To Our Shareholders

With the help of strong financial markets, we earned 20.4% on average shareholders' equity in 1997 (versus approximately 10% for the TSE 300). Net income after tax increased by 54% to $232.5 million. In spite of a 6% increase in shares outstanding, earnings per share increased by 41% to $21.59 per share. Book value per share increased by 44% to $125 but our share price increased by only 10% to $320 per share. The stock market was unimpressed! Those of you who take your cue from stock prices may think we had a poor year – particularly as the TSE 300 and S&P 500 rose by 13% and 31% respectively in local currency.

During the year, we strengthened our global reinsurance business with the purchase of Sphere Drake and again ended the year in a stronger financial position than when we began. We issued a 40 year debenture (I expect to be there at maturity) and ended the year with a cash position of $207 million in the holding company and unused, unsecured, committed, long term bank lines in excess of $1 billion. With the purchase of Sphere Drake, we increased our ''rainy day'' cushion (more on that later) to $221 million from $193 million (including CTR) in 1996, and also on closing increased our reserve and reinsurance recoverable indemnifications that are not shown on our balance sheet by $109 million. Not bad for a slow year!

Our purchase of Sphere Drake fit into our long term strategic plan discussed with you in last year's Annual Report – we responded to a telephone call! Late in 1996, Michael Watson, President and Chief Executive Officer of Sphere Drake, walked into our offices and impressed us with a very balanced review of the possibilities of Sphere Drake.

On June 23, 1997 we announced the purchase of Sphere Drake, a London, England-based reinsurance company listed on the NYSE, for a payment of US$7.50 per share in cash or Fairfax shares and a 10 year, 8% contingent note (subject to reduction from adverse reserve development and reinsurance recoverable bad debt) of US$4.50 per share. No interest or principal is due on the contingent note (officially named a contingent value right) until maturity. The total purchase price was US$217 million.

At December 31, 1996, Sphere Drake had a book value of over US$250 million (US$13.80 per share) and an investment portfolio of approximately US$900 million. Net premiums written in 1996 were US$289 million. Sphere Drake is the first public company that Fairfax has purchased.

So why did we buy Sphere Drake? The major reasons were:

1) Sphere Drake fills out the global network of Odyssey Re Group (Fairfax's reinsurance group) with operations in London and Bermuda. Sphere Drake has been in the London market since 1948 and in Bermuda since 1990. Michael Watson, who runs the company, joined Sphere Drake in March 1995. His two significant achievements since he joined the company, from our point of view, were to increase the reserves by US$90 million in December 1995 and to reduce the lines of business from 17 to the profitable core of 6 in 1996 (net premiums written dropped by 50% in 1996). In common with all the Fairfax insurance companies, Michael and his management team are focused on underwriting profitability. Like Jean-Philippe Casanova at CTR, Michael reports to Andy Barnard.

2) The addition of Sphere Drake's business and capital results in Odyssey Re Group being among the top reinsurance groups in the world with in excess of US$1 billion in capital and approximately US$750 million in net premiums written.

3) Like Odyssey Re and CTR, Sphere Drake provides Fairfax with further business and investment diversification.

4) The US$4.50 per share contingent note, together with the discount to book value, provides very meaningful downside protection for Fairfax. The contingent note itself provides an initial indemnification of US$171 million after tax in ten years from adverse reserve development and reinsurance recoverable bad debt.

5) Given Sphere Drake's combined ratio in the 105% area and its investment portfolio of US$900 million, as well as attractive purchase financing, Fairfax should achieve its 20% return objective on the purchase price.

6) We were able to finance the purchase of Sphere Drake at fair terms and Fairfax continues to maintain its very strong financial position.

As with the purchase of Odyssey Re and CTR, there are risks in any purchase and the main ones are discussed below:

1) The major risk is the run-off of old books of business in the London market that are exposed to asbestos and environmental long tail liabilities. We feel the contingent note provides sufficient protection but only time will tell.

2) Sphere Drake has reinsurance recoverables of US$560 million on a reserve base of US$1,246 million. The company is exposed to potential bad debts on its reinsurance recoverables. We feel comfortable with the bad debt reserve of US$33 million already in place and the contingent note indemnification we have, but again, only time will tell.

3) Sphere Drake's historical results have been mediocre (mainly due to adverse loss development). With the protection from adverse loss development in place and the reduction in net premiums to its profitable core, we think Sphere Drake has the ability to achieve underwriting profitability over time.

With the addition of Sphere Drake, the Odyssey Re Group will have combined capital in excess of US$1 billion, net premiums written of approximately US$750 million and major offices in New York, Paris, London, Bermuda, Toronto, Singapore and Tokyo. While this makes us one of the top 20 reinsurance groups in the world, our focus continues to be underwriting profit and *not* market share. We are excited about the acquisition of Sphere Drake and welcome Michael Watson and the employees of Sphere Drake to the Fairfax group.

We financed the purchase of Sphere Drake by issuing 650,000 shares at $395 per share to raise $246 million net, and US$125 million of unsecured debentures with a coupon of 7¾% and a 40 year term to maturity (a spread of 122 basis points above U.S. Treasuries). The additional money raised was used to pay back a US$100 million bank financing that Sphere Drake had as well as increase Fairfax's cash position in the holding company. As in the past, our equity issue was led by Dick Falconer from CIBC Wood Gundy and ably supported by Nesbitt Burns, ScotiaMcLeod, RBC Dominion Securities, TD Securities, Deutsche Morgan Grenfell, First Marathon, Midland Walwyn and Newcrest Capital. Also as in the past, our U.S. debt financing was led by J.P. Morgan and strongly supported by CS First Boston and Deutsche Morgan Grenfell. We thank our Canadian and U.S. investment dealers for doing an excellent job for us again and welcome our new shareholders and bondholders to the company. As emphasized in the past, our company is run for the long term benefit of our shareholders which implies maintaining a very strong financial position which will benefit our bondholders. The emphasis though is long term.

After the purchase and financing of Sphere Drake, Fairfax's investment portfolios have increased to approximately $5.8 billion or $521 per share – up 34% from $390 per share as at December 31, 1996 (including CTR). Investment income per share (interest and dividends only) from these portfolios, which ultimately drives earnings per share and book value per share, should increase to approximately $30 per share in 1998.

This is perhaps a good time to discuss stock price fluctuations – particularly for the benefit of some of our newer shareholders! Stock prices *have always* fluctuated – and *will always* fluctuate. This applies to stocks in general but to Fairfax in particular. Our consistent policies to attract long term investors, combined with a lack of promotion, should result in less fluctuation than stocks in general over the long term – but in the short term we will experience our share of "air pockets". We experienced this in 1997, when our share price began the year at $290, went to a high of $403 and then dropped to a low of $285 and closed at $320. From the issue price of $395, our stock price dropped by 19% to the close of $320.

A few points in relation to these fluctuations:

1) These fluctuations are magnified in terms of absolute dollar changes but are not abnormal based on percentage changes. In fact, if our stock was split 100:1 (don't worry, it won't happen), many of you would not have noticed the fluctuation from $3.95 to $3.20 even though the percentage drop would be the same.

2) In the past we have experienced similar and sometimes even larger share price fluctuations. The largest share price drop that Fairfax has experienced in the past, under present management, was in 1990 when our share price dropped from $21⅝ to $8⅞ or a decline of 60%. We could experience similar declines in the future but *if* we continue to achieve our 20% objective, these fluctuations will be as irrelevant in five years time as the 1990 fluctuations are from today's perspective. Please note the big "*if*" and remember there is no guarantee we will achieve our 20% objective in the future.

3) Some of our more recent shareholders have reacted to these fluctuations with persistent telephone calls to our head office asking about the effects of El Niño, the Mexican earthquake, the Asian crisis, etc., etc. We

> have to re-emphasize that our company is run for the long term; short term stock price fluctuations are meaningless and as we have only thirteen people in our head office, we do not have the time to answer these telephone calls. So as a matter of policy, we will not be responding to investor calls about stock price fluctuations or other questions about Fairfax on an individual basis but would be delighted to answer your questions at our annual meeting. Our Annual Reports provide you with full and complete disclosure supplemented by our more brief (thankfully!) quarterly reports. If we have significant additional information to disclose to you, rest assured we will do it through an immediate press release. So please, no telephone calls! If you cannot handle the short term fluctuations, then perhaps we are not the stock for you.

The objective of our Annual Report is to provide you with enough information so that you can get some idea about (a) what Fairfax is worth; (b) our ability to meet our obligations (in other words, our financial soundness); and (c) how we have done given the hand we have been dealt.

Most of this report deals with (b) and (c) but I would like briefly to discuss (a). What is Fairfax worth? In the 1995 Annual Report, I mentioned the concept of intrinsic value or what a company is worth. Intrinsic values do not fluctuate as much as stock prices and are based on the earnings or future cash flows from a company – the earnings or future cash flows that can be distributed to shareholders after the reinvestment requirements of the business for capital expenditures and working capital requirements. Broadly speaking, for our insurance and reinsurance business, capital expenditures and working capital requirements are minimal and so our earnings are free to be distributed to shareholders. So, the future earnings for Fairfax will determine the company's intrinsic value.

On the other hand, the book value of a company shows the net amount of moneys that have been invested in the company over time. Return on shareholders' equity, i.e. return on book value, is the link between book value and intrinsic value as future earnings will be determined by the return on shareholders' equity. When a company like Fairfax earns more than 20% on shareholders' equity then, given that long term interest rates are below this figure, the intrinsic value of the company will exceed its book value and its stock price will reflect its intrinsic value over time. So while stock prices fluctuate in the short term – reflecting the twin emotions of fear and greed – in the long term they always reflect underlying intrinsic value. This is how we view the link between book values, intrinsic values and stock prices. We have given you a framework to value Fairfax but you will have to come up with your own number for intrinsic value.

When we have made acquisitions and financed them through stock issues, we have made sure that stock prices are fair to the seller (us) and to the buyer, i.e. as close to intrinsic value as possible. However, this means that we have issued shares at premiums to book value. Some of you may think (mistakenly!) that all we are trying to do is increase book value per share by issuing shares at premiums to book value. Many companies actually do this and justify their acquisitions by saying that earnings will be accretive. The key we think is the return on shareholders' equity on the additional capital raised to make the acquisition. Earnings may be accretive even if the return on the additional capital is only 10%! Our objective has always been and continues to be a 20%+ return on the additional capital raised. Our after-tax return on the purchase price for our recent acquisitions is shown below.

	1997	**1996**	**1995**
	%	**%**	**%**
Lombard	54	38	27
Odyssey Re	32	24	–
CTR	14	–	–

These returns are based on the full purchase price and have not taken favourable debt financing into account. CTR has had a lower return because of lower investment returns but this should improve soon. While the financial markets have accentuated our returns because of realized capital gains, it is fair to say that we are focused on achieving a 20% return on our purchase price for every acquisition or we will not make the acquisition. We believe the structure of the Sphere Drake acquisition (together with Sphere Drake's becoming part of Odyssey Re) will ensure that that acquisition achieves our objectives. Since we began in 1985, the only insurance acquisition that has not met our return objectives is Ranger (we have made a positive return though!).

We should bring your attention to the best article that I have come across on why every company in the private sector should have a focus on increasing long term shareholder value. The article is by the late Roberto Goizueta, then Chairman of Coca-Cola, entitled ''Why Share Owner Value?'', and is included in Coke's 1996 annual report. The gist of Roberto's article is that increasing shareholder value in the *long* term benefits not only shareholders but customers, employees and also the community. Trying to increase shareholder value in the *short* term ultimately benefits no-one. Our own experience, comparing the company we began with in 1985 ($1.8 million market value and revenue, assets and shareholders' equity of $17 million, $42 million and $10 million, respectively) with our company in 1997 ($3.5 billion market value and revenue, assets and shareholders' equity of $2.1 billion, $10.2 billion and $1.4 billion, respectively), shows that currently we are in a much better position to fulfil our obligations to our customers, employees and shareholders than we were in 1985. In fact, based on our policy of donating at least 1% of pre-tax earnings to charitable organizations, we donated $3.8 million in 1997 – well in excess of the market value of the whole company in 1985. It is well worth reading Roberto's article!

For the benefit of our new shareholders who have not read our old Annual Reports, I want to re-emphasize that you continue to have one major short term disadvantage by my controlling all the multiple voting shares. I will not sell my shares even at a 100% premium to the market price and thus my multiple voting shares prevent you from getting an attractive one time bonanza. However, for this short term pain, this share structure has served Fairfax very well (easy for me to say!!) and, we hope, will provide you with attractive long term returns. In case you were unaware of the power of compounding, 20% over 13 years results in a zero being added to whatever you began with!!

The table below shows the sources of our net earnings.

	1997	**1996**
	($ millions)	
Insurance and underwriting	(56.2)	(50.6)
Interest and dividends	242.3	144.1
Total	186.1	93.5
Claims adjusting (Fairfax portion)	1.8	2.3
Interest expense	(43.2)	(35.0)
Goodwill and other amortization	(4.8)	(4.8)
Corporate overhead and other	(15.0)	(6.6)
Realized gains	206.8	131.3
Pre-tax income	331.7	180.7
Less: taxes	99.2	29.9
Net earnings	232.5	150.8

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 and includes one time expenses associated with our acquisitions and our issues of securities (don't worry – overhead at Fairfax has not increased much). 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 64 to 69.

Insurance operations

We have included a table below that shows clearly the combined ratios of each of our companies for 1996 and 1997. As you can see, our Canadian companies had another excellent year with a combined ratio of 100%. Odyssey Re performed as expected, CTR was close and Ranger had a much improved year. In total, our insurance operations had a combined ratio of 104%, a little better than 1996. Given our conservative reserving at all our companies, and the transition period before recent acquisitions achieve our objectives, we were pleased with these results even though we have not taken the total combined ratio for all our companies below 100% yet. The industry, across the world, continues to be fiercely competitive – and to think I thought the cycle would turn in 1991!!!

	1997	**1996**
	%	**%**
Commonwealth	88.8	87.0
Federated	97.4	100.2
Lombard	102.8	100.8
Markel	103.0	102.9
Total Canadian insurance	*100.0*	*99.0*
Ranger	112.1	123.5
Total U.S. insurance	*112.1*	*123.5*
Odyssey Re	106.0	110.0
CTR	109.2	–
Wentworth and other*	81.8	98.0
Total reinsurance	*104.7*	*109.7*
Total	*103.8*	*104.9*

* *includes Sphere Drake for one month in 1997*

Commonwealth, under John Watson's leadership, continued to produce exceptional results, with a combined ratio of 88.8% versus 87.0% in 1996. John and his management team have had combined ratios of less than 100% in six of the last seven years.

In 1997 Commonwealth's gross premiums written dropped by 10% to $235 million due to the soft market, while net premiums written dropped by 4% to $83 million. Exceptional underwriting results combined with excellent investment income produced net income after taxes of $28.2 million – another record! Commonwealth seems to go from one high to another.

Federated, led by John Paisley, had another exceptional year in 1997 with a combined ratio of 95.9% (versus 98.6% in 1996) for the property and casualty company (97.4% including the life operations). John and his management team have had combined ratios of less than 100% in seven of the last eight years in the property and casualty company.

In spite of a soft market, gross premiums written for Federated increased 2% to $71.2 million, while net premiums written increased by 5% to $63.6 million. In 1997 Federated successfully entered the Building Contractor market and also was among the first companies to introduce "Critical Illness Insurance" to its clients. The company continued to reduce its expense ratio from 34.8% in 1996 to 33.3% in 1997. Net income after taxes increased by 40% to $7.7 million from $5.5 million in 1996.

Byron Messier and his management team at Lombard had an excellent year in 1997 – even though they just missed the 100% objective! Everything included, Lombard had a combined ratio of 102.8% in 1997 – the "everything" includes all start-up expenses for Zenith Insurance in Ontario (which were written off in 1997) and the high marketing costs for the Privilege 50 program (discussed in last year's Annual Report). Excluding these start-up expenses and marketing costs, Lombard had a combined ratio of 100.6% – commercial lines at 102.3% and personal lines at 97.6%.

Zenith Insurance, as discussed last year, was launched in June in Ontario to provide home and car insurance to people over 50 years old. Total premiums written for Privilege 50 in 1997 (Ontario, Alberta and the Maritimes) were $14.3 million. The loss ratio on this business was in the 70% area but heavy marketing costs resulted in a combined ratio of approximately 130% for the program. In time we expect this to be an excellent program for Lombard and its customers.

Lombard's gross premiums written (including CRC (Bermuda)) decreased by 1% in 1997 to $500.9 million, while net premiums written increased 1% to $460.4 million. Net income after taxes increased to a record $82 million due to significant realized gains. In the three years since we purchased Lombard it has earned $183 million – in excess of our purchase price of $155 million.

Markel, under Mark Ram's leadership, had another excellent year as the company continued to deliver more unique, value-added products and services to its insureds, building on its almost five decades of continuous service to the Canadian trucking industry. In spite of being faced with irrational competition, Markel produced a combined ratio of 103%. The introduction of Markel Advantage Software (software developed in-house to assist in the management of various trucking operations of Markel's insureds), its second truck driver training school and its in-house dedicated toll-free service (24 hours a day, seven days a week) continue to make Markel the premier trucking insurance company in Canada.

The company's expertise has been recognized by its customers as over 90% of them renewed with Markel in 1997 despite the intense competition. Also in recognition of the company's expertise, Markel was the only insurer invited to participate fully in *Target '97*, a major road safety program organized by the Ontario government.

In 1997 Markel's gross premiums written and net premiums written dropped by 25% and 12% respectively to $73.3 million and $55.4 million, mainly due to Markel's cancellation of unprofitable programs. Net income after taxes increased by 61% to $7.4 million because of higher realized gains.

Ranger had a much improved (!) year in 1997 with a combined ratio of 112.1% versus 123.5% in 1996. Excluding the run-off lines, Ranger's combined ratio for continuing lines was 100.5% – close to our 100% objective. With Bob Rich at the helm, we feel comfortable that Ranger's combined ratio in 1998 will be in the 100% area.

In 1997 Ranger's gross premiums written were about flat at US$223 million, while net premiums written were down 6% from 1996 to US$146.0 million. Pre-tax income went from a loss of US$2.2 million in 1996 to a profit of US$15.8 million in 1997, while net income after taxes increased 12% to US$10 million. Year-end GAAP capital of US$131.4 million was the highest in Ranger's history.

Wentworth, benefiting from favourable development from the past of $7.8 million, showed an underwriting profit of $7.9 million on net premiums earned of $5.2 million. Excluding the favourable development, Wentworth had a combined ratio of 98% in 1997. Net income after taxes was a record $30 million in 1997 because of the significant underwriting profits and realized gains.

Odyssey Re, New York, had an excellent year in 1997 with a combined ratio of 106.0% as expected after US$15.5 million in indemnification from Skandia, Sweden. During the year, the company was able to enlarge its pool of management talent and establish a stronger, more diversified portfolio. Furthermore, significant strides were taken in developing alternative distribution channels, such as its subsidiary Hudson Insurance Company.

Net premiums written at Odyssey Re were US$197.4 million in 1997 – about 2% less than in 1996. Net income after taxes was US$70.8 million, up 10% from US$63.5 million in 1996. At the Odyssey Re level, we decided to write off lease costs in excess of market of US$11.9 million after tax (US$18.3 million pre-tax) which, because of negative goodwill at Fairfax, has no impact on Fairfax's net income but does reduce Odyssey Re's net income to US$58.9 million. The write-off of excess lease costs will result in rent savings of over US$2 million annually for the remaining lease term. Andy Barnard expects Odyssey Re's combined ratio in 1998 to be in the 103% area.

1997 was the first year for CTR under Fairfax ownership. Under Jean-Philippe Casanova's leadership, CTR had a combined ratio of 109.2% in 1997, higher than expected for its first year. Gross premiums written and net premiums written declined significantly due to extremely soft market conditions to FF1,331 million and FF945 million respectively. Net income after tax was FF82 million – a 14% return on our investment. With higher investment income and improved underwriting results, our returns are expected to increase to our target 20% level. CTR is expected to bring combined ratios to the 100% area in the next two years. During 1997 CTR added to its senior management depth in its Singapore based operations and its facultative operations. A.M Best and S&P have upgraded CTR to the A− level – the highest rating the company has ever had.

Late in 1997 we formed the Odyssey Re Group, a holding company that owns Odyssey Re (New York), CTR and Sphere Drake. Jim Dowd is Chairman of this Group, while Andy Barnard is President and CEO. Jean-Philippe Casanova and Michael Watson report to Andy while running their own decentralized operations. Over time, Andy, Jean-Philippe and Michael will be co-ordinating the operations and bringing them together to operate as one worldwide reinsurer. As shareholders, this offers great opportunity for us and we are extremly fortunate to have these men leading our reinsurance group.

S&P has raised its rating of each company and the Group to the A− level.

Our insurance companies are all well capitalized as shown on page 58. We continue to have significant unused capacity and it will continue to be unused as long as current conditions prevail.

As you know, it is our policy to have our reserves set at a level that results in redundancies in future years. How did we do in 1997? We provide extensive disclosure on our claims reserves beginning on page 43 in the MD&A. In Canada our insurance companies had redundancies of $12.0 million in 1997, while in the U.S. we had a deficiency of US$0.8 million. As explained on page 47 in the MD&A, the U.S. deficiency in 1997 was net of redundancies at Odyssey Re and Wentworth, but reflected a rather significant deficiency at Ranger of US$8.7 million resulting from the run-off of certain reinsurance assumed lines. While core lines at Ranger, as well as discontinued insurance lines, are well reserved, we were disappointed with the deficiency noted above. In total then, we had a net reserve redundancy of $10.8 million in 1997. Our reserves continue to be certified by independent actuaries at the individual insurance company level and on a consolidated basis.

In January 1998 we purchased Euro-America Insurance Limited, a small insurance company based in Hong Kong, for its net book value of HK$22.5 million. The company's name has been changed to Falcon Insurance Company Limited and its capital will be increased to HK$240 million. In case you think we must have been suffering a sudden attack of the Asian 'flu, we bought this company because Kenneth Kwok agreed to come in as its CEO. Kenneth has had a long and successful track record running a Continental subsidiary in Hong Kong and was well known to Byron Messier and his team at Lombard. We welcome Kenneth and the employees of Falcon Insurance to the Fairfax group and look forward to participating in the long term growth of the company.

Claims adjusting

Under Ken Polley's leadership, Lindsey Morden had another excellent year in 1997 – on the basis of free cash flow – even though earnings per share were down 34% from 1996. In 1997, after capital expenditures and working capital requirements, Lindsey Morden generated free cash flow of $6.3 million ($1.04 per share). The company used this free cash mainly to pay dividends of $2.8 million (50¢ per share) and reduce short and long term debt. As Ken, Don Smith and Ferd Roibas feel that this level of cash flow is sustainable, the board of Lindsey Morden decided to increase the dividend to 60¢ per share in 1998 and authorized the use of additional funds to buy back shares if appropriate.

It is quite remarkable that in the two years 1996 and 1997, Lindsey Morden generated $14 million in free cash flow compared to only $4 million in the previous five years. While many of you may not know this, Francis Chou has spent much time with Ken and his team, and along with Rick Salsberg, has been instrumental in developing a simple bonus formula based on free cash flow. The turnaround has been amazing!

Investment management

While 1997 was an excellent year on an absolute basis, relative to exploding U.S. and Canadian stock markets, our equity results did not keep pace. Our bond results in 1997 were excellent on both a relative and absolute basis.

The key, of course, is long term and as shown in the table below, HWIC has produced excellent results in all of the areas in which it provides investment management – Canadian equities, Canadian bonds, U.S. bonds and balanced funds.

Annualized rates of return (%)

Cumulative periods ended December 31, 1997

	5 years	10 years	15 years
Canadian Equities	24.1	14.2	15.6
TSE 300	17.5	11.0	11.9
U.S. Equities	30.3	24.9	22.3
S&P 500	23.1	19.2	18.7
Canadian Bonds	16.3	12.9	–
SM Index	10.9	11.6	–
U.S. Bonds	9.7	11.1*	–
ML Index	6.4	8.3*	–
Balanced Fund	20.4	14.7	–

* *9 years*

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

Total fees in 1997 were $9.8 million, down from a record $10.1 million in 1996, mainly because of no incentive fees being earned in 1997. Fairfax earned a 35% pre-tax cash return in 1997 on its $14 million investment in HWIC.

Financial position

As in previous reports, we feel our unaudited balance sheet with Lindsey Morden equity accounted (shown on page 66) is the best way to understand our financial position. Here is what our year-end financial position looks like compared to the end of 1996.

	1997	**1996**
	($ millions)	
Cash and short term investments	207.1	101.1
Long term debentures	718.4	470.5
Net debt	511.3	369.4
Common shareholders' equity	1,395.7	911.1
Net debt/equity	37%	41%
Net debt/total capital	27%	29%

As shown, common shareholders' equity, our capital, increased by $484.6 million – $246.4 million net from the stock issue, $7.3 million for shares issued in the Sphere Drake acquisition and $232.5 million from net income, less $1.6 million used to purchase 5,100 shares at about $309 per share. Our US$125 million debenture issue in July 1997 and our effective FF200 million borrowing in connection with our purchase of CTR resulted in the increase in long term debentures. Earnings plus the additional funds raised in excess of the funds required for the Sphere Drake acquisition resulted in our cash position doubling to $207 million from $101 million in 1996. Our net debt to equity and net debt to capital ratios dropped in 1997 to 37% and 27% respectively from 41% and 29% respectively in 1996 in spite of the Sphere Drake acquisition. Over the past two years we have purchased three reinsurance companies for a total of approximately $770 million and still ended 1997 with a significantly lower net debt to equity and net debt to capital ratio than at the end of 1995. Please note, we have not included the Sphere Drake contingent note ($46.0 million) in our debt to equity and debt to capital ratios as no principal or interest is payable for ten years, and adverse reserve development as well as reinsurance recoverable bad debt goes against the note.

A very significant item of financial conservatism on our balance sheet is the negative goodwill (or, as the accountants call it, excess of net assets acquired over purchase price) that is shown on our balance sheet. This item ($184 million), together with additional provisions arising from our recent acquisitions ($37 million), results in our "rainy day" cushion of $221 million. These cushions, together with the remaining $334 million of reserve/reinsurance unrecoverable protection that is not on our balance sheet, significantly protect our shareholders' equity from asset or liability deficiencies that may occur in the future.

One unintended aspect of our recent success in acquiring companies at a discount to book value is the imposition of an accounting rule that requires that the excess of net assets acquired over their purchase price be categorized as such on our balance sheet and be amortized into income over 30 years. We are not happy about increasing our annual income by the amount of this amortization, which was $7.7 million in 1997, and you can be confident that we have been and will be zealous in applying conservative accounting in other areas so as to mitigate the effect of this increase.

Our financial position continues to be very strong for the same reasons that we discussed in our 1996 Annual Report. Briefly they are:

1) We have no bank debt. Our debt consists of four public debentures with a long term to maturity (6 years, 18 years, 29 years and 40 years) and low interest rates (7¾%, 8¼%, 8¼% and 7¾%) and two small 6 year and 9 year debentures issued to vendors with a 7¾% and 2½% coupon respectively. All of this debt (except the 2½% debenture, which has comparable terms to the other debt) was issued under a single trust indenture containing no restrictive covenants, thus providing us with great flexibility. We have swapped the fixed interest rates on all the public debentures (with the exception of the one maturing in 6 years) into floating rates, saving approximately 125 basis points on average currently.

2) We have unused, unsecured, committed, long term bank lines in excess of $1 billion with excellent covenants. These bank lines are with five Canadian, three U.S. and two European banks. 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 among many insurance and reinsurance companies, Lindsey Morden and HWIC, and among Canadian, U.S. and, through CTR and Sphere Drake, 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 71.

5) With $207 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 five to six years our management holding company survival ratio!

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 10. We have done the same for CTR (in French Francs) and Sphere Drake (in U.S. dollars).

Investments

1997 was an exceptional year in the Canadian and U.S. financial markets and the best year ever for Fairfax as far as realized gains are concerned. The unrealized gains as of year-end are shown below.

	1997	**1996**
	($ millions)	
Bonds	116.6	26.9
Preferred stocks	25.5	19.0
Common stocks	(19.4)	81.2
	122.7	127.1

In spite of our concern expressed in last year's Annual Report about the level of stock prices in Canada and the U.S., we realized a record $207 million in gains – about 58% more than the $131 million realized in 1996 (which was almost twice the record $72 million realized in 1995). Since 1985 we have realized cumulative gains of $500 million. While we do not expect to realize the gains that we have recently had from Canadian and U.S. stock markets in the future, we do expect to continue to realize gains from our investment portfolios. While realized gains are not predictable as far as timing is concerned and many people de-emphasize them, we consider them as good as interest income and continue to search out opportunities for making these gains in the future. The $207 million in realized gains in 1997 was virtually all from common stock (see note 2).

The table on page 54 shows the returns on our investment portfolio. Investment income (interest and dividends) increased again in 1997 due to CTR and will do so again in 1998 due to Sphere Drake. Pre-tax investment income per share has increased from $15.42 per share in 1996 to $23.64 per share in 1997 and should increase in 1998 to approximately $30.00 per share because of Sphere Drake.

Gross realized gains totalled $223 million. After realized losses of $5 million and increased provisions of $11 million, net realized gains were $207 million. The major contributors to realized gains were Stelco ($25.7 million), Torstar ($23.6 million), Emco ($14.4 million), Edper Group ($14.1 million), Trizec ($10.8 million), E-L Financial ($7.5 million), CHUM Ltd. ($5.9 million), Dofasco ($5.7 million), Rothmans ($5.4 million), Gentra ($4.5 million), Jannock ($2.2 million), St. Lawrence Cement ($2.0 million), Morrison Petroleum ($1.9 million), Firebird Fund (a Russian mutual fund – $19.5 million), RLI Corp. ($7.8 million), Twentieth Century ($5.9 million), Outboard Marine ($4.8 million), Loews ($3.7 million), Salomon ($3.3 million), Partners Re ($2.1 million), American Express ($2.1 million) and Fifth Third Bancorp ($1.1 million).

Last year we made the point that "with many warning lights flashing, we were being more cautious than usual in making any new stock investments". Since making this profound statement, the TSE 300 and S&P 500 have increased 13% and 31% respectively in 1997. However, we have (perhaps stubbornly!) not changed our mind. In fact, we feel compelled to change the "warning flashing lights" to "red alert". Given the levels of the market, the possibility of deflation (or certainly no inflation) caused by massive Asian stock market and currency devaluations, mindless "long term" investing in mutual funds by individuals and a lack of investment "values" in the North American stock markets, we have reduced our U.S. and Canadian common stock investments significantly.

Perhaps an example will illustrate the amount of speculation in the U.S. market. According to a recent Doom, Boom and Gloom report by Marc Faber, GE's current market capitalization of $241 billion exceeds the combined value of the stock markets of Malaysia, Indonesia, Thailand, the Philippines and South Korea. Readers with a sense of history will remember that the market capitalization of Nippon Telephone, the Bell Canada of Japan, in 1987/88 exceeded the total value of the Canadian stock market. The Japanese market dropped 60% from 1989 to 1991 and Nippon Telephone, ten years later, is still 62% below its 1987 high. According to the November 21, 1997 issue of *Grant's Interest Rate Observer*, GE is currently selling at 2.5 times revenue (the previous peak being 1.4 times in 1972) and 27.5 times earnings (the previous peak being 28 times in 1972). In case you have forgotten, between 1972 and 1974, the S&P 500 dropped by approximately 50%!

There are two major risks that we see in the U.S. and Canadian financial markets. The first risk is mutual funds. Eleven years ago, Citibank, one of the largest U.S. banks, had US$196 billion in assets while Fidelity, the largest mutual fund organization in the U.S., had US$70 billion in assets. Today, Citibank has US$311 billion in assets, while Fidelity has US$550 billion. Since the depression, the U.S. and other major countries have developed mechanisms, including central banks like the Federal Reserve and the Bank of Canada, to prevent runs on banks. Today, the money is no longer in the banks but in mutual funds which are one phone call away from having a run on them with no preventative measures in place. A run on equity mutual funds could cause a "virulent decline", as Mr. Greenspan would say, in stock prices which could have a negative impact on the economy causing further damage.

The second major risk we see is what *Friedberg's Commodities and Currency Comments* considers to be the "repricing of risk". Falling interest rates and a benign economy have resulted in yield spreads declining significantly and bond investors reaching for yield. We are particularly cautious about bonds collateralized with consumer debt (credit card receivables, second mortgages, auto dealer receivables, etc.). We think future default experience will be significantly worse than the past and these type of bonds will experience "a repricing for risk". We do not own any of these bonds and own only very good quality bonds. I hope we haven't made you too uneasy!

So where have we invested the Fairfax portfolios? In common equities, while we are very concerned about North American markets, we see many excellent opportunities in Japan and the Far East. These markets have come down 50%+, and many currencies are down at least as much. We plan on adding to our positions in Japan and other Asian countries while maintaining our Latin American investments and reducing further our U.S. and Canadian investments. As of December 31, 1997 our common stock holdings in total were only 10% of our $5.8 billion investment portfolio the lowest level since we began at Fairfax.

In the bond area, we have built very significant holdings of "put" bonds over the past three years. These are high quality bonds that have dual maturity dates – the first maturity date being from 3 to 10 years and the second from 15 to 40 years. The issuer pays a slightly lower interest rate for providing this feature. From the buyers' perspective, if interest rates go up, these bonds trade like short term bonds, but if rates drop, these bonds trade like long term bonds. The risk/return characteristics of these bonds are excellent and Brian Bradstreet has accumulated approximately $2.2 billion of these bonds. If long term interest rates continue to decline, these bonds have significant upside potential.

The stress testing of violent market fluctuations on regulatory capital that we do monthly at Fairfax (which we now call our "doomsday test") continues to show that all our companies meet this test. As previous comments indicate, we are concerned that our "doomsday" scenario may be tested some time soon.

Miscellaneous

You may have missed that dividend cheque again that we paid you in 1997. By purchasing 5,100 shares at about $309 per share for a total cost of $1.6 million, we indirectly gave you a dividend of 14¢ per share. While we have had very minimal stock buybacks in the past few years, we should remind our newer shareholders that we have bought back significant amounts of our shares in the past (i.e. 1.6 million shares or 25% in 1990). By the way, you may not know, but the Michael Jordan of stock buybacks was Henry Singleton at Teledyne. Henry began Teledyne in 1961 with approximately seven million shares outstanding and grew the company through acquisitions while shares outstanding peaked in 1972 at 88 million. From 1972 to 1987, long before stock buybacks became popular, Henry reduced the shares outstanding by 87% to 12 million. Book value per share and stock prices compounded in excess of 22% per year during Henry's 27 year watch at Teledyne – one of the best track records in the business. We will always consider investing in our stock first (i.e. stock buyback) before making any acquisitions.

Please review page 70 which is an unaudited, unconsolidated balance sheet showing you where your money is invested. As you can see, we have $1,240.8 million invested in our reinsurance companies, $699.0 million in our insurance companies, $30.4 million in Lindsey Morden, $6.8 million in Hamblin Watsa and $207.1 million in cash. Our insurance companies and Lindsey Morden are carried at their underlying book value, i.e. very conservatively stated. You can see how conservatively stated when you note that General Accident paid $738 million or in excess of two times book value for Canadian General – a company not much larger than Lombard. While all our insurance companies are conservatively valued on our balance sheet, please do not look for a quick bonanza as *none* of them is for sale – at any price! As long term shareholders of Fairfax, you benefit greatly from the fact that all our presidents run their companies as their own with a loyalty and commitment that is unmatched in the industry. Any short term sale for a one time gain would destabilize this loyalty and commitment, ultimately resulting in lower long term returns for Fairfax.

Since we began in 1985, twelve years ago, our book value per share has compounded at 41% annually, while our stock price has compounded at 47% (both not repeatable in the future). During this time period, Fairfax has averaged a return on average equity of 20.4%, in excess of our objective and in excess of all but three companies on the TSE 300. So you can see, earning 20% on equity over time is very difficult – particularly with a much larger equity base. Having said that, this continues to be our goal over the next five years.

So what strengths does Fairfax have that will help it to achieve a 20% return on equity in the future? Let me list them for you.

1) Five main established insurance companies (Commonwealth, Federated, Lombard, Markel and Ranger) and three main established reinsurance companies (under the Odyssey Re Group) with strong management teams focused on underwriting profit. Together this adds up to a widely diversified base of $1.8 billion in premiums and about $10 billion in assets.

2) An investment team with a proven track record over the long term with the ability to invest directly or indirectly in any market in the world, managing an investment portfolio of $5.8 billion which should produce investment income (interest and dividends only) of $330 million annually or approximately $30 per share.

3) A lean head office team which is experienced in monitoring operations and in reacting quickly to make an acquisition when opportunities develop, in all cases with a continuing focus on financial conservatism and protecting the company from worst case events.

4) A track record of creating wealth for shareholders for the past twelve years while maintaining financial soundness. This results in our ability to access the stock and bond markets for long term capital and the banks for short term capital.

5) A twelve year record of treating people fairly. A company that *has not* and *will not* compromise its integrity.

6) A commitment to build our company over the long term – and not to flip it in the next few years. The whole focus of Fairfax is the *long term*.

Before you accuse your Chairman of excessive optimism (not uncommon), I should immediately direct your attention to the section on Issues and Risks on page 60 that lists the risks that Fairfax faces. Sorry, no free lunch!

We had another excellent annual meeting last year at the Metro Toronto Convention Centre – excellent because many of you came and your questions benefitted all shareholders. This year, our annual meeting will be held at 4:30 p.m. on Tuesday, April 14, 1998 in Room 106 at the Metro Toronto Convention Centre. As always, all our presidents, as well as the officers of Fairfax and the investment professionals at Hamblin Watsa, will be there. Given the fluctuations in the price of Fairfax stock, I may come incognito. We look forward to seeing you there.

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 27, 1998

V. P. Watsa

V. Prem Watsa

Chairman and
Chief Executive Officer