. This is how it works. The revenue base for HWIC in 1992 was $3.7 million of which $2.0 million covered expenses, including salaries and overhead, and $1.7 million was pre-tax profit. In each year after the sale, HWIC retains $2.0 million of the first $3.7 million of revenue to pay expenses, while Fairfax gets the remaining $1.7 million. Any revenue above $3.7 million in any year is split 50/50 between Fairfax and HWIC – Fairfax's 50% being additional profit (to the $1.7 million), while HWIC's 50% covers any incremental expenses beyond $2.0 million and thereafter constitutes a profit pool to be shared among its partners and employees. This is an excellent way to provide attractive returns for Fairfax while keeping the incentives at HWIC.

In 1994 HWIC had revenue from base fees of approximately $4.6 million. Incentive fees totalled $4.9 million of which $1.6 million was from Fairfax insurance subsidiaries. Through the revenue sharing mechanism discussed earlier, Fairfax earned a 33% pre-tax return on its $14 million investment in HWIC. These returns are all cash and, of course, there is no additional capital investment needed at HWIC. As mentioned last year, 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.

This is perhaps an appropriate point to mention where my compensation comes from. I get a straight salary of $250,000 from Fairfax with no bonuses, director's fees or other payments from Fairfax or any of its subsidiaries (other than HWIC). From HWIC, like all partners there, I get a $200,000 salary and participate in the profit sharing pool (up to 30%) described earlier. Any bonus that is shown for me in the proxy circular comes from this profit participation. Because my compensation can be significant depending on investment results, I wanted to make sure you understood exactly where it comes from.

While discussing my compensation, for the first seven years of Fairfax's history, I did not take any salary, bonus or other payment from the company but I did participate in the share purchase program. During 1995 I plan to sell my shares in the plan either to the plan or into the market and will no longer have an interest free loan from the company (our directors, senior officers and presidents will continue to have this arrangement). Thus I will be free to determine how the plan should work as I will no longer have an interest in it.

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 46.

Here's what it looks like compared to 1993.

	1994	**1993**
	($ millions)	
Short term bank debt	–	–
Long term bank debt	60.0	–
Debenture issue	165.3	132.4
Common shareholders' equity	391.9	279.5

As shown, common shareholders' equity increased by $112 million – $74 million net from the share issue and $38 million from net income. We used the share issue proceeds together with $25 million of the increase in the debenture issue (the remaining increase in these debentures is due to exchange rate fluctuations) and the $60 million in five year unsecured term loans from two Canadian banks to purchase Continental Canada, and we had $8 million in cash at year-end. Currently, we have unused, unsecured, committed, long term bank lines of $105 million from five major Canadian and U.S. banks. As discussed last year, these are unused bank lines and provide us with flexibility on an emergency basis – we certainly will not use them to make an acquisition (as we did not with Continental

Canada). We also have a letter of credit (LOC) facility of US$40 million from a U.S. bank for use in the ordinary course of our insurance businesses.

Our debt to equity ratio and debt to total capital ratio increased only slightly to 0.57:1 and 0.37:1 respectively even after the purchase of Continental Canada. As mentioned last year, these ratios are close to the maximum with which we would feel comfortable. Our financial position continues to be extremely strong for the following reasons:

1) Our debenture issue has an interest rate fixed at 7.75% and has a long term to maturity (another nine years). The bank loan has a five year term with floating interest rates (we could fix these rates if we wanted). We went with a term bank loan as opposed to another public U.S. debenture issue because we did not want to fix interest rates at these levels. Both debt instruments have a covenant package that provides us with great flexibility.

2) We have unused, unsecured, committed, long term bank lines of $105 million with excellent covenants with Canadian and U.S. banks. In addition, we have an LOC facility of US$40 million with a U.S. bank.

3) Our total long term debt is less than three times our expected earnings base with Continental Canada included. We expect to be able to pay the bank loan long before maturity – if that is what we want to do. The expected earnings base is not, please note, is *not*, an earnings forecast for 1995. It is just another way of looking at our debt levels!

4) Cash flow in 1995 at the holding company level should be more than sufficient to fund the interest costs on all of our outstanding debt. Cash flow from HWIC should continue to pay the overhead at Fairfax. In addition, we have cash and investments in the holding company of over $14 million as of year-end 1994.

5) As discussed in the MD&A, the solvency margins of all of our insurance subsidiaries, with the exception of Continental Canada, are well above the levels mandated by the applicable insurance regulatory authorities.

6) Our foreign exchange exposure with respect to the balance sheet has been mostly hedged by last year's U.S. debenture issue. As mentioned last year, we purchased a US$50 million, five year foreign exchange contract at C$1.37 to US$1.00 to hedge the remaining net balance sheet exposure (of US$17.4 million) and future Ranger earnings. We added to this hedge in 1994 by purchasing an additional US$25 million, five year foreign exchange contract at C$1.50 to US$1.00 to hedge future earnings from Ranger. The additional foreign exchange contracts mentioned in Note 9 hedge U.S. portfolio investments in Canadian insurance subsidiaries.

Investments

1994 was a down year for the stock and bond markets with the TSE 300, the S&P 500 and the ScotiaMcLeod Bond Index showing losses on a capital only basis. On a relative basis, our Canadian common stock and bond results were excellent. After many outstanding years, our U.S. results took a breather. All in all, 1994 was another good year.

The change in unrealized gains or losses is shown below:

	1994	**1993**
	($ millions)	
Bonds	(17.5)	3.1
Preferred stocks	(1.4)	8.8
Common stocks	(12.1)	(0.5)
	(31.0)	11.4

Higher interest rates and a declining stock market resulted in $11.4 million of unrealized gains at the end of 1993 being transformed into an unrealized loss of $31.0 million at the end of 1994, after not insignificant realized gains of $20.0 million during 1994 (2.4% of the average portfolio). The unrealized loss of $31.0 million is 2.0% of the portfolio at year-end.

Our aggregate provisions for losses as at December 31, 1993 of $11.5 million dropped to $6.9 million at the end of 1994 mainly because we realized losses in two investments for which we had made provisions. We feel that our remaining provisions will be adequate to provide against unexpected events.

You are probably getting tired of my harping about realized gains or losses being important in the long run while unrealized gains or losses are fluctuations that have no predictive value. Fortunately, I asked you not to get excited about the unrealized gains at year-end 1993 because they certainly disappeared in a hurry!

This is probably an appropriate time to mention the Canadian government's intent to annually tax unrealized stock gains in financial institutions' investment portfolios. We believe this is seriously wrong in principle and unjustly harmful both to the companies affected and the operation of the capital markets. We have come across no other country in the world that taxes unrealized gains, and consider this to be a significant disincentive (if passed into law) to long term capital investment in Canada by financial institutions. We hope that sanity will prevail as our government begins to recognize the importance of encouraging investors to make substantial long term capital commitments to Canadian enterprises.

The table on page 40 shows the returns on our investment portfolios. Investment income (interest and dividends) has increased dramatically because of the Ranger investment portfolio. Realized gains in 1993 and 1994 have gone a long way to making up for the drought in the three prior years. Total realized gains since 1985 amount to $83 million. After-tax investment income per share has increased to $4.85 per share in 1994 from $2.92 in 1993 as shown on page 39. After-tax investment income per share has compounded at 30% per year since we began in 1985. Continental Canada will result in another significant increase in investment income per share in 1995.

Gross realized gains in 1994 totalled $23.2 million. After realized losses (net of provisions) of $3.2 million, net realized gains were $20.0 million. The major contributors to realized gains were Gibraltar Mines ($5.0 million), Repap ($3.6 million), St. Lawrence Cement ($3.0 million), Stelco ($2.2 million), Noranda ($1.9 million), Philip Morris ($1.9 million), Dofasco ($1.3 million) and Phelps Dodge ($1.0 million). Realized losses resulted mainly from the sale of bonds at Ranger; these losses were substantially offset by realized gains from other sales of bonds at Ranger.

At the end of 1994 we had $134 million invested in common shares of banks, insurance and financial service companies, $89 million in natural resource companies and $49 million in industrial products companies.

At year-end 1994 Fairfax had $326 million invested in common shares of Canadian and U.S. companies (approximately $36 per share). You may be interested to know that in the U.S., in the late 60s and early 70s, the average property and casualty insurance company had approximately 100% of its surplus (common shareholders' equity) invested in common shares. This happened to be when the stock market was at historically high levels and P/E ratios were in the twenty times area. Since then, common stock holdings as a percentage of surplus for the average property and casualty insurance company has been coming down (currently at 40%) even though stocks have been great investments after the crash of 1973/74. We continue to feel that there are many attractive common stock holdings in North America that meet our long term value-oriented standards – thus, our relatively high exposure to common shares.

Another tidbit on common stock holdings that you may be interested in – an A.M. Best study of the hundred largest companies in the property and casualty insurance industry found that the ten companies that held the highest common stock holdings (greater than 20% of their assets) all had the highest A.M. Best ratings (A+/A++). We hope this works for us too!

Our "nuclear bomb" testing on insurance regulatory capital of a simultaneous decline of 50% in our common stock holdings and 30% in our preferred and bond holdings continues on a monthly basis. Our companies continue to meet this test, with the exception of Continental Canada. We are working to make sure that Continental Canada will also soon meet this test.

Miscellaneous

In May 1994 we disposed of our real estate investment in Calgary (the Village Square shopping mall) for approximately our cost of $8.0 million. We have taken back a $2 million first mortgage on the property at 7¼% due on June 1, 1996. As this mortgage is secured by a first charge on the shopping mall, we expect to be paid. We have two small remaining real estate investments, valued at approximately $1.2 million, which we plan to dispose of in 1995.

In 1994 Fairfax and its subsidiaries donated approximately $760,000 (1.7% of pre-tax income) to a variety of charities across North America.

On page 50, we have included an unaudited unconsolidated balance sheet on an equity accounted basis showing where your money is invested. As you can see, we have $560.7 million invested in our insurance companies, $26.0 million in Morden & Helwig and $14.1 million in Hamblin Watsa. Our insurance companies and Morden &

Helwig are shown at their underlying book values. Our insurance companies particularly are very conservatively valued. We felt this disclosure could help you when you think about our company and so we plan to disclose this every year.

Last year, we listed many short term risks that your company faces. These have not changed. The future continues to be as uncertain and unpredictable as it was when we began nine years ago. However, with good people at Fairfax and our subsidiaries, significant sustainable investment income that has taken many years to achieve and our share of good fortune, our long term prospects are excellent for achieving a return on shareholders' equity in excess of 20% by running Fairfax for the benefit of customers, employees and shareholders.

In 1994 one of our directors celebrated his 75th birthday. As I mentioned in our 1988 annual report, Fairfax has benefitted greatly from Robbert Hartog's wisdom. He has yet to slow down and we have yet to catch up with him. We look forward to Robbert's advice for a great many years to come.

As we appear to have outgrown the facilities at the new Toronto Stock Exchange, our annual meeting will be held at 4:30 p.m. on Wednesday, May 3, 1995 at the old Toronto Stock Exchange building on Bay Street. While this appears to be a step backward, it appeals to our contrarian instincts!

On your behalf, I would like to thank the Board and the management and employees of all our companies for their very valuable contributions in 1994.

March 15, 1995

V. P. Watsa

V. Prem Watsa
Chairman and
Chief Executive Officer