Q3 2012 Earnings Call

Company Participants

- Dave Bonham, CFO and EVP
- Paul Rivett, VP, Ops
- Prem Watsa, Chairman and CEO

Other Participants

- Chris Lafayette, Analyst
- Mark Dwelle, Analyst
- Paul Holden, Analyst
- Tessad Oki, Private Investor
- Tom MacKinnon, Analyst
- William Kontes, Analyst

Presentation

Operator

Good morning. Welcome to Fairfax's 2012 third 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 ask that you limit your question 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 Paul Rivett. Mr. Rivett, please begin.

Paul Rivett {BIO 15243791 <GO>}

Good morning, Audra. Welcome to the conference call to discuss Fairfax's Third Quarter results. The comments we make during this conference call may contain forward-looking statements. Actual results may differ perhaps materially from those contained in such forward-looking statements as a result of a variety of uncertainties and risk factors, the most foreseeable of which are listed in Fairfax's Annual Report which is available on our website and set out under Risk Factors in our Base Shelf Prospectus filed with Canadian securities regulators. I will now turn the call over to our Chairman and CEO, Prem Watsa.

Prem Watsa {BIO 1433188 <GO>}

Good morning, ladies and gentlemen. Welcome to Fairfax's Third Quarter conference call. I would like to give you some of the highlights and then pass it on to Dave Bonham, our CFO, for additional financial details.

In the Third Quarter of 2012, book value per share was up slightly 1.7% from year-end adjusted for the $10.00 per share common dividends paid out in the First Quarter of this year. We have continued improved underwriting results on increased premiums as we produced a small investment loss due to unrealized investment losses, related to our defensive hedging strategy. We finished the quarter with cash and marketable securities at the holding company of $967 million.

The consolidated combined ratio for Fairfax in the Third Quarter and the year-to-date was 95.4% and 97.1%, respectively.

Reserve redundancies were $38 million or 2.4percentage points on the combined ratio in the quarter. We continue to reserve conservatively.

As I have said in recent calls, we continue to grow our premiums. The large catastrophe losses in 2011, very low interest rate and the reduced reserve redundancies means that there is no bridge as high for the industry. Combined ratios have to drop well below 100% for the industry to make a single-digit return on equities received low interest rates.

In the Third Quarter, net premiums written by our insurance and reinsurance operations increased by 5.6% to $1.51 billion from $1.43 billion in 2011. At the subsidiary levels net premiums in the Third Quarter of 2012 were as follows -- for Zenith, up 27.3%; Crum & Forster, up 19.7%; OdysseyRe, up 6.1%; Fairfax Asia, up 8.2%; and Northbridge in Canadian dollars down 5.5% after eliminating the nonrenewable of Northbridge's US property line which was transferred to OdysseyRe.

Net investment losses of $23.6 million in the Third Quarter of 2012 consisted of the following. Please note the table on page two of our press release.

In the Third Quarter, the net realized gains and on bonds and equities of $340 million as you can see from the table was upset by net unrealized losses of $364 million, primarily from our equity hedges. In the nine months, net realized gains from equities and bonds in the main of approximately $730 million were offset by net unrealized losses of $723 million primarily from our equity hedges and CPI-linked derivatives and other losses.

We continue to be approximately 100% hedged in relation to our equity and equity-related securities which includes convertible bonds and convertible preferred stock. We have said for some time that we are concerned about the economies of North America and Western Europe, accentuated by the breaking of the real estate bubble in China in late 2011. And we continue to believe that we are not adequately paid to take risks with bonds and stock markets at current levels.

As of September 30, 2012, we have almost $8.1 billion in cash and short-term investments, about 33% of the investment portfolio, to take advantage of opportunities that may come our way. In the short term, our investment income will be reduced.

On October 12, 2012, the Company completed the purchase of the runoff business of Brit Group with a cash payment by the Company's runoff operations of $332 million at a discount to book value, Brit Insurance at an investment portfolio of approximately $1.4 billion.

On October 1, 2012, the Company announced they had (technical difficulty) Cunningham Lindsey for about $260 million and we expect it to close in the Fourth Quarter. In the Fourth Quarter we also completed a debt offering of CAD200 million and announced a note repayment of $200 million for (Chipec).

During the quarter, the Company completed the purchase of Thomas Cook India for about $173 million. We are very positive about the long-term prospects of this company in India.

The class-action litigation against Fairfax was dismissed with prejudice which means that no further possibility of appeal. Fairfax did not make any payments in connection with this dismissal.

The New Jersey litigation against hedge funds and other defendants was dismissed without prejudice on legal grounds. We believe the decision was incorrect and we plan to appeal.

Now I would like to turn it over to Dave so he can give you some information on the underlying financials. Dave?

Dave Bonham {BIO 15243784 <GO>}

First I will focus on Fairfax's consolidated financial results for the First Quarter, then move on to the key highlights of the operating Company's results and, finally, we'll discuss our financial position.

So first, the consolidated financial results. For the Third Quarter of 2012, Fairfax had net earnings of $35 million and fully diluted earnings per share of $0.90. That compares to net earnings of $974 million and fully diluted earnings per share of approximately $47 per share in the Third Quarter of 2011.

The biggest drivers of the change in our quarterly performance year over year were decreased net gains on investments in 2012, offset by the significant improvement in the underwriting performance of our operating companies.

For the Third Quarter of 2012, Fairfax's insurance and reinsurance operations reported a combined ratio of 95.4% and an underwriting profit of $74 million. That compares to a combined ratio of 107.5% and an underwriting loss of $105 million in the Third Quarter 2011.

The combined ratio in the most recently completed quarter benefited from lower catastrophe losses of $61 million or about 3.8 combined ratio points compared to the Third Quarter of 2011 which included catastrophe losses of $172 million or about 12.3 combined ratio points.

Catastrophe losses in the Third Quarter of 2012 were comprised of a number of smaller or attritional losses, as we sometimes call them, with the largest relating to Hurricane Isaac.

In terms of prior period reserve development, Fairfax's insurance and reinsurance operations recorded $38 million of net favorable development to prior year's reserves or about 2.4 combined ratio points in the Third Quarter of 2012. And that compared to $7.5 million of net unfavorable reserve development or about one half of the combined ratio point in the Third Quarter one year ago.

So that works out to an accident year combined ratio of 97.8% in the Third Quarter of 2012 and that compares to last year of 107%. The difference between the two accident year combined ratios, about 9.2 combined ratio points, principally reflects the absence of any significant catastrophe events during the Third Quarter of 2012, the likes of which occurred in 2011.

The Company recorded a net loss in investments of $24 million in the Third Quarter of 2012 compared to a net gain of investments with approximately $1.6 billion in the Third Quarter of 2012 -- Third Quarter of 2011. Last year's net gains included about $1.3 billion of gains on bonds, principally government bonds.

In the Third Quarter of 2012, our equity hedges or our equity holdings did not appreciate to the same extent as the indexes underlying the majority of our hedges. This caused us to record a net loss of $162 million on our net equity related holdings. Partially offsetting this loss were net gains on bonds primarily US, state, and municipal bonds.

Consolidated interest and dividend income decreased by 41% from $170 million in the Third Quarter of 2011 to $100 million in the Third Quarter of 2012, primarily as a result of sales during 2011 and 2012 of higher-yielding bonds, the proceeds of which were reinvested into lower yield in cash and short-term investments. And the decrease also reflected lower total return swap expense as a result of the timing of dividends payable by Fairfax on the short total return swaps and that was partially offset by the impact of additional short positions affected through total return swaps in late 2011.

The average portfolio size at fair value, including Holding company cash and investments, was comparable on a year-over-year basis at $24.8 billion at September 30, 2012, versus $24.9 billion at September 30, 2011. We ended up for with an investment portfolio at fair value of $25 billion.

Turning to our operating Company results, starting with OdysseyRe. OdysseyRe had a strong Third Quarter, producing a combined ratio of 86.3% and an underwriting profit of $95 million. In the Third Quarter of 2011, OdysseyRe had produced a combined ratio of 103.4% and an underwriting loss of $19 million.

On an accident year basis, the combined ratio at OdysseyRe in the Third Quarter of 2012 was 88.7% compared to 103.6% in the same quarter last year. Cat losses for OdysseyRe were $44 million or 6.3 combined ratio points in the Third Quarter of 2012 compared to cat losses in the Third Quarter of 2011 of $109 million or 19.7 combined ratio points. Cat losses in 2012 were comprised primarily attritional losses, Hurricane Isaac being the largest among them at about $10 million whereas in the Third Quarter of 2011, you will recall the cat losses at OdysseyRe were comprised principally of reserve increases on the Japan earthquake and tsunami, Hurricane Irene and other attritional losses.

OdysseyRe's net premiums written increased 6.1% in the Third Quarter of 2012 to $682 million from $643 million the same quarter last year, primarily reflecting increases in property, quota share, and property catastrophe reinsurance.

Moving on to Crum & Forster. Crum & Forster had an improved combined ratio of 101.4% in the Third Quarter of 2012 and a lower underwriting loss of $4.2 million compared to a combined ratio of 102% in the Third Quarter of 2011 and an underwriting loss of $5 million in that period. On an accident year basis, the combined ratio in the Third Quarter of 2012 of 101.4% was comparable to the accident year ratio of 101.7% in the Third Quarter of 2011.

Net premiums written by Crum & Forster increased by 19.7% to $318 million in the Third Quarter of 2012 and $266 million in the Third Quarter of 2011. This increase primarily reflected growth in Crum & Forster specialty lines of business, specifically in excess and surplus casualty, property, specialty, and accident and health lines of business.

Zenith National. Zenith reported a combined ratio of 114.7% in the Third Quarter of 2012 and an underwriting loss of $23 million compared to a combined ratio in the Third Quarter of 2011 of 124% and an underwriting loss of $31 million. Zenith did not have any net development to prior year's reserves in its most recently completed quarter so it's accident year combined ratio mirrors its calendar year combined ratio of 114%, whereas in the Third Quarter of 2011, Zenith reported net adverse development of $9 million or 6.8 combined ratio points and produced an accident year combined ratio of 117.5%.

Much of the improvement in Zenith's combined ratio reflected a 5.6 combined ratio point decrease in its expense ratio, excluding commissions on a year-over-year basis. And that was principally the result of increased net premiums earned.

Net premiums written by Zenith were $128 million in the Third Quarter of 2012 compared to $101 million in the Third Quarter of 2011, an increase of 27% reflecting Zenith's ability to write new business and retain existing customers at higher prices.

Moving to Northbridge. Northbridge's Third Quarter 2012 combined ratio of about 100% was stronger compared to its combined ratio of 101.4% in the Third Quarter of 2011, which included 9.5 and 4.6 combined ratio points of net favorable development in those periods respectively.

On an accident year basis, Northbridge's combined ratio was 109.7% in the Third Quarter of 2012 which, compared to an accident year combined ratio of 106% in the Third Quarter of 2011. When comparing the change in Northbridge's net premiums written year-over-year, keep in mind that on May 1, 2012, Northbridge transferred the renewal rights of its US property book of business to an affiliate of OdysseyRe where it would be a better strategic fit.

In our Interim Report on page 46, we have provided the details of Northbridge's premiums in Canadian dollars to avoid the distortion caused by the effects of foreign exchange and also excluding the premiums at Northbridge's US property business in 2012 and 2011.

Making reference to that table in Canadian dollars Northbridge's written premium was CAD217 million for the Third Quarter of 2012 compared to CAD230 million in the Third Quarter of 2011, a decrease of 5.5% year-over-year reflecting decreases in new business and lower retentions of existing business, partially mitigated by modest improvements in pricing.

Fairfax Asia, for the Third Quarter of 2012, Fairfax Asia reported a combined ratio of 83.2% and an underwriting profit of $10 million compared to a combined ratio of 73%, an underwriting profit of $15 million, in the Third Quarter of 2011. The Third Quarter 2012 accident year combined ratio was 84.3% compared to 75.6% in 2011. Net premiums written by Fairfax Asia were $54 million in the Third Quarter of 2012 compared to $50 million in the prior year quarter with the increase of 8.2% primarily the result of increased writings of commercial automobile, marine haul, and property lines of business at Pacific Insurance.

Moving on to insurance and insurance other segment. Insurance reinsurance other segment. That division in the Third Quarter of 2012 produced a combined ratio of 102.1% and an underwriting loss of $3 million compared to a combined ratio of 147% and an underwriting loss of $61 million during the same period last year.

Cat losses, once again primarily attritional cat losses, added 3.7 combined ratio points to the Third Quarter of 2012 combined ratio. They were significantly lower in comparison to the Third Quarter of 2011 when the combined ratio included 42 combined ratio points of cat losses.

The calendar year combined ratio of insurance and reinsurance other included 2.9 combined ratio points of net unfavorable about to prior years reserves compared to 9.9 combined ratio points of net unfavorable development in 2011.

Net premiums written decreased to $113 million from $125 million, a decrease of about 10.1% primarily as a result of the combination of the nonrenewal of certain classes of business or terms and conditions were considered inadequate at Advent and also lower reinstatement premiums at Advent year-over-year partially offset by decreased reinsurance purchased by Fairfax Brazil as well as Advent.

And finally, to runoff. Runoff had another positive quarter even though realized gains were reduced. It produced pretax income before interest expense of $13 million in the Third Quarter of 2012 compared to a pretax income before interest expense of $181 million in 2011.

So now, turning to our financial position starting with book value per share. Book value per share at September 30, 2012, was $360, an increase of slightly less than 1% from book value per share of $357 at June 30, 2012, and an increase of about 1.7% from our December 31, 2011 book value per share of $365, adjusted for the $10 per share common dividend that was paid in the First Quarter of this year.

Common shareholders' equity increased during the quarter by $65 million to $7.328 million from $7.264 million at June 30, 2012. The principal components of the increase included the net earnings that were attributable to shareholders at Fairfax of $35 million; the effect of increased accumulated other comprehensive income of $44 million, which principally comprised unrealized currency translation gains; and these were partially offset by the payment of dividends on preferred shares of $16 million.

In terms of financial leverage, our quarter end total debt to total capital ratio decreased to 26.2% compared to 26.4% at December 31, 2011. And this was primarily as a result of the repayment of $86 million of Fairfax debt which came due in April partially offset by the consolidation of the subsidiary debt of Thomas Cook India.

In October 2012, the Company issued $200 million of 10-year bonds with an annual coupon of 5.84% and followed that up by announcing the settlement of the note we incurred when we purchased General Fidelity Insurance in August 2010. That note will be settled for a cash payment of $200 million.

The acquisition of Thomas Cook India Ltd. Limited for $173 million added $135 million of goodwill and $41 million of subsidiary debt to our Third Quarter consolidated balance sheet. At the end of the quarter, Fairfax had cash and securities of almost $1 billion at the holding company and that concludes my section promptly.

Prem Watsa {BIO 1433188 <GO>}

Thank you, Dave. And now we are happy to answer your questions. Please give us your name, your Company name, and try to limit your question to only one so that it is fair to all on the call. Audra, we are ready for your questions.

Questions And Answers

Operator

(Operator Instructions) Tom MacKinnon, BMO Capital.

Q - Tom MacKinnon {BIO 2430137 <GO>}

Good morning. What we are seeing here, we are certainly seeing underwriting results improve both for you guys and for the industry. But your, to some extent, your investment portfolio was conservative and a cautious stance doesn't really allow you to participate fully in any kind of earnings run-up associated with what could be potentially firming markets. I'm wondering what you -- what's your message to investors, relative to this? Is this just to continue to be patient? And what would it take to change your mind vis-a-vis the equity hedges and the significant cash position?

A - Prem Watsa {BIO 1433188 <GO>}

That's a very good question. It is a key question. The underwriting operations for our Company, all our Companies is improving as you pointed out, improving quite significantly. But the investment side we are very conservative. We have got 33%, $8 billion in cash. Common stock positions are fully hedged. We have very little corporate borrowings. Muni bonds are predominantly guaranteed by Berkshire Hathaway. So it is a very conservative portfolio and the reason for us conservative portfolio is very simply that we -- it seems to us there is a disconnect between the fundamentals in terms of companies and economies and markets so the stock price -- stock and bond markets are high. The fundamentals, we think, are quite different, meaning on the low side.

And so, you'll either have the fundamentals go up over time to catch up with stock prices, catch up with very low spreads, or you'll have the markets come down. And we have said for some time, this time period we think of it as a one in 30; , one in 100-year event. It is not a normal time period. So we just think you have to be very, very careful.

The fact that we have got cash in our portfolio is making no money today. It's a big advantage as and when opportunities come, because of course the only people who can take advantage of it is the people who have cash.

In 2008, Tom, 2008, 2009 you had a very significant -- two things happened, right. You had the stock market drop almost 30% and the spreads widened significantly. And in that time period we had 75% of our portfolios in cash and government bonds. So we could take advantage of the opportunity that presented themselves to us and 2010, 2011 we have started hedging and in 2011 we've hedged significant parts of our portfolio. But on the other hand we (haven't) realized very significant gains. So in the first nine months I think we realized $730 million, but it is masked in a way by the unrealized losses on the hedges. And we expect that to reduce over time, and perhaps even become profits as it has in 2008, 2009.

So to summarize, Tom, we just -- we have always been long term. Our long-term results are excellent. In any single year, in any single quarter, we can't tell you what we will make. Investment results have been lumpy. They are not smooth. We are not looking at providing 5, 10, 15% growth every quarter. We don't know how to do it. We would love to do it if we could, but we have focused our Company from inception 27 years ago is on the long term. And that continues to be the case.

Q - Tom MacKinnon {BIO 2430137 <GO>}

Appreciate that. Thanks very much.

Operator

Mark Dwelle, RBC Capital Markets.

Q - Mark Dwelle {BIO 4211726 <GO>}

Good morning. Couple of questions that kind of relate to the acquisitions recently and divestitures. Let me start with the Cunningham Lindsey sales. If I am following the one chart correctly, a $260 million proceed, that should put result in plus or minus around $150 million of realized gain in the Fourth Quarter?

A - Prem Watsa {BIO 1433188 <GO>}

Yes, I think that is right. That's exactly right.

Q - Mark Dwelle {BIO 4211726 <GO>}

I guess following on with that, $35 million that you will reinvest related to that, that will just, I guess, remain as an investment and affiliate. I would deal it in with the new, but it is the same thing.

A - Prem Watsa {BIO 1433188 <GO>}

It is a small investment. Dave, would you put it and affiliates or where would you characterize that?

A - Dave Bonham {BIO 15243784 <GO>}

It will just go into our common stock portfolio and it would be carried on a fair value basis.

Q - Mark Dwelle {BIO 4211726 <GO>}

Very good. The second question I had if you just -- the acquisitions, the Brit acquisition I guess that's closed now, if I am mapping that out right, about 75% of book value is -- was the purchase price.

A - Prem Watsa {BIO 1433188 <GO>}

No. It was more like, I think we had said in the past press release we said it was closer to 95% of book value and we had two things that are -- we had -- it was a discount to book value, closer to 95%. We had the ability to, when we did our due diligence, any liabilities we didn't like were able to put it in a reinsurance transaction back to the Company. Back to Brit. And so and over 18 months, two years we are going to review those liabilities and if we feel comparable we will commute that reinsurance transaction.

So from our standpoint, it was we -- the advantage of a runoff. We have got a separate runoff company. They review every single claim. Claim by claim by claim, and so we feel very comfortable with what we have taken on. And approximately a little of this comes to book value. But what you have here is $1.4 billion in investment portfolios. That will pay off over time and we can invest it and make a return.

The Chipec transaction that we did about a year, year and a half ago has been a very positive one for us. In our Annual Report we will give you more the details. But it is working out very well. And this one we think will work out. This is perhaps the biggest one we've done. And we expect it to work out very well also.

Q - Mark Dwelle {BIO 4211726 <GO>}

And what is the nature of the underlying liabilities? Is it auto or commercial liabilities?

A - Prem Watsa {BIO 1433188 <GO>}

It is from around the UK. It has got a varied liability, book of liabilities. Dave, anything you would add to that? I don't know if you disclosed some of that in our --

A - Dave Bonham {BIO 15243784 <GO>}

Yes, no, I think you are right there. It is an assortment of UK and domestic international insurance and reinsurance businesses. So across the spectrum.

A - Prem Watsa {BIO 1433188 <GO>}

The duration will be like in five years, say, half the liabilities will be paid. And the remaining will be mostly paid by, say, 10 years. That is the sort of runoff that we get involved in. But the advantage is we have got a separate marker. I'm sorry, the advantage we've got is a separate runoff group that handles these liabilities. And there's maybe there's two or three of these groups in North America that can do it.

Q - Mark Dwelle {BIO 4211726 <GO>}

That's useful. Thanks for the detail.

Operator

William Kontes with Boenning.

Q - William Kontes

Good morning. My question regards the OdysseyRe political donation. And I was wondering if you could just help us understand a little bit more about why that was done and how you see it as being important to the success of the firm? Thank you.

A - Prem Watsa {BIO 1433188 <GO>}

Thank you for that question. Yes. The contribution was made by OdysseyRe and the decision to make the contribution was made entirely by OdysseyRe. Fairfax did not participate in the contribution or the decision to make the contribution. OdysseyRe chose to make that contribution because it is one of the only remaining reinsurers in the United States and it is paying US taxes.

The fact that competitors have moved offshore and pay lower taxes is a competitive disadvantage to OdysseyRe and OdysseyRe believes Governor Romney is the best choice to rectify this inequality. So that is why they made the donation. But thank you for asking that question. Next, Audra.

Operator

(Chris Lafayette), (inaudible).

Q - Chris Lafayette

Thank you for taking my question. I was wondering if you guys could talk a little bit about how you manage risk to any single catastrophic event? Then, given various operating structures and reinsurance agreements, how much of your book value would be at risk to any single event?

A - Prem Watsa {BIO 1433188 <GO>}

In, with catastrophe, right?

Q - Chris Lafayette

Correct, yes.

A - Prem Watsa {BIO 1433188 <GO>}

Yes. That is a very good question. It's one that we, in the property casualty business, catastrophe risk is the biggest risk that you trade. And we've, 27 years, we've focused on it single-mindedly. Each of our companies look at it at their level and it comes right up to Fairfax, comes right through our (cheap red carpet), comes to our officers and I am involved in it myself because this is the type of thing that can impact our Company.

And what we do broadly speaking is OdysseyRe is our main source of exposures. And they have said that they would expose their common equity, OdysseyRe's common equity, to about 15% of shareholders equity. And we link that 15% to the rate of return we expect to make over time. So if you think of 15% return that we make and 15% exposure, it is sort of a one-year payback. So that we will expose our Company not to capital, but to one year's worth of income. And last year is a good test because we had almost $1 billion of catastrophe losses and we still made $40 million or $50 million after-tax.

But that is what we -- and we look at it very carefully. We look at it at different scenarios, $100 billion event. Events that have not taken place. You have got to look at events that have not taken place. So you have got to look at the possibility. We have never had $100 billion event or a $200 billion event. But we simulate that in our companies. And but our exposure is mainly from OdysseyRe and to a large extent, Odyssey has limits so that we know what the exposures can be. But that is a good question. It is one we are focused on all the time.

Q - Chris Lafayette

Illustrate helpful. Thank you. Then just one more if I could. You recently renewed the buyback authorization. I was just wondering how you think about that with the stock trading around book value. The Company has done more aggressive historically. What do you look for as far as (multiple speakers).

A - Prem Watsa {BIO 1433188 <GO>}

We are always looking at the alternative of buying back our stock. But we won't do it at the expense of our holding company cash and marketable securities that we'd like to keep -- $1 billion. And in this uncertain environment, we are just very, very careful. But rest assured in any deal that we make that we are always comparing it in by our stock and retiring it. You pointed out in the past we thought maybe and this goes back a little time, but we might have bought 18%, 20% of our Company back at one point in time. And over time we expect to retire our shares. But in these times we will be careful doing it.

And it will never be done at the expense of our holding company cash and marketable securities of $1 billion. We will always keep that $1 billion there for the unexpected developments.

Q - Chris Lafayette

Thank you very much for taking my call.

Operator

Paul Holden, CIBC.

Q - Paul Holden {BIO 6328596 <GO>}

Good morning. Two questions. First relates to improvements in underwriting margins. So one of the ways I look at the combined ratio is on an accident year basis less cat losses. Year to date I come up with a number of 96.1% and that is versus 96.3% last year. So really not much of an improvement year over year. But I would've thought we would've seen a bigger improvement given some of the forces you highlighted in terms of lower investment yields and that's necessitating higher pricing.

So maybe you can talk about why we haven't seen a bigger improvement and what might change over the next 12 months to lower that -- the combined ratio -- on that basis?

A - Prem Watsa {BIO 1433188 <GO>}

So Paul, whenever you are -- our premiums are up, I think, for the first nine months approximately 11%. So whenever you -- and you look at each of the companies and you look at the (technical difficulty) come through it, but whenever you have premiums going up, your expense ratios come down. And so our expense ratios in the past have gone up because we've had soft markets and we reduced our premium. Now expense ratios are coming down because of the fact that premiums are going up.

So if you look at Zenith, for example, Zenith was up 47% in terms of its premium and so the expense ratios came down significantly. The loss ratios we maintained, Zenith has been historically maintaining a very -- 60%, 65% areas. But the expense ratios have come down. And so the markets have bottomed out. The rates are going up. But it is not like the hard markets of 2002, 2003, 2004. But the pricing has improved and improved pretty well across the board.

It is very good and anything that is exposed to catastrophe, given the losses of last year, the rates are still full up significantly and are remaining there. But should we see our combined ratios coming down, they -- with these low interest rates even if you have a combined ratio of 95% or less, you are going to have a single-digit return on equity. And so, combined ratios have to come down.

Now what you're seeing for companies that have not reduced their premium in the last few years, you are seeing reserve development crop up. You are seeing reserves go up and so you are seeing companies being put into runoff or lose their rating and that has begun now. And this is usually a sign of change taking place.

We are very careful about our reserving. We like our reserves to be strong. It's in our 10-year results, reserved redundancies run at 6% to 8% over time. And so we're very comfortable with where we are right now and we -- and the business, it's improving. But like I said, it's not a hard market. We are already approximately net premium -- it's not gross, it's net. We are already at about $6 billion.

And in a really good market -- I've said that in our annual meeting and I've said it elsewhere, that we can double that premium. And we have. We have different units and different management -- really good management teams, all focused at the right time, not on our forecast, but actually seeing prices to increase that premium. So we feel very good where we are in terms of our underwriting and I might say in our investment positions even though we are not making money for our shareholders. Our Company's is poised to reap the benefits of being that conservative. So we like where we are.

Q - Paul Holden {BIO 6328596 <GO>}

So I am going to try to summarize this, if I may. So the key to levers maybe over the next 12 months will be one firm's changing their -- with the industry broadly speaking changing their positions on reserves, i.e., they've been releasing a lot of reserves over the last few years and that has probably come to an end, and then also a decline in the expense ratio as you ramp up your underlying activity.

A - Prem Watsa {BIO 1433188 <GO>}

Yes, I think that's fair.

Q - Paul Holden {BIO 6328596 <GO>}

Okay. Then my second question would be related to the additional investment you made in the CPI derivative this quarter. Maybe just the thought process behind that.

A - Prem Watsa {BIO 1433188 <GO>}

Yes, so, all that is averaging down. We have done that before. And we added about $20 million. And in this case, we have structured it so that we have eight years remaining. It is a 10-year contract when we bought it. There's eight years remaining. The CPI has gone up a little since that time. So we put $2 million and increased the strike price. So we increased the strike price and we closed it to where the CPI is today. That's all we did. We just freshened it a little for $20 million, but we will always look at averaging down as we planned a significant unrealized loss by the way. More than two thirds of our investment is now in an unrealized loss position. It's -- I think we have got it at $140 million, something like that. And we've never paid more than $400 million to it. But it is all unrealized. It goes to our income statement like it is a loss, but as I said in my prepared comments, it is -- we haven't lost any money. It's just -- it is mark to market and that is what the accounting is these days. So it goes to -- it flows to our statement as losses but we haven't sold anything yet.

Q - Paul Holden {BIO 6328596 <GO>}

Got it. Thanks for your time.

Operator

(Operator Instructions) (Tessad Oki), Fairfax.

Q - Tessad Oki

I think there is an error there. I am actually not with Fairfax. I'm a small investor in Fairfax. And while a small investor, it's a significant portion of my very modest at work since I have been invested with you since 2010. I think my question is really maybe a follow-on to the gentleman from BMO Capital Markets where I guess I am looking for some guidance and counsel from you. As it feels like you are going through potentially another seven lean years as you did in the earlier part of 2000s where at least stock is invested, but book to value hasn't moved very much given all of the various forces you talked about at length in various quarterly calls and the annual shareholders meeting.

But if you have increasingly got -- as you said, either the markets will come down to the fundamentals or vice versa and it just -- I just wonder how you feel about things given every time the market seems to move down towards the fundamentals, the central banks are constantly coming in and priming the pump. And I just wonder if you feel -- if you ever feel you are fighting a losing battle against the Fed and the ECB.

A - Prem Watsa {BIO 1433188 <GO>}

Yes. That is a good question. And so the first thing I'd just to say to you is we have always focused on the long term and when we went through our seven lean years so that we were turning around our Company, we were turning around Crum & Forster and the tech reinsurance and all of that and it took some time to turn it around.

Today, our companies are in excellent position. They are underwriting focus, they are well reserved. They've cut back in the soft market and they are well positioned to expand significantly at the right time, and as they are expanding today. You are seeing that in Zenith, you are seeing it in Crum & Forster, you are seeing it in Odyssey and the Canadian markets always lag, have lagged in the past. And you will see it in time in Canada.

So underwriting operations are very well positioned. And our investment philosophy and positions are always long term. So when we have credit to form swaps in the past, it took a few years for it to work out and then, as you know, we made a lot of money. And so right now it is very important not to reach for yield. Because if you do reach for yield or if you put money into the stock market at these prices, you could suffer permanent losses. We will take temporary losses, but we don't like taking permanent losses.

So I don't think we will be in a position where our results will be poor for a long period of time. But you are right, for the last year and a half, it hasn't been good. But our results for year ending 2011 for the five years is among the best in the business. And of course, for the 26 years ending 2011 it is better than anyone else in our industry.

So we are focused on the long term and we continue. We have always been focused on the long term and continue to be focused on doing well for our shareholders.

Operator

At this time there are no further questions.

A - Prem Watsa {BIO 1433188 <GO>}

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. Thank you.

Operator

Thank you for participating. Today's call has concluded. Please disconnect your phone line at this time.