S&P Capital IQ

CONTENTS

Fairfax Financial Holdings Limited TSX:FFH

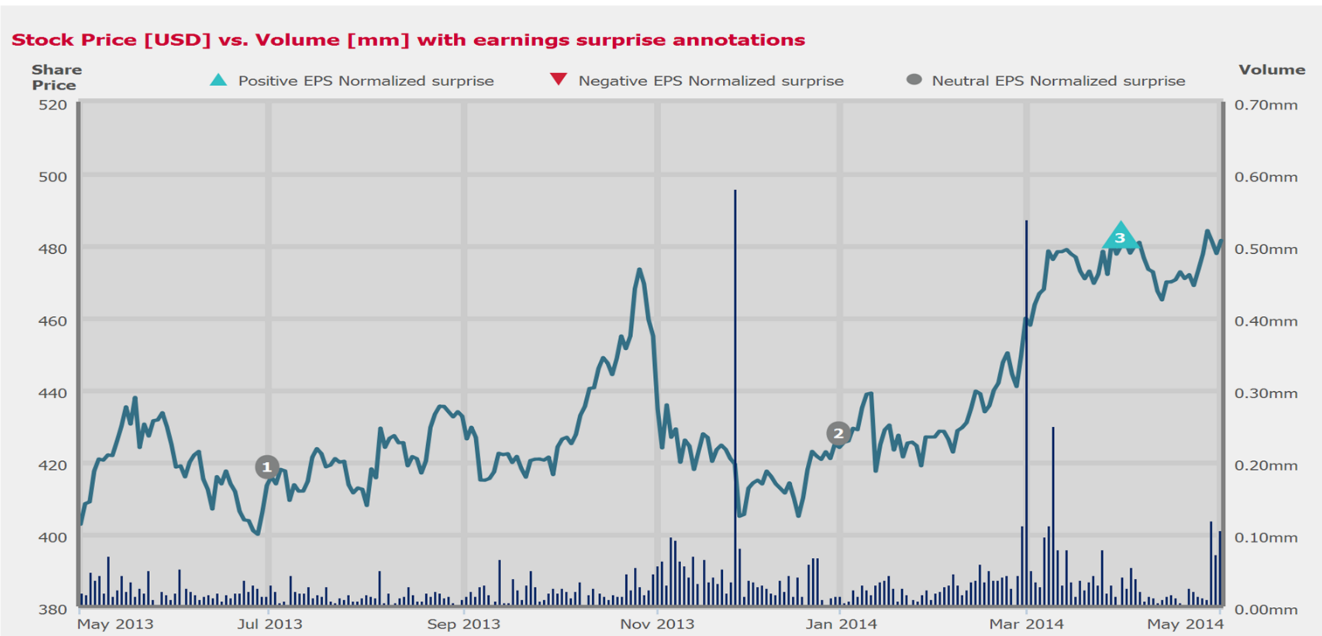
FQ2 2014 Earnings Call Transcripts

Friday, August 01, 2014 12:30 PM GMT

S&P Capital IQ Estimates

	-FQ2 2014-			-FQ3 2014-	-FY 2014-	-FY 2015-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	10.79	16.15	▲49.68	1.16	13.75	14.75
Revenue (mm)	2025.00	2407.50	▲18.89	1877.03	7995.17	7610.93

Currency: USD
Consensus as of Aug-01-2014 1:19 PM GMT



- EPS NORMALIZED -	CONSENSUS	ACTUAL	SURPRISE
FQ2 2013	(11.75)	(8.55)	NM
FQ3 2013	-	(29.02)	NM
FQ4 2013	4.82	(0.98)	NM
FQ1 2014	3.06	3.73	▲21.90 %

Call Participants

EXECUTIVES

David J. Bonham
Chief Financial Officer and Vice President

John Charles Varnell
Vice President of Corporate Development

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

ANALYSTS

Christopher Lafayette

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Paul David Holden
CIBC World Markets Inc., Research Division

Tom MacKinnon
BMO Capital Markets Equity Research

Presentation

Operator

Good morning, and welcome to Fairfax's 2014 Second Quarter Results Conference Call. [Operator Instructions] 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. And opening remarks, from John Varnell. Mr. Varnell, please begin.

John Charles Varnell
Vice President of Corporate Development

Thank you. Good morning, and welcome to our call to discuss Fairfax's 2014 second quarter results.

This call may include 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 set out under Risk Factors in our base shelf prospectus, which has been filed with Canadian securities regulators and is available on SEDAR.

I will now turn the call over to our Chairman and CEO, Prem Watsa.

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

Thank you, John. 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 Dave Bonham, our CFO, for additional financial details.

In the first half of 2014, book value per share increased by 17.1%, adjusted for the $10 per share common dividend paid in the first quarter of 2014. Our insurance companies had an excellent first half with a combined ratio of 92.8%, with excellent reserving and significant underwriting profits of $209 million.

In the second quarter, OdysseyRe again had an excellent combined ratio of 88.6%, while Zenith had a combined ratio of 89.8%.

As shown on Page 33 of our quarterly report, we realized gains on our investment portfolio of $329 million during the second quarter. Excluding all hedging losses and before mark-to-market fluctuations in our investment portfolio, we earned $443 million in pretax income. If you include all hedging losses and mark-to-market fluctuations in our investment portfolio, we reported pretax income of $523 million and after-tax income of $364 million in the second quarter of 2014.

Our second quarter has continued the trends of the first quarter. You will note our investment portfolios went up by $544 million in the second quarter of 2014 in spite of being about 85% hedged, 28% in cash, and little exposure to corporate bonds. How did this happen? Long U.S. government bond rates continued to drop and our common stocks did much better than the Russell Index. We have yet to financially benefit from our hedges and our approximately $100 billion in deflation swaps. And of course, our cash position gives us great optionality.

At our annual meeting, we made the point that, while we are protecting our capital on the downside, our investment portfolios could also do very well. The first and second quarters of 2014 were a case in point. Our common stock portfolios continued to be hedged at 85%. We did not add to our hedges, but our common stocks outperformed the index. We continue to be soundly financed, with year-end cash and marketable securities in the holding company of $1.1 billion.

A few more points. Our insurance and reinsurance premium volume increased by 4.4% in the quarter, adjusting for the crop insurance at OdysseyRe. The combined ratio for our insurance and reinsurance operations was 92.7% in the quarter.

At the subsidiary level, the increase in net premiums written, after adjusting for the onetime impact described on Page 32 of our interim report, and combined ratios for the second quarter were as follows. This is all in for the second quarter: OdysseyRe up 5.8%, with a combined ratio of 88.6%; Crum & Forster up 16.7%, with a combined ratio of 98.8%; Northbridge up 2.7% in Canadian dollars, with a combined ratio of 95.3%; Zenith up 5%, with a combined ratio of 89.8%; and Fairfax Asia up 14.8%, with a combined ratio of 93.4%.

As we have said before, very low interest rates and reduced reserve redundancies means there will be no place to hide for the industry. Combined ratios will have to drop well below 100% for the industry to make a single-digit return on equity with these low interest rates. However, with the significant excess capital in our industry today and many new entrants, insurance rates will likely go down first before they eventually go up.

On the investment side, net investment gains of $409 million in the second quarter consisted of the following. Please refer to Page 2 of our press release. Net gains on equity and equity-related investments, after equity hedges of $160 million, resulted -- resulting from net gains of $348 million and a $188 million net loss in our equity hedge, reflects the outperformance of our stock portfolio versus the Russell Index. We have realized gains of $320 million on our equity and equity-related holdings in the second quarter of 2014 and $713 million in the first half.

Also in the second quarter, we had unrealized gains of $381 million, primarily on our municipal and treasury bond portfolio, because of the impact of dropping interest rates.

As we've mentioned in our annual meetings, annual reports and quarterly calls, with IFRS accounting, where stocks and bonds are recorded at market and subject to mark-to-market gains and losses, quarterly and annual income will fluctuate widely, and investment results will only make sense over the long term.

Core inflation continues to be at or about 1% in the United States and Europe, levels not seen since the 1950s in spite of QE1, QE2 and QE3. Long-term government bond rates in Europe are making record lows, quite often the lowest in 200 years.

Our CPI-linked derivatives, with a notional value of approximately $104 billion, are down 80% from our cost and are carried on our balance sheet at $122 million, even though they have 7.6% -- 7.6 years to run. As I've said to you before, our CDS experience comes to mind. Also please remember that it took 5 years in Japan before deflation set in for the next 18 years.

When you review our statements, also please note that, when we own more than 20% of a company, we equity account, and when we own above 50%, we consolidate so that mark-to-market gains in these companies are not reflected in our results. As you can see on Page 11 of our quarterly report, the fair values of our investment in associates is $2.3 billion, which has a carrying value of $1.8 billion and unrealized gain of $440 million not on our balance sheet.

We continue to be very concerned about the prospects for the financial markets and the economies of North America and Western Europe, accentuated, as we have said many times before, by potential weakness in China and emerging markets. As we have said now for some time, we believe there continues to be a disconnect between the financial markets and the underlying economic fundamentals.

As of June 30, 2014, we have $7.5 billion in cash and short-term investments in our portfolio, which is 28% of our total investment portfolios to take advantage of opportunities that come our way. As a result, in the short term, our investment income will be reduced.

Finally, I want to bring to your attention, on Page 18 of our second quarter report, we have added a paragraph under contingencies regarding a regulatory investigation in Québec. We are fully cooperating with the Québec authorities, who required strict confidentiality during the investigation. While we are not permitted to give you any further details at this time, I can say there is no personal trading involved and we are confident that we did nothing wrong.

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

David J. Bonham
Chief Financial Officer and Vice President

Thank you, Prem.

First, I'll focus on Fairfax's consolidated results for the second quarter of 2014, then move on to the operating company results and finish with the consolidated financial position.

For the second quarter of 2014, Fairfax has reported net earnings of $364 million or $16.50 -- $16.15 per share on a fully diluted basis. That compared to the second quarter of 2013 when we reported a net loss of $158 million or $8.55 per fully diluted share. Year-to-date, Fairfax's reported net earnings of just over $1.1 billion or $51.84 per share on a fully diluted basis was significantly higher than year-to-date net earnings of $4 million at this time last year.

Our insurance and reinsurance operations reported higher underwriting profits of $110 million and $209 million and combined ratios of 92.7% and 92.8% in the second quarter and first 6 months of 2014. Last year, during those same periods, our underwriting profit was $84 million and $170 million and the combined ratios were 94.2% and 94.1%. So that's an increase of $39 million in our underwriting profit on a year-to-date basis.

Our combined ratios benefited from net favorable prior year reserve development of $76 million and $131 million, translating into 5 and 5.4 combined -- and 4.5 combined ratio points in the second quarter and first 6 months of 2014. And that was somewhat lower than net favorable development of $106 million and $142 million, representing 7.4 and 4.9 combined ratio points in the second quarter and first 6 months of 2013.

Current-period catastrophe losses were lower year-over-year and totaled $56 million or 3.7 combined ratio points in the second quarter of 2014 and $86 million or 3 combined ratio points in the first 6 months of 2014. By way of comparison, in the second quarter and first 6 months of 2013, we incurred cat losses of $112 million and $144 million, representing 7.7 and 5 combined ratio points, respectively.

Please note that during the second quarter of 2014, OdysseyRe changed the manner in which it recognized premiums from its U.S. crop business. Enhanced underwriting systems and the accumulation of sufficient internal historical data allowed OdysseyRe to recognize the majority of the premium from its U.S. crop insurance business in the second quarter to more closely correspond with the planting season, whereas in 2013, these premiums were recognized in the third quarter. The full effect of this change on our financial reporting is described on Page 43 of our interim report for the 6 months ended June 30, 2014. This change increased our net premiums written by $143 million in the second quarter and first 6 months. So after adjusting net premiums written in 2014 by this amount, net premiums written by our insurance and reinsurance operations increased by 4.4% and 2.3% in the second quarter and first 6 months.

Now turning to our operating company results.

We'll start with OdysseyRe. In the second quarter and first 6 months of 2014, Odyssey reported underwriting profits of $70 million and $146 million and combined ratios of 88.6% and 87.3%. That compared to underwriting profits of $75 million -- or rather $79 million and $174 million and combined ratios of 85.9% and 84.4% in the second quarter and first 6 months of 2013.

Catastrophe losses totaled $49 million and $71 million, and that translated into 7.8 and 6.2 combined ratio points in the second quarter and first 6 months of 2014, with the largest single loss totaling $25 million in connection with Windstorm Ela in the second quarter.

OdysseyRe's combined ratios included the benefit of $25 million and $47 million or about 4 combined ratio points of net favorable prior year reserve development in each of the second quarter and first 6 months of 2014, with the net favorable reserve development in the first 6 months of 2014 more heavily weighted towards favorable emergence on prior year's non-catastrophe loss reserves across all of OdysseyRe's divisions.

Excluding, in 2014, the net premiums written related to its U.S. crop insurance business, as we mentioned earlier, OdysseyRe wrote $531 million and a little over $1.1 billion of net premiums in the second quarter and first 6 months, reflecting an increase of 5.8% in the second quarter and a nominal decrease in the first 6 months of 2014, principally due to growth across most lines of businesses in the U.S. insurance division, offset by declines in writings of reinsurance business, primarily proportional and excess of loss property lines of business, and that was due to competitive market conditions.

Moving on to Crum & Forster. Crum & Forster's underwriting results improved in the second quarter and first 6 months of 2014, with underwriting profits of $4 million and $5 million and combined ratios of 98.8% and 99.3%. Crum & Forster reported underwriting losses of $6 million in each of the second quarter and first 6 months of 2013, and those corresponding combined ratios were 102% and just a little below 101%.

There was no prior year reserve development in 2014 and 2013. And current-period catastrophe losses were $5 million and $12 million in the second quarter and first 6 months of 2014, adding 1.1 and 1.9 points to the combined ratios during those respective periods.

Net premiums written by Crum & Forster increased by 16.7% and 16.4% in the second quarter and first 6 months of 2014, primarily reflecting incremental gross premiums written related to the renewal of the American Safety business and growth in the Fairmont accident and health business, combined with higher net risk retention in certain lines of business.

Turning to Zenith. Zenith reported underwriting profits of $18 million and $34 million, with corresponding combined ratios of 89.8% and 90.2%, in the second quarter and first 6 months of 2014. And that's a significant improvement over the combined ratios of 95.6% and 102.6% reported in the second quarter and first 6 months of 2013.

The improvement reflected the following: first, a year-over-year decrease of 2.3 and 4.7 percentage points in the estimated accident year loss ratios in the second quarter and first 6 months of 2014 due to favorable loss development trends for accident year 2013; second, increased net favorable development of prior year's reserves, representing 9.4 and 9.8 points on the combined ratios compared to net favorable development of 6 and 3.2 combined ratio points during those same periods last year; and finally, the underwriting expense ratios benefited from a 6% and an 8% increase in net premiums earned in the second quarter and first 6 months of 2014.

Net premiums written by Zenith of $151 million and $441 million in the second quarter and first 6 months of 2014 increased by 5% and 2.4% on a year-over-year basis, reflecting premium rate increases.

Northbridge reported underwriting profits of $11 million and $12 million and combined ratios of 95.3% and 97.5% in the second quarter and first 6 months of 2014, an improvement relative to the combined ratios of 100.4% reported in each of those same periods in 2013. Northbridge's underwriting results included the benefit of net favorable prior year reserve development across most accident years and lines of business of $27 million and $42 million, representing 11.6 and 9.2 combined ratio points in the second quarter and first 6 months of 2014. And that was somewhat lower than the net favorable development of $54 million and $62 million, representing 22 and 12.8 combined ratio points in the second quarter and first 6 months of 2013.

There were no catastrophe events in the first 6 months of 2014, whereas the Alberta floods in the second quarter of 2013 were principally responsible for adding 13.9 and 6.9 points to the combined ratios in the second quarter and first 6 months of 2013.

In Canadian dollar terms, net premiums written by Northbridge increased by 2.7% and 2.1% in the second quarter and first 6 months of 2014, reflecting higher net risk retention and increased gross premiums written at Federated Insurance and in the western region at Northbridge Insurance, partially offset by the strategic nonrenewal of an unprofitable portfolio of business. That's after adjusting for the onetime impact of the intercompany unearned premium portfolio transfer on January 1, 2013, between Northbridge and Group Re that we describe on Page 37 of our interim report.

Fairfax Asia. Fairfax Asia's combined ratios increased from 90.7% and 90.9% in the second quarter and first 6 months of 2013 to 93.4% and 93.6% in 2014, primarily as a result of net adverse prior-period reserve development of 3 and 3.8 combined ratio points in the second quarter and first 6 months of 2014, whereas Fairfax Asia reported net favorable prior-period reserve development in those corresponding periods last year. Unfavorable emergence in 2014 was principally related to losses assumed by Pacific Insurance from the Malaysia motor vehicle insurance pool, where participation is compulsory.

On a year-over-year basis, net premiums written by Fairfax Asia in the second quarter and first 6 months of 2014 increased by 15% and 26%, principally reflecting increased writings of marine hull, commercial automobile and property business.

The combined ratios of the Insurance and Reinsurance - Other division of 97.8% and 97.7% in the second quarter and first 6 months of 2014 improved compared to the combined ratios of 100.2% and 99.3% reported in the same periods in 2013. Net premiums written decreased by 16% and 17% in the second quarter and first 6 months of 2014, reflecting the nonrenewal of certain classes of business where terms and conditions were considered inadequate at Advent, Polish Re and Fairfax Brazil and excluding the onetime impact of the intercompany unearned premium portfolio transfer on January 1, 2013, between Northbridge and Group Re that we described earlier and which suppressed net premiums written by Group Re in 2013 by $39 million.

Turning to runoff. Runoff reported operating losses of $29 million and $50 million in the second quarter and first 6 months of 2014 compared to operating losses of $5 million and $6 million in the same periods in 2013. The year-over-year decrease in operating profitability primarily reflected net adverse development at U.S. runoff in 2014 and a gain on a significant commutation that was recorded in 2013. But after factoring in net gains on investments, runoff reported pretax earnings of $65 million and $233 million in the second quarter and first 6 months of 2014.

Turning to some of our consolidated results. Our consolidated interest and dividend income increased from $112 million in the second quarter of 2013 to $120 million in the second quarter of 2014, reflecting lower total return swap expense and a modest increase in investment income earned. In the half year, consolidated interest and dividend income decreased slightly from $212 million to $211 million, reflecting lower investment income earned partially offset by a decrease in total return swap expense.

The company recorded income tax provisions of $157 million and $491 million in the second quarter and first 6 months of 2014 at an effective tax rate of approximately 30%. The effective tax rate was higher than our Canadian statutory income tax rate of 26.5%, primarily as a result of significant income earned in the U.S., which is taxed at the higher U.S. statutory income tax rate of 35%.

Moving on to our financial position. Our total debt to total capital ratio decreased to 24.7% at June 30, 2014, from 26.1% at December 31, 2013, and that was primarily as a result of the increase in our common shareholders' equity, reflecting the net earnings in the first 6 months of the year.

And now I'll pass it back over to you, Prem.

V. Prem Watsa
Founder, Chairman and Chief Executive Officer
Well, thank you, Dave. Now we are happy to answer your questions. [Operator Instructions] So Rebecca, we are ready for the questions.

Question and Answer

Operator

[Operator Instructions] Our first question comes from Paul Holden from CIBC.

Paul David Holden
CIBC World Markets Inc., Research Division

So I have -- really it's 2 questions, but they're interconnected, so sort of one question, I guess. It's regarding OdysseyRe and the premium growth you saw there. So just wondering how much of OdysseyRe is comprised of the U.S. specialty lines versus the reinsurance. And then the second part to that is with respect to U.S. commercial lines, still seeing sort of an oversupply situation in the sort of the more plain vanilla type insurance lines. I'm wondering if any of that excess supply is starting to flow over to the specialty lines and causing any pricing pressure there.

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

Yes. Good question, Paul. OdysseyRe, of course, is a mix of specialty lines through Hudson and -- Hudson Insurance and reinsurance business to OdysseyRe. OdysseyRe has a worldwide platform, as you know, the reinsurance platform, so there's many dials that they can move up and many dials that they can move down. The one big change that's happening in the business right now, which you know of, is property cat prices are coming down. And so our exposures are coming down and our premium levels are coming down in that area. But the other areas and the specialty lines, I think -- I don't know, Dave, if you want to add. Some of the prices, if I was to look at Crum and -- then our prices are still going up 3.5%, 3% to 4%. Zenith, of course, is still having single-digit price increases. And our Canadian companies are having 3% to 4% price increases. The U.S. insurance for OdysseyRe, I think, we figure approximately 1/3 of our business, of the business. Dave, do you want to add to that?

David J. Bonham
Chief Financial Officer and Vice President

Yes, yes. U.S. insurance, about $370 million out of the $776 million in gross premiums written in the quarter and about $550 million out of the $1.4 billion of gross premiums written year-to-date.

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

Terrific. Thank you, Paul. If you have any more -- if you need a little more clarification, please phone Dave or John Varnell.

Operator

Next question comes from Mark Dwelle with RBC Capital Markets.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

A couple questions. Prem, the -- on the change in the accounting related to the crop business, can you give me an idea? I mean, is that most of their crop book? Or is that picking up about one additional month or a couple -- maybe just generally the overall size of the crop book.

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

Dave, you want to answer that?

David J. Bonham
Chief Financial Officer and Vice President

Sure, yes. The figures that we disclosed in the interim would basically be their entire -- virtually all of their spring planting crop premiums. So think of it as just bringing all of the -- or the majority of the crop premiums that would have been in there next quarter, bringing it into the second quarter.

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

So instead of -- Mark, instead of reporting that in the third quarter, they have enough systems now and enough confidence to put it in the second quarter. In the past, we were putting it in the third quarter. Now we're putting it in the second quarter. So we've explained that in the MD&A, but that's what it is. And it's pretty well all of the business, right, Dave?

David J. Bonham
Chief Financial Officer and Vice President

Yes, that's right.

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

Yes.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

No, it was pretty well disclosed. I just -- I wasn't sure whether that was, as I said, kind of all of the book, most of the book or just a fraction of the book, so that was what I was mainly after. The second question I had was related to the reserves. I mean, I definitely have seen an improvement in reserve releases over the last several quarters, which is excellent news. I was curious what accident years most of these are coming from. Are they relatively older accident years or more recent ones? And if there's any particular lines of business that are accounting for most of the releases.

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

So Mark, you know our policy is to have our current accident years always conservative and so that there -- reserve redundancies come in the future, of course. We don't want to ever be in that position where you go the opposite way. But when we look at it here, the -- a lot of the redundancies are coming across property lines and the more recent property lines and generally across all our companies, is what our Chief Actuary Peter Clarke says.

Operator

[Operator Instructions] Our next question comes from Tom MacKinnon, BMO Capital.

Tom MacKinnon
BMO Capital Markets Equity Research

A question with respect just to the cash. It looks like it's coming down a little bit over the last couple of quarters. And I don't know if there's any read-through here. Are you trying to put a little bit more cash to work? How should we be thinking about that? And then I have a follow-up.

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

So Tom, think of that cash as a resultant, right? So if we see something -- publicly, we've talked about Eurobank. And we put money into this bank in Greece which we liked. So we use cash for that. So if there's anything we like, we go in and buy it, but -- so it's not like we want to keep 30% cash at all times. We're using the cash wherever the opportunities are, and Eurobank is a classic example. But we don't find enough opportunities with significant downside protection to take advantage of the cash that we have. So our thinking is, what remains in as cash, it's still very significant, I think, 25% to 30%. And -- but it does give us the ability to react, and we see something like that Eurobank to put it in. And so we're continuing to look at opportunities all over the world but only if it meets our long-term value-oriented criteria.

Tom MacKinnon
BMO Capital Markets Equity Research

Well, how low do you think you'd want to take it? I assume you'd still want to keep at least $1 billion at in cash at the holdco, but with $7.5 billion in there, do you think you've got the opportunity to redeploy $3 billion to $4 billion to $5 billion of that $7.5 billion in cash?

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

Yes, no, I think that's right, Tom. We'll always keep the $1 billion, of course, in the holding company, as we've said before, but in the insurance companies, we have lots of flexibility to add to opportunities. Many people feel that because of our -- and I highlighted that in my prepared comments, that because of the fact that we've got cash, stocks are 85% hedged and we have few corporate bonds, that we can't make any money. Well, that's just not right. Under certain circumstances, we can make a ton of money. We've done it in the past. We can't tell you when we'll do -- when we can -- we can't predict the quarter or the year that it'll happen, but the first 2 quarters are a great example of that. Under certain circumstances, we can make a lot of money for our shareholders. And I remarked in my prepared comments that these interest rates in Europe are 200-year lows. That means the German 30-year, they call it, bonds, long government bonds, are selling below 2%. You have to go back 200 years. So that's just telling you that these markets -- something's happening in the marketplace when you have 200-year lows. There's no inflation to speak of. And the last number in Europe was 0.4%. And the U.S., it's running around 1%. So there's -- with all of this QE1, QE2, QE3; inflation's very muted, very low; and the economy, by the way -- and you saw the 4% in the second quarter, 1.7% of that was inventory buildup, so it's more like 2.3%. But if you look at the half, nominal GNP for the United States, nominal for the first half, was 2.5%. Real GDP for the first half was 0.9%. So still very tepid in spite of all of this monetary easing. And we have -- we are of the opinion that you have to protect yourself from that. We never want to look for money and be in a position where we get blindsided, and we continue to be that way inclined. And I know, in the last few years, that was not necessary. And perhaps we'll model through and perhaps that won't be necessary, but we worry about this. Perhaps one other point on that I can -- might make is, in China, there's a few numbers suggesting there's a little bit of a pickup. I just thought, I've talked about it in our annual report, but Bill Gates made an interesting point. He's written a little article where he said China used more cement in the last 3 years than the U.S., United States, used in the entire 20th century. That's 100 years. China used more cement in the last 3 years than the United States used in the entire 20th century. And then you'll be interested, anyone who looks -- who looked at Japan in the 1990s will be interested in these 2 comments that an executive from one of China's largest real estate companies made in London. The first comment he said was that total land value in Beijing, that's only Beijing, is 62% of U.S. GDP. Total land value in Beijing is 62%. And the second comment he made is China's house production per 1,000 head of population reached 35. It reached 35 in 2011, and that figure is below 12 in most developed economies. Even when the housing market is hot, no country has ever had a -- has had a figure of greater than 14. This is their house productions per 1,000 head of population. So this is staring us in the face, we think, and we just want to be careful and conservative. We are trying to build our company over 25, 30 years. We have to go through periods like this where you're not going to be -- where you have to be careful, but in spite of that, we do have many things in our portfolio, including our more recent purchases of common stock, that can do well for our shareholders.

Tom MacKinnon
BMO Capital Markets Equity Research

Okay. And I -- one quick follow-up, if I may. In your prepared remarks, you did talk about some pressure on investment income in the short term. And I assume that's from the costs of the total return swaps as well as some -- the higher cash component. I did notice, though, quarter-over-quarter, the total return swaps cost had declined substantially. Just thinking about how we should be looking that -- at that going forward. Or any reason why it may have fallen quarter-over-quarter? Is it just kind of a lumpy cost, or what is that?

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

Yes, so the -- yes, so Tom, on these hedges, the total return swaps, I'm thinking your thinking of the S&P -- the stock hedges, right, Tom?

Tom MacKinnon
BMO Capital Markets Equity Research

Yes.

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

Yes, so that's predominantly Russell 2000. And we haven't increased them. We've kept them flat. The nominal amounts are flat. Of course, they go up or down with the stock prices, but the nominal amounts are flat. And when we outperform those indexes, then the hedge ratio drops. And of course, if we underperform, the hedge ratio will increase. And if we add or sell, then it'll affect the ratio, too, add or sell common shares. If we buy Eurobank, then those -- that ratio will drop. And if we sell something, then that ratio will increase. But Dave, do you want to add to that, Dave [ph]?

David J. Bonham
Chief Financial Officer and Vice President

Yes, that's right. So the expense is going to be a function of the notional amount of the hedge that we have on. And just as an example, you'll recall we closed the S&P 500 hedge last year. That, by not having that hedge in this quarter, on the quarter expense, that saved us about $8 million in total return swap expense. So that accounts for a significant portion of the decrease in total return swap expense in the quarter, just that one...

Tom MacKinnon
BMO Capital Markets Equity Research

Yes. I'm just looking quarter-over-quarter, though. The notional amount hadn't changed, but the cost is running about half of what it was in the first quarter. Is it -- are these just -- maybe you can follow up later on that, but that's...

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

Well, why don't we follow up on that with you, Tom.

Operator

Our next question comes from Christopher Lafayette with The Clark Estates.

Christopher Lafayette

Just 2 questions regarding the equity hedge. And I think that you alluded to the first question that I have with your comment on China and the cement demand there. How do you expect a slowdown in China likely scenario to sort of flow through and impact North America? And second question is regarding your assumptions. It seems that a lot of them are macro related. Is there a valuation component to the equity hedges as well? And if so, what are you looking at from a valuation standpoint?

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

Yes, no, that's a good question, Chris. On the -- on China. China is the second largest economy, right? So you're talking $8 trillion, $9 trillion. The United States, $16 trillion, $17 trillion; Europe about the same. And then you've got China. And so any problem there will impact the world. You must remember -- you know this, of course, that China consumes 40%, 50% of almost every commodity you can think of: copper, steel, iron ore. And so a slowdown in China will impact the rest of the -- it will impact the rest of the world quite significantly. And in terms of valuation, your second question, the Russell 2000, any type of price earnings ratios that you would look at would suggest that they're very high levels. If you look at market cap-to-GDP ratios, going back 100 years, you'll see them at high levels. The Shiller ratios that we showed at our annual meeting are price-earnings ratios. Shiller bases it on a 10-year average. You'll see that, that's on the high side. So many valuation parameters, but also, Chris, of course, earnings. Earnings have been going up some. And in a tougher economic environment, earnings are likely to come down. The S&P is making a lot of money. There's lots of stock buybacks, so the earnings per share have been going up. And so there's not only the macro but the valuation parameters. And then finally, we look for things on a bottoms-up basis, and we're not finding too many things that we think that gives us downside protection and allows us to make a return over time. So you put all of those reasons together, and we like our position.

Operator

I'm showing no further questions.

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

Well, thank you, Rebecca. Well, if there are no more questions, then 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. Thank you, all, for attending today's conference. You may now disconnect.