To Our Shareholders

With the help of strong financial markets *again*, we earned 20.1% on average shareholders' equity in 1998 (versus approximately 3.2% for the TSE 300). Net income after tax increased by 67% to $388 million. After a 9% increase in shares outstanding, earnings per share increased by 51% to $32.63 per share. Book value per share increased by 47% to $185 per share and our share price followed suit, increasing 69% to $540 per share. Given the number of catastrophes we faced in 1998 and our poor underwriting results, we were very fortunate to report the results we did.

Since we began in 1985, thirteen years ago, our book value per share has compounded at 41% annually, while our stock price has compounded at 48% (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 3 companies on the TSE 300 and 57 companies on the S&P 500. So you can see, earning 20% on equity over time is very difficult – particularly with a much larger equity base. You may be interested to know that over the last thirteen years, there is only one Canadian company and two U.S. companies whose stock price has compounded at a rate faster than ours. That's one for the history books and will not help you in the future – as we will be very pleased if we can compound at rates less than half our historical rates.

While we are very gratified by these results, we are even more grateful for the fact that they were achieved by treating our customers, employees and shareholders – and others that we deal with – in a fair and friendly way. As we said in our 1995 Annual Report, ''This approach to business may penalize our results in the short term, but it is the only one we feel comfortable with and the way you can expect us to behave in the future.'' However, I would caution certain readers of this report not to mistake our approach to business as a sign of weakness – as it definitely is not!

In terms of growth, Fairfax had one of those jet-propelled years that we have had only twice before (1986 and 1990). Investments and net premiums written on an annualized pro forma basis just about tripled in 1998 because of the acquisitions of Skandia International, Crum & Forster (CFI) and TIG. You may well be suspicious that we mistake frenetic activity for results!

In our letter to you on May 19, 1998, we discussed the purchase of CFI and Skandia International and, in case some of you missed it, we have reprinted it for you in the Appendix. Please read it carefully as it not only outlines the reasons for our purchase but also the risks involved. The risks are many at CFI but with the strong leadership of Bob Rich and Jim Stark, we feel comfortable that this will be a very significant opportunity for us.

By the way, Jan Wangärd, the President of Skandia International, was the Chief Financial Officer of Skandia Insurance, Sweden when we purchased its subsidiary, Skandia America (now Odyssey Reinsurance, New York). We very much liked Jan when he was on the opposite side of the negotiating table but much prefer to have him on our side. We welcome Bob Rich, Jim Stark and the employees of CFI as well as Jan Wangärd and the employees of Skandia International (now named Odyssey Re Stockholm) to the Fairfax Group.

Late in 1998, we announced the purchase of TIG Holdings, Inc., a NYSE-listed insurance holding company, for US$16.50 per share in cash or US$847 million for the whole company. TIG Holdings owns two main subsidiaries: TIG Insurance, based in Dallas, Texas, which writes primarily commercial insurance of US$1 billion net, and TIG Reinsurance which writes approximately US$0.4 billion net. TIG Holdings has investment assets of approximately US$3.9 billion and book value of US$1.1 billion (approximately US$22.10 per share). TIG Holdings will be the second public company that Fairfax has purchased.

So why are we buying TIG Holdings? The major reasons are:

1) The addition of TIG Re to the Odyssey Re Group makes our reinsurance operations among the largest in the U.S. broker reinsurance market. With capital in excess of US$1.6 billion and net premiums written in excess of US$1.1 billion worldwide, Odyssey Re has become one of the largest reinsurance groups in the world. TIG Re's business is primarily in the U.S. but it does have a branch in the U.K., two Lloyds syndicates and a small Latin American operation with an office in Chile. Also, TIG Insurance adds approximately US$1 billion in premiums to our approximately US$0.9 billion base of U.S. commercial insurance premiums, putting Fairfax among the 15 largest commercial insurance groups in the U.S. Both TIG Re and TIG Insurance have many specialized commercial lines (though in this soft market it does not make much difference!) that will be a long term benefit to us. Both TIG Re and TIG Insurance are currently rated A by both A.M. Best and S&P.

2) We very much like the management of the subsidiaries of TIG Holdings. Michael Wacek, President and Chief Executive Officer of TIG Re, and Roland Jackson, Chief Financial Officer, have been at TIG Re for less than a year but have excellent long term records with their previous employers. As TIG Insurance was managed by the holding company in New York and the President decided not to join us, Courtney Smith will be the new President of TIG Insurance. Courtney comes to TIG Insurance with a very successful track record of underwriting profitability with Coregis.

3) Similar to our other acquisitions, TIG Holdings provides Fairfax with business and investment diversification.

4) The discount to book value of US$5.60 per share or US$280 million provides significant downside protection from reserve development or reinsurance recoverable bad debt. TIG insurance also has a US$90 million indemnity from Transamerica for environmental and asbestosis exposure which has yet to be used. Unlike our other recent acquisitions, TIG has very little exposure to these long tail liabilities. I hope you are not disappointed!!

5) With a combined ratio of about 105% and TIG's investment portfolio of US$3.9 billion, Fairfax should achieve its 20% objective on its purchase price of US$847 million.

6) We were able to raise financing for the purchase of TIG on fair terms which made Fairfax's financial position even stronger.

As with any acquisition, there are risks and the main ones are discussed below:

1) TIG Holdings has a mediocre track record with a combined ratio of 108.5% since going public in 1993. Excluding the onetime US$145 million increase in reserves in 1997 though, TIG Holdings has had a combined ratio of 106.6% (107.7% at TIG Insurance

and 104.3% at TIG Re). All in all, return on shareholders' equity from 1994 to 1998 has averaged only 6.8%.

2) TIG Insurance does its business through managing general agents who have the ability to bind the company. In insurance jargon, we have ''given the pen'' to our key agents. This can be very risky as the agent perhaps has less incentive to focus on underwriting profit. TIG Insurance minimizes this risk by being very selective in the choice of agents and by having very strong controls to ensure underwriting profitability.

3) In the insurance and reinsurance business there is always the possibility of reserve development from the past and reinsurance recoverable bad debt coming to haunt us. Our analysis of TIG's reserves and reinsurance recoverable suggests that we have more than adequate protection from worst case events from the discount to book value but what else would a buyer say? Again, only time will tell and sometimes, as you will read later, it is not a good story!

4) There is always the risk of growing too quickly. We think not, because of the excellent people who will be joining the Fairfax group through the purchase of TIG Holdings and also because of additions to the head office (reluctantly!) – but it's something we are very conscious of!

We raised financing for the purchase of TIG Holdings by the issue of 2 million shares of Fairfax at $500 per share to raise $1 billion or $960 million net. To put this financing in perspective, the 2 million shares we sold in 1986 raised us only $20 million! It took us months to raise the $20 million in 1986 while the $1 billion took us a week from the announcement of our purchase of TIG Holdings ($800 million the next day!) – and perhaps rightly so, because our shares were a lot more risky at $10 than at $500 per share. We have always said that we considered our shares as good as cash and this was demonstrated again in 1998. Since that issue in 1986, that they perhaps should not have done, Dick Falconer and CIBC Wood Gundy have led our equity issues, ably supported by Nesbitt Burns, ScotiaMcLeod, RBC Dominion Securities, Merrill Lynch, TD Securities, First Marathon, Deutsche Morgan Grenfell and Newcrest Capital.

Our bond issue for the purchase of CFI was led by CS First Boston and strongly supported by Deutsche Morgan Grenfell, Citicorp and Salomon Smith Barney. 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. We received our first A– rating for our senior debt in 1998 from DBRS. As emphasized in the past, *ad nauseam*, our company is run for the *long term* benefit of our shareholders while maintaining a very strong financial position which will benefit our bondholders. The emphasis though is 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.

Please don't forget what we said in our 1996 Annual Report, ''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!'' And, unlike prevailing practice in the financial markets, you will *not* get a ''profits warning'' announcement from us. To further dampen your expectations, we suggest you read our old Annual Reports that list all the mistakes we have made in the past (even I don't do that with a full stomach!).

By way of perspective, the table below shows you how significantly we have grown in the past five years:

As of December 31	**1993**	**1998***	**Increase**
	($ billions except share and per share data)		
Net premiums written	0.15	5.5	37x
Investment portfolio	0.80	18.0	23x
Shareholders' equity	0.30	3.2	11x
Net debt	0.10	1.5	15x
Shares outstanding (millions)	8.0	14.1	2x
Investments per share ($)	107	1,300	12x
Book value per share ($)	35	225	6x

* *Pro forma for CFI and TIG*

While this growth is mind-boggling even for us, the bad news is that it was not based on a ''vision'' statement or long term plan that we have at Fairfax (I have checked but have yet to find it!). This, of course, means that this growth *cannot* be extrapolated in the future (we will own the world if it is!). However, it does mean that with a premium base of $5.5 billion, an investment portfolio of $18 billion and excellent management at our operating subsidiaries, we have a sound base of operations to deliver 20%+ return on equity to our shareholders in the long term with no acquisitions. I'm not saying we won't make any more though if the stars and the moon are all in alignment!

While all this activity took place in the past five years, there have been no additions to our small staff at Fairfax (with the one exception of Francis Chou in 1996) since 1989! Isn't that difficult to believe? Fortunately, John Varnell and Rick Salsberg decided to add Trevor Ambridge and Brad Martin in 1998. Trevor Ambridge was a partner at Coopers & Lybrand for thirteen years and more importantly had been the partner on our account for ten years, while Brad Martin was a partner at Tory Tory (our lawyers) for four years and on our account for five years. We are extremely fortunate that these two individuals have joined Fairfax and, along with Rick Salsberg, John Varnell, Brenda Harvey, Sam Chan, Ronald Schokking and Francis Chou, rest assured we have significant unused capacity for growth if it comes our way!

After being Chief Financial Officer for the past ten years, John Varnell decided to pass the mantle on to Trevor Ambridge as he spearheaded a new initiative for Fairfax. During 1998, The Hub Group Ltd. was created which owns eleven insurance brokers in Canada with 50 offices, 700 employees and approximately $60 million in commission revenues. The company raised $50 million in early 1999 through an IPO and private warrant issue with Fairfax having a 45% interest. John Varnell is the Chairman of The Hub Group, representing our interests, while Rick Gulliver is the President and Chief Executive Officer of the company. This is a very strategic holding (i.e. forever) for us and the company has excellent long term growth prospects with John and Rick at the helm. John will continue to oversee our Canadian operations while Trevor and Francis watch over our non-Canadian operations. I continue to be amazed at what a few capable, hardworking, trusted individuals can accomplish working together as a team with no egos.

Over the years, I have mentioned many times (1986, 1995 and 1997) that you have a major short term disadvantage by my controlling all the multiple voting shares. You cannot grow rich quickly by buying Fairfax shares as my shares (should I say votes!) are not for sale as we are building our company over the next 20+ years. Also, we have said that none of our subsidiaries is for sale, irrespective of price. This major negative for you is a very significant positive for our subsidiaries, as today we are one of the very few companies in the P&C industry (for that matter, any industry!) that can escape the trauma of being swallowed up in the current merger and acquisitions activity which is not limited by size. Thus, many of our much larger competitors in the U.S. (and elsewhere) are fearful for their independence and sometimes, as a defensive move, make uneconomic acquisitions. We will not *knowingly* make uneconomic acquisitions and our managements can truly build for the long term unencumbered by fears about their company being sold.

Also rest assured that the experience at Oshawa Group will never take place at Fairfax. When that company was taken over in 1998, the multiple voting shares were purchased at $116 per share while the non-voting shares received $36 per share (a 69% discount). We continue to be surprised at the atrocities that take place in the marketplace.

The table below shows the sources of our net earnings.

	1998	**1997**
	($ millions)	
Insurance underwriting	(311.4)	(56.2)
Interest and dividends	432.0	242.3
Total	120.6	186.1
Realized gains	440.8	206.8
Claims adjusting (Fairfax portion)	12.4	1.8
Interest expense	(84.4)	(43.2)
Goodwill and other amortization	(5.0)	(4.8)
Corporate overhead and other	(15.9)	(15.0)
Pre-tax income	468.5	331.7
Less: taxes	81.0	99.2
Net earnings	387.5	232.5

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 ($3.6 million). The corporate overhead expense is net of Hamblin Watsa's pre-tax income and interest income on Fairfax cash balances 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 68 to 73.

The increase in underwriting losses in 1998 was largely due to Ranger ($114.3 million) again as well as Odyssey Re Group ($154.6 million). Catastrophes significantly impacted us in 1998 as Hurricanes Georges and Mitch cost us $28 million and the Quebec ice storm $16 million. Interest and dividend income, as well as interest expense, increased because of the Odyssey Re London and Bermuda acquisition late in 1997 and the CFI acquisition in 1998. Lindsey Morden's contribution was at a record level while corporate overhead and other increased slightly. Realized gains were more than twice the record 1997 levels, more than offsetting the increase in underwriting losses, and were the main reason for the increase in earnings in 1998. Fairfax's effective tax rate was 18% in 1998 mainly reflecting tax-free Canadian dividend income and international operations and capital gains with lower tax rates.

Book value per share increased from $125.38 to $184.54 per share, approximately half from earnings and half from our share issue.

Insurance operations

The table below shows the combined ratios of each of our companies for 1997 and 1998. As you can see, 1998 was a very poor year for our underwriting operations. Even Commonwealth had a difficult year! Our Canadian insurance operations had a combined ratio higher than the 100.0% in 1997. Ranger was a disaster with a combined ratio before internal stop loss of 156.8% (146.0% after an internal stop loss treaty). CFI, excluding accounting adjustments, was running at 116.6% for the approximately five months since we acquired it. Odyssey Re Group also had a poor year with a combined ratio of 115.6%. While the insurance industry was as competitive as ever, our performance in 1998 was significantly worse than the industry.

	1998 %	**1997** %
Commonwealth	108.5	88.8
Federated	100.1	97.4
Lombard	102.8	102.8
Markel	106.8	103.0
Total Canadian insurance	*105.2*	*100.0*
Ranger	146.0	112.1
CFI	116.6	–
Total U.S. insurance	*123.2*	*112.1*
Odyssey Re Group*	115.6	104.7
Total reinsurance	*115.6*	*104.7*
Total	*113.0*	*103.8*

** includes Odyssey Re London and Bermuda for one month in 1997*

Commonwealth, led by John Watson, hit an air pocket in 1998, mainly due to an oil drillers'/operators' extra expense program that had gross losses of $30 million for a net impact of $12.6 million. Commonwealth had a combined ratio of 108.5%. Hurricane Georges also cost the company $5 million net.

In 1998, Commonwealth's gross premiums written dropped by 17% to $196 million, while net premiums written dropped by 12% to $73 million. Commonwealth earned $15.6 million after taxes.

Federated, under John Paisley's leadership, had another excellent year in 1998 with a combined ratio of 98.0% for the property and casualty company (100.1% including the life operations). John and his management team have had combined ratios of less than 100% in eight of the last nine years in the property and casualty company.

In spite of the soft market, Federated's property and casualty company increased gross premiums written by 3% to $62 million while net premiums written increased 3% to $54 million. During the year, Federated's property and casualty company obtained four additional trade association recommendations for its target markets and retained over 90% of its commercial policyholders while reducing its expense ratio to 29.9% (from 31.4% in 1997). Federated Life also had a fine year with a 17% growth in premiums written. All in all, an excellent year for Federated. The company earned $8.1 million after taxes in 1998 versus $7.7 million in 1997.

In spite of the Quebec ice storm ($8 million net), Byron Messier and his management team at Lombard had another very good year in 1998 – even though they just missed the 100% objective! Including the continuing high marketing costs for the Privilege 50 program, Lombard had a combined ratio of 102.8%. Excluding these marketing costs, Lombard had a combined ratio of 101.4% – commercial lines at 101.1% and personal lines at 104.4%.

Net premiums written from the Privilege 50 program increased by 79% to $25 million in 1998 (versus $14 million in 1997). While the loss ratio on the business was slightly higher in the 77% area, high marketing costs resulted in a combined ratio of 159% for this program. We continue to expect this to be a good program for Lombard and its customers in the future.

Lombard's gross premiums written (including CRC (Bermuda)) increased by 4% in 1998 to $523 million, while net premiums written increased by 5% to $485 million. Net income after taxes dropped by 37% to $52 million due to lower realized gains.

As mentioned in last year's Annual Report, Falcon, our Hong Kong company, was established in January 1998 with Kenneth Kwok at the helm. With an A– rating from S&P, Falcon should gradually begin to establish itself in the Hong Kong marketplace. Kenneth works closely with Byron Messier and Kim Tan from Lombard.

Markel's combined ratio of 106.8% in 1998 was slightly higher than in recent years due mainly to an extraordinary frequency of large losses and also due to its trucking line's very competitive market conditions. Excluding the impact of these extraordinary losses, Markel's portfolio continued to run smoothly with a normalized combined ratio of 101.6% for 1998. Overall frequency remained consistent with prior years. While gross premiums written increased by

5% to $77 million, net premiums earned decreased 15% to $56 million. Net income after taxes decreased by 21% to $5.9 million because of lower realized gains.

Over the past four years under the leadership of Mark Ram's team, Markel has written $350 million of business at a cumulative combined ratio of 103.8%. The company continues to post conservative reserves. Although Markel's niche has never been an easy one, the company continues to lead the Canadian long-haul trucking insurance market with an unparalleled level of service and the highest combination of ratings of any insurer in the line. Once again, Markel's insureds agreed with the Markel philosophy, as over 88% chose to remain with the company in 1998. Markel remains focused on the long term, working to define Canadian transportation insurance for the next decade.

Ranger had a disastrous year in 1998 – the worst year in its history and the worst results of any company under our stewardship over the past 13 years! Ranger had a combined ratio before internal stop loss of 156.8% (146.0% after an internal stop loss treaty) – and after I said last year that I thought they were close to 100%! The company had the largest single fire loss in its history (gross US$46 million; net US$5 million) in 1998 and case under-reserving problems surfaced *again*. We increased case reserves by US$48 million in 1998 – after my comment to you that we felt we were well reserved at year-end 1997.

Bob Rich has made many significant management changes at Ranger and hired Phil Broughton as President as he moved on to join CFI as Chairman and CEO.

Ranger's underwriting loss in 1998 was $114.3 million; after investment income, the company lost $58 million after taxes – another record that Fairfax could well do without! Ranger and I have been more optimistic about loss ratios than warranted as results of the company have clearly demonstrated. Ranger has been a problem child for us for five years now – it shows you that in spite of good intentions, insurance can be a very tough business! In 1999, Ranger will be downsizing significantly as Phil Broughton focuses on product lines that clearly have prospects for underwriting profit. I have said to you in the past that only time will tell – and in the case of Ranger, it is clearly not a good story! No predictions from me on Ranger – I will wait for the results to speak for themselves!

We closed our purchase of CFI on August 13, 1998. While the combined ratio in the second half for CFI was in excess of 115%, significant realized gains resulted in net income after taxes of $185 million. Early in 1999, CFI announced a re-organization to better serve clients and reduce costs as it reduced the number of operating regions from 20 to 6. All affected associates of CFI will be well looked after in this reorganization. Bob Rich and Jim Stark are clearly focused on achieving a combined ratio of 110% in 1999, 106% in 2000 and 104% in the following year.

Odyssey Re Group completed its first full year of operation in 1998 with Jim Dowd as Chairman and Andy Barnard as President and CEO. Michael Watson was named Executive Vice President and Chief Operating Officer of the Group while Jan Wangärd was appointed President and CEO of Odyssey Re London and Bermuda. Early in 1999, Michael Wacek from TIG Re became President and CEO of Odyssey Reinsurance (New York) as well, and Roland Jackson (CFO of TIG Re) became Group CFO. We have an excellent management team at

Odyssey Re Group under Andy Barnard's leadership, which will focus on underwriting profit and building the company in the years to come.

In 1998, Odyssey Re Group had a combined ratio of 115.6% mainly because of Odyssey Re London and Bermuda's combined ratio of 129.2%. Excluding hurricanes and some extraordinary satellite losses, Odyssey Re Group had a combined ratio of 110.4%. Net income after taxes from the Group amounted to $178 million. Andy is focused on steadily reducing the combined ratio of the Group.

During 1998, Odyssey Re Group added offices in Stockholm, Mexico City and Cologne (Germany). As well, our operations in Asia have advanced despite turbulent conditions in the region. Also during the year, North American Programs Division was created which realigns four underwriting divisions from three companies under common strategic management.

Our insurance companies are all well capitalized as shown on page 62. As suggested last year, ''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 1998? We provide extensive disclosure on our claims reserves beginning on page 44 in the MD&A. In Canada, our insurance companies had redundancies of $2.5 million in 1998 while in the U.S. Ranger had a deficiency of US$44 million. Our reinsurance companies had unfavourable development of US$26 million, principally due to Odyssey Re London and Bermuda.

Claims adjusting

Lindsey Morden was transformed in 1998 into one of the very few global loss adjusters in the world. Looking back, it is quite amazing what happened in 1998.

Let me give you a blow-by-blow account:

1) On May 8, 1998, Lindsey Morden announced the purchase of Hambro Insurance Services Group (HIS) for £88 million, a company with which, in 1994, it had created a worldwide loss adjusting and claims management network. In 1997, HIS had revenue of £111 million and pre-tax profit of £10.9 million. HIS owned:

   (a) Cunningham Group, loss adjusters with 140 offices in the United Kingdom, Continental Europe, the Far East, the Middle East and Latin America;

   (b) Hambro Assistance, one of the largest telephone help line services in the U.K.; and

   (c) a one third interest in Oracle (a similar business to Hambro Assistance operating in Canada).

   The purchase was financed through the issue of 4 million subordinate voting shares of Lindsey Morden (of which Fairfax took 2.5 million shares) at $20 per share to raise $78.1 million (net of commissions and expenses of issue) in equity capital and a $125 million, 10 year unsecured debenture issue with a coupon of 7%, which realized net proceeds of $123 million.

2) Hambro Assistance and Oracle were businesses in which Lindsey Morden had no experience and so they were sold for £51 million (£48 million in cash and £3 million in a 2 year note) and £8 million in Sykes' (the acquirer) shares respectively.

3) On October 30, 1998, Lindsey Morden purchased Ellis & Buckle, another premier adjuster in the U.K., owned by Rutland Trust, for £15 million in Lindsey Morden subordinate voting shares at $20 per share and £45.75 million in unsecured notes. These notes were repaid by the cash from the Hambro Assistance sale. Ellis & Buckle has one of the best ten-year track records of any business that we have come across and is run by Gerry Loughney. Ellis & Buckle has been merged with the U.K. operations of Cunningham Group under Gerry's leadership.

Wow! Just writing that was difficult! While the whole management team at Lindsey Morden has done a wonderful job with strong support from Fairfax, these transactions would not have happened if not for Ken Polley, Ferd Roibas and Francis Chou from Fairfax. Ken Polley and Ferd Roibas have had to juggle many roles to get this transformation done and deserve a standing ovation from all shareholders. Francis Chou continues to help focus Lindsey Morden employees on free cash flow and the results are very dramatic. In 1998, Lindsey Morden's North American Operations generated a record free cash flow of $8 million, a total of $22 million in the three years since Francis got involved.

We now have a very strong management team at Lindsey Morden with Ken Polley, Ferd Roibas, Don Smith (North American Operations), Gerry Loughney and Andrew Lund (U.K.), Pim Polak Schoute (Europe) and Jim Grant (International). We welcome all of the employees of Cunningham Group and Ellis & Buckle indirectly to the Fairfax family. We also welcome Christopher Sporborg, formerly Chairman of HIS, Michael Langdon, Chairman of Rutland Trust, and Francis Chou to the Board of Lindsey Morden.

Because of record free cash flow and a very strong financial position, the Board of Lindsey Morden has decided to increase the dividend from $0.60 per share in 1998 to $1.00 per share in 1999. With very strong management, annualized revenues in excess of $500 million, 460 branches all over the world and 4,767 employees, the best is yet to come from Lindsey Morden.

For shareholders who have been with the company since it went public in 1987 at $10 per share, your patience is being (and will continue to be) rewarded. At $30 per share, long term shareholders (i.e. since going public) have had capital appreciation of approximately 11% per year plus dividends. While this is less than our long term objective of 20%, it is much higher than the 4.5% capital return from the TSE 300 during the same period. For further information on the company, please read the annual report of Lindsey Morden, which you can obtain by phoning Ferd Roibas at (903) 561-6700 or (416) 596-8020.

Investment management

While 1998 was another good year in the U.S. equity markets and marginally down in the Canadian equity markets, our equity results did not keep pace. Our bond results in 1998 continued to be 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 and U.S. equities and Canadian and U.S. bonds. HWIC now shows 20 year results as the investment team, consisting of five partners, have worked together for over 24 years.

Annualized rates of return (%)

Cumulative periods ended December 31, 1998

	5 years	**10 years**	**15 years**	**20 years**
Canadian Equities	8.4	9.2	12.1	14.1
TSE 300	10.7	9.7	9.6	11.9
U.S. Equities	25.6	24.3	21.6	21.4
S&P 500	27.8	22.2	19.6	19.3
Canadian Bonds	11.2	13.4	–	–
SM Index	9.2	11.6	–	–
U.S. Bonds	7.9	10.8	–	–
ML Index	6.5	8.3	–	–
Balanced Fund	11.8	12.8	–	–

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

Total fees in 1998 were $12.3 million, up from $9.8 million in 1997 mainly because of the addition of Odyssey Re London and Bermuda and CFI. Fairfax earned a 49% pre-tax cash return in 1998 on its $14 million investment in HWIC.

Financial position

As mentioned in previous reports, we feel our unaudited balance sheet with Lindsey Morden equity accounted (shown on page 70 is the best way to understand our financial position. Here is what our year-end financial position looks like compared to the end of 1997. We have also shown our financial position with TIG on a pro forma basis (which does not reflect the approximately $300 million of additional financing which will be raised to complete this acquisition).

	1998 Pro Forma (with TIG)	**1998**	**1997**
		($ millions)	
Cash and short term investments	305.4	305.4	207.1
Long term debentures	1,444.4	1,444.4	718.4
TIG obligations	375.0(1)	–	–
Net debt	1,514.0	1,139.0	511.3
Common shareholders' equity	3,198.6	2,238.9(2)	1,395.7
Net debt/equity	47%	51%(2)	37%
Net debt/total capital	32%	34%(2)	27%

(1) Includes notes payable US$100 million, capital preferred securities US$125 million and preferred stock US$25 million as debt (aggregate C$375 million).

(2) Excludes $959.7 million of equity raised by December 1998 stock issue in trust.

As shown, common shareholders' equity, our capital, increased by $843 million, $455 million from a stock issue and $388 million from net income. Long term debentures increased due to the US$400 million debenture issue in connection with the purchase of CFI and the weakening of the Canadian dollar versus the U.S. dollar (this translation effect has no economic impact as our exposures are hedged). Our cash position at Fairfax increased significantly to $305 million because of our earnings and because we reduced some of our excess capital at our insurance companies. Our net debt to equity and net debt to total capital ratios increased in 1998 because of two very significant acquisitions and the weakening of the Canadian dollar (as discussed above) but remained at acceptable levels.

As mentioned in last year's Annual Report, a very significant element 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 ($227.8 million), together with additional provisions arising from our recent acquisitions ($220 million), results in our ''rainy day'' cushion of $447.8 million. With TIG, our ''rainy day'' cushion may well increase above $900 million. These cushions, together with the remaining $957 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.

As discussed in last year's Annual Report, we are required to amortize the excess of net assets acquired over their purchase price into income. We have reduced the amortization period from thirty to ten years and used this amortization ($23 million) to offset the amortization of the cost of our S&P puts ($36 million) discussed later in the Investments section.

Our financial position continues to be very strong for the same reasons that we discussed in our 1997 Annual Report. Briefly they are:

1) We have no bank debt. Our debt consists of six public debentures with a long term to maturity (5 years to 39 years) and low interest rates ($6\frac{7}{8}$% to 8.30%) and three small 2 year, 5 year and 8 year debentures issued to vendors with STIBOR*, $7\frac{3}{4}$% and $2\frac{1}{2}$% coupons respectively. All of this debt (except the STIBOR and $2\frac{1}{2}$% debentures, which have 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 most of the public debentures (with the exception of the ones maturing in less than 10 years) into floating rates, saving approximately 71 basis points on average currently. Also, we swapped US$125 million of our 7.375% debentures due April 15, 2018 for Japanese yen denominated debt of the same maturity with a fixed rate of 3.48% per annum (see note 5).

2) We have unused, unsecured, committed, long term bank lines in excess of $1.3 billion with excellent covenants. These bank lines are with five Canadian, five U.S. and three European banks. In addition, we have LOC facilities in excess of $100 million.

* *Swedish interbank offered rate*

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 geographically from Canadian, U.S. and international sources 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 which are much less than our maximum dividend-paying capacity. Note Fairfax's parent company-only income statement on page 75.

5) With $305 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 significant solvency margins in excess of mandated regulatory levels.

7) Our foreign exchange exposure from our U.S. insurance and reinsurance companies has been fully hedged by the U.S. debenture issues and the purchase of foreign exchange contracts. We have done the same for CTR (in French Francs) and Odyssey Re London and Bermuda (in U.S. dollars).

Investments

While 1997 was the best ever for realized gains, 1998 was even better! The unrealized gains as of year-end are shown below:

	1998	**1997**
	($ millions)	
Bonds	28.0	116.6
Preferred stocks	4.4	25.5
Common stocks	(26.9)	(19.4)
	5.5	122.7

We realized an amazing $441 million in gains in 1998 – more than double the $207 million in 1997 – and thank goodness we did because we would not have made our 20% return objective without it!! To put the realized gains in perspective, it took us 12 years to achieve cumulative realized gains of $500 million – we achieved 88% of it in 1998 alone! While these realized gains are significant, they are less than 4% of our $12 billion portfolio (excluding TIG). While some of you may look at the unrealized gains of less than $6 million at year end 1998 and probably think that we have exhausted our realized gains potential, you may want to note that:

(1) We have $797 million invested in common stock on which we expect to make significant gains;

(2) We have in excess of $4 billion in ''put'' bonds (described in our 1997 Annual Report) that have significant upside potential if interest rates decline (limited downside if interest rates increase); and

(3) We have US$700 million in S&P Index puts that can result in large profits if the U.S. stock market declines significantly (please note: our letter to shareholders dated October 2, 1998 which describes these puts has been included in the Appendix).

As in the past, the timing of these potential realized gains is very uncertain but we very much expect to make them in the future. The approximately $1 billion in realized gains that Fairfax has achieved over the past 13 years is one of the key reasons we entered the insurance business many years ago. We come to the insurance business with an investment mindset as opposed to an insurance mindset (focused on increasing market share), a key long term positive for Fairfax. With $18 billion in investments after the acquisition of TIG Holdings (all marketable!) and an experienced investment team focused on identifying long term values wherever they are, we continue to expect to achieve significant realized gains in the long term.

The table on page 58 shows the return on our investment portfolio. Investment income (interest and dividends) increased again in 1998 due to Odyssey Re London and Bermuda and the purchase of CFI. Pre-tax investment income per share has increased from $23.64 per share in 1997 to $37.37 per share in 1998 and should increase again to about $69 per share in 1999 because of CFI and TIG.

Gross realized gains totalled $456 million. After realized losses of $2 million and increased provisions of $13 million, net realized gains were $441 million. Net gains from fixed income securities were $347 million while net gains from common stock were $107 million.

The major contributors to stock realized gains were Kookmin Bank ($26.2 million), FCA ($12.8 million), Rothmans ($8.5 million), Korea International Fund ($4.0 million), Reitmans ($3.5 million), Washington Post ($3.1 million), St. Lawrence Cement ($1.9 million), TransAlta ($1.6 million) and Jannock ($1.5 million).

I would rather not comment on one of my major mistakes in the past decade, but as full disclosure is one of our objectives, here are the gory details. In 1989, we purchased 2.2 million shares at $10.25 per share of FCA, one of the largest credit collection companies in North America at that time. FCA had an excellent long term track record just prior to our purchase. Since our purchase, FCA never regained its position in the industry – in spite of our best intentions. We were fortunate to sell our position to NCO Group under their offer to all shareholders at $9.60 per share – about the same price we paid for them almost a decade ago. We showed realized gains because we had written down our original cost of FCA. Another great investment by your Chairman! If I had invested that $22.5 million in 1989 in Coca Cola shares at $7.22 per share (adjusted for splits), your company would have $236 million today as opposed to the same $22.5 million. A very costly mistake, as you can see! We thank Ted Jarmain, who became Chairman of FCA a few years ago, for his hard work at FCA and his help in the sale process. We wish John Moynan, Bob DiSante and the management and employees of FCA the very best in the future.

We continue to be very concerned about the level of the U.S. stock market as discussed in our 1996 and 1997 Annual Reports – even though the S&P 500 increased again by 26.7% in 1998. The possibility of deflation, mindless long term investing in mutual funds and a lack of investment ‘‘values’’ in the North American stock markets do not appear to bother most investors. In fact, speculation is rampant in the U.S. markets as demonstrated by the ‘‘internet’’ stocks. America Online has a market cap that exceeds the total market cap of the five largest Canadian banks even though AOL has been a public company for only six years. Amazon.com has a market cap that is in excess of Sears (U.S.) even though Sears annually earns more than twice Amazon.com's revenues. Finally, Yahoo! has a market cap in excess of Boeing even though the latter has revenues of $55 billion compared to Yahoo!'s $190 million. The speculative juices are flowing freely in the U.S. but the music will stop and many investors (speculators!) will not have any chairs to sit on. *Caveat emptor*!

The following table from Barron's summarizes the key ''Vital and Fatal'' signs for the U.S. stock market.

Vital and Fatal Signs

	1982	**1998**
Dividend yield	6.3%	1.6%
Price/book	1.1	5.0
Price/earnings	7	25
Value of NYSE/GDP	0.3	1.2
No. of equity mutual funds	320	2,500
No. of investment clubs	4,000	32,000

Source: Barron's, October 12, 1998

It is interesting to note that in 1982, with the market at seven times earnings and yielding 6.3%, there were very few ''long term'' investors. Currently, with the market at 25 times earnings (or higher!) and a dividend yield of less than 2%, there are masses of ''long term'' investors in the U.S. Please note again, the increase in equity mutual funds and the number of investment clubs. The U.S. equity market is ''priced for perfection''. There is virtually no margin of safety should there be any negative developments. Count us among the skeptics!!

We continue to have less than 7% of our investment portfolios in common shares and 93%+ of the portfolios in cash and good quality marketable bonds (92% of the bond portfolio in bonds rated A or above). By country, our common stock investments at December 31, 1998 were as follows:

	Book value	**Market value**
	($ millions)	
United States	195	198
Canada	182	155
Korea	168	213
Japan	158	137
Other Emerging Markets	94	68
	797	771

As shown, most of our common stock investments are outside North America — i.e. in Asia and Latin America — where we think the long term investment values are. Francis Chou, Chandran Ratnaswami and Paul Fink have been responsible for identifying the investment values outside North America and we expect to benefit greatly from these investments.

The ''doomsday test'' of violent market fluctuations on regulatory capital that we do monthly at Fairfax 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

In 1998, Fairfax and its subsidiaries donated $5.0 million (1% of pre-tax income) to a variety of charities across North America. When we began this policy in 1991, our annual donations amounted to $200,000.

In the past two years, each of our Canadian subsidiaries has made a one-time significant donation to the charity of its choice in its community. This one-time gift will spread each year to the other communities where Fairfax operates across the world. Also, in 1999, Fairfax will fund 60 scholarships (based on merit and means) for university and community college education in Canada. We are very privileged to be able to invest in the communities in which we live.

Please review page 74 which is an unaudited unconsolidated balance sheet showing you where your money is invested. As you can see, we have $1.8 billion invested in our insurance companies, $1.6 billion invested in our reinsurance companies, $8 million invested in Lindsey Morden (not including 6.2 million common shares with a carrying value of $14.98 per share that are held by our reinsurance companies), $5 million in HWIC and $305 million in cash. Rumour has it that our investment in Noro is worth a lot more than shown on our books but unfortunately it is not for sale!

Our insurance and reinsurance companies and Lindsey Morden are carried at their underlying book value, i.e. very conservatively stated. Unfortunately, you will not see any short term bonanza as none of them is for sale — at any price! As we said last year, ''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.''

As you know, we have never had options at Fairfax but we have provided key officers of our companies with interest free loans to buy Fairfax shares in the marketplace (not treasury stock). At December 31, 1998, as note 10 shows, we had loans of $28 million to purchase 409,142 shares at an average cost of $68 per share. At a 6% interest rate, the annual after-tax cost to you is about $1 million or 8¢ per share. Also, as described in our 1996 Annual Report, we have a very successful 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. If an employee with a salary of only $20,000 had participated fully in the plan over the 11 years of its existence, he or she would have approximately 789 shares worth $426,060 at the end of 1998! We like our management and employees to be owners of the company so as to benefit from that ownership over the long term.

We said in our 1995 Annual Report that you should sell Fairfax if we ever made the TSE options list. In 1998, we continued to have very few shares traded on the TSE compared to other listed companies. During 1998, 3.5 million shares of Fairfax were traded on the TSE or 33% of the float. When compared to all companies listed on the TSE 300, Fairfax's turnover (shares traded as a percentage of the float) continued to rank in the bottom 10%. Interestingly enough, compared to the companies listed on the S&P 500, Fairfax's turnover ranked in the bottom 3%. Thus, even though we are the 25th largest company in Canada, we did not make the S&P/TSE 60 – a happy occurrence! The other measure that indicates to us that we have attracted shareholders with a long term horizon is that I have yet to see Fairfax appear in the monthly listing of shares that are sold ''short'' on The Toronto Stock Exchange. Our focus continues to be on the long term.

The strengths that Fairfax has to achieve its 20% return on equity objective over time have not changed since we listed them for you last year. Neither have the risks – that we have again listed for you on page 64.

In late 1998, Steven Markel and I, to neither of our surprise, decided that the time had come to step off each other's boards as our companies were running into each other in the U.S. Steven Markel has been on the Fairfax board even longer than I have as his family began the business in Canada in 1951. Markel Corporation has been hugely successful in the U.S. and we consider Steven Markel one of the founders of our company. Steven's integrity, experience and strong support were among the key reasons for the birth of Fairfax in 1985 and its continued success in the 13 years following. While Steven and I continue to be very good friends, we will miss his wise counsel at our board meetings. We wish Steven and Markel Corporation great success in the future – unless they are competing against our companies!

Robbert Hartog, Chairman of the Audit Committee, turned 80 early in 1999. Trevor Ambridge and John Varnell are waiting for Robbert to slow down so they can keep up! I wouldn't bet on it!

Our Annual Meeting last year at the Metro Toronto Convention Centre worked out well because many of you came and your questions benefitted all shareholders. While we cannot answer your questions on the telephone, we look forward to answering them all at our Annual Meeting – which will be held at 4:30 p.m. on Tuesday, April 13, 1999 in Room 106 at the Metro Toronto Convention Centre. Again, on your behalf, I would like to thank the board and the management and employees of all of our companies for another 20% year.

March 1, 1999

V. P. Watsa

V. Prem Watsa (signed)
Chairman and
Chief Executive Officer