S&P Capital IQ

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Fairfax Financial Holdings Limited TSX:FFH

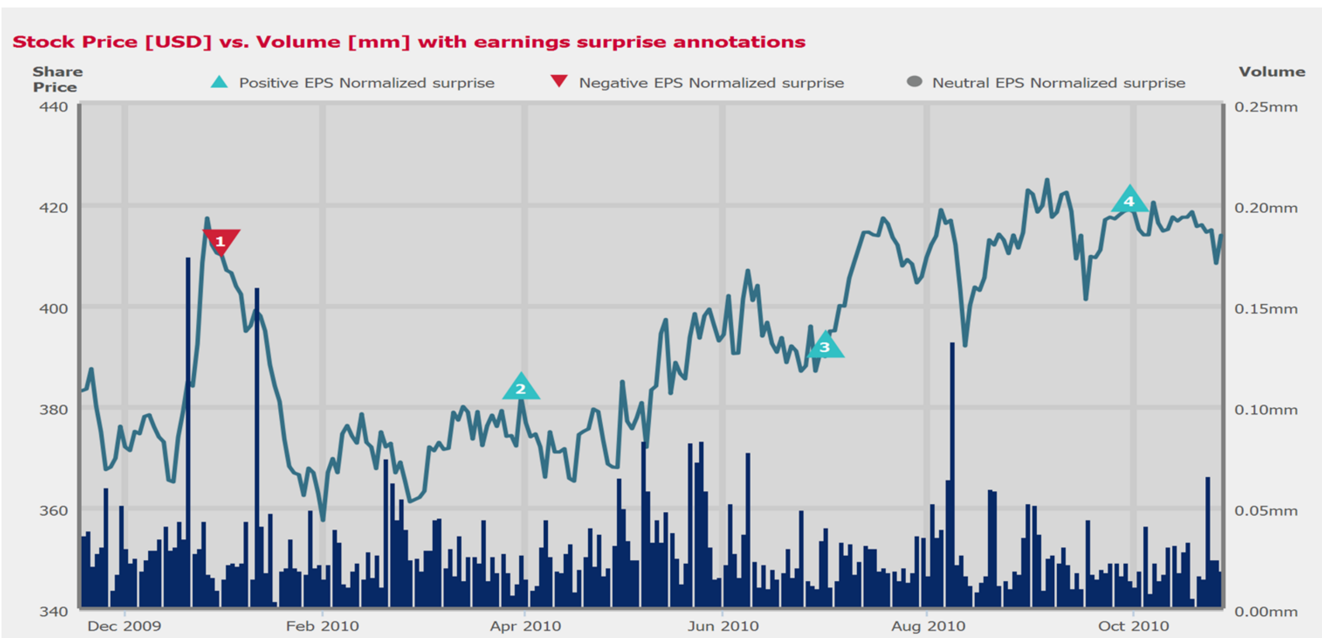
FY 2010 Earnings Call Transcripts

Friday, February 18, 2011 1:30 PM GMT

S&P Capital IQ Estimates

	-FQ4 2010-			-FQ1 2011-		
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	SURPRISE	CONSENSUS
EPS Normalized	(5.68)	(18.43)	NM	6.52	-	15.38
Revenue (mm)	1647.50	866.60	(47.40 %)	1651.90	6.94	6944.60

Currency: USD
Consensus as of Feb-18-2011 10:51 AM GMT



Call Participants

EXECUTIVES

Bradley Paul L. Martin
Vice President of Strategic Investments

John Charles Varnell
Vice President of Corporate Development

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

ANALYSTS

Jeffrey Michael Fenwick
Cormark Securities Inc., Research Division

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Tom McKinnon

Presentation

Operator

Good morning, and welcome to the Fairfax's 2010 Year End Results Conference Call. [Operator Instructions] Your host for today's call is Prem Watsa, but Brad Martin will make a brief statement first. Please go ahead, Mr. Martin.

Bradley Paul L. Martin
Vice President of Strategic Investments

Good morning. Welcome to the conference call to discuss Fairfax's 2010 year end 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 large variety of uncertainties and risks factors, the most foreseeable of which are listed in Fairfax's Annual Report, which is available on our website at fairfax.ca, or set out under Risk Factors in Fairfax's base shelf prospectus, filed with the securities regulatory authorities in Canada and the United States, which is available on SEDAR and EDGAR. 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, Brad. Good morning, ladies and gentlemen. Welcome to Fairfax's year end conference call. I plan to give you some of the highlights and then pass it on to John Varnell, our CFO, for additional financial results. After an outstanding three years, during which our book value per share went up by more than 146%, our book value per share increased by only 5% in 2010 to $379 per share, which includes our $10 dividend that we paid. Our muted increase in book value in 2010 reflected mark-to-market losses in our Bond portfolios, particularly our muni bonds, primarily as a result of an increase in interest rates, together with the elimination of significant gains in our common stock portfolios due to our decision to hedge those stock portfolios. We remain comfortable with the safety and total return potential of our bond holdings, which consist primarily of high-quality municipals, predominantly guaranteed by Berkshire Hathaway, and government securities, which we plan to hold for the long term. Our excess capital we generated over the last few years permitted Fairfax to acquire five companies in 2010: Zenith National Insurance Company; First Mercury, which closed on February 9, 2011; Pacific Insurance Berhad, Malaysia, expected to close in the first quarter of 2011; a 41% increase in Gulf Insurance; and General Fidelity Insurance, a runoff company. As we recently closed the First Mercury transaction, we want to officially welcome Richard Smith and the employees of First Mercury. And soon, when we close the Pacific Insurance Berhad transaction, we want to welcome Sonny Tan and the employees of Pacific to the Fairfax family.

The reception we’ve received in the Canadian capital markets in 2010 was extremely satisfying. We raised more than CAD $1.025 billion to public offerings of tenure bonds and perpetual preferred shares and $200 million in our common stock financing. Our company continues to be soundly financed and we ended the year with $1.5 billion of cash and marketable securities at the holding company level.

Now 2010 marks the end of the first 25 years of Fairfax. During that period, book value per share has compounded at a very gratifying 25% per year and our common stock price has followed suit at 21% a year. As far as 2010 is concerned, you know our results can be lumpy. For example, in 2010, here's what we earned per share on a quarterly basis: Earnings per share in the first quarter was $14 a share, and I'm just giving it to you today in terms of the last decimal, $14.02; in the second quarter, $15.49; quarter number three, $10.24; and quarter number four, the last quarter, we had a loss of $18.43. For the year, we had earnings of $21.31.

Now our book value, which our company is focused on, ended the year 2009 at $369.80, say, $367 a share. So at the end of quarter one, our book value was $384; at the end of quarter two, with $383; the end of quarter three, $401; at the end of quarter four, we went down to $379.46. For the whole year, our book value per share moved up 5.3%, including the dividends. So with fluctuating markets and mark-to-market accounting, we don't see our results can be anything but lumpy. As we've said before many, many times, we prefer a lumpy 15% to a smooth 12% over the long term.

Some further highlights for 2010. Our consolidated combined ratio was 105.2% with good reserving and our companies are well capitalized. We benefited from the fact that we had no major hurricanes in the United States, but we did suffer from above average catastrophe losses, principally, from earthquakes in Chile and New Zealand in 2010. In a soft market with continued irrational pricing, our insurance and reinsurance companies are doing exactly what we have done in the past, letting unprofitable business go. Of course, declining premiums have resulted in higher rate expense ratios and combined ratios above 100%. We are very vigilant in soft markets to make sure we immediately increase reserves if we see any inadequacy. Our focus continues to be on underwriting profits, good reserving and not on market share. In the right market environment, we have the ability to expand significantly. In the meantime, we are patient.

Interest and dividend income for the year was $762.4 million in 2010, a 7% increase from $712.7 million last year. Interest income, as you know, is not adjusted for the positive tax effect of the company's significant holdings in muni bonds. Operating income, excluding net gains on investments, decreased in 2010 to $367 million, from $564 million in 2009 due to underwriting losses in 2010. Our holding company's cash and marketable securities at the end of the year was $1.5 billion. Our holding company's debt to total capital ratio was 23.8% as of December 31, 2010, versus 23% as of December 31, 2009.

Finally, our equity portfolio was approximately 89% hedged at the end of 2010. We continue to focus on de-risking our equity exposure as the stock markets have gone up significantly, with the long-term risk still very much prevalent.

Now I would like to turn it over to John for further details.

John Charles Varnell
Vice President of Corporate Development

Thank you, Prem. We'll start with Fairfax consolidated results for the fourth quarter and for 2010. We'll touch on the operating company results and we'll finish up with financial position. I'd also like to remind you that the comprehensive report on the fourth quarter and full 2010 results posted on our website and our full annual report with the digital disclosures will be published on the evening of Friday, March 4.

For the full year 2010, we had net earnings of $469 million, and that compares the prior year of $856.8 million. 2010 earnings per share were $21.31, versus 2009 with $43.75 per share. Net losses for the fourth quarter were $364.6 million or fully diluted loss per share of negative $18.43, that compares to the fourth quarter of 2009 where we had $79.4 million in net earnings and fully diluted EPS of $1.65. As Prem said, that resulted in book value per share at year end of $379, that's up only 5.3% on a year-over-year basis when you factor in the $10 a share dividend we paid early in 2010. The major differences between 2009 and 2010 earnings were the investment losses, primarily mark-to-market and the underwriting results.

So let's turn to the sources of earnings. For the full year 2010, we had a combined ratio of 105.2, that compares to a 99.8% combined ratio in 2009. We had an underwriting loss in 2010 of $236.6 million, and that compared to an underwriting profit of $7.3 million in 2009. The year-over-year decline in our underwriting results was due to the Zenith acquisition, partly, which added $100 million of underwriting losses to our results; and the Crum & Forster underwriting losses, which were weaker by $33 million; and Northbridge results, which were down by $15 million. 2010 catastrophe losses were $331 million, which includes Chile, New Zealand, Xynthia storm, as well as some other attritional cuts for 7.3 combined ratio points compared to 2009 cat losses, which were only $165 million and represented about 3.8 combined ratio points.

In terms of prior-period reserve development, as Prem said, our company's claims reserves remain strong in 2010. We did record a modest benefit from favorable reserve development in the year, $11.5 million, or about three tenths of one combined ratio point benefit, compared to $26 million or about 6/10 of one combined ratio point of benefit recorded in 2009. What that works out to in terms of accident year combined ratios, our accident year combined in 2010 was 105.4, that compares to 2009 of 100.4. If we exclude the cat losses, our accident year combined ratio in 2010 was 98.2 compared to 96.7 in 2009. So you can see that the industry and our company, as well, are still in challenging underwriting market conditions and I will now review the operating companies' underwriting results.

Actually, I'll do investments first. Earnings interest and dividend income increased year-over-year for Fairfax, it was up 7% to $762 million in 2010 from $712 million in 2009, primarily due to the larger Investment portfolio from our acquisitions through the year. Our 12-month interest and dividend yield was flat at 3.39% in 2010 compared to 3.42% in 2009. Our average portfolio size, and this includes our holding company cash and investments, increased in 2010. The average portfolio size was $22.5 billion, and that compared to $20.9 billion in 2009. So there is a $1.6 billion increase in average portfolio size year-over-year.

As you know, we have significant holdings of municipal and other tax-exempt bonds, as well as corporate bonds. The tax effect of the tax-advantaged interest income and U.S. dividend income has been significant. If you look at our 2010 effective tax rate, it was negative 34% compared to positive 17.8% in 2009. And that compares to a statutory rate that you would expect to see at 31% and 33%, respectively in 2010 and 2009. We had an income tax recovery in 2010 of $316 million, the two biggest factors in that are the tax-advantaged investment income, which accounts for $89 million of the benefit, and we have income tax at lower rates in other jurisdictions, which amount to a $92 million benefit in 2010.

Investment gains for the fourth quarter of 2010 were actually investment losses. We had $188 million of net gains for the full year 2010 compared to $944.5 million of investment gains in 2009. The decreased gains resulted mainly from mark-to-market losses on our Bond portfolios, particularly munis, and the hedging of our Stock portfolios. The current quarter's net investment losses of $684 million are primarily comprised of net losses on equity hedges, $764 million; net losses principally unrealized on municipal bonds of $425 million; partially offset by net gains on common stocks and equities of $285 million.

When you analyze 2010, the main driver of the $188 million net gains on investments that went through the earnings statement are bond gains of $574 million. We made $735 million in equities, offset by the derivative losses of $937 million. We had other and temporary impairment investment rate downs for 2010 of $34 million, compared to $340 million in 2009.

Now on the operating companies, and the details are in the filings we posted to our website last night. We'll start with OdysseyRe, they had a strong fourth quarter and another strong fiscal year. In the fourth quarter, their combined ratio was 92.9 and they generated an underwriting profit of $33.9 million. For the full year 2010, Odyssey had a 98.6% combined ratio and an underwriting profit of $25.8 million. On an accident year basis, the combined ratio at Odyssey was 98.8% for 2010, very good results. Cat losses in 2010 accounted for 11.6 combined ratio points for Odyssey, reflecting Chile, New Zealand, Xynthia and a variety of smaller cats, that compares a 6.1 combined ratio points in 2009 results due to cats. On an accident year basis, excluding cat losses, Odyssey performed at 87.2% in 2010, that compares to about 91.2% in 2009. And on a net premium basis, net premiums written, they wrote $1.85 billion this year, down slightly from $1.89 billion last year. With increased interest and dividends at Odyssey of $289 million and net investment losses at Odyssey of $29 million, that gave Odyssey pretax earnings of $224 million for the year, for a good year.

At Crum & Forster, they continue to deal with commercial lines markets that have been tough for some time now. Crum in the fourth quarter had a combined ratio of 116.4; for the full fiscal year, their combined ratio was 109.1. The 2009 combined ratio was 104.1; and on an accident year basis, the combined ratio was 107.1 for the year. Net earned premium at Crum, you will recall we talked about it declining at previous years. For the full year, net earned premium was $731 million, that compares to $781 million in 2009, a small decrease but we're seeing premiums stabilized. Crum is having continued growth in their specialty lines. Accident and health and certain specialty lines at Seneca, partially offset by decreased ratings of standard commercial property and casualty lines as a result of challenging U.S. markets. The impact of the decline in earned premium at Crum, we pointed out last time and we'll point it out again, does have an impact on the expense ratio within the combined, so we had a 2010 expense ratio at Crum with 34.8%, compared to 2009 expense ratio at Crum with 34.9%.

Zenith, we purchased in May 2010, had a combined ratio for the year of 137, and an accident year ratio of 128. Net premium written by Zenith continues to be affected by the impact of the weak economy on the payrolls of its insured customers as well as competition in great levels, and that has resulted in an expense ratio of 48% for Zenith, as earned premiums are $268 million, down from past years. Pricing declines appear to have bottomed out at Zenith, so that's where we are there.

Northbridge's experience in 2010 was similar to Crum. Fourth quarter combined was 111.1. The full year combined ratio for Northbridge was 107.3. On an accident year basis, the combined ratio at Northbridge was 107.4, excluding cats was 105.3. Net premiums written by Northbridge, measured in U.S. dollars, increased by 6.1%, however, if you measure it in their Canadian dollar terms, it decreased by 3.8%, during the 12 months of 2010 as a result of the weakness in commercial lines and the market conditions and pricing discipline at Northbridge as they let unprofitable business go. That produced an impact on the expense ratio. So Northbridge had an expense ratio of 32.4% in 2010, and that's up from 30.2% in 2009. And that's just the arithmetic at work, the decline in earned premium affects those ratios even though the foreign exchange impact makes it appear the premiums rose.

Now turning to Fairfax Asia, strong results again. Another year of profitable growth at Fairfax Asia. The fourth quarter combined for Fairfax Asia was 90.8%. For the whole year, the combined ratio at Fairfax Asia was 89.3%, and the segment generated an underwriting income of $56 million. Gross premiums written, net premiums written and net premiums earned by Fairfax Asia increased by 24%, 23% and 34%. So profitable growth there is evident. Pretax income for the year at Fairfax Asia was $52 million, and that compares to $47 million in 2009. So strong results.

The segment that we call reinsurance and insurance other in the fourth quarter had a combined ratio of 90%, but for the full fiscal year had an underwriting loss and combined of 107, that included combined ratios at Group Re of 103, Advent Capital of 108, and Polish Re of 104.

And finally our runoff group had another good year and earned a $143 million in 2010, which includes the $83 million gain on the GFIC purchase loan at asset value. Our companies continue to be well-capitalized, as you can see from our conservative premium-to-surplus ratios. So Northbridge measured on net premium written statutory surplus rating at 0.8x, Crum & Forster at 0.6x, Zenith at 0.6x, OdysseyRe at 0.5x, and Asia at 0.4x. And as Prem said, that gives lots of opportunity for when markets are better, that we can write additional business.

Turning to financial position. With the holding company liquidity, we ended the year with $1.5 billion in cash and short-term investments and marketable securities at the holding company. Early in the fourth quarter, we closed our offering of Series I preferred shares, that was a CAD $300 million operating netting about CAD $291 million. We did pay our common dividend early in the first quarter of 2011, that was a $200 million event. And we closed our First Mercury acquisition on February 9, which used approximately $350 million in cash, in total. In terms of financial leverage, our balance sheet remained strong throughout 2010. Our year end debt-to-capital ratio, as Prem mentioned, was 23.8%, just slightly higher than the 23% in 2009. Our shareholders' equity finished at $8.7 billion at December 31, up from $7.7 billion last year, partly due to the $700 million of preferred issue and also retained earnings.

On the Investment portfolio, just to finish up, we ended the year with an investment portfolio, which includes holding company cash and investments of $23.5 billion, that's increased from $21.3 billion one year ago. That increase is due primarily to the acquisitions completed during 2010. The Bond portfolio finished at $11.7 billion, significant part of that is tax-advantaged state and municipal bonds, and about 65% of those bonds are insured by Berkshire Hathaway.

The equity hedges are disclosed in our report. The initial hedge of $1.5 billion, we reported to you previously, that was done in an S&P index level of 1,062.5, and the $3.3 billion notional Russell 2000 index value was 646.5.

And that's about it, Pram. So back to you.

V. Prem Watsa
Founder, Chairman and Chief Executive Officer
Thank you, John. Now, Theresa, we'll be happy to answer their questions. Please give us your name, your company name and try to limit your questions to only one so that it's fair to all on the call. Theresa, we are ready for the questions.

Question and Answer

Operator

[Operator Instructions] Jeff Fenwick, you may ask your question.

Jeffrey Michael Fenwick
Cormark Securities Inc., Research Division

Prem, I just wanted to start this morning on operating performance across several of the groups this quarter. A fair amount of adverse development of reserves, in particular, Zenith. I was wondering if you could just touch on at least Zenith to start with here, almost 22 points of reserve development. Can you give us a sense of what's at play there? Is this Fairfax going through scrubbing their book of claims or is there some other items in there that are impacting that?

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

That's a good question. This is for Zenith, it's for Crum & Foster and it's for Northbridge. Whenever we see -- whenever there's a possibility of increased reserves, particularly in a soft market, we make sure that we increase the reserves. So in the case of Zenith, we increased the reserves in the fourth quarter by about $25 million. And so it's a lot of points because we had only, as John said, a little more than a half of the premium for the year. But I remind you that Zenith's combined ratio for the last few years reflects very high expense ratios. Its 30-year average combined ratio is 95%, and we see it in the first -- early in 2011, rates have bottomed out and in fact, have been increasing, and we see it coming back over time. We are long term in our approach to Zenith. We have tremendous CEO in Stanley Zax, and his management team will run the company, and we feel very confident that over time they'll come back to 95%. But just like at Crum, Northbridge and our other companies in the soft market, when we see our reserves that need to be increased, we will increase them. That's what happened with Zenith, and a fall away in Crum and Northbridge.

Jeffrey Michael Fenwick
Cormark Securities Inc., Research Division

I mean, in Northbridge, there were a couple of items that you did give us some detail on about collectible reinsurance recoverables, and I believe some discontinued business was in there as well. Is there any one thing in particular there that's impacting that? I guess, the uncollectible reinsurance recoverables just stands out, is there sort of a risk there with some of the parties that you deal with around recovering those?

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

We are always sensitive to reinsurance recoverables. So wherever we feel there is any risk of recoverability, we take a chance. It will start small, we had in the case of Northbridge. But across our system, in our annual report, we'll be showing you all the details for the whole year 2010. But on a quarter-by-quarter basis, we just reflect whatever the experience was. I hope this is long term. This is the soft part of the cycle, our business is coming down. John said to you, in terms of capital, we are writing $0.50 of premium for $1 of capital on average. And we can write at least $1 of premium and in tough markets, we've written $1.50 of premium per dollar of capital. So we have very good management, we have good reserving, we're well-capitalized, more of this is discussed in our regular report. And right now in these soft markets, we have to be patient and that's what we are. But at the moment it changes, and we have said it before, we’ll expand very significantly.

Operator

Mark Dwelle, you may ask your question.

Mark Alan Dwelle

RBC Capital Markets, LLC, Research Division

One, just a kind of a numbers question. What was Zenith's expense ratio for the fourth quarter? You've given that on a full year basis.

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

For the fourth quarter, Mark?

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Yes.

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

John, do you have that handy?

John Charles Varnell
Vice President of Corporate Development

Yes. It sits around 50%. For the full year we are 48%, and for the quarter it was 50%.

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

So the expense ratios for Zenith have been significant. If you look at their last ratios, Mark, for the full quarter, for the year 2010 and for the last 30 years, they are between 15 and 20 points lower than the industry. So their loss ratios have been significantly better than the industry. They were writing a few years ago, $1,000,000,001, and they've dramatically reduced that to below $500 million. We see it bottoming out here at $450 million, $500 million, and over the next few years we expect it to increase. How much, of course, no one knows. But the pricing has bottomed out in California. We expect it to increase some and the people who are writing business in the last two years, we think, will not have dollars that they're going to be happy about, and ultimately will cut back, and of course that provides opportunity for companies like ours to expand.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Related to the First Mercury acquisition. I know that closed just a few days ago, is there any plans to significantly change kind of the run rates of where premiums were in that business relative to their history? Or would that be kind of a good benchmark for thinking about how that might add both premiums and losses, at least on a near-term basis?

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

Yes, so Mark, First Mercury, of course, being a public company, so in the past, you have seen their results. They've got very good combined ratios. And in a soft market, excess and surplus lines, surplus lines is our business, you know how the business shifts from the admitted markets to surplus lines and back. In a soft market, of course, it goes into the admitted markets. Surplus lines are very much reduced. They're writing about $300 million, something in that area. They control another $100 million through an MGA called AMC, which they very much like that business. So those are the two components. But when the markets change, as they will sometime, we expect First Mercury to write a significant amount of business, a lot more business, when the surplus lines market increases significantly. Right now, we don't see that, we see it flat, maybe even coming down some. So we don't see that change in any significant way.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

And just a quick accounting question on that, that's going to be accounted for in the U.S. insurance operating results and kind of broken out as a third column of numbers in reporting?

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

That's right, Mark. And in fact, it's going to be part of Crum & Forster and it will be integrated with Crum & Forster. It will become these service lines platform for Crum & Forster.

Operator

Tom McKinnon, you may ask your question.

Tom McKinnon

With respect to Northbridge, it looks like there's some sort of strategic exits from certain lines of business and certain regions, so I'm wondering if you can elaborate on a little bit on what you're doing there. And then if you can maybe comment on how the kind of all-important renewal season is coming along with respect to Odyssey and some of your other global reinsurers.

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

Yes, Tom. So in terms of Northbridge, of course our annual report comes out in about a few weeks. So we'll give a lot of information there. Northbridge is very focused on very simply, any lines that are not profitable, they basically will not write the business. This applies in Northbridge and our other companies. If we don't see the profit, we will not write the business. And so they've done some of that. And I'll pass it on to John to add a few more comments, if you want. So that's on Northbridge. Why don't you add to that, John, and I'll come back to Odyssey.

John Charles Varnell
Vice President of Corporate Development

Yes. Just in some areas of Commercial Auto, Tom, that they've been exiting some lines. So that's all that's going on there. Second part of the question was on renewal?

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

Renewal rates for that business, between what you've heard in the marketplace, Tom, between 5% and 10% down, sometimes flat depending on the line. In terms of cat exposures and rates for cat exposures in the United States, especially Florida, down now 5%, 10% in that area. Workers' compensation though, early in 2011, seems to have flattened out as I've said before. Prices seems to be going up. You'll remember that Zenith is recognized as the best company in the workers' comp business in California. And Zenith dropped its premium from $1.1 billion to $450 million to $500 million. So whoever wrote that other business is competing with Zenith, who has been in the business for 30 years and has decided not write it. So I suggest to you that over time, and this is our industry, over time, that the results were low and it seems to be impacting that component already, workers' compensation in California. If you look at the cycle, Tom, you'll remember, and I've said this to you before, the accident year combined ratios for the industry is running above 100%, for the whole U.S. industry. But the redundancies from the past of getting the calendar combined ratios below 100%, and the redundancies will dry up, if they haven't already dried-up. The investment income, on the other side, continues to drop as portfolios with durations of three to four years as they roll over and get the lower interest rates, even though interest rates have come back, come up a little, but they’re still significantly lower than where they were three or four years ago, so investment income comes down. So at current interest rates, the industry needs combined ratios of 95% in that area to make a single-digit return on equity numbers. So the cycle will change, the only question is when, and we don't know that, no one knows that, and what you do is after what we do, what we've done, is to have patience and wait. We keep $1.5 billion in cash in the holding companies. After these acquisitions settle in the first quarter, our cash will be in the -- cash and marketable will be close to

$1 billion. And you wait for the time when others see their results deteriorate. And when that happens, we'll expand significantly. In the meantime, we just have to be patient.

Tom McKinnon

We could have made the same argument about a year ago, it just seems to be this is taking longer to happen, just generally, in the industry. You just think there's just too much capital in the system right now?

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

Yes, I think that's right, Tom. We made the same argument a year ago, and I hope I'm not making the same argument a year from now, Tom, but that could well be the case. Because these industries, these cycles are not predictable. One, is the comments I gave you, the fundamentals, meaning combined ratios and investment income. To that, of course, you have to throw in unexpected events. Catastrophes, changes in the marketplace, spreads widening, those kinds of things. And it's difficult to say when it will change, but I do know that writing at times when the business is unprofitable is a sure sign of getting into problems in the future. And we've survived 25 years and done well for our shareholders over that long period by being very, very careful of cutting back in soft markets and waiting patiently for the cycle to expand. And of course, there's no better example than Zenith, which as I said, I can't think of another company that's gone from $1.1 billion to $450 million and has a 30-year combined ratio average of 95%. So Tom, we are like, this is a business that you really have to look long term. And we are focused on long term, we don't provide any guidance for that very reason that you can take the long-term view and of course, we've attracted a lot of shareholders who are similarly inclined. But that's just the nature of the beast, Tom.

Operator

Jaideep Shah [ph].

Analyst

My question is about your hedge situation on the swaps and derivatives you have, please. Looking through the filing, I'm wondering is there a way to figure out what is the maximum loss you could possibly take on your swaps and hedges if you're wrong? The stock market's obviously been going up even in 2011, so the unrealized loss, I know it's mark-to-market, it keeps rising. Is there some maximum that you can go to? It doesn't seem like it would be the note full value. I went through the 67 pages and I didn't -- couldn't figure out what that maximum would be.

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

That's a good question, Jaideep. So what we've done is we basically hedged our common stock position. So that means if there's $100 of common stock that we own, Jaideep, we've got either S&P 500 or Russell 2000's shorts equal to 90% to 100%. It's about 89%, I think, we mentioned to you at the end of the year. So that means, whatever we make on -- so what's happened in the fourth quarter of 2010 and in the year 2010, is whatever we made in the common stock, in our common stock investments, we basically lost it in the hedges. So that's just how it works. There is, you might be implying that there is a basis risk, that means our common stock portfolios may not go up as much as to make up for the hedges, there is that. But it’s our experience, our portfolios over the last five, 10 years have basically matched the industry, sometimes going up a lot more. So if I had to step back a little, Jaideep, and just put that in perspective for you, if 2008 and 2009 was just another recession like we've had in the past 50 years, then this would be a time to buy or a time to continue to be aggressive in your common stock holdings. We don't think so. We think of 2008, 2009 as a one in 50, one in a 100-year event, with potential unintended consequences that come. So we remained cautious. As we have said before, our common equity -- our shareholders' equity for Fairfax has gone from $4.9 billion in 2008, to $7.7 billion currently. So from the middle of 2010, Jaideep, we have focused on protecting our capital from worst-case events. We are happy with the $7.7 billion, we want to make sure we don't lose it. So our gains from our Common Stock portfolio, as we were just talking, which by the way we continue to realize, is negated by the unrealized losses in our hedge. Unrealized in the sense that we still have the hedge on. If we are right, and there's no guarantee we will be, the unrealized losses on the hedge will be reduced or eliminated in the future, while our realized gains will remain in our book value. So we are long term, and fluctuations in the market base [indiscernible] with 35 years, and we expect that our results will continue to be lumpy as they have been in the last few years. That's our perspective on it.

Analyst

Could I follow-up and ask you to clarify something then about that?

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

Sure, go right ahead Jaideep.

Analyst

I missed on the conference, what you're saying. Just the question I'm asking or what I'm concerned about and just to be clear of -- very good, long-term holder of Fairfax and I own a decent amount of stock. So it's from the $85 days. I kind of enjoyed those days, looks like we'll just buy more and more stocks. And so, the concern I have is at what point are you willing to say, "You know what, I'd rather just be hedged by being in cash." Because the choice you made was to have your loan portfolio and then also in some ways try to make money by having the swap and hedge, I understand it's a hedge, but if the unrealized gain keeps going up or at some point it may start affecting your underwriting capital availability, I don't know if that's right or not, but if it keeps going up, if you have a $600 million unrealized gain every quarter, at some point, that becomes an issue, so is there a mechanism where you can lock the loss and say, "I can buy out the remaining contracts," or you admit defeat and walk away, or do you go all the way to the $5 billion of supplemental value?

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

We can unwind these hedges at any point in time. We can do it tomorrow, we can do it next month. So it's very easy to unwind it. And you must realize, of course, at the end of 2010, whatever we lost, say, we lost, in realized and unrealized in those hedges, say, we lost about $700 million, we've got $700 million in realized and unrealized gains in our common stock portfolio. So our capital was impaired. It was approximately the same through the hedge. What dropped our book value, Jaideep, was the fact that our Muni Bond portfolio in that one quarter went down by $500 million. And it's a fluctuation. And even when it went down by $500 million in that fourth quarter, it was still -- we still had an unrealized gain in our Muni Bond portfolio of $225 million, that's because we bought most of that in the fourth quarter of 2008 at interest rate of 5 3/4%. So our capital, unrealized, and not statutory capital, but in our GAAP capital came down by $500 million through the Muni Bond portfolios, which by the way is if you divide that by 20.5 million shares, it's about $24 a share, pretax though. So that's most of our drop in book value in that fourth quarter. And muni bonds, John told you 65% of our Muni Bond portfolio books are Berkshire Hathaway guaranteed. They are selling at about 6%, some of them issues at 6% bonds, 6.25%. That's like 8.8% pretax with Berkshire Hathaway credit.

Analyst

No, it's a great deal, you're getting the money and it's their problem.

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

So that's the fluctuation in our shareholders' equity, not the hedge. The hedge did exactly what it's supposed to do, which is whatever we gained on the common stock portfolio was offset by the hedge. So it was a zero-sum gain in effect, not -- there wasn't any significant loss associated with the hedge.

Analyst

On your stock portfolio, and again I -- overall, I'm a happy shareholder, it's just this filing for some reason has me questioning a few things. What I noticed is you guys did such an amazing job with the CDS stuff, you guys were right in so many ways through 2007 through 2009, and you were so liquid and able to write these muni bonds, get them insured by Berkshire, so all these great things at the right time by the having capacity, liquidity on all fronts. The one thing I did notice in your common stock portfolio, there's a lot of very messy equity decisions that have been made in the last one or two years. When I thought that you guys would have used your liquidity to buy high-quality things, given how much money you guys had, and how some very large liquid companies were available, I'm just throwing out names not making any suggestions, like Colgate and United Technologies were fairly cheap, but you guys invested in level three, more and more level three and the Pulp [ph] Company and the Regional Airline and these sort of things, DELL overstock, USG, and I'm just wondering, is there something in the G&A at Fairfax that attracts you to these overly messy things? I mean just like the history of buying messy insurance companies.

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

Jaideep, we have our annual meeting in a couple weeks. Actually, our annual report comes out in about two weeks and then our annual meeting is in April. I think, it's April 20. Is it somewhere there? Why don't you come for that and ask all your questions there, because those are a little detailed questions for a conference call, Jaideep. So we'll have to move along, but thank you for your questions and thank you for being a nice shareholder long term.

Operator

John Louie [ph], you may ask your question.

Analyst

I'm a long-timer shareholder as well. I've been with you since the $50 range actually. My question, basically, also goes back to investment portfolio. Just have a couple of questions with the recent concerns on the muni markets. Do you feel that there may be some opportunities that may crop up and near-term to mid-term? And second of all, do you have any sort of outlook on interest rates and any thoughts about hedging interest rates as they happen to go up? I know that you were more on the deflationary side earlier last year, but I was wondering about your outlook going forward.

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

So, John, on the muni bonds, I just spoke to Jaideep here on the muni bonds. But if I could just tell you, just highlight it again for you. With these Berkshire Hathaway guaranteed bonds, muni bonds, when you are getting 5 1/2%, 5 3/4%, and some issues at 6%, the pretax equivalent is pretty close to 9% -- 8.8%, 9% depending on the tax rate. Now these are bonds that'll give you that for 10 years, noncallable for 10 years. So the way we look at it is that no credit risk, they are very little credit risk. We collect 9% on our money approximately for the next 10 years and the fluctuations in the value is going to our balance sheet up and down, and it doesn't have much impact on us. Another way to look at those muni bonds is to say, what does that -- that 8.8% you compare that to a 10-year treasuries at $365. So $365 for 10-year treasuries and muni bonds at 8.8%, guaranteed by Berkshire Hathaway. Another way we look at it and in the investment business this is how you look at it, you look at the spreads on muni bonds, which are tax exempt in the main versus treasuries. So they are selling that spread 150 to 200 basis points and perhaps higher than what treasuries are selling, and even though you don't pay any tax. Whereas in the past, if you go back, they sold at a 50 to 100 basis points discount. So you have that discrepancy and those discrepancies, in our view, with being in the market for a long time, they don't last for long and they will change. For example, we go into the marketplace. We can buy $1 million of Berkshire Hathaway guaranteed bonds even though the yields are 5 3/4% and 6%, there's none for sale in the marketplace. It's a bid, there's pessimism on muni bonds across all muni bonds and perhaps some justified, but we think totally unjustified in the ones that we have. And so we look at this as a time of opportunity, but we like the rates, but there's with very little available. I did say that, that fluctuation, $500 million in the fourth quarter, in spite of that, our yields are closer to $575 on the whole $3.6 billion portfolio of Berkshire

Hathaway guaranteed bonds. So for us, not to have experienced that fluctuation in the fourth quarter, we'd have had to sell it $3.6 billion and try to buy it now, which of course would've been impossible. And so we're very happy with these muni bonds that we have. We think it'll fluctuate up and down while we collect a very good interest rate and get good investment income. In terms of inflation, what was the inflation, John? Just one simple comment and again, you're welcome to come to our annual meeting where we'll discuss this further. We just think that in the last three to six months, the environment, or the feeling in the marketplace is there's more inflation. We think it takes a lot more time. As I mentioned to you, if you think this is just like any recession in the past 50 years, then you might think inflation is on its way. But if you think there's a chance that this is an exceptional event, 2008 and 2009, then perhaps you'd be a little more worried about deflation, about the fact that inflation might be more difficult to come by. So this is what we continue to feel today, but we'd love to have you at our annual meeting and look to further discussion on the stock.

Analyst

So you do see the opportunities in munis, you just find it very difficult to take advantage of it, is that correct?

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

Well, if we can come back to you, John.

Operator

Tom McKinnon, you may ask your question.

Tom McKinnon

First of all, with respect to the Zenith adverse development, can you share with us what the accident years that was related to?

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

Yes. The accident years were, John, did you...

John Charles Varnell
Vice President of Corporate Development

Yes, they're the recent years.

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

They were the recent years, 2008 and after. So 2008, 2009 in that area. But Tom, Stanley, in fact, is known to be very conservative. And so if he sees anything like us, he'll immediately increase results. And that's what he's done and we've done the same. That's just our view.

Tom McKinnon

And just with respect to the net impact, if you look at the earnings and OCI, if you will, of equities including the hedges, and I'm going to put all preferreds in there as well, you're not a 100% hedged. I think you're around 90% hedged. So if markets would go up, you'd assume there'd be a slight gain but I guess it's because -- but we're finding out that it's a loss. Is that because the, I guess, the gains that you've got in your stock portfolio aren't really getting the same kind of lift as the hedges that you've got in place. Is that a way of describing it?

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

In the fourth quarter, Tom, the right way to do it is also look at our -- when you look at our preferred stock, you'll see they are really convertible prefs. And this is public so I can tell you, it's mainly convertible pref and the big convertible pref is SandRidge Energy. And in the convertible bonds, it's also basically common stock. In that case, it was [indiscernible] and level three, as of the public markets. So if you include those quasi-convertibles, then you'll find that they're very -- in fact, we've got a gain. When you include the equity-accounted holdings that we have, those don't go up or down because they are at, basically, at equity, at cost. And so that's the other side of it. But it's fair to say that our stock portfolios have performed, even in an up market like we've had in the fourth quarter, pretty comparable to what the end of season. And Russell 2000, by the way, is a very speculative Index. It goes up much more and goes down much more than the S&P 500.

Analyst

That hedge percentage, though, excludes the equity-accounted stuff, though, right? The hedge percentage that you're saying 90% hedged, that excludes the equity-accounted business, though, doesn't it?

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

No. I think we've included that. We've included the equity-accounted, and when we put that 90% -- but if you take the equity-accounted and you put the convertibles and the preferreds and the bonds atop, it will be approximately the same.

Operator

[Operator Instructions]

V. Prem Watsa
Founder, Chairman and Chief Executive Officer

Well, Teresa, if there's no more questions, thank you all for joining us on this call. We hope to see many of you at our annual meeting. So thanks, again, Teresa.

Operator
Thank you. This conclude today's conference call. Thank you for your participation.