FAIRFAX

FINANCIAL HOLDINGS LIMITED

1987 Annual Report

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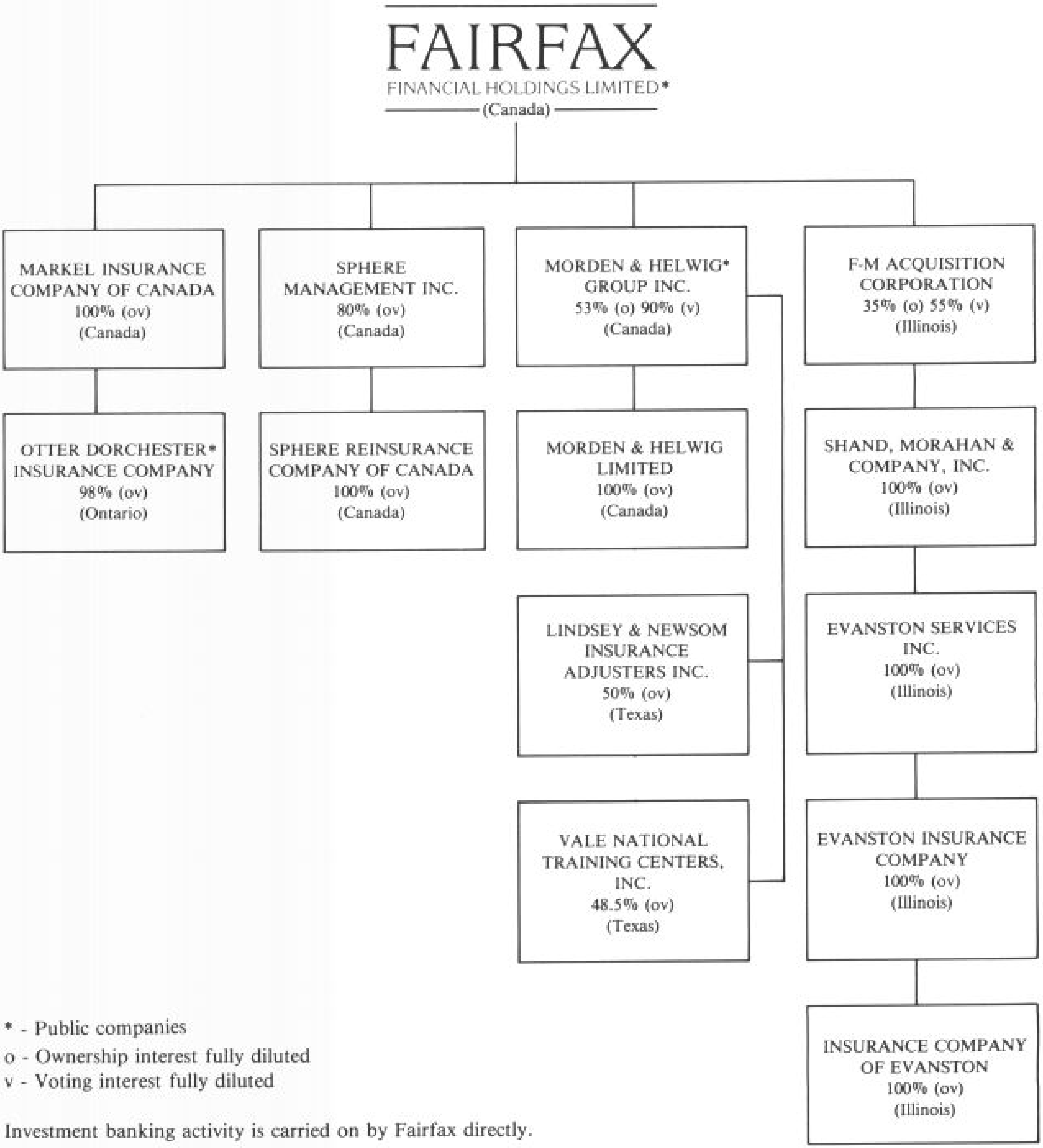
FINANCIAL HIGHLIGHTS

	1987	($000) 1986	1985
Total revenues	112,971	53,733	17,015
Operating earnings after tax	10,795	4,837	(910)
Net earnings	16,019	6,548	(910)
Total assets	185,413	129,845	41,477
Shareholders' equity	61,048	41,275	10,379
Return on average equity	31.3%	25.4%	—
Per share - fully diluted			
Operating earnings	1.50	1.01	(1.89)
Net earnings	2.23	1.35	(1.89)
Shareholders' equity	8.32	5.89	2.08
Market prices			
High	17.50	14.13	6.00
Low	10.50	6.00	3.00
Close	12.37	12.75	6.00

CORPORATE CHART

The following chart sets out Fairfax and its principal subsidiaries and affiliates:



* - Public companies
o - Ownership interest fully diluted
v - Voting interest fully diluted

Investment banking activity is carried on by Fairfax directly.

FAIRFAX
FINANCIAL HOLDINGS LIMITED

CORPORATE PROFILE

Fairfax Financial Holdings Limited is a financial services holding company primarily engaged in insurance and related activities through decentralized operating subsidiaries. The corporate objective is to achieve a high rate of return on invested capital and build long term shareholder value.

F-M Acquisition Corporation acquired Shand, Morahan & Company, Inc. and Evanston Services, Inc., both of Evanston, Illinois, in December 1987. The companies provide specialty insurance coverages, primarily in the professional and product liability markets. In 1987 gross revenues on a combined basis totalled US $134 million and the group had 337 full-time employees at year end.

Markel Insurance Company of Canada is one of the largest trucking insurance companies in Canada and has provided the Canadian trucking industry with a continuous market for this very specialized class of insurance since 1951. For 1987, gross premium volume was $52.5 million and the company had 78 employees.

Morden & Helwig Group Inc., acquired in 1986, is engaged in providing claims adjusting, appraisal and loss management services to a wide variety of insurance companies and self-insured organizations across Canada and in Texas. For the year gross revenues totalled $33.5 million, and the company had 679 employees located in 153 branches across Canada.

Otter Dorchester Insurance Company Limited, acquired by Markel Insurance Company of Canada in 1987, specializes in providing property and casualty insurance for farm risks. In 1987, gross premiums were $10.7 million and staff consisted of 34 employees.

Sphere Reinsurance Company of Canada Limited, acquired in 1986, is one of only two Canadian owned reinsurance companies writing property, auto and casualty risks. Gross premiums totalled $19 million for the 1987 year and there were 7 employees.

To Our Shareholders:

Halley's Comet flew over us in 1987. We earned $16 million after taxes on an average equity base of $52 million - a 31% return on shareholders equity. Given the return on equity earned by the average company in Canada and the U.S. of 13-14% and our own objective of 20%, it is not likely that this return will be repeated in the future. Net earnings per share of $2.15 were up 60% from 1986. Book value per share increased 41% to $8.32 per share.

The table below shows the sources of our net earnings:

	($ millions)		
	1987	1986	% Change
Pre-tax earnings before realized gains	9.0	8.1	+ 11%
Realized investment gains	9.2	1.0	+ 820%
Total pre-tax earnings	18.2	9.1	+ 100%
Income taxes	5.9	4.2	+ 40%
Net earnings before minority interest and extraordinary item	12.3	4.9	+ 151%
Less minority interest	1.5	0.1	—
Add gain on sale of Morden & Helwig shares	3.5	—	—
Add recovery of income taxes	1.7	1.7	—
Net earnings	16.0	6.5	+ 146%

As you can see fróm the table, the major source of our earnings gains in 1987 was two fold:

a) Realized security gains of $9.2 million (after tax - $6.8 million)

b) After-tax gain of $3.5 million on the sale of Morden & Helwig Group Inc. shares.

These two sources accounted for 64% of our reported earnings. While the timing of (a) is uncertain, we fully expect to continue to increase book value over the longer term with these types of gains. Gains like (b) are not likely to be repeated again. All of (a) and most of (b) though are cash earnings and do legitimately increase book value.

As far as realized gains are concerned you should note that we could easily increase our future investment income by selling stocks and buying bonds or preferred stock. However, we invest for total return and thus have no plans on changing our bias towards stocks. Realized gains in 1987 amounted to approximately 8% on the average portfolio.

While earnings before realized gains only increased 11%, our companies are in excellent shape. Markel Insurance had an excellent year under the leadership of Keith Ingoe, earning an underwriting profit even after a significant build-up in reserves. As you will see in Keith's section, Markel Insurance earned a very attractive return on its equity for the second year in a row.

In spite of significant competition, Keith and his team are building a reputation as the best trucking (and lately, transportation) insurance company in Canada. We are excited to be shareholders. In August 1987, Markel Insurance acquired Otter Dorchester Insurance Company, a property and casualty company specializing in the agricultural industry. Otter Dorchester writes $11 million in gross premium (net premium: $3.7 million). We purchased Otter Dorchester for $2.6 million, a 35% premium to its book value of $2 million. Otter Dorchester is run by Reg Black. We welcome Reg and his team to the Fairfax group and look forward to participating in the company's growth as it expands its service to rural communities throughout Ontario.

Sphere Reinsurance, run by Rui Quintal and Bill Grant, had a very good year in 1987, earning 20% on average equity. On our invested capital of $4 million, the returns are exceptional. Based on current actuarial projections, it appears that part of the note of $2.8 million to the former shareholder of Sphere may not be paid due to reserve development prior to our purchase. However, we continue to show the note on our balance sheet at the full $2.8 million. Rui discusses the operations in further detail in his section.

As discussed in our 1986 annual report, we took Morden & Helwig (M&H) public in 1987 to take advantage of the tremendous growth potential in Canada and abroad. The same group that raised $20 million for Fairfax in 1986, did a public offering of $20 million for M&H in 1987 - $15 million for the treasury and $5 million for Fairfax. On your behalf, we again thank Dick Falconer, Jim Hinds and Joe Brosseau from Wood Gundy; Bryan Smith and Rob Bell from Dean Witter Reynolds; and Rick Salsberg and Bob Karp from Tory, Tory for their hard work in completing this issue. We don't plan on this being an annual feature!!!

After months of preparation for this issue, Ken Polley and his team could again concentrate on business at hand. As you will note in Ken's section, M&H had an excellent year in 1987, completing 13 acquisitions in Canada. The share capital raised reduced the company's return on equity in 1987. As M&H is the largest claims adjusting company in Canada, with 679 employees and 153 branches, we fully expect it to earn our targeted 20% return over time.

Prior to the public issue, all Morden & Helwig employees had the opportunity to acquire shares, with the result that a substantial number of employees are shareholders once again.

Late in 1987, M&H and Markel Corporation (U.S.) each acquired 50% of Lindsey & Newsom (L&N). L&N is the largest independent claims adjusting company in Texas with 44 offices and 310 employees. Also acquired was Vale National Training Centers, a school for training adjusters. Total purchase price was US $14 million, approximately 8.6 times earnings for this company; being a service business, book value at US $2.8 million, was not significant.

Bob Irwin runs this fine company with Terry Grant as his first mate. Under Bob's leadership, we see tremendous growth potential in the U.S. We are planning a merger of M&H, Markel Corporation's U.S. claims business and L&N in 1988/89 as a first step in building an international claims adjusting company. In any merger, particularly an across-the-border one, there are many hurdles to be overcome. However, I am very optimistic about the growth opportunities of this company because of the fine people we have to manage it. As shareholders, I would recommend that all of you read M&H's annual report to better understand the business. We look forward to working with Bob Irwin.

The name Fairfax, as we suggested in our last annual report, comes from **Fair, F**riendly, **A**cquisitions. I have already discussed two acquisitions made in 1987 - Otter Dorchester and Lindsey & Newsom. On December 29, 1987, after months of negotiation, Fairfax, Markel Corporation and an investment banker purchased the shares of Shand, Morahan and Evanston Services Inc. from Alexander & Alexander, Kansa General Insurance and C. J. Coleman Holdings. Fairfax is the controlling shareholder but as in our other ventures, we consider Markel Corporation to be our equal partner. At closing, Fairfax has a 35% interest, Markel Corporation 35%, investment banker 20%, Management 5% and Coleman 5% - with Fairfax having the votes and the first call on the investment banker's 20%. This is the biggest deal we have done to date! Shand, Morahan/Evanston is an insurance company specializing in underwriting professional liability. In 1987, it earned premiums of US $105 million, had assets of US $535 million and common equity of approximately US $80 million.

The total purchase price consisted of US $30 million cash and a five year note of US $47 million with almost no interest and no principal payment for five years. Also the note is subject to offset from reserve development and reinsurance uncollectibles associated with insurance written prior to December 31, 1986. The company is run by Joe Prochaska and his team. Joe discusses the company further in his section. We are very impressed with the high quality of the people in this company and under Joe's leadership - we are excited about the potential returns for shareholders from this investment. The downside to this investment is (a) it is in the "long tail" end of the business and so reserves are always uncertain, (b) the judicial system in the U.S. is still largely a lottery, and (c), any losses in this company would significantly impact Fairfax.

We are more optimistic (are managements ever **not!!**) about Shand, Morahan because of the very significant changes that have taken place in their business in the past four years as shown below:

— an increase in premium levels averaging in excess of 400%
— a tenfold reduction in exposure limits from $20-30 million per policy to $2-3 million per policy
— a slowing of growth in the size of court liability awards
— a dramatic increase in selectivity on policy coverage
— a majority of policies written on a "claims made" basis
— the guarantees of A&A, Kansa and Coleman to reimburse adverse development and reinsurance unrecoverables arising out of the 1986 and prior book of business to an amount of US $44.6 million plus interest.

Finally, the investment portfolio at Evanston is in excess of US $280 million which, if managed well, could provide additional returns to shareholders.

As shareholders, we welcome Joe Prochaska and the employees of Shand/Evanston and Bob Irwin and the employees of Lindsey & Newsom to our team. We look forward to a long association.

Fairfax has always prided itself on a strong balance sheet. At year end 1987, a few comments are in order. As in the past, the reserves of all our insurance and reinsurance companies including Evanston Services have been certified by The Wyatt Company, independent actuarial consultants. Goodwill of

$3.4 million on the balance sheet is from M&H ($2.8 million) and Otter Dorchester ($0.6 million). Unfortunately, accounting conventions do not allow us to write these items off. Because of very low capital requirements, strong free cash flow and low book values, M&H will always have goodwill arising from acquisitions. We think this may be a valid asset over time. The Shand, Morahan/Evanston acquisition has resulted in significant off balance sheet debt to Fairfax as discussed in note 14 to the financial statements. Most of this debt is due in five years and is subject to offset from reserve deterioration and reinsurance uncollectibles. This debt is very similar to the $2.8 million note we assumed in connection with the Sphere Re purchase. We think you should know about these even though we think our share of these payments will be quite comfortably met in the future. Our balance sheet is less strong though because of these payments. Also at year end, we had unrealized losses in our portfolio of approximately $7 million. We consider unrealized losses and gains as temporary fluctuations and only measure them when they are realized. Obviously, if we had to liquidate the portfolio at year end 1987, common equity would be reduced by approximately $5 million (after tax impact of unrealized losses). On the plus side, we have been extremely conservative and have provided for additional reserves as and when we could.

Many of you probably realize this already, but as the years go by, it seems to me that all business is, is people. As the CEO of a very successful high technology company recently said, "It is not the processes, technology, etc. that distinguish this company but the ability to attract the best in the business." In 1987, this was certainly true for Fairfax. In last year's annual report, I mentioned that David Rooney joined us as CFO. David's experience and creativity will be one of the major reasons for our success in the future. Later in the year, John Varnell, after many years of experience in private industry and public practice, joined David as Controller. Bill Andrus, with many years' experience as a consulting actuary and publisher of the TRAC Report, joined us as Vice President, Corporate Development. He was instrumental in our making the initial investment in Fairfax (then Markel Financial) in 1985. Paul Fink, with years of experience in investment research and structuring deals, joined us as our one-man Investment Banking Department. Over the years, we expect this area to continue to grow and perhaps become a separate company. Finally, Brenda Adams, who invented our company name, joined us as Corporate Secretary after years of experience at Markel Insurance. Fairfax, as a holding company, has now taken shape. As shareholders (myself included), you should be extremely happy that these people have decided to work for Fairfax. Our future success will be largely dependent on their efforts.

In 1987, we issued 330,000 subordinate voting shares at $14.50 per share to the directors and officers of Fairfax and key officers of independent operating units. These people were given five-year interest free loans to buy these shares. Unlike options, these shares are owned by the individuals and the positive or negative impact of share fluctuations is fully reflected in their economic net worth - just as it is for any of you. The after-tax cost to the shareholders of the interest free loan works out to approximately $260,000 annually. As you probably know, Steven and I do not get paid a salary but we do own 75,000 shares each in this program. Also, both of us have a very significant interest in Fairfax; through Sixty Two Investment Company for me and through Markel Corporation (U.S.) for Steven. All of us at Fairfax have the same interest as yours - maximize shareholder value over the long term.

Also in 1987, we have instituted significant bonus plans and share ownership plans for our insurance companies (M&H already had these in place). These plans are mainly based on underwriting profit with additional bonuses for achieving our targetted 20% return on equity. These plans are unlimited in amounts and flow down through the whole organization. Thus based on performance, it is very possible for management as well as clerical staff in our companies to have significant bonuses. Bonuses at Fairfax, the holding company, are based on returns on equity achieved by the total company.

We have been asked many times as to what the vision for Fairfax is. What are its long term plans? While our independent operating units do have a "vision" and a "mission" statement, at Fairfax, ours is simply to achieve a 20% + return on common equity over the long term. We have no long term plans other than to react to opportunities on a day by day basis. Our operating companies are run independently by the president of each company. He runs it as he wants except for four areas:

1) **Performance evaluation:** He runs it but we evaluate his performance.

2) **Choosing his successor:** As we run our companies with a hands-off style, we need to be comfortable with his successor.

3) **Acquisitions/ Change in business strategy:** Acquisitions are a Fairfax responsibility - particularly price. Also, if Markel went from insuring trucks to insuring satellites, we would like to know!

4) **Financings:** All financings and capital decisions are a Fairfax responsibility.

With these exceptions, each of our presidents runs his operation completely independently.

In the 1985 and 1986 annual reports, we discussed our investment philosophy and guidelines in detail. We manage the insurance company portfolios with a long term value oriented philosophy. Realized gains are the key to long term performance as unrealized gains can disappear at any time. During 1987, we benefitted greatly from the fact that we sold more than 50% of the stock portfolio and realized significant capital gains for the company. However, in the "melt down" on October 19, our cheap stocks went down with the market. An unrealized gain of approximately $10 million as of September 30, 1987 became an unrealized loss of $7 million as of December 31, 1987.

Many have suggested that the crash in October could lead to a depression. Can this be 1929 repeated all over again? Unfortunately, we don't know the answer to these questions. What we do know is that short term fluctuations in the market have always resulted from the twin emotions of fear and greed and have **nothing** to do with the underlying business fundamentals of the country or company. As Ben Graham, dean of security analysts, stated a long time ago in his book "The Intelligent Investor,"

> "The investor with a portfolio of sound stocks should expect their prices to fluctuate and should neither be concerned by sizeable declines nor become excited by sizeable advances. He should always remember that market quotations are there for his convenience, either to be taken advantage of or to be ignored. He should never buy a stock because it has gone up or sell because it has gone down. He would not be far wrong if this motto read more simply: 'Never buy a stock immediately after a substantial rise or sell one immediately after a substantial drop.' "

In 1987, we benefitted significantly from our investment in the natural resource sector. We realized $8.6 million or 80% of our realized profits from this sector. Other significant contributors to realized profits in 1987 were Rothmans ($0.8 million), Ford US ($0.3 million) and American President ($0.2 million). Total realized losses in 1987 were less than $100,000. Our position in the banks hurt our performance in 1987.

As detailed in the 1986 annual report, we continue to be quite optimistic about the long term values available in the U.S. and Canadian markets. The major risk we see is a collapse in the highly speculative Japanese stock and real estate markets. If any of you know when that will happen, please let me know! In the meantime, we continue to focus on identifying long term values and investing in them as and when we find them. At year end 1987, we had $14.8 million invested in industrial products, $13.7 million in the banks and $6.8 million in the mines.

Since we began in September 1985, Fairfax has increased its book value from $1.84 per share to $8.32 per share, earnings from a loss to $2.23 per share, total assets from $28 million to $193 million and common equity from $1 million to $61 million. The stock price has reacted accordingly and increased from $3.25 in September 1985 to $12.38 as of December 31, 1987. In September 1985, we had one operating unit; today we have five. Fairfax now has its own offices and has been able to attract extremely capable people. While you should be cautious about extrapolating the past, we think the long term future of the company continues to be attractive. On your behalf, we would like to thank the Board and the management and employees of our subsidiaries for making 1987 another very successful year.

March 31, 1988

V. P. Watsa

V. Prem Watsa
Chairman of the Board and
Chief Executive Officer.

PRESIDENT'S OPERATING REVIEW

1987 was a year of excitement and success for your company. We achieved most of our goals and with the acquisitions completed at year end are very optimistic about our future.

Total revenues increased over 100% to $113 million. This was primarily the result of the inclusion for a full year of the results of our 1986 acquisitions of Sphere Reinsurance and Morden & Helwig. Additionally, we realized investment gains of $9.2 million as compared to $1.0 million in 1986.

As Prem pointed out, net income increased 146% to $16.0 million but of this, our pre-tax income before realized investment gains was up by only 11%.

As we pointed out in last year's report, the insurance marketplace is continuing its cycle. In 1985 and 1986 price levels were firm and in many cases there was limited availability of coverage. In 1987 we saw more competition and the beginning of a downward pressure on price levels. As we look to 1988 we expect this trend to continue, although we do not expect to see the unrealistic pricing of the early 1980's. In any event, we are committed to maintaining our sound underwriting standards and price levels necessary to earn underwriting profits.

We are mindful of the Canadian legislative changes already implemented or being considered. Of primary importance is the Ontario Rate Review Board, the no-fault study in Ontario and the Federal White Paper on Financial Institutions. All of the opinions we have received to date confirm our belief that these changes will bring increased stability and opportunity to the marketplace. We will continue to monitor these changes as they develop and be in a position to seize the opportunities as they arise.

Our operating companies all participate in different segments of the insurance industry. Each is run independently, yet we share some common goals. Foremost among them is to earn a 20% return on shareholders' equity.

Markel Insurance Company completed a very successful 1987. Underwriting results were quite good and we are very confident that our loss reserves are very conservatively estimated to meet our future obligations. With the increasing competition for insurance for the trucking industry, we have increased our emphasis on the small and mid-sized account where price competition is not as keen. We have continued to enhance our customer service so that price is not the only factor our clients consider. We are certainly the leader in our market segment and are proud of the accomplishments of Keith Ingoe and his team over the past few years.

Markel Insurance's acquisition of Otter Dorchester Insurance Company, specialists in agricultural insurance, brings a new dimension to the group and we are pleased they have joined us.

Sphere Reinsurance Company is focussed on providing reinsurance to the Canadian insurance market. Most of its business is in the proportional property reinsurance market. During 1987, Fairfax increased its investment in Sphere by $2 million so that the company's capital and surplus is now $11.4 million. This will enable Sphere to continue to grow and compete for business.

Morden & Helwig is the leading independent claims management company in Canada. In 1987 Morden & Helwig completed its initial public offering, raising $15 million in additional capital. These funds were put to work as the company completed several acquisitions designed to further enhance its position in the Canadian market. Additionally, the company, in partnership with Markel Corporation (U.S.), acquired

Lindsey & Newsom - the leading claims firm in Texas. This acquisition is the base for further expansion in the claims business as we seek to become a leading international claims organization.

The acquisition of Shand, Morahan and Evanston Services is likely to be one of the most significant events in our company's history. The Shand/Evanston group is one of the leading insurance markets providing professional liability insurance for architects and engineers; errors and omissions, and directors and officers' liability coverage for insurance companies and mutual funds; errors and omissions liability for insurance agents and brokers; medical malpractice for professionals and hospitals; and product liability.

The company's strengths include a strong management team and an excellent reputation in the market. The organization is professional and has a great deal of knowledge and expertise in its particular market niches. Many of its products are large premium policies which are under increasing competition as the insurance cycle becomes softer. As with our other underwriting activities we expect price levels and sound underwriting to generate underwriting profits. As a result, premium revenues will decline as the market softens. Investment revenues, however, should continue to grow as the investment portfolio is in excess of US $280 million and growing.

We welcome the Shand/Evanston group to Fairfax and look forward to their future success.

As we have discussed in our prior reports, we are committed to maintaining a high level of financial security. The 1987 results have increased shareholders' equity to $61.0 million, up almost $20.0 million from last year. We are very confident that we have provided adequately for loss reserves and have again obtained independent actuarial reports to increase our comfort level. As Prem points out, however, we do have significant contingent payments due as a result of the Shand/Evanston acquisition. We believe these obligations can be met or re-financed when they become due.

With our 1987 success as part of our history, we look forward optimistically to our future. We certainly do not expect a 31% return on average shareholders' equity every year, but we remain committed to achieving our goal of a 20% return over time.

March 31, 1988

SAMarkel

Steven A. Markel
President and Vice Chairman

F-M ACQUISITION CORPORATION - OPERATING REVIEW

Selected Financial Information (US $000) Combined Shand, Morahan and Evanston Services

	For the years ended December 31				
	1987	**1986**	**1985**	**1984**	**1983**
Gross premiums written - insurance companies	124,745	157,899	151,961	107,617	73,838
Net premiums earned	105,391	120,110	44,262	15,782	11,975
Net commission and fees	10,728	16,447	19,130	18,341	20,822
Net incurred losses	88,327	104,529	53,284	24,934	12,053
Underwriting loss	9,107	13,209	15,747	11,571	3,724
COMBINED RATIO	108.6%	111.0%	135.6%	173.3%	131.1%
Investment income	18,124	21,681	15,608	12,634	10,419
Earnings after tax	3,094	7,782	4,180	4,860	11,192
Total assets	542,694	472,069	362,225	247,527	193,694
Shareholders' equity	81,021	68,174	60,495	58,165	56,250
RETURN ON EQUITY	4.2%	11.7%	6.8%	8.3%	19.8%

F-M Acquisition Corporation, an Illinois holding company, acquired Shand, Morahan & Company, Inc. and Evanston Services, Inc. and its subsidiaries (Evanston Insurance Company and Insurance Company of Evanston) on December 29, 1987. We were pleased to be incorporated under the Fairfax corporate umbrella prior to year end.

The company through its operating subsidiaries is a major writer of professional liability and specialty insurance coverages in the United States. Shand, Morahan underwrites the coverages, supervises the claims and handles the accounts of all the issuing companies.

Evanston Insurance Company and Insurance Company of Evanston are the risk-bearing entities in the group. Most of the premium volume underwritten by Shand, Morahan is placed through these two insurance companies.

The insurance marketplace in the United States over the last two to three years could be characterized as a "hard" market, or one where there is a restriction of capacity for many coverages. This "hardness" allows adequate premium rates to be maintained because competition is less intense. In 1987, the marketplace began to soften as more capacity to write coverages returned to the marketplace. In some lines of business, this has resulted in price decreases.

Our intent is to maintain the sound underwriting practices we have had in place for the last few years and this may cause some reductions in our gross premium volume. We will not sacrifice underwriting profit for market share, but we will aggressively market our products and seek out the niches where we believe proper pricing can be maintained.

On a quarterly basis we review the adequacy of our loss and loss adjustment expense reserves. In 1987, we did add to prior years' reserves at the insurance company level. This was attributed mainly to the run-off of segments of our Lawyers Professional Liability book of business. There were also some additions to our reserves for potentially uncollectible reinsurance. These adjustments do not affect Fairfax, rather they will adjust the ultimate purchase price to be paid for the two companies.

We have taken all reasonable efforts to properly state the company's loss and loss adjustment expense reserves at year end including obtaining Fairfax's customary reserve certification by an independent actuarial firm.

In 1987, we had the spectre of the sale of Shand, Morahan and Evanston Services adding uncertainty to our business all year long. We also suffered a downgrading in our rating from A. M. Best Co. to "B" from "B+." Finally, one of Shand, Morahan's major accounts - the Professional Insurance Agents Program - was cancelled by the association. Our staff size was reduced to reflect the volume reductions. Despite these events our financial results improved significantly especially at the insurance companies. Our underwriting results have improved and I believe we will continue to improve our profitability in 1988.

Challenges lie ahead for 1988 to continue the improvements in our underwriting results and begin improving our rating from A. M. Best Co. With the sale behind us and the support of Fairfax, our other shareholders and our staff, I am confident we will continue to move forward and successfully address these challenges.

On behalf of the company I would like to extend my sincere appreciation to our staff, insureds, brokers and reinsurers who have supported us throughout.

March 31, 1988

Joseph J. Prochaska, Jr.
President and Chief Executive Officer

MARKEL INSURANCE COMPANY OF CANADA — OPERATING REVIEW

FINANCIAL SUMMARY ($000)	For the years ended December 31				
	1987	1986	1985	1984	1983
Gross premiums written	52,507	51,615	23,415	21,064	24,326
Net premiums earned	42,723	34,633	14,049	16,616	19,620
Net incurred losses	30,515	24,614	13,533	17,588	14,598
Net commission & operating expenses	10,809	7,363	4,147	5,646	6,958
COMBINED RATIO	96.7%	92.4%	125.8%	139.7%	109.9%
Underwriting income (loss)	1,399	2,656	(3,631)	(6,619)	(1,934)
Investment income	11,977	4,297	2,850	2,150	2,104
Earnings (loss) after tax	10,070	5,612	(781)	(4,468)	178
Total assets	97,163	71,525	38,472	29,875	32,048
Shareholders' equity	28,153	18,083	7,471	3,252	6,720
RETURN ON EQUITY	43.6%	43.9%	—	—	2.7%

Markel Insurance Company of Canada is principally engaged in providing property and casualty insurance and related services to the transportation industry. We specialize in insuring small to medium Canadian long-haul common carrier fleets against public liability and property damage. In addition, the company writes small portfolios of cargo insurance, umbrella excess liability insurance and surety.

During 1986, the insurance market remained firm, but in 1987 we saw a slow steady return to increasing competition from property-casualty companies who had previously retired from writing transportation business due to substantial losses and new entries into the market.

Markel, following its stated objectives of adequate pricing and refusing to compete on price alone, suffered some loss of policyholders of mid to large sized fleets from its automotive portfolio. This unavoidable situation was counterbalanced by the specific marketing plan of concentrating on writing small to medium size insurance risks where the competition was less severe. This strategy combined with extending our underwriting to include tour buses, daily car rentals, taxis and surety business enabled Markel to increase its gross written premiums from $51.6 million in 1986 to $52.5 million in 1987. Earned premiums increased from $34.6 million to $42.7 million.

The major share of our business continues to come from Ontario, increasing in 1987 to 65% from 57% in 1986, while Quebec's share shifted to 23% from 29%. The main reason for these changes is the broadening of our underwriting scope to additional classes of business which took place first in Ontario and has since been extended to the other provinces.

Even though the Maritimes and Western Canada produced a smaller volume of premiums written, we are excited about their future. In the second quarter of 1987 we opened service offices in Halifax and Edmonton. These 'two person' offices have marketing and underwriting goals of bringing Markel's facilities back to the regions and providing a viable alternative to the existing market. We have been encouraged by the reception given us by the policyholders and brokers and are looking for positive results of profitable production in 1988.

During 1987 we saw a steady escalation of average claims costs. Our efficient claims handling, combined with sound risk selection and loss prevention services, allowed us to control losses resulting in an earned loss ratio of 71.4%. This compared with 71.0% in 1986. Such a small increase is significant proof of the conservative reserving practices of the company. This has been reinforced through independent actuarial certification of our claims reserves and audits of case reserves.

During the second quarter an opportunity was recognized in the surety business. We added three experienced employees to set up and operate this department. The results were much better than planned with $690,000 of premium income developed. We expect this class to add significantly to underwriting profit in the future.

Despite the increased costs to establish several future profit centres, acquire a complete new automation system, including hardware, and move to new premises, the operating expense ratio was satisfactory at 25.2%. We expect that the unusual expenses of 1987 will be reduced to a more normal level in 1988 and be more consistent with the 21.3% of 1986. Adding the loss ratio of 71.4% to the expense ratio a Combined Ratio of 96.7% was attained as was anticipated in our 1987 plans.

Investment income was much higher than planned due mainly to the excellent capital gains prior to "Black Monday." The impact of "Black Monday" on our investment portfolio was that market value as of December 31, 1987 was $6 million below cost. In spite of this temporary downturn, our capital position is more than adequate to meet regulatory guidelines.

Shareholders' equity grew to $28 million from $18 million in 1986 positioning the company well for future development.

During 1987 Markel planned an ambitious program of upgrading current services. In January 1988 the head office in Toronto was relocated to new quarters which will allow us to make long term plans without fear of space constraints. The introduction of a superior computer system is planned for early 1988. This not only will provide management with up to date information to allow sound decision making, but will provide an underwriting operating system designed to increase productivity and customer service.

During 1987 Markel Insurance Company of Canada acquired through share purchase the Otter Dorchester Insurance Company Limited. This insurance company has $10.7 million of written premiums and specializes in insuring agricultural exposures. The cost of acquiring the Otter Dorchester was $2.6 million and a further $2.5 million was injected to strengthen its capital surplus position and provide a solid base for future growth.

1988 will bring increased challenges to the operation of our business. Competition from other insurance companies for our established policyholders may cause a reduced rate of premium growth. In addition, the intervention of the Ontario Government into rate setting may limit our flexibility in premium charges for the exposure undertaken.

We are confident we will be able to meet these challenges successfully. We will continue to use risk selection wisely, providing services that will inhibit losses and satisfy our relations with our policyholders and brokers. In short, we will service our "Customer." In doing this well, we can expect our plans to succeed.

We are very proud of our accomplishments during 1987 and thanks are due to our insureds and brokers for their support. Our staff again provided an excellent performance and this we know will extend into 1988.

March 31, 1988

Keith E. Ingoe
President and Chief Executive Officer

MORDEN & HELWIG GROUP INC. — OPERATING REVIEW

FINANCIAL SUMMARY ($000)

	For the years ended December 31				
	1987	**1986**	**1985**	**1984**	**1983**
REVENUES	33,528	30,939	27,398	23,331	23,119
Earnings before extraordinary items	2,389	1,423	1,304	660	74
Earnings after tax	2,389	2,155	1,764	740	74
Total assets	34,117	14,501	14,121	12,475	12,178
Shareholders' equity	23,510	6,219	4,429	2,684	1,986
RETURN ON EQUITY	16.1%	40.5%	49.6%	31.7%	3.8%

Morden & Helwig Group Inc. continues to be Canada's largest independent insurance claims management company providing adjusting, appraisal and loss management services through 153 branch offices in all provinces of Canada, as well as the Yukon Territory. These services have been supplemented by the opening of a branch office in London, England in September 1987.

In May 1987, our company raised $14 million after expenses through an initial public offering to position our organization to take advantage of expansion opportunities both in Canada and internationally.

Morden & Helwig's core business of claims adjusting continues to generate approximately two-thirds of our revenue, the balance being derived from loss management services, appraisal services and printing. In total we have 679 employees, of which 352 are licensed adjusters or accredited appraisers.

Our 1987 revenues increased by 8.4% to $33.5 million. This revenue increase is due to increased assignments, particularly during the last half of 1987, as well as a number of business acquisitions. Our per share earnings before extraordinary items increased by 8.5¢ in 1987 to 61.7¢ on a much greater number of shares outstanding.

In July 1987 we acquired all the remaining outstanding shares of Centapp Services Inc., an appraisal and printing company and in addition we purchased 13 other high quality adjusting companies in Canada, the majority of which were acquired late in 1987 so the full impact of their contribution will be felt in 1988.

During the first half of 1987 there was a general decline in the number of claims managed; at year end, however, our volume had improved significantly as a result of the efforts of our sales and marketing department and this contributed to our increased revenue. Weather conditions continue to play a role in our operations, and have resulted in increased assignments arising from the Edmonton tornado and the Montreal flood, both of which caused heavy insured and uninsured losses.

The increased complexity of the claims handled has provided many additional challenges to our corporation which we are meeting through the employment of more, high quality personnel, increased education facility and improved quality control.

During 1987 our company had increased expenses as a result of the initial public offering and the subsequent acquisitions. In addition, there were related expenses in connection with a number of business opportunities which were explored throughout the year and which, for various reasons, were not acted upon.

There have been no new developments with respect to the proposals before the Ontario Government regarding the implementation of a form of privately administered "no fault" automobile insurance for personal injury compensation based on first party rather than third party liability. We continue to believe this may ultimately have some negative effect on our revenues; however, we have continued to strengthen our market position in other provinces so as to diminish our reliance on motor vehicle claims in Ontario.

Emerging as a result of our actions in 1987 is a highly qualified company, able to respond to any type of disaster occurring anywhere in Canada, utilizing experienced personnel with the depth of knowledge that will result in substantial cost savings and service benefits for our clients.

Our strategy for internal growth in Canada is developing as we had planned. The areas of specialization among our adjusters in our traditional business has improved considerably and continues to do so in early 1988. We anticipate this will be one of the large growth sectors of our operation in the years to come, and we will continue to examine all areas in an effort to broaden facilities such as rehabilitation, which we believe will become an important factor if "no fault" insurance benefits are implemented.

In December 1987, Morden & Helwig Group Inc. and National Claims Service each acquired 50% of Lindsey & Newsom Insurance Adjusters, Inc., a regional adjusting company in the State of Texas with operations handled through 44 offices and the head office in Tyler, Texas. Also acquired was 48.5% of Vale National Training Centers Inc., a nationally recognized training facility for claims management personnel in the United States, with campuses in Pennsylvania, California and Texas. Their earnings will contribute significantly to our results in 1988, and in addition will allow us the benefit of their regional experience in a large section of the south-western United States, and provide a base from which to expand.

Management recognises the tremendous responsibility it has on behalf of our shareholders, and that in order to obtain a maximum return on equity it will be necessary to incorporate the individuality of all of the acquisitions.

The contribution of all of our employees in 1987 has allowed us to report another record year end result. Our employees continue to meet our need for hard work and provide a continuing flow of ideas that will help us move forward in the years ahead.

Personally, I am quite pleased with 1987. However, "the best is yet to come."

March 31, 1988

Kenneth R. Polley
President and Chief Executive Officer

OTTER DORCHESTER INSURANCE COMPANY LIMITED — OPERATING REVIEW

FINANCIAL SUMMARY ($000)	For the years ended December 31				
	1987	1986	1985	1984	1983
Gross premiums written	10,752	9,372	9,267	9,125	9,384
Net premiums earned	3,709	2,912	2,948	3,036	2,965
Net incurred losses	2,730	1,961	2,279	1,970	2,043
Net commission & operating expenses	1,351	1,002	1,177	1,198	1,068
COMBINED RATIO	110.0%	101.8%	177.4%	104.3%	104.9%
Underwriting loss	372	51	508	132	146
Investment income	475	278	314	233	230
Earnings (loss) after tax	103	227	(196)	101	84
Total assets	9,502	5,624	4,671	4,348	4,150
Shareholders' equity	4,494	1,810	1,539	1,653	1,578
RETURN ON EQUITY	2.3%	12.5%	12.6%	6.1%	5.3%

The Otter Dorchester Insurance Company Limited was incorporated in 1887 as a premium note mutual insurance company, writing primarily farm and habitational insurance. After 80 years of operation in Oxford County, Ontario the company was writing approximately $200,000 of gross premiums covering the peril of fire only. Prior to 1970, the mutual operated in a very non-aggressive stance insuring only in traditional restricted geographical boundaries. In 1970 the present management was installed with the mandate to enlarge the company's service to policyholders and its premium volume. In quick succession the company changed its charter to a "Cash Mutual" status, amalgamated with the smaller N. & S. Dorchester Mutual (writing primarily in Elgin County) and with the improved underwriting capacity began writing multi-peril contracts, commercial property insurance, tobacco crop insurance and, in 1976, automobile insurance.

These additional classes produced an exciting growth rate and the company very quickly became the largest farm writing mutual in Ontario.

The 1979 Woodstock tornado centred itself in the historic underwriting territory of the company and losses exceeded the actual resources of the company. Fortunately, management was able to secure the authority from mutual policyholders to convert the company to a stock company. A purchaser of the controlling interest of shares, SCOR Reinsurance Company of Canada, guaranteed sufficient capital to permit reconstruction of the company as a stock company - Otter Dorchester Insurance Company Limited - early in 1980. Although the company was solidly back in business it lacked capital to produce anything but very modest growth capacity. The support of local policyholders was however strongly indicated by their purchase of over one third of the shares offered, as was the support of brokers who continued to support and increase writings with the company.

In 1987 the company celebrated its 100th year of operation. It serviced in excess of 16,000 policyholders and was writing $10.7 million of gross premiums.

During this centennial year, Markel Insurance Company of Canada extended an offer to purchase the controlling interest in the company and thereafter succeeded in purchasing about 98% of all shares outstanding.

The management and staff, who had been very appreciative of the previous owners, were at first somewhat apprehensive about the transfer of ownership. Those apprehensions soon changed to enthusiastic acclaim when it became evident that the new owners, "Markel Insurance Company of Canada" were as good as their word. The main objectives were underwriting profit and an improved return on equity. Within days additional capital of $2.5 million was infused. Serious planning for the company began. Staff incentives were put in place and service capabilities were enhanced.

By December 31, 1987 written premiums grew by 14.7% to $10.7 million and bottom line profit of $103,307 was attained. An in-depth analysis of claims reserves has been completed by The Wyatt Company. Following an increase of $163,000 in these reserves, they have certified them for 1987.

The auto and general liability lines remained unprofitable in 1987 but there was improvement in both lines. Farm and commercial property lines were profitable. The profits generated and the capital infused increased shareholder equity to $4.5 million. It is our expectation that this will be satisfactory to accommodate the 1988 anticipated growth.

The company's reinsurance program has been completely revised for 1988 to an excess of loss basis rather than quota share, and the Catastrophe cover limit has been increased 50% from $10 million to $15 million. This change will permit a significant increase in retained premiums, a much more efficient operation and also provide for a larger investment portfolio.

1987 was a very eventful year. We wish to thank our policyholders and brokers for their support. Our staff gave an excellent performance and we know this will extend into 1988.

March 31, 1988

Reginald G. Black
President and Chief Executive Officer

SPHERE REINSURANCE COMPANY OF CANADA — OPERATING REVIEW

FINANCIAL SUMMARY ($000)	For the years ended December 31				
	1987	1986	1985	1984	1983
Gross premiums written	18,871	17,506	15,352	14,229	13,400
Net premiums earned	17,655	16,359	12,162	9,751	8,427
Net incurred losses	13,745	12,693	10,000	7,547	5,966
Net commission & operating expenses	5,905	5,308	4,101	3,430	3,083
COMBINED RATIO	111.3%	110.0%	115.9%	112.6%	107.4%
Underwriting loss	1,995	1,642	1,939	1,226	622
Investment income	3,954	2,855	2,164	2,005	1,700
Earnings after tax	1,885	807	262	779	1,078
Total assets	38,823	31,352	24,636	21,035	18,572
Shareholders' equity	11,372	7,487	6,680	6,419	5,640
RETURN ON EQUITY	20.0%	11.4%	4.0%	12.9%	21.1%

Sphere Reinsurance is one of only two Canadian owned reinsurance companies. The company is registered under the Canadian Insurance Act and is licensed to write all classes of insurance other than life. Property risks represent the largest part of Sphere's premium volume, while auto and casualty risks make up the remainder. Proportional treaties account for the majority of premiums.

For the year 1987, Sphere's net premiums earned totalled $17.6 million. This is an increase of $1.3 million or 8% over 1986 and is reflective of the slower growth in 1987 of premiums written by the Canadian insurance industry.

Our portfolio mix remained stable with property risks making up the largest portion of our business.

The property business produced favorable results in 1987; however, the automobile section continues to show poor experience, particularly in the province of Ontario. The overall loss ratio for 1987 was 78% which was similar to 1986. The Edmonton tornado of July 1987, which produced the largest catastrophe loss in the industry's history, had an adverse impact in our underwriting results to the extent of $750,000 or 4.2% of our claims ratio. Net commissions and operating expenses were slightly higher in 1987 resulting in a combined ratio of 111% and an underwriting loss of $2 million.

Total investment income rose to $4 million in 1987 compared with $2.9 million for 1986. The amount of interest and dividends was down $0.5 million to $2 million, whereas our realized capital gains for the year rose to $2.2 million from $0.5 million in 1986, reflecting increased emphasis on equities in the portfolio.

The net earnings for the year were $1.9 million, up 133% from 1986. The return on equity equals 20% compared to 11.4% for the previous year.

At the end of 1987 our total assets stood at $38.8 million, up $7.5 million or 24% from the end of 1986. Included in this amount is $2 million in capital subscriptions received at September 30. Cash and investments total $34 million or 88% of total assets. The asset growth is essential in strengthening the company's financial position and as a contributor to future earnings.

Total liabilities at end of year were $27.5 million, up $3.6 million or 15% from previous year-end. Our claims reserves, which have been certified by an independent actuary, stood at $17.4 million, an increase of $3.6 million over 1986.

For 1988 there has been a return of additional reinsurance capacity to the marketplace and a contraction of reinsurance available due to mergers of insurance companies and increased retentions. However, Sphere Reinsurance expects to write basically the same volume as in 1987 and, barring any major catastrophe, we should see improved profit levels in the coming year.

May we take this opportunity to express our thanks to our employees, insureds and the brokers for their continued support.

March 31, 1988

L. Rui Quintal
President and Chief Executive Officer.

CONSOLIDATED BALANCE SHEET AS AT DECEMBER 31, 1987

	1987 ($000)	1986 ($000)
ASSETS		
Cash and short-term investments	31,661	24,389
Accounts receivable	21,045	17,759
Claims in process	6,126	4,383
Prepaid expenses	560	550
	59,392	47,081
Investments		
Bonds - at amortized cost (market value - $22,834; 1986 - $30,635)	22,591	29,893
Preferred stocks - at cost (market value - $15,667; 1986 - $14,150)	18,374	14,657
Common stocks - at cost (market value - $46,918; 1986 - $27,499)	51,390	26,694
	92,355	71,244
Investments in associated companies *(note 14)*	15,740	—
Deferred premium acquisition costs	4,520	3,936
Fixed assets *(note 4)*	3,582	1,983
Goodwill	3,431	5,106
Other assets *(note 5)*	6,393	495
	185,413	129,845

Signed on behalf of the Board

V. P. Watsa

Director

SAMarkel

Director

	1987	1986
	($000)	($000)
LIABILITIES		
Bank loans *(note 6)*	3,461	2,176
Accounts payable and accrued liabilities	12,479	6,900
Payable to reinsurers	1,217	5,815
Premium deposits	4,730	4,739
Deposits from unlicensed reinsurers	3,981	5,561
Income taxes payable	4,515	1,173
	30,383	26,364
Provision for claims	59,438	40,236
Unearned premiums	20,799	17,121
Notes payable *(note 7)*	3,067	3,000
Deferred income taxes	627	1,322
Minority interest	10,051	527
	124,365	88,570
SHAREHOLDERS' EQUITY		
Capital stock *(note 3)*	43,656	38,858
Retained earnings	17,392	2,417
	61,048	41,275
	185,413	129,845

CONSOLIDATED STATEMENT OF EARNINGS
FOR THE YEAR ENDED DECEMBER 31, 1987

	1987 ($000)	1986 ($000)
Operating Income		
Premiums earned	62,012	40,885
Claims fees	33,529	6,850
Other income	211	368
	95,752	48,103
Investment Income		
Interest and dividends	8,042	4,678
Realized gains on investments	9,159	952
Equity in earnings of associated companies *(note 14)*	18	—
	112,971	53,733
Expenses		
Losses on claims	45,275	28,193
Operating expenses	40,702	12,144
Agents' commissions	5,757	3,281
Reinsurance commissions	3,034	1,030
	94,768	44,648
Earnings before income taxes	18,203	9,085
Provision for income taxes *(note 11)*	5,878	4,184
Earnings before the following	12,325	4,901
Gain on reduction of interest in subsidiary, net of tax *(note 15)*	3,524	—
Earnings before extraordinary item and minority interest	15,849	4,901
Extraordinary item - recovery of deferred income taxes	1,700	1,711
Minority interest	(1,530)	(64)
Net earnings for the year	16,019	6,548
Earnings per share - fully diluted *(note 16)*		
Earnings before gain on reduction of interest in subsidiary	$1.50	$1.01
Earnings before extraordinary item	$1.99	$1.01
Net earnings	$2.23	$1.35

CONSOLIDATED STATEMENT OF RETAINED EARNINGS
FOR THE YEAR ENDED DECEMBER 31, 1987

	1987 ($000)	1986 ($000)
Retained earnings (deficit) - beginning of period	2,417	(2,759)
Earnings for the period	16,019	6,548
Dividends on preferred shares	(1,044)	(1,044)
Share issuance costs	—	(328)
Retained earnings - end of period	17,392	2,417

CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION
FOR THE YEAR ENDED DECEMBER 31, 1987

	1987	1986
	($000)	($000)
Operating Activities		
Net earnings before extraordinary item and minority interest	15,849	4,901
Depreciation and amortization	1,015	224
Deferred income taxes	391	2,749
Realized gains on investments	(9,159)	(952)
Gain on reduction of interest in subsidiary	(3,524)	—
Equity in earnings of associated companies	(18)	—
	4,554	6,922
Increase in provision for claims	19,202	23,397
Increase in unearned premiums	3,678	10,167
Decrease in cash funds resulting from changes in other operating working capital items	1,285	(11,081)
Cash resources provided by operating activities	28,719	29,405
Investing Activities		
Investments - purchases	(62,197)	(37,472)
- proceeds on sale	50,189	9,675
Purchase of fixed assets - net	(954)	(86)
Acquisition of subsidiary companies	(7,308)	(15,806)
Investment in associated companies	(15,740)	—
	(36,010)	(43,689)
Financing Activities		
Issuance of capital stock	4,798	25,721
Dividends on preferred shares	(1,044)	(1,044)
Share issuance costs	—	(328)
Issue of promissory note	—	2,800
Minority interest	9,524	527
	13,278	27,676
Increase in cash resources	5,987	13,392
Cash resources - beginning of year	22,213	8,821
Cash resources - end of year	28,200	22,213

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEAR ENDED DECEMBER 31, 1987

(in $000s except per share amounts)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Business operations

The company is a financial services holding company engaged, through subsidiaries and affiliates, in the insurance and reinsurance of commercial property and casualty risks, and the provision of claims adjusting, appraisal and loss management services in Canada and the United States.

Principles of consolidation

The consolidated financial statements include the accounts of the company and all of its subsidiaries. The company's investments in associated companies are accounted for under the equity method.

Premiums

Premiums are taken into income evenly throughout the terms of the related policies. As premium deposits secure the payment of premiums and are refundable, they are not taken into income unless default in payment of premiums occurs.

Claims in process

The company records its inventory of claims in process at their estimated value at year end, and management has determined the claims in process at year end through a complete physical count of related files. Claims fees arising therefrom are accounted for on an estimated percentage-of-completion basis.

Deferred premium acquisition costs

The costs incurred in acquiring insurance premiums are deferred, to the extent that they are considered recoverable, and amortized over the same period as the related premiums are taken into income.

Investments

Bonds are carried at amortized cost providing for the amortization of the discount or premium over the term of the investment to the maturity date. Preferred and common stocks are carried at cost. Any investment considered to have a permanent impairment in value is written down to its net realizable value.

Investment income

Investment income is recorded as it accrues. The discount or premium on a bond or debenture is amortized on a straight-line basis to maturity. Dividends are recorded as income on the record date. Gains and losses realized on the disposal of investments are taken into income on the date of disposal.

Claims

Claim provisions are established by the case basis method as claims are reported. The provisions are subsequently adjusted as additional information on the estimated amount of a claim becomes known during the course of its settlement. A provision is also made for claims incurred but not reported based on the volume of business currently in force and the historical experience on such late reported claims.

Translation of foreign currencies

Assets and liabilities in foreign currencies are translated into Canadian dollars at year end exchange rates. Income and expenses are translated at the exchange rates in effect at the date incurred. Realized and unrealized gains and losses on foreign exchange are recognized in the statement of earnings.

Goodwill
The difference between purchase cost and the fair value of the net assets of acquired businesses is amortized on a straight line basis over periods ranging from 10 to 40 years.

2. NAME CHANGE

During the year the company changed its name from Markel Financial Holdings Limited to Fairfax Financial Holdings Limited.

3. CAPITAL STOCK

Authorized capital
The authorized share capital of the company consists of an unlimited number of preferred shares issuable in series, 2,348,000 Series I preferred shares, 2,874,000 Series II preferred shares, an unlimited number of multiple voting shares and an unlimited number of subordinate voting shares.

The Series I preferred and the multiple voting shares are entitled to ten votes per share while the Series II preferred and the subordinate voting shares are entitled to one vote per share. Under certain circumstances, such as a significant reduction in the number of Series I preferred and multiple voting shares held by the present controlling shareholders of the company, the number of votes attached to all Series I preferred and multiple voting shares will automatically and permanently be reduced to one vote per share.

The Series I and II preferred shares are entitled to cumulative annual dividends of $0.363375, are redeemable at the option of the company at any time after September 26, 1990 at a price per share of $3.23 plus accrued dividends, and are convertible on a share for share basis into multiple voting and subordinate voting shares respectively.

Issued capital

	1987		1986	
	Number	($000s)	Number	($000s)
Series I preferred shares	2,348,000	7,584	2,348,000	7,584
Series II preferred shares	526,000	1,699	526,000	1,699
Subordinate voting shares	4,463,000	34,373	4,133,000	29,575
		43,656		38,858

During the year 330,000 subordinate voting shares were issued for a total cash consideration of $4,798 under the company's employee stock purchase plans.

Notes to Consolidated Financial Statements

4. FIXED ASSETS

	1987	1986
Land and buildings	1,451	1,157
Furniture and equipment	6,169	4,422
Leasehold improvements	410	228
	8,030	5,807
Less accumulated depreciation	4,448	3,824
	3,582	1,983

5. OTHER ASSETS

Included in other assets are non-interest bearing loans to officers and directors of the company and its subsidiaries under the company's employee stock purchase plans totalling $5,981.

6. BANK LOANS

Bank loans represent temporary operating loans by a subsidiary, Morden & Helwig Group Inc., on its operating line of credit, of which $2,313 is secured by a general assignment of book debts.

7. NOTES PAYABLE

Included in notes payable is an amount of $2,800 payable in 1991 with respect to the acquisition of Sphere Reinsurance Company of Canada. This amount is subject to reduction based on development of Sphere Reinsurance's unpaid claims and claims adjustment expenses.

8. OPERATING LEASES

Aggregate future commitments at December 31, 1987 under operating leases relating to premises, automobiles and equipment for various terms up to 10 years are as follows:

1988	$ 2,700
1989	2,400
1990	1,500
1991	1,100
1992	1,100
Thereafter	3,900
	$12,700

9. REINSURANCE

The company follows the policy of underwriting and reinsuring contracts of insurance which, in the main, limit the liability of the company to a maximum amount on any one loss to $500. The company's reinsurance is generally placed on an excess of loss basis in several layers. This reinsurance does not, however, relieve the company of its primary obligation to the policyholders. As at December 31, 1987, provision for claims reflects recoveries from reinsurers of $22,592 (1986 - $13,769). During the year, the company ceded $15,447 (1986 - $12,788) of premium income and $7,099 (1986 - $6,784) of claims incurred.

10. RELATED PARTY TRANSACTIONS

During the year the company and its subsidiaries purchased investment counsel, data processing and administrative services, in the normal course of business and on normal market terms, from Hamblin Watsa Investment Counsel Ltd. and Markel Corporation, companies in which officers of the company have significant interest. The cost of these services amounted to $580 in 1987 and $855 in 1986.

The company holds an investment of 94,400 issued common shares of Markel Corporation at a cost of $1,310.

The company reinsures a portion of risks with an associated company. Net premiums ceded amounted to $419 (1986 - $2,495) and net losses recovered $5 (1986 - $1,676). Included in deposits is an amount due from the related company of $109 (1986 - $1,053). Included in payable to reinsurers is an amount due to related companies of $649 (1986 - $1,444). At year end, there are letters of credit outstanding of US $250 (1986 - $80) issued to subsidiaries of Markel Corporation.

During the year the company assumed a portion of risks from an affiliated company. The net premium assumed amounted to approximately $263 and the net losses paid amounted to approximately $17.

11. INCOME TAX POSITION

The company provides for income taxes using the tax allocation method. The provision for income taxes in the consolidated statement of earnings includes provision for deferred income taxes of $391 (1986 - $2,749).

The provision for income taxes differs from the statutory marginal rate as certain sources of income are exempt from tax or are taxed at other than the marginal rate. Reconciliations of the statutory marginal tax rate and the effective tax rate are summarized below:

	1987	1986
	%	%
Provision for taxes at Canadian statutory marginal income tax rate	53.0	52.0
Non-taxable capital gains	(12.9)	(3.1)
Non-taxable investment income	(8.9)	(2.6)
Unearned premium reserve for financial statement purposes in excess of that recorded for tax purposes	(3.2)	—
Share issuance costs	(3.4)	(1.6)
Other - net	7.4	1.3
Provision for income taxes at effective rate	32.0%	46.0%

Notes to Consolidated Financial Statements

12. STATUTORY REQUIREMENTS - INSURANCE SUBSIDIARIES

(a) Dividend restrictions:

Payments of dividends by the company's insurance and reinsurance subsidiaries and affiliates are governed by insurance statutes and regulations.

(b) Solvency position:

Two of the company's insurance and reinsurance subsidiaries are incorporated under The Canadian and British Insurance Companies Act (the "Act"). At December 31, 1987 these subsidiaries have a combined surplus under the solvency requirements of Section 103 of the Act of $16,934 (1986 - $14,054).

13. ACQUISITIONS

During the year subsidiaries of the company completed several acquisitions mainly for cash. The total net assets acquired at fair values assigned as at the effective dates of the acquisitions were as follows:

Total assets	$8,880
Total liabilities	5,280
Net assets acquired	3,600
Total purchase consideration	7,308

The excess of the purchase consideration over the fair value of the net assets acquired will be amortized over periods ranging from 10 to 40 years.

14. INVESTMENTS IN ASSOCIATED COMPANIES

F-M Acquisition Corporation	6,385
Lindsey & Newsom Insurance Adjusters, Inc.	7,970
Vale National Training Centers, Inc.	1,385
	15,740

F-M Acquisition Corporation:

As of December 31, 1987 the company purchased a 35% interest in F-M Acquisition Corporation ("F-M"), an Illinois corporation, for a cash consideration of $6,402. F-M was incorporated by the company and a group of investors for the purposes of acquiring all of the outstanding shares of Shand, Morahan & Company, Inc., an underwriting management company, and Evanston Services Inc., an insurance holding company, both of Chicago, Illinois.

A summary of F-M's consolidated balance sheet at fair values assigned and pro forma statement of earnings (converted to Canadian dollars at year end rates of exchange) is as follows:

BALANCE SHEET	December 31, 1987
Cash and investments	480,079
Reinsurance and premium receivables	168,345
Property and equipment	31,623
Other assets	17,935
Total assets	697,982
Reinsurance and other payables	213,500
Provision for claims	288,887
Unearned premiums and fees	49,363
Capitalized lease obligations	29,129
Notes payable	77,693
Total liabilities	658,572
Shareholders' equity	
Preferred	21,166
Common	18,244
Total	39,410
Total liabilities and shareholders' equity	697,982

PRO FORMA STATEMENT OF EARNINGS (UNAUDITED)	Year to December 31, 1987
Operating revenue	156,240
Investment income	26,260
	182,500
Operating costs	166,444
	16,056
Income tax recovery	874
Net earnings	16,930

The unaudited pro forma summary statement of earnings gives effect to the purchase of Shand, Morahan & Company, Inc. and Evanston Services Inc. as if the acquisitions had been completed on January 1, 1987, with adjustments primarily for additional interest costs, indemnifications and amortization of purchase adjustments.

Notes to Consolidated Financial Statements

14. INVESTMENTS IN ASSOCIATED COMPANIES (cont'd)

Included in notes payable are amounts totalling $45,291 payable in 1992 to the vendors of Shand, Morahan and Evanston Services. The amounts are subject to reduction based on, among other factors, the development of Evanston Services' unpaid claims and claims adjustment expenses and uncollectible reinsurance reserves.

As of the date of acquisition the company's proportionate interest in the net assets of F-M at fair values assigned was equal to the cost of the investment. The company intends to account for its investment in F-M on an equity basis.

Lindsey & Newsom Insurance Adjusters, Inc. and Vale National Training Centers, Inc.:

The company's 53% owned subsidiary, Morden & Helwig Group Inc., in partnership with Markel Corporation, each acquired 50% of Lindsey & Newsom Insurance Adjusters, Inc. and 48.5% of Vale National Training Centers, Inc. of Tyler, Texas for cash. The investment in Lindsey & Newsom totalled $7,970 and Morden & Helwig's proportionate interest in the net assets at fair values assigned as of the December 31, 1987 effective date was $1,257. The investment in Vale National totalled $1,350 and Morden & Helwig's proportionate interest in the net assets at fair values assigned as of the September 30, 1987 effective date was $212. Morden & Helwig accounts for these investments on the equity basis with the excess of the purchase price over the fair value of the assets acquired amortized over 40 years.

15. GAIN ON REDUCTION OF INTEREST IN SUBSIDIARY

On May 4, 1987 the company's subsidiary Morden & Helwig Group Inc. completed its initial public offering which resulted in a dilution of the company's interest. In conjunction with the public offering the company sold a portion of its shareholding in Morden & Helwig reducing its ownership interest to 53%. The gain on reduction of interest in subsidiary reflects the gain on sale of Morden & Helwig shares, net of applicable income taxes of $720 and the company's portion of the increase in the book value of the shares of Morden & Helwig resulting from the public offering.

16. EARNINGS PER SHARE

Earnings per share on the Consolidated Statement of Earnings have been presented on a fully diluted basis as, in the opinion of management, there is virtual certainty that the Series I and Series II preferred shares will ultimately be converted to multiple voting shares and subordinate voting shares respectively, and management believes basic earnings per share to be misleading. Basic earnings per share are as follows:

	1987	1986
Basic earnings per share before gain on reduction of interest in subsidiary	$2.25	$1.95
Basic earnings per share before extraordinary item	$3.07	$1.95
Basic earnings per share	$3.46	$2.78

17. CONTINGENCIES

A subsidiary of the company is the defendant in several damage suits and has been named as third party in other suits. The uninsured exposure to the company is not considered to be material.

The company and Markel Corporation have jointly guaranteed a note payable by F-M Acquisition Corporation in the amount of US $3 million. In order to hedge US dollar portfolio assets, the company has also committed to purchase forward contracts for the US dollar equivalent of $11,850 which expire over the next three years.

The company has also committed to purchase forward contracts for the US dollar equivalent of $11,850 which expire over the next three years.

18. SEGMENTED INFORMATION

The company is a financial services holding company operating primarily in Canada in two industries - the insurance and reinsurance of commercial property and casualty risks, and the provision of claims adjusting, appraisal and loss management services. The comparability of the segmented information is impacted by the acquisition of the company's reinsurance and claims adjusting, appraisal and loss management subsidiaries in September and October 1986 respectively.

(a) Industry Segments

	Insurance & Reinsurance		Claims Adjusting, Appraisal & Loss Management		Corporate and Consolidation Adjustments		Consolidated	
	1987	1986	1987	1986	1987	1986	1987	1986
Revenue	62,223	41,253	33,529	6,850	—	—	95,752	48,103
Earnings before income taxes	15,770	7,893	3,826	1,033	(1,393)	159	18,203	9,085
Identifiable assets	143,080	104,295	34,117	14,501	8,216	11,049	185,413	129,845
Depreciation & amortization	173	75	592	82	250	67	1,015	224

(b) Geographic segments

Assets and revenue attributable to operations in the United States do not exceed 10% of the consolidated total assets and total revenue of the company.

19. COMPARATIVE FIGURES

Certain of the 1986 comparative figures have been re-stated to conform to the presentation adopted for 1987.

February 26, 1988

REPORT OF THE PROPERTY-CASUALTY VALUATION ACTUARY

The Wyatt Company has made the valuation of the net claims liabilities of the subsidiary and affiliated general insurance companies of Fairfax Financial Holdings Limited for Fairfax's consolidated balance sheet at 31 December 1987 and its consolidated income statement for the year then ended, except for the Evanston Insurance Company and the Insurance Company of Evanston for which we have relied upon the valuation made by Milliman and Robertson. In our opinion:

(i) The amount of claims liabilities in the consolidated balance sheet makes proper provision for future payments under the subsidiary and affiliated companies' policies.

(ii) A proper charge on account of those liabilities has been made in the consolidated income statement.

The Wyatt Company
Actuaries and Consultants

February 26, 1988

AUDITORS' REPORT TO THE SHAREHOLDERS

We have examined the consolidated balance sheet of Fairfax Financial Holdings Limited as at December 31, 1987 and the consolidated statements of earnings, retained earnings and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these consolidated financial statements present fairly the financial position of the company as at December 31, 1987 and the results of its operations and the changes in its financial position for the year then ended in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Coopers & Lybrand
Chartered Accountants
Toronto, Canada.

CONSOLIDATED FINANCIAL SUMMARY ($000 except per share amounts)

	For the years ended December 31									
	1987	1986	1985	1984	1983	1982	1981	1980	1979	1978
REVENUES										
Insurance premiums earned	62,012	40,885	14,049	16,616	19,621	14,443	10,676	7,633	6,250	7,604
Service revenues	33,529	6,850	—	—	—	—	—	—	—	—
Interest & dividend income	8,042	4,678	2,455	2,337	2,009	2,198	2,421	1,757	1,619	1,534
TOTAL REVENUES OF CONSOLIDATED COMPANIES	103,812	52,781	16,623	18,953	21,630	16,641	13,097	9,390	7,869	9,138
EARNINGS										
Earnings before realized investment gains and taxes	9,044	8,133	(1,339)	(4,879)	93	542	(538)	(2,425)	143	1,041
Realized investment gains	9,159	952	459	25	215	(66)	(276)	424	219	64
Total pre-tax earnings	18,203	9,085	(880)	(4,854)	308	476	(814)	(2,001)	362	1,105
Extraordinary items	1,700	1,711	—	—	—	—	—	—	—	—
NET EARNINGS AFTER TAX	16,019	6,548	(910)	(4,775)	280	218	(326)	(785)	524	742
TOTAL ASSETS	185,413	129,845	41,477	31,401	32,325	28,739	29,351	27,714	25,341	22,927
CASH & INVESTMENTS	124,016	95,633	32,728	25,391	24,218	20,337	22,265	21,853	19,701	18,057
TOTAL DEBT	3,067	3,000	—	1,000	300	800	—	—	—	—
SHAREHOLDERS' EQUITY	61,048	41,275	10,379	2,287	7,062	6,782	6,565	6,891	7,715	7,389
NUMBER OF SHARES — FULLY DILUTED	7,336	7,007	5,000	616	616	616	616	616	616	616
RETURN ON SHAREHOLDERS' EQUITY	31.3%	25.4%	—	—	4.1%	3.3%	—	—	7.0%	11.0%
PER COMMON SHARE — FULLY DILUTED										
Net earnings	2.23	1.35	(1.89)	(7.75)	0.45	0.35	(0.53)	(1.27)	0.85	1.20
Dividends	—	—	—	—	—	—	—	0.0625	0.25	0.25
Shareholders' equity	8.32	5.89	2.08	3.71	11.46	11.01	10.66	11.19	12.52	12.00

Directors of the Company

† George Christoff,
Account Executive, Dean Witter Reynolds (Canada) Inc.

+* Robbert Hartog,
President, Robhar Investments Limited

Keith E. Ingoe,
President & Chief Executive Officer,
Markel Insurance Company of Canada

* Wilfred Kaneb,
Chairman, Olco Petroleum Inc.

Anthony F. Markel,
Executive Vice President,
Markel Corporation (U.S.)

+†* Steven A. Markel,
President and Vice Chairman

† James R. Martin,
Investment Vice President,
Confederation Life Insurance Co.

* Robert W. McDowell,
Partner, Fasken & Calvin

Kenneth R. Polley,
President & Chief Executive Officer,
Morden & Helwig Group, Inc.

+* V. Prem Watsa,
Chairman of the Board and
Chief Executive Officer

* Audit Committee Member
+ Executive Committee Member
† Investment Committee Member

Officers of the Company

Brenda Adams
Corporate Secretary

William R. Andrus
Vice President, Business Development

J. Paul T. Fink
Vice President, Investment Banking

David E. Rooney
Vice President, Finance and
Chief Financial Officer

John C. Varnell
Controller

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Chief Financial Officer

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Montreal, Toronto, Vancouver

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Toronto Stock Exchange
Exchange Symbol FFH

General Counsel
Fasken & Calvin
Toronto, Canada

Auditors
Coopers & Lybrand
Toronto, Canada

Operating Management

Joseph J. Prochaska, Jr.
President & Chief Executive Officer
F-M ACQUISITION CORPORATION

Keith E. Ingoe
President & Chief Executive Officer
MARKEL INSURANCE COMPANY OF CANADA

Kenneth R. Polley
President & Chief Executive Officer
MORDEN & HELWIG GROUP INC.

Reginald G. Black
President & Chief Executive Officer
OTTER DORCHESTER INSURANCE COMPANY LIMITED

L. Rui Quintal
President & Chief Executive Officer
SPHERE REINSURANCE COMPANY OF CANADA