To Our Shareholders

What a way to begin the second decade of our corporate existence! While we have had some great years in the past, 1996 was certainly the best yet. We earned 21.4% on average shareholders' equity in 1996 (versus 9.1% for the TSE 300). Net income after tax increased by 72% to $150.8 million. In spite of an 18% increase in shares outstanding, earnings per share increased by 57% to $15.36. Book value per share increased by 63% to $87.05 and our shares almost tripled to $290 per share. I did not realize that my comment last year about my shares not being for sale at *even* $200 per share would be tested so soon!

While we were gratified by these results, what made 1996 special was that we developed a global reinsurance business through the purchase of two reinsurance companies, and ended the year in a stronger financial position than when we began. We accessed the long end of the U.S. bond market (30 years) for the first time and we ended the year with in excess of $100 million in cash in the holding company and unused, unsecured, committed, long term bank lines of $600 million. Also, unlike many companies that have grown through acquisition, we have negative goodwill resulting from acquisitions at discounts to book value that, with the recent purchase of CTR, will amount to $193 million ($18 per share). This is effectively an after-tax reserve or cushion for the proverbial "rainy day". In addition, we have about $350 million (or $33 per share) in reserve and reinsurance recoverable indemnifications that are not shown on our balance sheet. You can see why we think 1996 was so good.

This is perhaps the best time to give you the bad news! All of this was not based on a "vision" statement or long term plan that we have at Fairfax. It was simply reacting to the opportunities that presented themselves to us and doing what we considered was best for shareholders in the long term. If Jim Dowd, Chief Executive Officer of Odyssey Re, hadn't phoned me in December 1995, all of this may not have taken place. This also means that there is no way the results in 1996 can be extrapolated into the future. So don't be surprised if we make no acquisitions in the next five years.

The acquisitions of Odyssey Re and CTR were so significant to Fairfax that we decided to provide additional disclosure on each purchase in our first and third quarter reports to you (as opposed to waiting for this report). These disclosures are reprinted in the Appendix for those of you who are truly long term investors and only read our Annual Report! Please read them carefully as they not only outline the reasons for our purchase but also the risks involved.

The following are highlights on the two purchases together:

1) Odyssey Re is a North American reinsurer while CTR operates worldwide with offices in Paris, Singapore, Tokyo and New York. CTR's North American business is small and was easily amalgamated into Odyssey Re. Essentially there is very little overlap between the two companies and together they have a global network. Jim Dowd and Andy Barnard run Odyssey Re and Jean-Philippe Casanova runs CTR in co-ordination with Andy. All three are firmly committed to underwriting profitability and not market share growth. As we have little experience outside North America, it is fair to say that we would not have purchased CTR if Andy had not joined the group.

2) The two companies together will write net premiums in excess of US$500 million with capital in excess of US$500 million, ranking the Odyssey Re/CTR group among the top reinsurers in the U.S.

3) Both companies were purchased in our "fair and friendly" way from Skandia, Sweden and the GAN group, France.

4) Both companies have significant long tail liabilities (including asbestos and environmental). We feel the indemnifications are sufficient protection, but only time will tell.

5) Both companies have significant reinsurance recoverables and are exposed to potential bad debts on these recoverables. We feel the bad debt reserves in place, together with the indemnifications, will prove adequate, but again only time will tell.

6) As mentioned in our first quarter report, reinsurance is a business that magnifies the abilities of management. We are very excited about our long term prospects in the reinsurance business under the stewardship of Jim, Andy and Jean-Philippe. We welcome them and the employees of Odyssey Re and CTR to Fairfax and look forward to participating in their companies' growth.

We financed the purchase of the two reinsurance companies by issuing 1.1 million shares at $155 per share and 500,000 shares at $260 per share to raise a total of approximately $300 million. The issues were led by Dick Falconer from CIBC Wood Gundy and ably supported by ScotiaMcLeod, RBC Dominion Securities, Nesbitt Burns, TD Securities, Deutsche Morgan Grenfell Canada, First Marathon, Midland Walwyn and Newcrest Capital. We thank them for an excellent job. After not issuing shares for seven years ending in 1993, we have raised almost $500 million from share issues in the past three years. No wonder the investment dealer industry is doing well! We welcome our new shareholders and emphasize again, as we did in 1993 and 1994, 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 have been fortunate not to have had any short term (read quarterly) surprises but I'm sure they will come one of these days!

We have mentioned in the past that we are very careful about issuing shares. In our 1986 Annual Report we said, ''We consider our stock as good as cash. When we issue stock, we will ensure that we get as much value as we give.'' While we have been very clear about the ''getting'' part, we consider the ''giving'' part to be equally important. So, while we have raised money at higher and higher stock prices in 1996, we feel our new shareholders are getting excellent long term value – otherwise we would not issue shares at these prices. Remember we said long term. In the short term, we have no idea where our shares will trade.

To help finance the purchase of Odyssey Re, we did our third U.S. debt financing, led again by J. P. Morgan and strongly supported by Credit Suisse First Boston and Deutsche Morgan Grenfell. For the first time, as we said earlier, we were able to access the long end of the U.S. bond market with the issue of US$125 million of unsecured debentures with an effective interest cost of 8¼% per annum and a 30 year term to maturity. You may be surprised to know that in the property and casualty industry there are only nine companies in the U.S., and only Fairfax in Canada, that have 30 year bonds outstanding. We were happy with the absolute rate but the spread of 153 basis points over comparable treasuries was a little higher than we expected.

The spread over comparable treasuries of all three of our U.S. debenture issues has contracted dramatically in 1996 and at year-end was in the range of 85 basis points for our 2003 issue, 110 basis points for our 2015 issue and 120 basis points for our 2026 issue – all significantly down from where we issued the debentures. While much of this is due to the general narrowing in corporate spreads, we feel there is a wider recognition in the bond market of our very strong financial position. Unfortunately, we have yet to convince the rating agencies to upgrade Fairfax to an A from BBB+.

We welcome our new debenture investors and want to reassure them that we continue to have an A rating as our objective. Our ability to access the U.S. bond market over all maturity levels is a very significant strength of our company and one that we do not take lightly.

By way of perspective, the table below shows you how significantly we have grown in 1996.

As of December 31	**1995**	**1996***	**Increase**
		($ millions)	
Net premiums written	865	1,500	1.7x
Investment portfolio	1,669	4,100	2.5x
Shareholders' equity	473	911	1.9x
Net debt	228	417	1.8x
Shares outstanding	8.9	10.5	1.2x

* *Includes CTR, which closed in February 1997*

As shown, net premiums written, shareholders' equity and net debt have grown by approximately 2 times and the investment portfolio has increased 2.5 times, while the number of shares outstanding has increased only 1.2 times. Obviously, reinsurance is now a very significant activity for Fairfax and our future will be very dependent on the performance of our two recent acquisitions. Investments per share have increased from $188 per share at year-end 1995 to $390 per share at year-end 1996 (including CTR) – an increase of 107%. Investment income per share (only interest and dividends) from this portfolio, which ultimately drives earnings per share and book value per share, should increase significantly in 1997.

While all of this frenetic activity took place in 1996, there were no changes in the small Fairfax head office. It is quite amazing what our small group, led by Rick Salsberg and John Varnell and ably supported by Brenda Adams, Sam Chan and Ronald Schokking, did over the past year. Most other companies would need a corporate head office many, many times larger and still perhaps not be as effective. Our Fairfax head office shows what a few capable, hardworking and trusted individuals can accomplish working together as a team with no egos. Late in 1996 Francis

Chou joined the company. Francis was the person who gave me the idea about Fairfax almost 12 years ago. We look forward to more ideas like that from Francis.

The table below shows the sources of our net earnings.

	1996	**1995**
	($ millions)	
Insurance underwriting	(50.6)	(40.9)
Interest and dividends	144.1	86.3
Total	93.5	45.4
Claims adjusting (Fairfax portion)	2.3	2.1
Interest expense	(35.0)	(19.1)
Goodwill and other amortization	(4.8)	(4.8)
Corporate overhead and other	(6.6)	(5.6)
Realized gains	131.3	71.9
Pre-tax income	180.7	89.9
Less: taxes	29.9	2.4
Net earnings	150.8	87.5

The table shows you the results from our insurance (underwriting and investments) and non-insurance operations. *In this report insurance operations include reinsurance operations*. Claims adjusting shows you our share of Lindsey Morden's after-tax income. Goodwill and other amortization includes Hamblin Watsa goodwill ($1.4 million) and amortization from Ranger ($3.4 million). The corporate overhead expense is net of Hamblin Watsa's pre-tax income. Shown separately are realized gains so that you can better understand our earnings from our operating companies. Also please note the unaudited financial statements of our combined insurance operations and of Fairfax with Lindsey Morden equity accounted, as well as Lindsey Morden's financial statements, shown on pages 54 to 59.

The increase in underwriting losses in 1996 was largely due to Ranger. Interest and dividend income as well as interest expense increased because of the Odyssey Re acquisition in May 1996. Lindsey Morden's contribution increased in 1996 from record 1995 levels. Corporate overhead and other increased because of one time expenses associated with the debt and share issues. Realized gains were very large and almost twice 1995 levels. These gains more than offset the increase in underwriting losses and were the main reason for the increase in earnings in 1996. Fairfax's effective tax rate was 17% in 1996 reflecting utilization of loss carryforwards, tax-free Canadian dividend income and international operations with lower tax rates.

Book value per share increased from $53.28 to $87.05, approximately 45% from earnings and 55% from our share issues.

Insurance operations

1996 was another excellent year for our Canadian insurance companies with a combined ratio of 99.1%. Odyssey Re performed as expected but Ranger had another poor year as discussed later. In total, our insurance and reinsurance operations had a combined ratio of 104.9%, the same as in 1995. This means that we have achieved our target of a combined ratio of 100% or less in only five of the last eleven years. While we are not pleased with this record, it has been achieved in an industry environment which has been in a cyclical downturn for nine of the past eleven years – with no sign of an upturn yet!

Commonwealth, led by John Watson, continued to produce extraordinary results with a combined ratio of 87.0%, even better than the 89.5% in 1995. John and his management team have had combined ratios of less than 100% in five out of the last six years.

Because of the competitive environment discussed in last year's Annual Report, Commonwealth's gross premiums written declined 10% to $262 million while net premiums written remained flat at $87 million. Net income after taxes was a record $24.4 million because of significant underwriting profits and realized gains. Since we purchased Commonwealth in 1990, it has had cumulative underwriting profits and net income after taxes of $18 million and $94 million respectively, paid out a total of $45 million in dividends and ended 1996 with shareholders' equity of $137 million – all versus our purchase price of $57½ million in 1990.

Of course, Commonwealth's record goes much further back than 1990. It was started in its present form in Vancouver in 1968 with a $10,000 investment, with the only significant additional capital being a contribution of about $20 million in the middle 1980s. Ron Schwab, Executive Vice President, Underwriting, was one of the founding employees at the time. The company has had almost no employee turnover and has never lost money since its founding – an exceptional track record and a major contributor to Fairfax's success.

While we are exposed to catastrophes at Commonwealth, the risk is managed well. Also, the company has recently further increased its catastrophe protection. While there are no guarantees, we continue to feel a major catastrophe would impact Commonwealth's income statement but not its balance sheet.

Federated, under John Paisley's leadership, had another excellent year in 1996 with a combined ratio of 98.6% for the property and casualty company (100.2% including the life operations). Gross premiums written increased by 6% to $58.6 million while net premiums written increased 5% to $49.5 million. Federated's expense ratio of 34.8% in 1996 was better than the 36.6% in 1995 and significantly better than the 42% that prevailed three years ago. Net income after taxes of $5.5 million was down 20% from $6.9 million in 1995 mainly because of lower realized gains. Since we purchased Federated in 1989, the company has had cumulative underwriting profits and net income after taxes of $0.1 million and $46 million respectively, paid out total dividends of $22 million and ended the year with shareholders' equity of $52 million – all versus our purchase price of $28 million in 1989. Under John's leadership Federated has done very well in the past, but we think it will do even better in the future.

Byron Messier and his management team at Lombard had an excellent year in 1996 with a normalized combined ratio of 99.5% – more than fulfilling the 100% objective Byron had set in 1993 for 1996. On a net premium base of $443 million (including CRC (Bermuda)), this was truly outstanding! Both sides of the house, commercial lines and personal lines, achieved combined ratios below 100%.

Lombard maintained its gross and net premiums written in 1996 at 1995 levels but net income after taxes increased to a record $59 million. In the two years since we purchased Lombard it has earned $101 million after taxes. It won't be long before we have earned our purchase price of $155 million!

In 1995/96, Lombard commenced a pilot program of direct marketing of automobile and home insurance to people over 50 years old, partnering with a select group of brokers in Alberta and then the Maritimes. The program, called Privilege 50, provides 24-hour service via telephone with binding quotes and three day policy delivery. The program has been well received and will be introduced in Ontario during March 1997 through Zenith Insurance, a broker joint venture with Lombard. More on the results next year!

Lombard's commercial book of business continues to be more focused on its market niches and thus less susceptible to competitive market pressures.

Considering the highly competitive state of the market, Markel, under Mark Ram's leadership, had a very good year with a combined ratio of 102.9% in 1996. As mentioned in last year's Annual Report, Mark and his management team continue to build Markel into the premier trucking insurance company in Canada by providing the best claims, underwriting and loss prevention services available in the country, a first rate driver training school, the first truck skid school in Canada, a new A– (excellent) rating from A.M. Best, etc., etc. Pricing, though, has collapsed and we have been losing some accounts at 30-50% discounts to our prices, a level at which other insurers have historically lost money. We have experienced this kind of irrational competition before and, since we began in 1985, two of Markel's largest competitors have gone bankrupt, leaving their insureds in a bind. As Santayana said, "Those who cannot remember the past are condemned to repeat it." Markel remains committed to providing stability to its insureds. Net premiums written dropped 21% to $62.6 million in 1996. Pre-tax income at $8.2 million was only 6% off 1995 levels but net income after tax has dropped in half because we didn't pay any taxes in 1995.

I was wrong, again, on Ranger in 1996. The key word is *I* and not Pete Wallner and his management team. The problems of the past continued to haunt Pete and Ranger with a combined ratio of 123.5%. Excluding the lines in run-off and a further increase in reserves for past years, Ranger's combined ratio from continuing operations drops to 105.5% – a good indication of Pete's performance in 1996.

The table below shows you our experience at Ranger in 1995 and 1996.

	1995	1996	Total
		(US$ millions)	
Underwriting loss	(50.2)	(35.3)	(85.5)
Combined ratio	138%	124%	131%
Indemnities – vendor	11.5	–	11.5
– Fairfax	14.0	–	14.0
	25.5	–	25.5
Underwriting loss (after indemnities)	(24.7)	(35.3)	(60.0)
Investment income	38.0	33.1	71.1
Pre-tax income (loss)	13.3	(2.2)	11.1
Taxes (credit)	–	(11.1)	(11.1)
Net income	13.3	8.9	22.2

Some observations:

1) Underwriting losses totalled US$86 million in the two years. The combined ratio for the two years was 131%. The cost to Fairfax in the two years of these underwriting losses, excluding the vendor's indemnification but including the Fairfax indemnification and some related reinsurance, was US$85 million, i.e. more than $11 per share pre-tax!

2) Run-off lines cost us US$56 million in losses for the two years, increasing Ranger's combined ratio by 20 percentage points to 131%. The combined ratio for these lines was 193%.

3) The reserve increase for 1995 and prior years (at year-end 1996) on Ranger's core lines totalled US$24 million, approximately 8 percentage points of Ranger's combined ratio.

4) In spite of these underwriting losses, Ranger had net income of US$13.3 million in 1995 and US$8.9 million in 1996 for a total of US$22.2 million. Year-end GAAP capital of US$121.3 million was the highest in Ranger's history. However, A.M. Best did drop Ranger's rating to A− from A.

5) Ranger had net premiums written of US$156.0 million in 1996 – up 19% from 1995 levels. After realized gains of US$19.6 million (including US$8.1 million from the sale of a largely inactive subsidiary, Ranger County Mutual), Ranger had a US$2.2 million pre-tax loss. Including tax credits, Ranger had a net income after tax of US$8.9 million in 1996.

As you can see, Pete Wallner and his management team have worked very hard to correct the problems of the past and, dare I say, 1997 should be a much better year.

While we have increased reserves at Ranger again in 1996 (even though we felt they were adequate last year), we do not think this will be repeated in 1997. I hope I don't have to eat humble pie again!

Wentworth, our Barbados company, continued to have good results with a combined ratio of 98% on much reduced net premiums written of $8.3 million. Net income dropped to $2.5 million in 1996 because of lower realized gains.

Odyssey Re had a good year in 1996. It had a combined ratio of 110% as expected after US$15.7 million in indemnification from Skandia, Sweden. Net premiums written were US$201.1 million for the year – about the same as last year. After significant realized gains, Odyssey Re earned US$63.5 million after taxes in 1996. Even though all the earnings in 1996 accrued to the benefit of Fairfax, only US$56 million was included in our statements as the purchase closed during the second quarter. Jim Dowd and Andy Barnard are focused on reducing Odyssey Re's combined ratio below 100% in the next two years. CTR's net income will flow into Fairfax for the full year 1997. Kris Datt and his team (from Ranger Re) have joined the reinsurance group of Odyssey Re and CTR.

Our insurance companies are all well capitalized as shown on page 49. We continue to have significant unused capacity with no signs as to when we can use it. Our reserves continue to be certified at the individual insurance company level and on a consolidated basis as in the past. Odyssey Re and CTR will have their reserves certified by external actuaries in 1997. We mentioned last year that our goal at Fairfax is to ensure that the reserve ''past'' does not hurt us in the future but helps us, i.e. we expect to see reserve redundancies each year in each of our insurance companies. In 1996 our Canadian insurance companies had redundancies of $16.7 million, while Ranger had a deficiency of US$24.0 million (C$32.7 million). In total then, we had a net reserve deficiency of $16.0 million in 1996 – not very good. We think we have more than adequately provided for reserves at Ranger but only time will tell. We provide extensive disclosure on our reserves beginning on page 38.

Claims adjusting

Under Ken Polley's leadership, Lindsey Morden had an excellent year in 1996. While earnings hit another record, the real story was free cash flow. In 1996, after capital expenditures and working capital requirements, Lindsey Morden generated $6.7 million which, with existing cash, was used to reduce short and long term debt by $7.2 million. If this level of earnings and cash flow persists in 1997, Lindsey Morden will soon be free of debt. With no use for additional capital, the board of Lindsey Morden has decided to increase annual dividends from 10¢ per share to 50¢ per share and will review dividend payouts at the end of each year. Our confidence in the management of Lindsey Morden has been fully justified and we feel the company has developed excellent momentum, thanks to Ken Polley, Don Smith, Don Cain and Ferd Roibas, the new Vice President, Finance. We really appreciate the efforts of Don Cain who came out of retirement to help turn around the Canadian operations and has headed back to Fredericton after a job well done.

In 1996 Lindsey Morden's revenue increased 5% to $162.3 million while net income after taxes increased 9% to $4.4 million. Return on average shareholders' equity in 1996 remained at the 1995 level of approximately 11%. Lindsey Morden's financial position strengthened considerably with the debt to equity ratio dropping to 0.31:1 from 0.52:1 at year-end 1995. Lindsey Morden is on its way to providing excellent returns for its shareholders.

For further information on Lindsey Morden, please read the annual report – available by phoning Doreen Brown at (416) 362-6762.

Investment management

1996 was an exceptional year on an absolute and relative basis for Canadian equities and bonds. Not surprisingly, our U.S. equity results did not keep pace with the explosive U.S. market. However, as shown below, on a long term basis the partners of Hamblin Watsa Investment Counsel have produced excellent results in all of the areas in which they provide investment management – Canadian equities, U.S. equities, Canadian bonds, U.S. bonds and balanced funds.

Please note the U.S. bond results which we have disclosed for the first time. Brian Bradstreet, who manages our Canadian and U.S. bonds, has done an exceptional job in both countries. Brian Bradstreet, Frances Burke, Tony Hamblin, Roger Lace and I have worked together for more than 20 years and are responsible for the results shown below.

Annualized rates of return (%)

Cumulative periods ended December 31, 1996

	5 years	**10 years**	**15 years**
Canadian Equities	18.0	14.7	16.3
TSE 300	13.9	10.0	11.3
U.S. Equities	29.9	21.8	19.2
S&P 500	19.2	15.2	17.9
Canadian Bonds	15.5	12.1	–
SM Index	11.0	11.0	–
U.S. Bonds	9.8	11.2*	–
ML Index	6.3	8.4*	–
Balanced Fund	17.8	15.2	–

* *8 years*

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

Incentive fees were earned from some clients as HWIC met the 1996 test for all funds but not the long term test (i.e. results from incentive fee inception date) for some clients. Total fees in 1996 increased to a record $10.1 million from $5.3 million in 1995 mainly because of incentive fees ($3.0 million), the addition of Odyssey Re ($1.3 million) and the rising markets. With the addition of Odyssey Re, HWIC has reduced its average base fee (before incentive fees) paid by Fairfax insurance subsidiaries from 0.17% of assets to a flat fee of 0.15% of assets. For more details of HWIC fees, please read the 1994 Annual Report. Fairfax earned a 35% pre-tax cash return in 1996 on its $14 million investment in HWIC. On a cumulative basis, since 1992 Fairfax has earned a pre-tax cash return of 107% on its investment while revenues have increased from $3.7 million in 1992 to $10.1 million in 1996.

We welcome Jean Ouellet, who joined HWIC in early 1997 to manage CTR's non-North American bond portfolios.

Financial position

As in previous reports, we feel our unaudited balance sheet with Lindsey Morden equity accounted (shown on page 56) is the best way to understand our financial position.

Here is what our year-end financial position looks like compared to the end of 1995.

	1996	**1995**
	($ millions)	
Cash and short term investments	101.1	70.4
Bank debt	–	–
Long term debentures	470.5	298.0
Net debt	369.4	227.7
Common shareholders' equity	911.1	472.6
Net debt/equity	41%	48%
Net debt/total capital	29%	33%

As shown, common shareholders' equity, our capital, increased by $438.5 million – $288.3 million net from the two stock issues and $150.8 million from net income less $0.6 million used to purchase 3,500 shares at $160 per share. The long term debentures increased because of the US$125 million debenture issue in April 1996. Our cash position in the holding company (i.e. Fairfax) increased to $101.1 million from $70.4 million at the end of 1995. This excludes the cash raised for the acquisition of CTR which was invested in Wentworth pending the closing (note our unconsolidated balance sheet on page 60). Our net debt (i.e. long term debentures less cash) to equity ratio dropped to 41% from 48% last year and our net debt to total capital ratio dropped to 29% from 33% last year. Including CTR, which closed in February 1997, our net debt to equity ratio at year-end 1996 would have dropped to 46% and our net debt to total capital ratio to 31%. So in spite of two significant purchases in 1996, we improved our financial ratios (and built a $193 million negative goodwill cushion).

Also, we have increased our unused, unsecured, committed, long term bank lines to $600 million (from $215 million) from eight major banks – four Canadian, three U.S. and one European. Just three years ago we had only $75 million in bank lines. As emphasized repeatedly in the past, these are unused bank lines which, for a low standby cost, provide us flexibility on an emergency basis – we have not and will not use them to make an acquisition. We also have letter of credit (LOC) facilities in excess of $70 million for use in the ordinary course of our insurance businesses.

Our financial position continues to be very strong for the same reasons that we discussed in our 1995 Annual Report. Briefly they are:

1) We have no bank debt. Our debt consists of three public debentures with a long term to maturity (7 years, 19 years and 30 years) and low interest rates (7¾%, 8¼% and 8¼% respectively), and a small seven year 7¾% debenture issued to a vendor. All of this debt was issued under a single trust indenture containing a covenant package that provides us with great flexibility. Late in the year we decided to swap the fixed interest rate on the 30 year debenture issue into floating rates, saving approximately 120 basis points currently. On closing CTR in February 1997, we issued a 2½% ten year French franc debenture.

2) We have unused, unsecured, committed, long term bank lines of $600 million with excellent covenants. In addition, we have LOC facilities in excess of $70 million.

3) Our net long term debt is less than three times our earnings base. Also, our earnings base is well diversified between many insurance and reinsurance companies, Lindsey Morden, HWIC, and Canadian, U.S. and, through CTR, non-North American streams of income.

4) Available cash flow at the Fairfax (holding company) level from dividends, management fees and interest covers our expenses (administrative and interest) by about two times. This is based on normal dividend payouts from our insurance companies (and effectively none from our reinsurance companies), which is much less than our maximum dividend-paying capacity. Note Fairfax's parent company-only income statement on page 61.

5) With $101 million in cash in the holding company, we can pay our administrative and interest expenses at Fairfax, with *no* dividends from any of our insurance or reinsurance companies, for four to five years – a management holding company survival ratio, if you will!

6) As discussed in the MD&A, our insurance companies are all over-capitalized with large solvency margins in excess of mandated regulatory levels.

7) Our foreign exchange exposure from Ranger and Odyssey Re has been fully hedged by the U.S. debenture issues and the purchase of foreign exchange contracts. We have also hedged our expected U.S. dollar income for the next five years with the purchase of additional foreign exchange contracts, as disclosed in note 12. During 1996 we were able to take advantage of collapsing Canadian/U.S. interest rate spreads in the three to five year area and realize $6.7 million in profits by extending the term of our contracts to ten years. Our French franc exposure from CTR has also been fully hedged, together with our estimated French franc net income over the next three to five years (note 12).

Investments

1996 was an excellent year for the financial markets, particularly the Canadian and U.S. stock markets. This resulted in a record year for realized gains and a very significant increase in unrealized gains as shown below:

	1996	**1995**
	($ millions)	
Bonds	26.9	21.7
Preferred stocks	19.0	5.7
Common stocks	81.2	(12.9)
	127.1	14.5

Even though they are substantial, I would de-emphasize the unrealized gains as they can easily disappear if the markets decline. However, our realized gains of $131 million were almost twice the record $72 million realized in 1995 – you probably thought we had run out of ammunition! Realized gains are totally unpredictable but we purchase stocks with the intention of making significant gains in the long term – sometimes they come a little sooner! Since we began in 1985, we have realized cumulative gains of $286 million or $27 per share pre-tax. The $131 million in gains in 1996 consisted of $43 million from bonds, $69 million from stocks, $11 million from the sale of Ranger County Mutual (a largely inactive subsidiary of Ranger Insurance Company), and almost all the remaining $8 million from the sale of foreign exchange contracts.

The $69 million realized from stocks is about a 15% return on an average common stock portfolio of approximately $447 million – about 7% (forgetting dividends) above the 8% interest income we could have obtained if it was all invested in bonds.

The table on page 45 shows the returns on our investment portfolios. Investment income (interest and dividends) has increased dramatically because of the Odyssey Re portfolio. Pre-tax investment income per share has increased from $10.00 in 1995 to $15.42 in 1996. Since the 87¢ per share generated in 1985, pre-tax investment income per share has compounded at 30% annually. Investment income per share will increase again in 1997 because of the CTR acquisition.

In our 1994 Annual Report, we mentioned the Canadian government's intention to tax unrealized stock gains in financial institutions' investment portfolios annually. We said, "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." Well, sanity did not prevail and we will be paying cash taxes of approximately $24 million in 1997 on unrealized capital gains on Canadian common and preferred stocks at year-end 1996 of $55 million.

Gross realized gains totalled $143.7 million. After realized losses of $4.8 million and increased provisions of $7.6 million, net realized gains were $131.3 million. The major contributors to realized gains were Salomon Inc. ($8.5 million), Trizec Hahn ($8.0 million), Sears ($7.6 million), Royal Bank ($6.5 million), American Express ($5.3 million), Bank of Montreal ($4.5 million), Mercury General ($3.6 million), E-L Financial ($3.5 million), AIG ($3.4 million), Toronto-Dominion Bank ($2.6 million), Canadian Tire ($2.3 million), Trilon ($2.2 million) and Canadian Gypsum ($1.2 million).

Last year we made the point that it was getting increasingly difficult to identify good long term values in the U.S. while we could find them abundantly in Canada. With both markets up significantly in 1996, we are now finding it very difficult to identify long term values in both markets. For the first time since Fairfax's inception in 1985, we are becoming concerned about the overall stock market environment. The S&P 500 is selling at a very high P/E of approximately 18 times, exceeded in only four years since WWII (1962, 1991, 1992, 1993). With a 2% yield and long term growth in earnings per share of only 7%, the S&P 500 can provide a return of only 9% in the next decade if the current extremely high P/E ratios are maintained. If corporate earnings were to stumble, interest rates rise or P/E ratios contract, the performance of stocks could be extremely disappointing. We don't think we are being unduly pessimistic in surmising that recent extraordinary historical rates of return in U.S. equities cannot be sustained. While Canadian equities may have a little way to go, the same logic applies.

Investors with a long term perspective may be interested in knowing that the July 1996 article in *Reader's Digest*, entitled "You Can Make A Million" and extolling the virtues of long term investing in the stock market, was almost identical to the article in the August 1929 issue of the *Ladies Home Journal* entitled "Everybody Ought to be Rich". While we do not disagree with this thesis, it appears to us to be a classic example of a sound concept rendered unsound by mindless overuse and total disregard for prices paid. The explosion in U.S. mutual funds (from 161 in 1960 to 4,764 in 1996), the proliferation of U.S. investment clubs (4,000 in 1981 to 24,000 currently) and record IPOs are all indications of a frothy market. According to the July 19, 1996 issue of *Grant's Interest Rate Observer*, "In the 20 years immediately following publication of "Everybody Ought to be Rich", big cap stocks returned 3.1% a year." *Grant's* continues, in the same issue, "The return of one's money, the humblest investment attribute in good times, is always prized in bad times." With many warning lights flashing, we are being more cautious than usual in making any new stock investments.

At the end of 1996 we had approximately $507 million ($48 per share) or 15% of our $3.5 billion investment portfolios in common stock. As a percentage of our investment portfolios or as a percentage of common shareholders' equity, our common stock holdings are currently at close to their lowest relative levels in the past 11 years. Of the $507 million in common stock, $377 million is invested in Canadian common stock and $130 million in U.S. common stock. Of this amount, $121 million is invested in industrial products companies, $120 million in financial services companies, $112 million in consumer product companies, $66 million in natural resource companies and $88 million in other miscellaneous categories.

Last year I mentioned that Paul Fink and Chandran Ratnaswami are reviewing international insurance and common stock investments for us. In 1996 we began investing outside of North America – mainly through value-oriented managers with good long term records.

Our "nuclear bomb" testing on insurance regulatory capital of a simultaneous decline of 50% in our common stock holdings, 30% in our preferred stock holdings and 20% in our bond holdings continues on a monthly basis. While all our insurance and reinsurance companies met this test, we have decided to buy a "put" at Odyssey Re similar to the one purchased in 1995 for Lombard. We consider the cost of this put (US$1 million) to be cheap insurance if the nuclear bomb were to explode!

We have added to our small real estate investments with the purchase of an 80% interest in a warehouse building in Toronto for a net investment of $5.0 million. We expect to receive an income return in excess of 10% with some possible long term appreciation. We made the investment because we liked our partner who is managing the property.

Miscellaneous

In 1996 Fairfax and its subsidiaries donated approximately $1.6 million (about 1% of pre-tax income) to over 300 charities in North America. Our individual companies make a significant percentage of these donations, and Fairfax makes the rest.

Please review page 63 which is an unaudited, unconsolidated balance sheet on an equity accounted basis showing you where your money is invested. The table shows our investment in Odyssey Re at $390 million – approximately $118 million below its underlying book value. The increased investment in Wentworth is because we are financing CTR through Wentworth even though CTR will be grouped with Odyssey Re for management purposes. Excluding Odyssey Re and Wentworth, we have $718.0 million invested in our insurance companies, $30.3 million in Lindsey Morden, $8.2 million in HWIC and $101.1 million in cash. Our insurance companies and Lindsey Morden are shown at their underlying book value, i.e. very conservatively valued. In case you missed Noro Inc., that means "No Return On Investment" (courtesy of John Varnell). This is the subsidiary that owns a plane we purchased in February 1996 for US$1.8 million. Another indicator of irrational exuberance!

You may have again missed that dividend that we paid you in 1996. By purchasing 3,500 shares at $160 per share for a total cost of $0.6 million, we indirectly gave you a dividend of 6¢ per share. You can't live on Fairfax's dividends though! We always consider investing in our stock first (i.e. stock buybacks) before making any acquisitions.

Since we began in 1985, eleven years ago, our book value has compounded at 40.4% annually while our stock price has compounded at 50.4%. During some portions of that period, the reverse has happened: our book value compounded at a rate higher than our stock price. In the long run, these rates should converge. While we are very grateful for the past, rest assured it won't help you in the future. Our objective continues to be to achieve a 20% return on shareholders' equity in the future, retain all earnings and compound book values at 20% annually – about half of what we have achieved in the past eleven years.

Our return on average shareholders' equity over the past eleven years has averaged 20.4%, slightly in excess of our target of 20%. In case you think this is an easy bogey, the TSE 300 averaged 7.7% over the same period. In the July 1996 issue of Report on Business Magazine, Fairfax's five year return on equity was ranked 79th out of the top 1,000 companies listed on Canadian stock exchanges, i.e. in the top 7-8% of all companies in Canada. Our own analysis indicates that our ten year ROE (ending December 1995) ranks 7th out of all the TSE 300 companies. So achieving 20% is not going to be easy but it continues to be our objective.

Two further points on our record. We have an employee share purchase plan that allows employees to contribute up to 10% of their salary and the company matches 30% automatically with a further 20% if Fairfax achieves its 20% ROE objective. You will be interested to know that if an employee, at a salary of only $20,000, had participated fully in the plan over the nine years of its existence, he or she would have approximately 775 shares worth $225,000 at the end of 1996. You know why many of our employees have smiles on their faces! All our companies have high employee participation rates in our plan and we continue to encourage our employees to think long term. We like our employees to be owners of our company and this plan is a great way to do it. Lest you non-employee shareholders are concerned, Fairfax shares are purchased in the market and not from the treasury.

The second point on our record leads me to corporate governance. There is much discussion in the media about corporate governance, board composition, etc., etc. Also there has been some negative press about dual voting share structures. I must say that a major reason for Fairfax's track record is its small, non-bureaucratic board and its share structure that together allow us to be entrepreneurial and react quickly to opportunities, and to take the long view and not be worried about stock market fluctuations. In the past 18 months, we have seen two excellent companies in the oil industry, Nowsco and Morrison Petroleum, be taken over because their share prices were temporarily low and vulnerable to hostile takeovers. Management at both companies have served shareholders well over the long term and probably would have benefitted from a dual voting structure. While there are many abuses of this share structure, as far as Fairfax is concerned it is a big plus! Please read the proxy circular for additional information on corporate governance at Fairfax.

Our company is run for the long term and over time has attracted shareholders with a long term horizon. During 1996 2.5 million shares of Fairfax were traded on the TSE or approximately 25% of the float. When compared to all companies on the TSE 300, Fairfax's turnover (shares traded as a percentage of the float) continues to be ranked in the bottom 10%. Long term shareholders are reminded to note the section on Issues and Risks on page 51 that lists the risks that Fairfax faces. Caveat emptor!

We had an excellent annual meeting last year at the old Toronto Stock Exchange building – many of you came and your questions benefitted all shareholders. In order to provide more space this year, the meeting will be held at 4:30 p.m. on April 16, 1997 in Room 105 at the Metro Toronto Convention Centre. We hope to see as many of you there as possible, including some of our newer shareholders.

Again, on your behalf, I would like to thank the board and the management and employees of all our companies for an outstanding year.

February 28, 1997

V. P. Watsa

V. Prem Watsa

Chairman and
Chief Executive Officer