Q4 2011 Earnings Call

Company Participants

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

Other Participants

- Daniel Baldini, Analyst
- Howard Plinker, Analyst
- Jeff Fenwick, Analyst
- Mark Dwelle, Analyst
- Paul Holden, Analyst
- Shawn Berry, Analyst
- Tom MacKinnon, Analyst

Presentation

Operator

Good morning. Welcome to Fairfax's 2011 year-end 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)

For time's sake we will ask that you limit your questions to one. Today's conference is being recorded. If you have any objections you may disconnect at this time. Your host for today's call is Prem Watsa, with opening remarks from Brad Martin. Mr. Martin, please begin.

Brad Martin {BIO 3466650 <GO>}

Good morning. Welcome to the conference call to discuss Fairfax's 2011 year-end results. The comments we make during this conference call may contain forward-looking statements. Actual results to differ perhaps materially from those contained in such forward-looking statements as a result of a large variety of uncertainties and risk factors, the most foreseeable of which are listed in Fairfax's annual report, which is available on our website at fairfax.ca, or are set out in a risk factors in Fairfax's base shale perspectives filed with the Securities Regulatory Authority of 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 year end conference call. I plan to give you the highlights, and then pass it on to John Varnell, our CFO for additional financial results. Our book value per share decreased by about 0.4% and 2011 to $364.55 per share from about $376 a share at the end of December, 2010, after we adjust for the $10 dividend per share that we paid in the First Quarter of 2011. Our results have always spent lumpy, as I've said during the Third Quarter call, and they were again in the Fourth Quarter. We had realized and unrealized gains of $1.6 billion in the Third Quarter, of which $0.9 billion was reversed in the Fourth Quarter. So the best way to look at our results is for the full year 2011.

Firstly, 2011 was the second worst year on record for major catastrophes for the industry. The Japanese earthquake cost the industry $35 billion; the Thai floods, $15 billion to $20 billion, US tornadoes, $14 billion; New Zealand earthquake, $12 billion; and Hurricane Irene, $5 billion, and some other catastrophes ended up costing our industry, in 2011, approximately $105 billion. The worst year for catastrophes was 2005, with the Katrina, Rita, Wilma hurricanes costing the industry $125 billion. These catastrophes in the 2011 cost us approximately $1 billion, the worst catastrophe loss in our history. In spite of these losses, our investment results of $700 million of investment income, interest and dividends that is, and $691 million of realized and unrealized gains resulted in Fairfax basically breaking even in 2011, with our book value being essentially unchanged after adjusting for that $10 per share dividend that was paid out in the First Quarter of 2011. As you know, our results are lumpy, as I've said to you many, many times, and particularly lumpy in the short-term.

Here is what happened to our book value per share on a quarterly basis in 2011. We ended the year 2010 at a book value of $376 per share. At the end of the First Quarter, our book value went down to $355 a share; end of Second Quarter, $359 a share; at the end of the quarter three, $403 a share; and at the end of quarter four, back to $365. So with fluctuating markets, and mark-to-market accounting, we don't see how results can be anything but lumpy. White 2011 and 2010 were nothing to write home about, our last five-year compound annual growth rate in book value per share was 19.5%. And over our history of 26 years, the compound growth rate in book value was 23.5%, among the best in the business that we are in. We achieved these results by taking short-term gain for long-term gain. We have always been focused on the long-term.

In our industry, catastrophes happen. They are unpredictable, and they often destroy companies. We have always focused, since we began in this industry, we've always focused on our total exposures, and we work hard towards limiting our losses to one year's worth of income, but no loss of shareholders capital. At both the OdysseyRe level and Fairfax, we again achieved this objective. By the way, the best way to look at results in the property casualty business is over long periods of time. For example, for all of the OdysseyRe's property business, over the 12 underwriting years, 2000 to 2011, which encompassed September 11, the 4 hurricanes of 2004, and Katrina, Rita, Wilma in 2005, and hurricane Ike in 2008, and the Chilean earthquake in 2010, OdysseyRe wrote a cumulative $6.4 billion of net premiums at an average combined ratio of 94.5%. For you, our shareholders, the most important point to recognize in our 2011 results is that business is expanding again, after being in a downturn for the past four years.

In 2011, including the acquisitions we made, net premiums written at Fairfax grew by 23%. Excluding acquisitions, Fairfax grew by 11%. At the subsidiary level, net premiums written in 2011 grew as follows; Zenith, plus 18%; Crum and Forster, plus 14%; OdysseyRe, plus 13%; Fairfax, Asia, plus 14%; Northbridge, plus 2%. We are growing again. The huge catastrophe losses in 2011, very low interest rates, and a lack of reserve redundancies means there is no place to hide for the industry. Combined ratios have to drop well below 100% for the industry to make a single-digit return on equity with these low interest rates.

In the investment area, net investment gains of $691 million for the year 2011 consisted of the following. If you will please note page two of our press releases, the table there is what I am highlighting, now. Net losses on equity and equity related investments of $793 million are predominantly unrealized, and were reduced by net unrealized gains of $414 million on our equity hedges. So our equity hedges were a positive in 2011. Net bond gains of $1.3 billion, and net losses in CPI linked derivatives of $234 million, and other net gains of $25 million, resulted in a net investment gains of $691 million in 2011 for Fairfax.

In total, we realized almost $1.1 billion in gains in 2011, which were offset by $397 million in unrealized losses, for a net gain of $691 million. We sold about 50% of our long treasury position at about 3% on the long treasuries, for a gain of $271 million. Much of the unrealized losses are only fluctuations, and if history is any guide, should result in profits over time. As of December 31, 2011, the Company held approximately $1 billion of cash, short-term investments and marketable securities at the holding company level. Our Company continues to be soundly financed, with little near-term debt maturities, as we extended the term of our debt at lower interest rates in 2011.

Finally, we continue to be approximately fully hedged in relationship to our equity and equity related securities, which includes convertible bonds and convertible preferred stock, with some variation in the percentage hedged, due to fluctuating markets. We continue to be very concerned about the prospects for the financial markets and the economies of North America and Western Europe, accentuated by the breaking of the real estate bubble in China in late 2011. 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>}

Thank you, Prem. I will start with the Fairfax consolidated results for the Fourth Quarter and for 2011. I will talk about the operating Company results, and I will finish up with a bit on financial position. For the full year 2011, we had net earnings of $45.1 million. That compares to prior-year earnings of $335.8 million. The 2011 loss, fully diluted per share, was $0.31 per share, and that deducts the preferred dividends, versus our 2010 results of $14.82 per share. We had a net loss for the Fourth Quarter of $771 million, or fully diluted, $38.47 per share. That compares with the Fourth Quarter of 2010, where we had a $494 million net loss, and that diluted is $24.77 per share. For the full year 2011, Fairfax had a combined ratio of 114.2. The compares to a 103.5 combined ratio in 2010. We had an underwriting loss in 2011 of $754 million. That compares to an underwriting loss of $160 million in 2010.

As Prem said, the catastrophe losses for the year 2011 were just over $1 billion, made up of the Japanese earthquake, Thailand floods, and to a lesser extent, the US tornadoes, New Zealand, and Hurricane Irene, which had an impact of 19.3 combined ratio points. For comparison purposes, the cat losses in 2010 were $331 million, which included Chile, New Zealand, and the Xynthia storm, as well as some other catastrophes, for a 7.3 combined ratio point impact. In terms of prior-period reserve development, we had good results in 2011. We did record a benefit from favorable reserve development for the year, $89.4 million, or about 1.7 combined ratio points. And that was about the same impact as we had in 2010. That works out to an accident year combined ratio in 2011 of 115.9, and that compares to a 2010 combined ratio of 105.2.

Now, I will talk about the operating companies, starting with OdysseyRe. In the Fourth Quarter and fiscal year they had underwriting losses due to Thailand and Japan. In the Fourth Quarter, their combined ratio was s 122.7, and they generated an underwriting loss of $122 million. In 2010, they had an 85.8 combined ratio, and an underwriting profit of $68 million. For the full-year 2011, Odyssey had a 116 combined ratio, and an underwriting loss of $336 million. For the full year 2010, Odyssey had a 95% combined ratio, and an underwriting profit of $95 million.

On an accident year basis, the combined ratio at Odyssey was 119.3 for 2011, compared to 98.6 in 2010. Cat losses in 2011 accounted for $734 million, or 36.7 combined ratio points from the catastrophes we have mentioned previously. Cat losses in 2010 accounted for 11.7 combined ratio points for Odyssey. On an accident year basis, excluding the cat losses, Odyssey performed at 82.5% in 2011. That compared to about 87% in 2010. And on a net premium written basis, Odyssey wrote $2.1 billion this year, up from $1.85 billion last year, as Prem mentioned. Odyssey's net premiums written increased 9.7% in the Fourth Quarter of 2011, to $477 million. Compared to the Fourth Quarter of 2010, they wrote net premium of $435 million, which reflected increased writings across many of OdysseyRe's lines of business, which included property, marine business, travel business, and commercial automobile lines of business.

Crum & Forster in the Fourth Quarter had a combined ratio of 120 and an underwriting loss of $57 million. For the full fiscal year, the combined ratio was 107.9, and an underwriting loss of $79 million. On an accident year basis, the combined ratio was 104.2. Net premiums written at Crum & Forster were just under $1.1 billion, compared to $773 million in 2010, and that reflects the acquisition of First Mercury, as well as internal growth. Crum & Forster continues to focus on growing its specialty business, and that resulted in year over year increases of 25% net premiums written in the Fourth Quarter of 2011. The growth in Crum & Forster's specialty lines of business are primarily at Seneca and ANC Fairmont divisions, including the accident and health lines of business, and they increased gross premiums written by the $44 million, or 29% in the Fourth Quarter compared to the previous quarter.

Zenith had a combined ratio for the year of 127, and an accident year ratio of 122. Net premiums written by Zenith were $524 million in 2011, compared to $186 million for the 2010 year, and the 2010 year was just a partial year that they were owned by Fairfax. Net premiums earned by Zenith during the Fourth Quarter and year ended December 31, 2011 increased year over year by 19% and 15.8%, respectively, reflecting Zenith's ability to write new business and retain existing customers at higher prices, as there were changes in the economic and competitive environment for workers compensation business.

Northbridge's Fourth Quarter combined was 101.9. The full year combined ratio for Northbridge was 102.8. On an accident year basis, the combined ratio at Northbridge was 106, as Northbridge benefited from favorable development of 3.7 points. Net premiums written by Northbridge were $1.1 billion for the year, compared to $985 million in 2010, measured in US dollars, and that was an increase of 11%. Northbridge's net premiums written increased by 3.7%, or 4.9% in Canadian dollar terms in the Fourth Quarter of 2011 compared to the Fourth Quarter of 2010, reflecting some price improvements and increased levels of new business retentions of existing business.

Fairfax Asia, the Fourth Quarter combined for Fairfax Asia was 89.2%. For the whole year the combined ratio at Fairfax Asia was 83.2%, compared to 89.3% in 2010, and they generated an underwriting income of $34 million, compared to $17 million in 2010. Net premiums written by Fairfax Asia were $213 million, compared to $157 million in 2010. Their net premiums written increased by 13% as a result of increased writings of professional indemnity, commercial automobile, and property business, and the favorable effect of foreign currency translation at first capital.

Reinsurance and insurance other in the Fourth Quarter had a combined ratio of 155, and for the full fiscal year had a combined ratio of 140.9 due to our participation in cat loss programs. There was favorable development of 7.9 combined ratio points in 2011. The net premium written declined by about $50 million in 2011. And finally, our runoff group had another good year, and earned $361 million pretax in 2011, compared to $136 million earned in 2010. Our Companies continue to be well-capitalized by a premium-to-surplus ratio test. Northbridge, on a premium written-to-statutory surplus is writing at 0.7 to 1, Crum & Forster a 0.9 to 1, Zenith at 0.8 to 1, OdysseyRe at 0.6 to 1, and Asia at 0.5 to 1, and overall, Fairfax is writing at a 0.7 to 1 premium-to-surplus ratio. Interest and dividend income decreased slightly year over year for Fairfax. It was down 1%, to $705 million from $711 million in 2010.

Our 12 month interest and dividend yield was flat at 3.26% in 2011, compared to 3.36% in 2010 before hedging expense. Our average portfolio size over the last 12 months, and this includes holding company cash and investments, increased in 2011. The average portfolio size was $24.1 billion, and we ended the year with an investment portfolio, which included holding company cash and investments, of $24.5 billion. In terms of financial leverage, our year-end debt-to-capital ratio was 26.4%, compared to 23.9% in 2010. And before I pass it over to Prem, I would like to remind everyone that our annual general meeting will be held on Thursday, April 26, at 9.30 AM at Roy Thompson Hall. The details will be in the annual report on the last page, which will be published on March 9 in the evening. Back to you, Prem.

Prem Watsa {BIO 1433188 <GO>}

Terrific, John. Thank you very much. And 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's fair to everyone on the call. Okay, Caroline, we are ready for the questions.

Questions And Answers

Operator

Thank you.

(Operator Instructions)

Please limit yourself to one question. Our first question or comment comes from Paul Holden, from CIBC.

Q - Paul Holden {BIO 6328596 <GO>}

Hi. Good morning. Wondering if you can talk a little bit more about your reinsurance operations from sort of three perspectives. Your experience with the January rate renewals, your capacity to underwrite more business and reinsurance, and then should we still expect cat losses of say 4% to 5% of premiums written long-term?

A - Prem Watsa {BIO 1433188 <GO>}

The last component again, Paul?

Q - Paul Holden {BIO 6328596 <GO>}

Sorry, cat losses of 4% to 5% of premiums written. Is that a good long-term average?

A - Prem Watsa {BIO 1433188 <GO>}

Yes. So just on the 1-1, as I mentioned to you, cat losses in 2011 were very, very high. And so, the industry, many participants in the industry have had losses for the year, including investment income. And so, capital has depreciated significantly. In the property cat area, prices have gone up quite significantly. In Japan for example, you'd have price increases in the 50% area, in Thailand it's early days, but 100% price increases, so the cat exposure pricing is up significantly, and maintaining pressure all over North America also. So that's an area where we find the pricing is attractive and we are taking advantage of it. So whenever you have catastrophes, you have losses, the other side of it is the opportunity side, and we are facing a as we speak. On cat loss, over time, 4 to 5percentage points is reasonable for Fairfax, but in any one year, it's one of those situations where you have years where there is no catastrophe, and some years where you have catastrophes, but 4 to 5percentage points over the long-term is not a bad cost to take into account.

Q - Paul Holden {BIO 6328596 <GO>}

Thank you.

A - Prem Watsa {BIO 1433188 <GO>}

Thank you, our next question, Caroline?

Operator

Our next question comes from Jeff Fenwick from Cormark Securities.

Q - Jeff Fenwick {BIO 15350794 <GO>}

Good morning.

A - Prem Watsa {BIO 1433188 <GO>}

Good morning, Jeff.

Q - Jeff Fenwick {BIO 15350794 <GO>}

I just wanted to follow up on the reinsurance question first, and maybe we can talk a bit about US P&C. So on the reinsurance side there the exposure to the Thai flood there was a bit larger than I would've thought, and maybe just a little bit of color on how it was that large. Then secondly in Japan, we continued to see some emergence of claims there, as well. So how should we be thinking about that sort of ongoing process in Japan and how it's going to impact future quarters here?

A - Prem Watsa {BIO 1433188 <GO>}

Yes. So in terms of Thailand, that's a very good question. It was a little higher than what we expected also. And the reason for that was Thailand wasn't really a catastrophe exposed area, but not considered a catastrophe exposed area, so the Thailand floods were a surprise. The exposures were very significant, Japanese industry had built a huge amount of manufacturing in Thailand, outside Bangkok, so those losses were a surprise. I think we feel comfortable that we've reserved for it, and also look and analyze so that we can be more effective in the future. As far as the Japanese earthquake, tsunami losses, there was one account, the (technical difficulty) account, which we basically we've -- it resulted at limit, so it can't move. So we feel comfortable there, too, Jeff, that these losses are behind us. And as I said, the pricing -- so when you get these big losses, many companies withdraw from writing in the industry. They recognize the risk, see the risk. We haven't had a Japanese earthquake for a long time. Thailand hasn't had a flood in 50 years, so then the exposures are very obvious to everyone. And so the prices go up, and when the prices go up, you're getting paid to take the risk, and so we will make sure that we maintain our exposures, and sometimes increase our exposures, always within our limits.

Q - Jeff Fenwick {BIO 15350794 <GO>}

That's fair enough. And maybe we would just speak a little bit about the US insurance business. Obviously some encouraging signs from some of the specialty lines, in terms of growth, but the adverse development there in the quarter out of Crum and Zenith was maybe a little more also than I would've expected. Any color around what was the play there, and what we should think in terms of emergence patterns there going forward?

A - Prem Watsa {BIO 1433188 <GO>}

Yes. So just maybe on the adverse development. We're very conscious of reserves, and we always want to be properly reserved at any time, and so Zenith saw some reserve development. They hit it hard in 2010, they hit it hard in 2011. You'll see, for four years now, we've been reducing business -- I am talking about Fairfax in total, we've been reducing our business. All of the companies that have increased their business will see the emergence of these losses, and will have to face up to them in time. We'd like to think we are ahead of the game by reserving properly as and when we see these developments, so Zenith is well reserved, and in terms of pricing, we're seeing significant price increases in the workers compensation area for Zenith. For example, you saw and I told you, in terms of the price, in terms of the premium increases, this is for Zenith for the year, John mentioned to you that we've owned it in the middle of 2010, but if you look at Zenith results, Zenith 2011 compared to Zenith 2010, for the full year, they are up 18%, and the trends as of January 1 2012 are very good, also.

So they carry over, and what happens is if you write business in the soft markets, the reserve development comes to haunt you. And we've had this over 26 years, we've experienced this and the key thing, the key strategy tactics, is to drop your premiums at the time, which we've done in Crum and Zenith. Zenith, of course, is a classic, they did even before, (Zenith) did it even before we've bought it. They were writing $1.1 billion, they dropped it to $450 million, they are running at through $500 million, and it has bottomed out now. And the expense ratio for Zenith, and when John talks about the combined ratio at 125%, it's not the loss ratio, their loss ratio is very, very steady in the 60%, 65% area. But the expense ratio increases, because of the drop in premiums. Well that expense ratio is going to drop now, and Zenith is well-positioned to expand significantly in the years to come.

So the specialty areas, property related areas, any exposure to catastrophe have had price increases. Casualty pricing has bottomed out, and of course will have to see how the momentum continues. From an industry-wide basis, Jeff, it's just that interest rates have come down to such low levels there is really a lack of investment income. I'm taking interest income, particularly, for the industry. Four or five years ago, five-year treasury rates were in the 5% area. They are now less than 1%, 0.75%, So that's very significant decreases in interest rates, and if you take shorter rates, like two and three year rates, they are basically non-existent, so the underwriting profit has to be significant just to make a single-digit, 6%, 7%, 8% return on equity.

You have to get very significant underwriting profit, and so we think those trends are coming to bear, but you have to monitor, of course, and only time will tell. But we like what happened to us in 2011, in the Fourth Quarter of 2011 also, and our businesses are growing again, as I said. From a shareholder standpoint, that is the single most important thing to focus on, from a long-term standpoint, because when our business grows, our investment portfolios growth, our investment income over time will grow, and I have talked about this before, it's a virtuous cycle, and it works. So early days still, let me remind you, early days, but we like what we see.

Q - Jeff Fenwick {BIO 15350794 <GO>}

Great. Thanks for the color.

A - Prem Watsa {BIO 1433188 <GO>}

Thank you. Thank you, Jeff. Next question, Caroline?

Operator

Our next question comes from the line of Mark Dwelle, RBC Capital Markets.

Q - Mark Dwelle {BIO 4211726 <GO>}

Good morning. A few questions.

A - Prem Watsa {BIO 1433188 <GO>}

Morning, Mark.

Q - Mark Dwelle {BIO 4211726 <GO>}

Can you provide a breakdown in terms of the actual catastrophe losses in the quarter, and what portion of that was in-quarter losses, and what portion were additions related to catastrophes that occurred in prior quarters?

A - Prem Watsa {BIO 1433188 <GO>}

Yes. I think we do that in our statements, don't we, Dave? We break it down through the statement. The big ones were Thailand in 2011 Fourth Quarter. Thailand was the big one, and the one that we had an increase on was the Japanese earthquake. So in the Fourth Quarter, the Thailand flood was about a little more than $200 million. And the Japanese earthquake, Mark, was about $105 million. That's an increase, right?

A - John Varnell {BIO 5699703 <GO>}

Correct.

A - Prem Watsa {BIO 1433188 <GO>}

And that's basically to limit. Then we had odds and sorts of $8 million for New Zealand, this is on page 80, by the way, in the interim report. It is 108 pages, I think, Mark, so it's a little tough to go through it. It's all this IFRS reporting, but $8 million in New Zealand earthquakes, the US tornadoes $5 million, and odds, and so as I said, the total comes about $360 million. That was about 25.8percentage points, that's for the quarter, John mentioned 19.3% for the year. And our combined ratio was 114%.

Q - Mark Dwelle {BIO 4211726 <GO>}

Right. Okay. My second question, you post-the end of the quarter, you guys acquired Thai Re, and I'm wondering if you could provide a little bit of an overview in terms of what the size of that business is, when it may close, a little bit of background to help us model how that might go going forward?

A - Prem Watsa {BIO 1433188 <GO>}

Sure. Whenever you have these catastrophes, Mark, and you know this, you've followed the industry for some time, there's the opportunity side. Thai Re is a company, Thai Re has been in business for a long time in Thailand. It is the dominant local reinsurer, it is run by gentleman by the name of Surachai, and his track record over 22 years is, in the combined ratios, in the middle 80%s, 85% area, over 22 long years. Very, very smart businessman. And we've been looking -- we've known him for 10 years, and we've been looking for an opportunity to have a deeper relationship with him. Well you have the Thai floods, and the Company's equity, I think, was basically eliminated, and so they are doing a rights issue, and we are putting in approximately $70 million for approximately 25% of the Company, fully diluted. And add to it, we think, a very good price with an accomplished insurance executive, Surachai, and we're going to be partners with them.

This will close, Mark, before the end of the First Quarter. And I think the rights issue comes in about a few weeks time, and then we close after that. We get two members of the board, and we also will help them on the investment side. So it's very -- we are really excited about that company in terms of, it's not huge for us, but we are developing our Asian business. You saw our Asian business, what is quite remarkable to me, and I talk about it in our annual report is Mr. Appathan, who runs Fairfax Asia, and runs First Capital, particularly and most of these catastrophes took place in Asia. He still had a very good combined ratio, excellent combined ratio. In the high 70%s, I think below 80% last year. So our Asian business is growing, our Asian business is running very well. This Thailand in investment for us, 25%, is another way to build it, and we think we got it at a good price.

Q - Mark Dwelle {BIO 4211726 <GO>}

Okay, that's helpful. One last question if I may. Has there been any material change in your equity hedge position since the end of December? You were obviously 105% hedged or so at the end of the quarter. Has there been any big change in that since that time?

A - Prem Watsa {BIO 1433188 <GO>}

No. No. There hasn't been, and that 105%, by the way, we aim for 100%, sometimes we sell some stock positions, or the sub common stock positions go up, so the hedge is plus-minus 100%, really. It doesn't mean that we are a lot more negative on the stock market, or anything like that, it is plus-minus 100%. But no change. Yes, no change. We think -- I mentioned in my opening comments, and we'll say more in the annual report, but we've had periods like this in 2010 and 2011, where markets get excited. We think the problems in Europe are well known. We think the United States is having a tepid recovery, the 2.8% growth in the Fourth Quarter, if you take out inventories, is more like 0.8%, and I know some of the numbers are coming in a little bit more positive. We just think that a long period of deleveraging that's going to take place with these ups and downs in the marketplace, as perhaps more optimism comes at one time, and pessimism at the other, and you have to protect yourself during periods like this. But there will be a time when -- if you take a long-term view, that common stocks will be very attractive. So we like the common stock portfolio that we have, the stocks that we own, but we just worry about the downside.

Q - Mark Dwelle {BIO 4211726 <GO>}

Okay. Thank you. That's very helpful.

A - Prem Watsa {BIO 1433188 <GO>}

Terrific, thanks, Mark. Next question, Carolyn.

Operator

Our next question comes from 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, Prem, you said in your remarks that you think the industry combined ratios need to drop below 90%, and I imagine you're referring to industry combined ratios as they relate to reinsurers and commercial line writers. Now --

A - Prem Watsa {BIO 1433188 <GO>}

I'm talking broadly speaking, and not below 90%, I'm talking in the 90% area, Tom, so that if you did the math, and you take some average interest rate to get any type of return on equity, with these low interest rates, and remember the five-year rates are rolling off. Every month, you've got interest income coming down, as the old interest rates roll off, right? So if you've got two year maturities and three year maturities, they're rolling off, and investment income is coming down. There is not too many places, obvious places, of getting investment income. And so, to compensate for that, underwriting profits have to be significantly higher, and-or you're going to make no return on your capital.

Q - Tom MacKinnon {BIO 2430137 <GO>}

Now, I don't know how much you think your combined ratios could decline, but even if they fell 4 or 5 points, and you actually got a significant increase in your earned premium, say 40% or 50%, if equity -- how do you respond --?

A - Prem Watsa {BIO 1433188 <GO>}

To that? Tom the way we look at it --

Q - Tom MacKinnon {BIO 2430137 <GO>}

If equity markets went up, and bond rates went up, it would be a wash. So I think you're somewhat positioned for a firming market, but an improving macro environment might offset some of that. You are more levered on the investment side, if you will, then on the underwriting side. It depends upon the scenario -- based on leveraging scenarios, if you will.

A - Prem Watsa {BIO 1433188 <GO>}

So let me tell you, on the underwriting side, when we've been shrinking our business, two things happen, right? The first one is our expense ratios have gone up, we keep talking about that. Our expense ratios have gone up. Well with our business going up, the expense ratios will come down, and better pricing will just get you -- or loss ratios will get you better loss ratios, particularly in some of our specialty lines and in our property lines, and over time in the casualty area. So the loss ratios will come down, but the expense ratios come down. And in the investment side, we have $6 billion in cash in our insurance companies. $6 billion in cash. We've got muni bonds. Our treasury bonds, you might have thought with economic growth, we've sold 50% of them, so we've got the other 50%. We sold it at not too different interest rates, long rates, from where they are today.

So about 3%, and those will be sold some time. Sometime we'll take the hedge out, and we've got a lot of flexibility. That's what we've built into our Company. Lots of flexibility to take advantage of opportunity as and when it arises over time. And so, I mentioned at the end of 2011, our five-year compounded growth in book value of 19.5%, I don't think you'll find too many companies with that. But that means we don't worry about a quarter, and quite often a year. So 2011 wasn't a significant year for us, and 2010 wasn't a significant year for us. But the last five years, you take them together, and its 19.5% compounded growth in book value. So that's how we've always built our Company. Over 26 years, our growth in our book value is 23.5% per year, for 26 years.

Very, very few companies in any industry have achieved that. And we do that, as I said, by taking short-term pain, like the Fourth Quarter, for long-term gain. And it's very difficult to do for most companies. But we've always -- we've got a culture of focusing in the underwriting side and in the investment side on the long-term. And we attract a certain shareholder base that likes that. If you are looking for quarterly results, and perhaps annual results, Fairfax really is not the Company for those investors, because we really don't know how to do well for our shareholders on a quarter-by-quarter basis. But we have done well for our shareholders over the long-term. And that continues to be our focus.

Q - Tom MacKinnon {BIO 2430137 <GO>}

Okay. Thanks, Prem. Thanks for highlighting the flexibility, I think that's important thing to note.

A - Prem Watsa {BIO 1433188 <GO>}

Thank you, Tom. Next question, Carolyn.

Operator

Our next question comes from the line of Daniel Baldini from Oberon Asset Management.

Q - Daniel Baldini

Hi. Good morning, thanks for taking my call.

A - Brad Martin {BIO 3466650 <GO>}

You're welcome a thank you, Daniel.

Q - Daniel Baldini

Sure. Say, when I look at the results up a couple of these insurance companies that folks consider best in class, like Archer, Marquel, or White Mountain, or WR Berkley, their combined ratios over the past couple of years have been lower than Fairfax's. And in Archer's and Marquel's recent press releases, they also talk about these extraordinary cat losses. I'm sort of interested to understand a little better how your underwriting strategy might be different from theirs. Are you pricing lower than them, in expectation or hopes of acquiring more float, which you can very cleverly invest? Are you, maybe, intentionally taking more risk with the expectation that when things go well the payoff will be higher? Any color on that would be really interesting.

A - Prem Watsa {BIO 1433188 <GO>}

Daniel, that's a good question, but no, we definitely don't do that. Were not pricing lower to get more business, so that we can have a higher float, so that we have money to invest. We definitely don't do that. But when you look at some of these companies you quoted, like Archer, Marquel, remember, Odyssey Re is almost 50% of our business. So we've got a Company that is in the reinsurance business worldwide, and it's about 50% of our business, so you have a catastrophe, you compare our results to (Evers Re), you compare our results to Transatlantic, and we give you results for Odyssey Re, so you can compare Odyssey to any of those companies, or Partner Re, or Platinum, or any of these other reinsurance companies that are Bermuda-based. You will see Odyssey does very well. Then if you look at each of these companies, they're good companies, the ones that you mentioned. But you look at them on a 5-year basis and a 10-year basis, and you look at them on a 15, 20-year basis, our returns compare very well. In fact, we tend to exceed them over almost any long-term period.

But those are good companies, they follow the same approach we do in terms of focusing on underwriting profit and reserving well. And that's what we've done for 26 years, and we've continued to do that, and when the markets turn, as they seem to be doing today, we'll see our expense ratios come down and our loss ratios improve, and have good underwriting profit again. So in the last four years, Daniel, we've dropped our business. If you look at each of our companies, Crum & Forster, Zenith, I mentioned Odyssey, our premiums have come down. Northbridge, our premiums have come down, not gone up. So we're definitely not interested in getting float for the sake of getting float. We look at the two sides separately. Our presidents are all focused on the underwriting profit, no bonuses, compensation for the top line, and no bonuses, compensation for generating float. It's all about underwriting profitability with good reserving.

Q - Daniel Baldini

Thank you.

A - Prem Watsa {BIO 1433188 <GO>}

Thank you, Daniel. Next question, Carolyn.

Operator

Thank you.

(Operator Instructions)

Howard Plinker from Plinker and Company.

Q - Howard Plinker

Hello, everybody.

A - Brad Martin {BIO 3466650 <GO>}

Hi. Good morning, Howard.

Q - Howard Plinker

I'm not sure I heard you clearly, but if I didn't, maybe you can skew a few numbers. What were the expense and loss ratios for the two Fourth Quarters, this year and last year, and for the full-year last year? And separately, what was the growth in premiums written in this year's Fourth Quarter adjusted for acquisitions?

A - Prem Watsa {BIO 1433188 <GO>}

So Howard on page 79 of our --

Q - Howard Plinker

Oh, I didn't look at the whole thing. On page 79, okay, I'll look it up.

A - Prem Watsa {BIO 1433188 <GO>}

If you look at page 79, it will give you the Fourth Quarter loss ratios, underwriting expense, combined ratios for the accident year, and for the calendar year.

Q - Howard Plinker

For the whole Company or for separate division?

A - Prem Watsa {BIO 1433188 <GO>}

That will give it to you in total.

Q - Howard Plinker

Okay. Thank you.

A - Prem Watsa {BIO 1433188 <GO>}

And if you look at it, in the sections on each Company, you will find the combined ratios and the premiums for each of them by quarter. I apologize it's a long report.

Q - Howard Plinker

Yes I didn't look, I looked at the shorter version.

A - Prem Watsa {BIO 1433188 <GO>}

I can't blame you. But when you look at that long report, you will find all the information there.

Q - Howard Plinker

And the adjusted growth in premiums written in the Fourth Quarter? Or the real growth, if you want to call it that?

A - Prem Watsa {BIO 1433188 <GO>}

Yes. It's all there --

Q - Howard Plinker

It is?

A - Prem Watsa {BIO 1433188 <GO>}

It's all there, Howard.

Q - Howard Plinker

Okay.

A - Prem Watsa {BIO 1433188 <GO>}

For you to read.

Q - Howard Plinker

Finally, I will add that at a 90% combined ratio for the industry, it will probably earn about 8% on equity?

A - Prem Watsa {BIO 1433188 <GO>}

There you are, what interest rate did you use?

Q - Howard Plinker

Current.

A - Prem Watsa {BIO 1433188 <GO>}

Yes.

Q - Howard Plinker

3% in the long bond, and make it 2% on the 10 year.

A - Prem Watsa {BIO 1433188 <GO>}

Yes. So there you are.

Q - Howard Plinker

Nothing to write home about.

A - Prem Watsa {BIO 1433188 <GO>}

I'm sorry?

Q - Howard Plinker

8% is still nothing to write home about.

A - Prem Watsa {BIO 1433188 <GO>}

Well that's right. That's exactly our view, Howard.

Q - Howard Plinker

I'm with you. Okay. Thank you very much I will go to the longer version, that will answer my questions.

A - Prem Watsa {BIO 1433188 <GO>}

Okay, terrific, Howard. Thank you for your questions, and Caroline, next question please?

Operator

Our next question comes from Shawn Berry from RBC Dominion Securities.

Q - Shawn Berry {BIO 15039538 <GO>}

Thank you very much. I appreciate your time, gentlemen. Can you speak a little --

A - Prem Watsa {BIO 1433188 <GO>}

Good morning, Shawn.

Q - Shawn Berry {BIO 15039538 <GO>}

Thanks, Prem. Can you speak a little to your investment in Gulf Insurance, and things that are going on there? And any concerns there?

A - John Varnell {BIO 5699703 <GO>}

On what insurance?

A - Brad Martin {BIO 3466650 <GO>}

Gulf Insurance.

A - Prem Watsa {BIO 1433188 <GO>}

On Gulf Insurance. Gulf Insurance is a partnership with KIPCO. They are in the Middle East, Shawn, and they have had another excellent year. Combined ratios in the 80% area, and it's a fine company. Were very happy with our partners. Looking forward to expanding in that area over time. We are in seven countries there. We have, more recently, been helping them to manage the investment portfolios, because as Howard's previous question said, the property casualty business, Shawn, without an investment component, is not a very profitable business, and you can look at it, and when I say that I am talking 10, 15, 20 years.

If you look at the property casually industry, the increase in book value, or the return on equity is nothing like other industries. And the only reason we've been able to do as well as we have is we manage the investment portfolios perhaps a little better than the others. And so, that investment expertise, we are bringing in. More recently, we brought it into Gulf Insurance company in the Middle East, and as I said earlier, we are bringing into Thailand. In our partnership in India, we already manage those portfolios. We, of course, in our 100% owned companies, we manage all the investment portfolios, but we take the property casualty business without an investment perspective. Always taking a long-term perspective is not very attractive. So the Gulf Insurance company is doing very well.

Q - Shawn Berry {BIO 15039538 <GO>}

Were they able to increase their premiums? Because I thought last year they were a combined ratio at about 94%, and with all the concerns with respect to the Arab spring, and everything going on in Syria, et cetera. You said their combined ratio is in the low 80%s now?

A - Prem Watsa {BIO 1433188 <GO>}

We've increased the business, I think, in the 10% area. We will give you a little more information, Shawn, in the annual report for each of our companies.

Q - Shawn Berry {BIO 15039538 <GO>}

Okay.

A - Prem Watsa {BIO 1433188 <GO>}

So the business has grown at 10% plus, I think, and the combined ratios, as I said, have continued to be excellent.

Q - Shawn Berry {BIO 15039538 <GO>}

Great. Thank you.

A - Prem Watsa {BIO 1433188 <GO>}

Thank you, Shawn. Carolyn, next question, please.

Operator

Thank you. And I'm currently showing no further questions or comments at this time.

A - Prem Watsa {BIO 1433188 <GO>}

So Carolyn, if there's no more questions, thank you all for joining us on this call. We look forward to presenting to you again in the next quarter, and prior to that, as John announced, we look forward to seeing you at our annual general meeting on April 26. Thank you very much.

Operator

That concludes today's conference call, thank you for your participation. You may disconnect at this time.