# Q2 2011 Earnings Call

## Company Participants

- Brad Martin, VP, COO
- John Varnell, VP, CFO
- Prem Watsa, Chairman, CEO

## Other Participants

- James Fendlay, Analyst
- Jeff Fenwick, Analyst
- Mark Dwelle, Analyst
- Paul Holden, Analyst
- Robert Alford, Analyst
- Sergie Catrin, Analyst
- Tom MacKinnon, Analyst

## Presentation

### Operator

Good morning. And welcome to Fairfax's 2011 Second Quarter results conference call. Your lines have been placed in a listen-only mode. After the presentation, we will conduct a question-and-answer session. (Operator Instructions) Today's conference is being recorded. If you have any objections, you may disconnect at this time. Your host for today's conference call is Mr. Prem Watsa, with opening remarks from Brad Martin. Mr. Martin, please begin, sir.

### Brad Martin {BIO 3466650 <GO>}

Good morning. Welcome to the conference call to discuss Fairfax's Second Quarter 2011 results. The comments we make during this conference may contain forward-looking statements. Actual results may differ perhaps materially from those contained in such forward-looking statements, as a result, a large variety of uncertainties and risks and uncertainties, most perceivable of which are listed in Fairfax's Annual Report, which is available on our website at Fairfax.ca. Or set out in the Risk Factors in base shell prospectus filed with Securities regulatory authorities in Canada, which is available on SEDAR. I will now turn the call over to our Chairman and CEO, Prem Watsa.

### Prem Watsa {BIO 1433188 <GO>}

Thank you, Brad. Good morning, ladies and gentlemen. Welcome to Fairfax's Second Quarter conference call. I plan to give you some of the highlights, and then pass it on to

John Varnell, our Chief Financial Officer, for additional financial details. In the first half of 2011, book value per share decreased by 2%. Adjusted for the $10 per share common dividend paid in the First Quarter of 2011. The book value decreased to $359 per share. In the Second Quarter, book value increased by $4.00 per share, or 1.1%. This is our Second Quarter reporting under the International Financial Reporting Standards, IFRS. Our investments are now shown at market value at the end of the quarter, and the fluctuation in market values flows through the income statement.

Highlights during the quarter include, we had a net profit of $83.3 million in the Second Quarter of 2011, approximately $3.40 per share. Mainly because of good operating results, $119.6 million, approximately $120 million in net gains and investments, offset by a $104 million loss on the premium paid for tendered bonds. The combined ratio of the Company's insurance and reinsurance operations was 100.5% on a consolidated basis. Underwriting results in the Second Quarter were negatively impacted by the $88.1 million of pre-tax catastrophe losses, primarily related to US tornado losses, which increased the combined ratio by 6.9percentage points.

Net investment gains of $120 million in the Second Quarter of 2011 consisted of the following. Please note the table on page two of our press release, which shows you the breakdown of these gains. In the table, you can see net gains on bonds of $260 million, predominately and were largely offset by net unrealized losses of $118 million on our CPI consumer price index derivatives. Losses on equity and equity-related investments of $119 million, again largely unrealized, were offset by gains on our equity hedges. However, we had large unrealized gains on cost of $389 million, which includes international coal.



Net premiums written by the Company's insurance and reinsurance operations in the Second Quarter of 2011 increased by 24.4% to $1.3708 billion. Excluding acquisitions, our consolidated premium grew by 10% in the Second Quarter, which included some foreign exchange gains. Also during the quarter, we retired $694 million US of outstanding Fairfax, Crum & Forster and Odyssey renotes, and refinanced this by issuing ten-year Fairfax bonds in the United States and Canada at record low interest rates for us. The Company held $1.14 billion of cash, short-term investments and marketable securities at the holding company level, approximately $1.11 billion net of the short sale in derivative obligations. This is all at June 30th 2011.

Finally, we continue to be approximately 86% hedged in relationship to our equity and equity-related securities, which includes convertible bonds and convertible preferred stocks. Now I would like to turn it over to John, so he can give you some more information on the underlying financials. John?

## John Varnell {BIO 5699703 <GO>}

Thanks, Prem. First, I will talk about investment income, then operating company results, and finally our financial position. On investment income, interest and dividend income in the Second Quarter of 2011, increased by 4.6% to $195.1 million from the Second Quarter of 2010 of $186.6 million. On a pre-tax equivalent basis, we own about $4.6 billion of tax advantage municipal bonds, and therefore, the interest and dividend income related to that should be grossed up for the tax advantage. The average portfolio size during the

Second Quarter of 2011 for investments was almost $24.1 billion, compared to $22.4 billion in the Second Quarter of 2010. Our annualized portfolio yield in the Second Quarter was 3.42%, compared to a yield of 3.5% in the Second Quarter of 2010.

Turning to operating company results, starting with Odyssey. In the Second Quarter of 2011, Odyssey had a combined ratio of 93.1, and an underwriting profit of $32.2 million. In the Second Quarter of 2010, Odyssey had a combined ratio of 92.8, and an underwriting profit of about $33.7 million. The Second Quarter 2011 combined ratio included about 10 combined ratio points, or $47 million, net of reinsurance and reinstatement premiums related to cat losses, compared to about $17 million, or about 3.6 combined ratio points last year. In the Second Quarter of 2010, just for comparison, Odyssey also had $30 million, or 6.6 combined ratio points related to the deepwater Horizon loss.

The Second Quarter 2011 underwriting result for Odyssey included 0.5 combined ratio point, or about $1.8 million, attributable to net favorable development of prior year's reserves. In terms of premium volumes, Odyssey had a 9.1% increase, or $38 million in net premiums written, to $460 million in the Second Quarter from $421 million last year. Primarily as a result of increased property business, some foreign exchange movements, offset by reduced casualty business.

Crum & Forster reported an underwriting loss of $8.4 million, and a combined ratio of 103.4 in the Second Quarter of 2011. Compared to an underwriting loss of $10.7 million, and a combined ratio of 106 in the Second Quarter of 2010. Crum & Forster results included 0.7 of a combined ratio point, or $1.8 million of unfavorable development of prior year's reserves. 2010 had $5.3 million, or 2.9 points of favorable development. Crum & Forster's net premiums written increased by 40% in the quarter, compared to the Second Quarter 2010. Principally due to the acquisition of First Mercury. If we excluded First Mercury, the premiums at Crum & Forster increased 6.4%, as a result of growth in their specialty business.

Zenith National reported an underwriting loss of $35 million, and a combined ratio of 129 for the Second Quarter of 2011. There was development of prior year reserves of $6.6 million, or 5.5 combined ratio points. Net premiums earned during the Second Quarter and first six months of 2011 increased year-over-year by 14% for both periods respectively, reflecting the combined impacts of new business and higher retention of their renewal business.

Northbridge reported a combined ratio of 104.3 and an underwriting loss of $11.6 million in the Second Quarter. That compared to a 106.6 combined ratio, and a $16.4 million underwriting loss in the year-ago quarter. Second quarter of 2011 underwriting results for Northbridge included 6.7 combined ratio points, or $18 million of net favorable development. There was 3.7 combined ratio points, or almost $9 million of favorable prior-period reserve development in the Second Quarter of 2010. Net premiums written at Northbridge were $337 million in the quarter, an increase of 8% from $312 million in US dollar terms last year, largely reflecting the stronger Canadian dollar.

Fairfax Asia had another successful quarter. Their combined ratio was 85. This quarter compared to a combined ratio of 94.5 last year. Their net premiums written were $52 million, up 40% from $37 million last year. However, the Second Quarter 2011 does include $10.3 million of Pacific Insurance premium, which was the acquisition we closed in the first part of the year.

In our segment that we call reinsurance and insurance other, the net premiums increased to $146 million for the Second Quarter, compared to $113 million last year. The Second Quarter combined ratio was 92.7, compared to 91.8 last year for that segment. And the individual results in the Second Quarter were combined ratios for group RE of 99, Advent of 73, and Polish RE of 110. Turning to our financial position, as Prem said, we ended the quarter $358.60 a share. That is an IFRS book value that would be comparable out IFRS book value at December 31st of $376.33 per share. Common shareholders equity increased slightly from $7.24 billion at March 31st 2011, to $7.31 billion at June 30th 2011.

As Prem said, we issued ten-year senior notes for US $500 million at 5.8%, and Canadian $400 million at 6.4% in the quarter. And when we retired the debt, we recorded a one-time charge of $104 million in connection with the repurchase of the Fairfax, Crum & Forster and Odyssey notes. Our debt at the holding company increased slightly, and the debt at the subsidiary decreased during the Second Quarter. At the holding company it increased at the subs, it decreased overall on a total consolidated basis, it increased somewhat. Due to the senior note repurchase, we finished the Second Quarter with a slightly higher total debt to total cap ratio of 27.1%, which is compared to 25.5% at March 31st. That is it, Prem.



## Prem Watsa {BIO 1433188 <GO>}

Thank you, John. Now we are happy to answer your questions. Please give us your name, your company name, and try to limit your questions to only one, so that it is fair to all on the call. Okay. Julianne, we are ready for the questions.

# Questions And Answers

## Operator

(Operator Instructions) One moment please. Our first question comes from Jeff Fenwick from Cormark Securities.

## A - Prem Watsa {BIO 1433188 <GO>}

Hi, Jeff.

## Q - Jeff Fenwick {BIO 15350794 <GO>}

Good morning, gentlemen. So Prem, in the quarter we saw the news that Andy Bernard is moving into a role to oversee the global insurance operations, and that was followed by some restructuring at Northbridge. Maybe you can speak about what the vision is for

Andy. Is this the first step in several sort of enhancements to the business that we can expect going forward?

## A - Prem Watsa {BIO 1433188 <GO>}

Yes, Jeff. So this is something that we have announced in the Annual Report and talked at our Annual Meeting, as you know. It is a very significant development for us. We have very decentralized operations. With Andy Bernard being put in charge of our insurance/reinsurance operations, what we expect to do is to get a lot more coordination between our companies, in the US particularly. But also elsewhere. And in terms of opportunity, and of course, if there is competition among our companies, then that is the kind of areas where Andy will come in to reduce that. So it is a very positive move. Andy has been with us for the better part of 15 years, maybe 16 years now. And has built Odyssey as you know from $150 million to $2.5 billion worldwide reinsurance company. So we are very excited about that. So we continue to be decentralized. But Andy will coordinate our insurance/reinsurance operations. The Canadian operations restructuring, the fact that we are forming Northbridge Insurance Company. No. That was planned sometime back, Jeff. No connection between the two.

## Q - Jeff Fenwick {BIO 15350794 <GO>}

Okay. And perhaps if I just follow-up with one more question. So after a period here of seeing premiums held back and shrinking through soft market, we have seen a couple quarters now with some nice organic growth out of your operations. Are we starting to see some hardening in some various corners of where Fairfax is active, and what is your feel there? That seems to be a fairly significant change here in the approach to underwriting?

## A - Prem Watsa {BIO 1433188 <GO>}

Yes. So Jeff, you are exactly right, in a soft cycle we shrink. We've seen the markets stabilize. We are seeing property cat prices strong. Workers' compensation is stabilizing and perhaps increasing a little . The speciality lines are also firming up, so you are seeing Crum & Forster, excluding the acquisition of First Mercury up about 9.5% in that area, Odyssey RE is up. So we are seeing the markets react some. But it is still early days. The redundancies of the past are disappearing as you know. So that has helped the industry. That is slowly changing. And might well be pretty well gone this year, and perhaps next. And the investment income continues to come down, as you have the bonds rolling over from higher rates to lower rates. So we think the markets will change. And perhaps significantly. We can't say when. But our companies are well positioned to, as we have done in the past, to increase premiums very significantly, not on our forecast, but on the prices actually going up significantly. We are focused on underwriting profit, and when we get the opportunity we will react.

## Q - Jeff Fenwick {BIO 15350794 <GO>}

Okay. Great. Thank you.

## A - Prem Watsa {BIO 1433188 <GO>}

Thanks, Jeff. Next question, Julianne.

## Operator

Thank you. Paul Holden from CIBC.

## Q - Paul Holden {BIO 6328596 <GO>}

Thank you. Good morning.

## A - Prem Watsa {BIO 1433188 <GO>}

Hi. Good morning.

## Q - Paul Holden {BIO 6328596 <GO>}

First question is related to cat losses from Japan. When you booked them in Q1, you said there might be some deviation or volatility, in terms of that estimate because it was hard to determine at that time. Do you have any more comfort now with your original estimate for cat losses?

## A - Prem Watsa {BIO 1433188 <GO>}

Yes. Our Japanese, you could still say it's early days, because it's Second Quarter. But it has stabilized. So we haven't seen any movement of any significance. The cat pricing, though, has gone up on renewals quite significantly. Right up to 50% for Japanese renewals, particularly with some cat exposure. And so we are seeing that. But our estimates for the Japanese I believe are holding.

## Q - Paul Holden {BIO 6328596 <GO>}

Okay. One more question, if I may, just regarding your position in US Treasuries and Munis, given what is taking place in the US and potential for a sovereign rating downgrade. Any sort of change of opinion or stance or comments that you can make with respect to your holding in US Treasuries?

## A - Prem Watsa {BIO 1433188 <GO>}

Well we are long-term and we think that debt limits will be worked out ultimately. And even in the worst case, where the United States takes a downgrade, if you compare the world, I think investors worldwide will still consider US Treasuries to be the best government bonds that you can buy. The best country to invest in, in spite of all of the problems that exist in the world. So we think this is a short-term issue. It will be solved. It will be resolved one way or the other. And we, of course, focus on the long-term.

## Q - Paul Holden {BIO 6328596 <GO>}

Thank you.

## A - Prem Watsa {BIO 1433188 <GO>}

Thank you very much. Julianne, next question.

## Operator

Thank you. Tom MacKinnon from BMO Capital.

## Q - Tom MacKinnon {BIO 2430137 <GO>}

Yes. Thanks very much. Good morning, everyone.

## A - Prem Watsa {BIO 1433188 <GO>}

Good morning, Tom.

## Q - Tom MacKinnon {BIO 2430137 <GO>}

Question with respect to I guess the underwriting environment. It looks like we are seeing some improving results really at Odyssey RE to some extent, and then across the board with a lot of other reinsurers. And I am wondering if you can comment on why that hasn't really necessarily transpired into improvements in Northbridge and Crum & Forster, even if we look at combined ratios kind of ex-cats and ex-reserve development. We really haven't seen over the last couple of years really any improvement in Northbridge and Crum & Forster, but we have seen some improvement with Odyssey RE. Maybe dig down into how much of the property cat price was related?

## A - Prem Watsa {BIO 1433188 <GO>}

In terms of pricing, the US tends to go down much faster and then also come back much faster. Canada tends to lag. On top of that, I think we had quite, with the (Sladlick) files and we had some cat losses too in Canada. John, you want to add to that?

## A - John Varnell {BIO 5699703 <GO>}

Sure. Well Northbridge and Crum both have more commercial business as well. So the commercial business has been quite competitive in both Canada and the United States. So that is where there is more pricing pressure. Odyssey has more of a mixture, where they can move around. So they can do more property cat. They can decrease their casualty lines. So they have more flexibility in what they can do, whereas Northbridge and Crum have to work at that commercial business. They will move and more to specialty lines, but they still have the commercial business that they have to compete in.

## Q - Tom MacKinnon {BIO 2430137 <GO>}

Okay. That helps explain it. What percentage, John, of what is being written at Odyssey would be property cat?

## A - Prem Watsa {BIO 1433188 <GO>}

Some property cat exposure would be, if you had to take our business that has some exposure, it would be about 20% or 25%. Some type of cat exposure. And so we are writing more of, that well within our limits. Well within our limits, of course, Tom. But we see opportunity in the property cat area. And so we are taking Odyssey RE under Brian Young and Andy Bernard of course are taking advantage of that.

## Q - Tom MacKinnon {BIO 2430137 <GO>}

So going forward, I guess the $1 million question is when is this going to trickle down into some sort of firmness in commercial lines? And I guess the question is there is nothing that you can see that is going to indicate that? I mean, you are still in the release--?

## A - Prem Watsa {BIO 1433188 <GO>}

It is like everything else associated with markets. You have to be ready. You have to be patient. You can't write when the markets are not appropriate and sub-markets. Then you have got to wait. And we are patient. We have been in business for 25 years. We have seen the cycles. So you just wait. And when the opportunity comes, we will react. But we won't until the opportunity is in front of us. And it is the same in the financial markets, Tom. You are right. You remember in 2006 and 2007, we were very patient. We had government bonds. We had our stock positions hedged, in 2008 completely hedged. But when the markets went down 50%, we took the hedges off. We bought a lot of common stock, and when the spreads widened dramatically at the end of 2008 and early 2009, we reacted. But you had to be patient. You had to have government bonds. You had to have hedged your stock positions to take advantage of that opportunity. In the insurance business, it is very similar. So all of our presidents are being very careful and focused on underwriting, and waiting for that right time when the markets have changed, and the opportunity is in front of us.

## Q - Tom MacKinnon {BIO 2430137 <GO>}

Thanks.

## A - Prem Watsa {BIO 1433188 <GO>}

Thank you, Tom. Next question, Julianne.

## Operator

Mark Dwelle from RBC Capital Markets.

## Q - Mark Dwelle {BIO 4211726 <GO>}

Yes. Good morning.

## A - Prem Watsa {BIO 1433188 <GO>}

Good morning.

## Q - Mark Dwelle {BIO 4211726 <GO>}

Quick questions related to, thank you. Good morning. A couple questions on the investment side. It looks like you liquidated a fairly large portion of the equity warrants position. Was that the main driver of the capital gains in the quarter?

## A - Prem Watsa {BIO 1433188 <GO>}

No. We had quite a few situations that gave us the gains mark. But the one that we have talked about in the past, which has been in the press, is international coal. That was significant. But we had other realized and unrealized. We had quite a few unrealized positions that went up. But the one that we have, we are able to talk about is international coal. Once at the end of the year, of course, we tell you where the big gains were on cost, unrealized. But our common stock position, if you look at the press release that we have for you on page two, you can see in the Second Quarter, equity and equity-related investments, we lost $119 million.

And on the hedges, we made $119 million. So it was flat. And if you go into the six months, Mark, you will see remaining $500 million and equity hedges were $309 million. So we made after the hedges about $200 million, $194 million to be exact. But there are fluctuations with IFRS, all of the fluctuations go through our balance sheet and our income statement. But we like our position, we like the fact that we are hedged 86%. We like the fact that we have got government bonds, a significant amount of them. The spreads have narrowed significantly. The stock prices are up 100% from the bottom. We think that you have to be cautious, you have to be careful, and so that is where we are. We are very cautious in capital today. That doesn't mean we don't take advantage of opportunities that we see. But we are cautious in this environment.

## Q - Mark Dwelle {BIO 4211726 <GO>}

Okay. One other real quick question. The recently reported position in Bank of Ireland, is that going to be a holding company investment? Or is that going to be purchased by using the cash at the subsidiary levels?

## A - Prem Watsa {BIO 1433188 <GO>}

No. This is just a regular insurance investment, Mark. Because it was in the Bank of Ireland, and in Ireland it was significant. Got a lot of publicity. So we explained why we acquired that position. We did that, I guess there were three others that acquired it together with us, separately I may add. But did their own work. But we like Ireland, we have been there for 20 years. And so like Ireland. We like the Bank of Ireland as the best bank in Ireland, the only private one. And a full-service bank with 250 branches. And as a financial services analyst, Mark, you will recognize that their capital position is very strong. Tier one capital is at 15%. Core equity capital, meaning equity capital is 10%. They have, the Central Bank of Ireland has very significant, very tough stress tests. And they hired Blackrock to put these stress tests in. And the two tests that they have, one, house prices dropped 60% from the top. And commercial property prices dropped 70% from the top. And you still have to have your minimum capital levels. So the 15 tier one and 10 from core can handle these to two stress events. And so we liked it. We like the management team. We like Richie Boucher, who is CEO, he is very disciplined, focused, very commercial. So we liked him. And we made our investment, we own less than 10%. But it will be an investment for us, part of our $24 billion portfolio.

## Q - Mark Dwelle {BIO 4211726 <GO>}

Okay. That is all of my questions. Thank you.

### A - Prem Watsa {BIO 1433188 <GO>}

Thank you, Mark. Next question, Julianne.

### Operator

Thank you. Robert Alford from Atlas.

### Q - Robert Alford {BIO 16912062 <GO>}

My question was on the Bank of Ireland. You just answered it. Thank you.

### A - Prem Watsa {BIO 1433188 <GO>}

Good morning, Robert.

### Q - Robert Alford {BIO 16912062 <GO>}

Good morning.

### A - Prem Watsa {BIO 1433188 <GO>}

Your question has been answered. So we pass it onto perhaps Julianne, any other questions?

### Operator

Yes. The next question comes from (Sergie Catrin, KIP).



### Q - Sergie Catrin

Good morning. Hello. Could you please comment on your insurance runoff business? And the second question is, could you please comment on your CPI deliveries please?

### A - Prem Watsa {BIO 1433188 <GO>}

Okay. So the runoff business, it is a business that we have. And have had for a long time, 1998. So for 12 years. We like the business. We have a very good team run by Nick Bentley. And we have made a couple of acquisitions which we described in our Annual Report. We like the business. We like the management that we have. And over time it has been a very good business. You can see the results in our Second Quarter statements. Under CPI, the consumer price index, so we had a cost of $428 million that we invested in the consumer price index derivatives, that benefit from deflation, but that suffer from inflation, again explained in our Annual Report. Versus cost, versus what we paid for it. We have already taken a $246 million loss, unrealized. These are ten-year contracts, so in our books it is at $182 million.

When you look at the six months, you will see a $285 million loss in the six months, that is because we had some unrealized profits in 2010. But if you look at costs, we paid $428 million, we have taken a $246 million loss. So it is in our books at $182 million. This is what fluctuations do, they go up and down. These are ten-year contracts. We think of this as insurance in terms of the unexpected. And if we have deflation, these contracts can be very, very valuable, and we have not sold any. We have the better part of $50 billion in terms of nominal exposure. But the fluctuations, so our statements in the first six months, $285 million loss, that has gone through our statements. But in terms of our costs, it is original cost, $246 million. We like it and we like it over the long-term.

## Q - Sergie Catrin

Okay. Thank you.

## A - Prem Watsa {BIO 1433188 <GO>}

Thank you very much. Julianne, next question.

## Operator

Thank you, James Findlay from Park.

## Q - James Fendlay

Good morning.

## A - Prem Watsa {BIO 1433188 <GO>}

Good morning.

## Q - James Fendlay

Could you just remind me what your cost is in some of your international operations? And how you think about the value of those? You seem to be every quarter you make more investments.

## A - John Varnell {BIO 5699703 <GO>}

Okay. Cost in the international operations. Wait until I get my sheet here.

## A - Prem Watsa {BIO 1433188 <GO>}

Yes. We have a little in the Annual Report for you. But John, approximately how much have you got in international operations? Our share?

## A - John Varnell {BIO 5699703 <GO>}

Our share of book value would be the, just under $1.3 billion. We would have premiums that would be greater, somewhat greater than that $1.3 billion. In some of those cases we have 100% ownerships, in other cases we have 26% ownership in India. So we have a good mix there. The reason we like those markets is that there is not a lot of insurance written there. So you can grow your insurance business quite a bit, and also you have low penetration in terms of the number of people buying. So you have good growth opportunities there. And the example, best example would be India, where we went in about ten years ago, put in $10 million, $20 million, and now we have the largest private insurer in India, which would rate in excess of $800 million, $900 million. And so that is the reason we like it, is the growth opportunity, as well as the investment opportunity for looking at local investments, with local management, who know the market, so it gives (Hamm & Watson) advantage there as well.

### A - Prem Watsa {BIO 1433188 <GO>}

We have built these over the last ten years, and they are getting to be quite significant and as John said, growing. But that is, we have put little money in.

### Q - James Fendlay

Pardon? What was that?The $1.3 billion book cost, how much of that would be India?

### A - Prem Watsa {BIO 1433188 <GO>}

How much is in India?

### A - John Varnell {BIO 5699703 <GO>}

100. Just over $100 million in terms of book.

### A - Prem Watsa {BIO 1433188 <GO>}

Our core equity interest in our Indian operation, that is 26%. That is the maximum that the Indian government allows foreign companies to own is approximately $100 million.

### Q - James Fendlay

100. Okay. Thank you.

### A - Prem Watsa {BIO 1433188 <GO>}

Next question, Julianne.

### Operator

Thank you. I have no further questions in the queue at this time.

### A - Prem Watsa {BIO 1433188 <GO>}

No more questions, Julianne? Well if there are no more questions. Thank you, all for joining us on this call. We look forward to presenting to you again after the next quarter. So thank you.

### Operator

This concludes today's conference call. Thank you for joining. All parties may disconnect at this time.