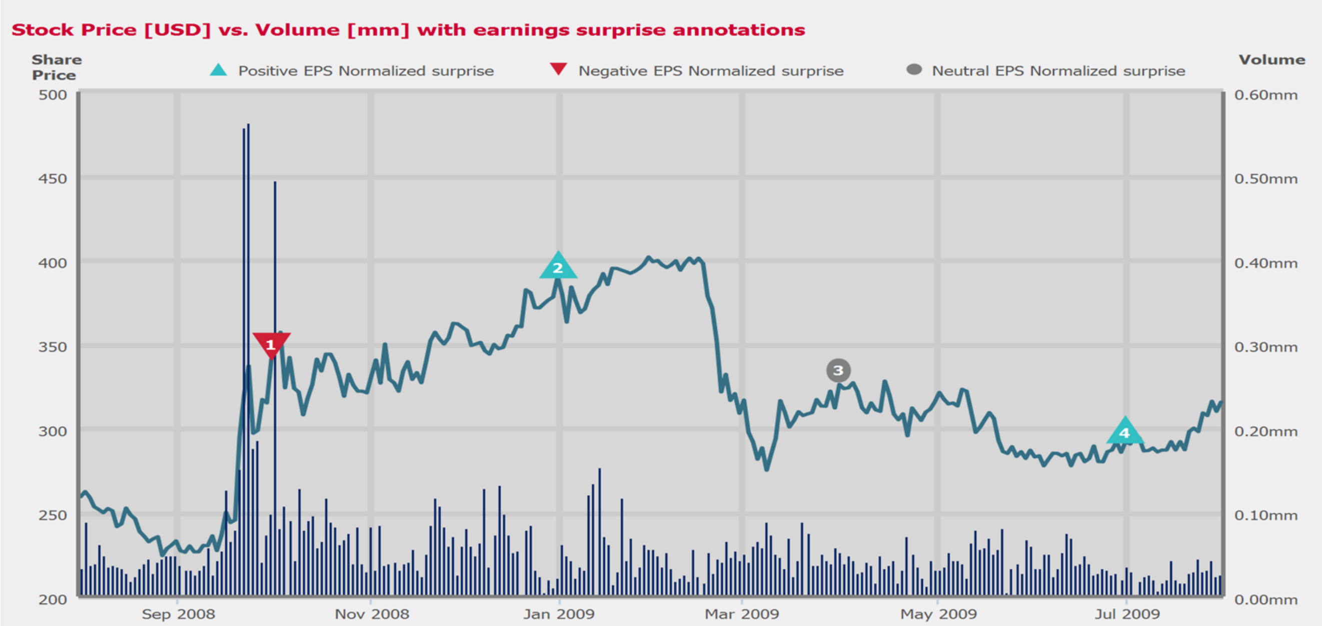
Fairfax Financial Holdings Limited
TSX:FFH
FQ3 2009 Earnings Call Transcripts
Friday, October 30, 2009 12:30 PM GMT
S&P Global Market Intelligence Estimates

	-FQ3 2009-			-FQ4 2009-	-FY 2009-	-FY 2010-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	10.91	30.88	▲183.04	8.12	30.33	31.33
Revenue	-	-	▲36.73	-	-	-
Revenue (mm)	1618.80	2213.40	-	1562.70	6198.95	6379.90

Currency: USD
Consensus as of Oct-19-2009 12:00 PM GMT



- EPS NORMALIZED -	CONSENSUS	ACTUAL	SURPRISE
FQ3 2008	4.00	2.24	▼1 (44.00 %)
FQ4 2008	12.92	19.62	▲2 51.86 %
FQ1 2009	6.70	(3.55)	NM
FQ2 2009	6.06	15.56	▲3 156.77 %

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Call Participants

EXECUTIVES

Brad Martin

Greg Taylor

Prem Watsa

ANALYSTS

Jeff Fenwick
Cormark Securities

Mark Dwelle
RBC Capital Markets

Rich Derov

Robert Albert
Atlas

Shama Thana

Tom MacKinnon
Scotia Capital

Presentation

Operator

Good morning and welcome to Fairfax's 2009 third quarter results conference call. Your lines have been placed on a listen-only mode. After the presentation, we will conduct a question-and-answer session. (Operator instructions).

Today's conference is being recorded. If you have any objections, you may disconnect at this time. Your host for today's call is Prem Watsa, but Brad Martin will make a brief statement first.

Please go ahead, Mr. Martin.

Brad Martin

Good morning. 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 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.

Prem Watsa

Thank you, Brad. Good morning, ladies and gentlemen. Welcome to Fairfax's third quarter conference call. I plan to give you some of the highlights and then pass it on to Greg Taylor, our CFO, for additional financial results.

As we have said in our press release, our third quarter in 2009 was a key milestone in the history of Fairfax. Besides excellent results, we have now privatized OdysseyRe and we financed it by issuing $1 billion of common stock. We have also now publicly issued 10-year bonds and preferred shares in Canada for the first time ever. After the OdysseyRe privatization, Fairfax continues to have in excess of $1 billion in cash and marketable securities at the holding company level and also has a significantly increased annual dividend capacity from its three major insurance and reinsurance operations.

We ended the quarter with shareholders' equity of $7.5 billion and a book value per share of $371.85. Including the $8 per share dividend paid in the first quarter, book value per share was up 36.5% in the first nine months of the year. Our company has never been stronger.

Some further highlights for the quarter. Our consolidated combined ratio was 99.8% with good reserving and our companies are well capitalized. In a soft market with much 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 expense ratios and combined ratio is creeping upwards to a 100%. This is also not unexpected. Our focus continues to be on underwriting profits with good reserving.

Interest and dividend income for the nine months was up 12% and on a tax equivalent basis, was up 27% to $624 million. Our holding company cash and marketable securities after the privatization of OdysseyRe, as I said previously, is in excess of $1 billion. The stock markets continue to be very volatile and as I mentioned to you at our AGM and in our quarterly calls, our investment portfolios and book values will also be volatile in the future due to the significant common stock positions we have purchased in the last quarter of 2008 and first quarter of 2009.

You can see the volatility as our book value per share went from $278 per share at the end of 2008 to $255 per share at March 31st, 2009 to $316 per share at June 30th and now to $372 per share at

September 30th, 2009. We think that five years from now, if we have chosen properly, our book value will be up significantly because of the high-quality common stocks that we have purchased earlier at very attractive prices.

While we like our common stock positions for the long term, a very significant increase in stock prices since March 2009 has prompted us to hedge approximately 25% of our portfolios by shorting the S&P 500 to total return swap contracts. We did this at an average level of 1,062 for the S&P 500.

As an aside, if I can reminiscent for a moment, we began in 1985 with total assets of $30 million and common shareholders' equity of $7.6 million. At September 30th, 2009, almost 24 years later, we have $30 billion in assets and $7.5 billion of common shareholders' equity, approximately 1,000 times what we began with.

With that, I would like to turn it over to Greg to give you an update on our financials. Greg?

Greg Taylor

Great. Thank you very much, Prem. Good morning to everybody. I think we'll start the call with a very short recap of recent events and transactions and how they've impacted our company. Then we will move on to our customary look at our third quarter and nine-month financial results including Fairfax's consolidated financial results, the financial results for our operating companies, and then of course our financial position.

So starting with recent events and transactions, as Prem mentioned we did a lot of capital raising in the third quarter. In all, we raised, in U.S. dollar terms, $1.6 billion in brand new capital for the company. In August, we issued Canadian $400 million dollars of 10-year senior unsecured notes. We were taking advantage of a favorable debt-to-market demand in the Canadian market and a significant narrowing in corporate credit spreads.

In September, the company issued $1 billion in brand new equity at $347 per share and just for some guide posts, our book value per share at the end of the second quarter, as Prem said, was $316. At September 30, it was $372. So we issued somewhere in between $347 per share at the time, we thought that that was a wise move. Obviously, we used it to specifically fund the OdysseyRe transaction. So we issued 2.88 million brand new shares of common stock.

In September - September we issued and in October, early in the fourth quarter, closed, we issued Series C preferred shares, 5.75% Canadian $250 million in gross proceeds. This is permanent capital. These are essentially perpetual preferred shares where the dividend rate resets every five years at a fixed spread is how you should think of that capital.

We obviously put the capital to use quite quickly, some of it, but not all of it. In October, you saw us complete the acquisition of 100% of Advent Capital and now Advent has been de-listed from AIM. The big one, obviously, we just completed last week the acquisition of OdysseyRe and we now own 100% of that. It cost us pretty much $1 billion in cash. As I said, we just completed the transaction this week. Odyssey's common stock has been de-listed from the New York Stock Exchange. Its preferred shares remain listed there.

In December, one more thing coming. We've - we have given notice to the holders of our Series A and Series B preferred shares that we are going to redeem those shares in December that will use Canadian $150 million of the proceeds of this U.S. $1.6 billion that we have raised recently.

The impact on the company of these financings, I'll just give you just four aspects of it. First, our consolidated debt-to-capital ratio. Recall that at the end of fiscal '08, that ratio was 23.7%, again, well within the region that we've talked to you about that we wanted the company to be at. At September 30, that ratio had improved to 20.9%.

Again, I just ask you to factor in a couple of things. We had the closing of the preferred shares Series C in early October that brought in another $250 million. We will have the redemption in December, early December of the preferred Series A and B for Canadian $150 million, and obviously, we had the completion of the OdysseyRe privatization this week that will reduce our cash holdings; it will also take out close to $1 billion of minority interest off the balance sheet. And so if you are trying to come up with a pro forma debt-to-capital ratio for those three additional items, it would take you to approximately 22.6%. So again, still better than where we ended fiscal '08.

Second big impact on the company, obviously, holding company liquidity. From our balance sheet, you can see that we had more than U.S. $2.3 billion in cash, short-term investments, and marketable securities at the holding company level on September 30th. And again, I'd ask you to think - to remember that we've just spent $1 billion of that to complete the OdysseyRe privatization. And so we will - in Q4, we still have obviously well in excess of $1 billion in holding company liquidity.

Third impact is, as Prem mentioned, will be on our capital management in 2010 and beyond as now with having privatized Northbridge early in this year and already owning a 100% of Crum & Forster and now owning 100% of OdysseyRe, we now have control of 100% of the earnings and the cash flows and significantly, the dividend capacity of Northbridge, Crum & Forster, and OdysseyRe.

Fourth impact was on our ratings. As we completed all of these financings and these acquisition transactions through the third quarter and into the fourth quarter, all of our ratings have been affirmed. We've made a lot of ground in the past year-and-a-half with upgrades across the board for all of our companies from all of the rating agencies and we've had all of those ratings affirmed, whether it was our issuer capital - our - sorry, our issuer credit ratings or insure and reinsure the financial strength ratings. Again, affirmed by all of S&P, Moody's, A.M. Best, DBRS, and Fitch ratings.

So turning now to our customary comments, Q3 and nine-month financial results. As you saw, our net earnings for the third quarter was over $562 million compared to $467 million a year ago. For the nine months, net earnings $777 million compares to better than $1.1 billion in the year-ago nine-month period, largely, as you recall, because of very significant investment gains.

Our fully diluted EPS for the third quarter was $30.88 versus $25.27. For the nine months, we earned $43.42 compared to just about $60 in the year-ago nine-month period. Prem said our book value per share, we ended September 30th, $371.85. That's up $56 in the third quarter or about 17.7%. That's up $94 for the year or if you include our $8 dividend from the first quarter, we were up $102 for the year - year-to-date period. That's a 36% increase in 2009.

How you should think about maybe breaking down this $102 increase. Or think of it this ways perhaps. Common shareholders' equity at the end of fiscal '08 was $4.86 billion. At September 30, as Prem said, it's $7.55 billion. That's a $2.68 billion increase. And just let me split it into the three components for you to offer some additional insight for you. Obviously, part of that $2.68 billion was because of our equity offering where we raised $1 billion in new common equity. That has only a nominal impact on book value per share given that we issued it at $347 per share.

A big piece is accumulated other comprehensive income and that increased in the nine months by over $1 billion and a lot of that - on a pretax basis, a lot of that has to do with unrealized appreciation on our investment portfolio. And common stocks alone in there, on a pretax basis, represent $1.1 billion of increased unrealized gains as part of that increase.

And last piece obviously is our significantly increased retained earnings. So I told you, we had nine-month earnings of $777 million. We paid dividends, common and preferred dividends so far in the nine months of $147 million, so the balance over $600 million. Increase in retained earnings makes up the last component of that $2.68 billion increase in our common shareholders' equity and that's what drove our book value per share.

Turning to our sources of earnings, in the third quarter, the industry-wide experience was continuing challenging market conditions in insurance and reinsurance globally and our companies were no exception. You'll see that our gross premiums written declined 3.7%. Our net premiums written were down about 6%, sort of in line with the industry numbers that we've seen reported in the third quarter to date.

In terms of underwriting, our underwriting results, they are positive for the quarter and for the nine months, but just modestly so and it shows the challenging markets that we are in. For the third quarter, our combined ratio was 99.8%. For the nine months, our combined ratio was 99%. There is a big year-over-year improvement that you'll see over the '08 results and much of that has to do with catastrophe losses in '08. Obviously, '08 results were heavily impacted by hurricanes Dolly, Gustav, Ike and a series of other global catastrophe losses that happened.

Our CAT losses for the nine months in 2009 are $127 million in OE. That number was $366 million. Our - the CAT losses accounted for 3.9 combined ratio of points in our nine-month results. The nine months of '08 were impacted by 10.8 combined ratio points. So you can see the huge positive swing in underwriting results because of the different experience on catastrophe losses.

In terms of prior year development of the reserves, we continue to experience favorable development overall on our prior year's results. In the third quarter, it benefited the results by about 1.6 months. For the nine months, it was about 1.2 points and so on an accident year basis, our third quarter combined ratio was 101.4, for the nine months it's a 100.2 So again, on an accident year basis, our underwriting is right around the 100 mark.

Second driver of our earnings obviously is interest and dividend income. And the trend that we talked to you about in the first and second quarters continues in the third quarter. Third quarter, year-over-year, our interest and dividend income is up 36%. For the nine months, year-over-year, it's a 12.5% increase. And that's because our pretax annualized portfolio yield continues to increase. In the third quarter, that yield was 3.46% and that compares to the year-over-year period of about 2.66%. So we've got an 80 basis point pickup in yield year-over-year for the third quarter.

Same reasons as we articulated to you before. We have increased municipal and tax-exempt bond holdings. We have increased corporate bond holdings compared to prior periods. We have increased common equity with significant dividend paying companies in that portfolio year-over-year. Slight offset is that - is that we still hold meaningful cash and short-term investments at the company and we very much felt the year-over-year drop in short-term treasury yields as they've been extremely low in '09 compared to where they were in '08.

I might also mention that after tax, our interest income has increased greatly year-over-year, obviously because of the municipals and tax exempts. So at September 30, our bond portfolio was $10.9 billion. Of that $10.9 billion, municipals and tax exempts was $4.7 billion. If we look at September 30 of '08, bond portfolio was about $10.5 billion. Less than $1 billion - $965 million of that was the municipals and tax exempts. So these have had a huge impact on our tax equivalent yields and our after-tax retention of our interest and dividend income.

Last driver of the earnings obviously is investment gains. And the investment gains that don't go through the income statement obviously and through OCI are a big driver of our book value per share, as I shared with you. In third quarter of '09, we had investment gains at just shy of $800 million. That compares to $864 million in the third quarter of '08. For nine months, our investment gains are $974.8 million in the '08 period. They were almost $1.9 billion. And as you recall, in the '08 period the gains were dominated by credit default swaps and equity hedge gains.

In '09, really the gains that go through the earnings statement are dominated by bonds. Our third quarter bond gains were $620 million of that $800 million overall number. For the nine months, of our $974 million in overall net gains, our bond gains were $1.038 billion. So it's - in the P&L, it's about the bond gains.

The flipside is the other comprehensive income as I said, big driver of book value per share, doesn't go through earnings, ends up in AOCI and shareholders' equity, but it's the flipside of the coin there. It's really dominated by the equity gains. So on the third quarter, the change in AOCI on our balance sheet on an after-tax basis was just shy of $500 million. Included in that number on a pretax basis was equities - unrealized gains on equities of $560 million. And for the nine-month period, our change in AOCI, it was up on an after-tax basis of almost $1.1 billion and included in that number, a pretax unrealized increases in appreciation in equity portfolio was $1.13 billion.

Turning to the operating companies' financial results, just quickly, starting with OdysseyRe. Odyssey had a very strong quarter, OdysseyRe will file its 10-Q early next week or publicly mid next week, but you can see - in our quarterly interim report, you can see obviously all of their results.

So Odyssey had underwriting profit in the third quarter of $15.1 million that compared to an underwriting loss of $71 million a year ago. And again, that goes back to hurricanes Ike, Gustav and some of the international CAT losses that happened in '08. So a big improvement in Odyssey's underwriting profitability year-over-year. Its combined ratio was 96.9% that compared to113% in the year-ago quarter. On an accident year basis, Odyssey's combined ratio was 97%. So not - hardly any impact at all from movement of prior year's reserves.

CAT losses in the current quarter for Odyssey were 7.4 points and so its accident year ex the CAT losses was 89 - a very healthy 89.5%. So obviously, very solid underwriting results at Odyssey, also a strong investment contribution. Both interest and dividend income and investment gains at Odyssey, both of them were up year-over-year. And so net result is pretax income for Odyssey for the third quarter of $353 million. That's up 76% year-over-year.

For our primary insurance operations, mainly Crum & Forster and Northbridge, Q3 was very much like the first half of 2009, very, very challenging conditions. Crum & Forster in the third quarter had an underwriting loss of $14.4 million and a combined ratio of 107.9 and that compared to the '08 period with underwriting loss of $66.3 million and a combined ratio of 128.5%, obviously reflecting Ike and Gustav and some other charges that Crum took in '08.

Accident year basis, third quarter '09, Crum performed at 109.7% combined ratio. And its CAT losses were quite modest. Accident year ex CAT was 107.9 for Crum in the third quarter. One explanatory note, that 107.9% combined ratio, it obviously includes a big expense ratio component. The expense ratio, you'll see, is about 38.3 points of that and Crum's general underwriting expenses actually declined modestly year-over-year, but the year-end premium decline is greater than that and hence the effect you see.

So net premiums earned for Q3 at Crum were down 15.5% and for the nine months were down 20.8%. So obviously you can see that U.S. commercial lines market conditions are very challenging right now.

Crum nevertheless had a very strong contribution to earnings from investments and due to this and due to the reduced CAT losses and other '08 charges that Crum had, Crum's pretax income year-over-year is up for both the three-month period and the nine-month period. Three months pretax earnings at Crum & Forster were $176 million compared to $150 million in the year-ago period. For nine months, Crum's pretax income was $304 million and that compares to $300 million in the first nine months of 2008. As a result, Crum's U.S. GAAP equity has risen year-to-date. It's $1.4 billion at the end of the third quarter and that's up from $1.05 billion at the end of fiscal '08.

Northbridge briefly, lots of parallels with Crum & Forster. Commercial lines markets are very tough in Canada. As a result, Northbridge's premium volumes, measured in Canadian dollars, in the third quarter net premiums written were down 13.4%. For the nine months, Northbridge's net premiums written were down 9.6%. In terms of underwriting performance, in the third quarter, Northbridge had an underwriting loss of $8.7 million and a combined ratio of 103.5 and that would compare to Q3 '08 where they had an underwriting loss of $25.9 million and a combined ratio of 109.3, the '08 results, obviously having been impacted by - somewhat by hurricane Ike.

Northbridge's accident year result for Q3 '09 was 111.8. There were some CAT losses in there of 2.1 points. Those were for Ontario, wind losses, tornado losses, and Alberta hailstorm losses. They were very modest in relation to the rest of the Canadian insurance industry. And so Northbridge for the quarter ends up with an accident year combined ratio ex CAT losses of 109.7. So again, like Crum, very challenging market conditions very much in evidence there.

Also like Crum is a similar impact in terms of the declining in premium effect and its impact on the expense ratio and the combined ratio. So like Crum, Northbridge is managing through the tough commercial lines markets. They are maintaining strict underwriting discipline and again, striving to maintain very prudent and sound reserve levels and these actions are going to produce the premium declines that we've seen.

Fairfax Asia, third quarter combined ratio was 63% and they had an underwriting profit of $11.5 million. Nine-month results for Fairfax Asia, combined ratio of 81.5% and an underwriting profit of $15.4 million. We see continued premium growth at First Capital Insurance in Singapore.

We also see a significantly increased investment income for Fairfax Asia year-over-year. And as a result, the pretax earnings in Fairfax Asia tripled in the third quarter year-over-year to $22.3 million compared to $6.8 million in the prior year's quarter. And on a nine-month basis, Fairfax Asia pretax earnings again tripled, $46.1 million in pretax earnings compared to $14.4 million in the year before.

Just finishing up, in the segment that we call reinsurance and other, we had a combined ratio in the third quarter of 101.3, again, again, reflecting the same types of market conditions and the economy that we've been talking about. At Group Re, we had a combined ratio of 98.3; Advent was 104.5; Polish Re was 102.8.

The bottom line for our operating companies, in most lines, in most markets the weakness in the economy is adding to what we - what were already a very challenging soft market conditions. Our insurance and reinsurance companies will continue to compete strongly, but as Prem said, we are going to maintain underwriting discipline in matters of pricing and terms and conditions and we are going to maintain our focus on sound reserving practices.

Just to finish up here, financial position, we talked about that a bit in the beginning in relation to the transactions and the financings, but just the quickest of recaps. Again, our holding company liquidity, the quarter we ended in excess of $2.3 billion. We see that going to $1.3 billion after we adjust for the Series C preferred financing closing, the redemption of the Series A and B preferreds and obviously, the $1 billion we spent this week to complete the OdysseyRe privatization.

In terms of our capital ratios, again, I shared with you that our debt-to-capital ratio, even after all of these financings and transactions, including the privatization of Northbridge and Advent and OdysseyRe, is lower and better than it was at the end of fiscal '08 and ratings I shared with you that everything has been affirmed, we have maintained all the ground we won in the past 18 months of ratings upgrades across the board for all of our companies.

What we didn't really talk about was the investment portfolio. Prem talked about it a little bit. The equities is where I just want to focus. At September 30, in fair value terms we had $5.9 billion worth of equities, about 25% of our overall portfolio. Just like to point out that a lot of these holding were acquired in the fourth quarter of '08 and the first quarter of '09 when the S&P 500 was bouncing around between 700 and 900 index value. The - at September 30, the S&P 500 was at 1,057. As Prem said, in the nine-month period, on a price appreciation basis alone, it was up 17% to date to yesterday's close, the S&P 500 is up 18% on a price appreciation basis, 20.5% on a total return basis.

And that lead us to put in place the hedge that we talked about. So we've hedged about a quarter of those equity holdings that I told you about of $5.9 billion. We've put in $1.5 billion of S&P 500 referenced total return swaps at the S&P 500 level of 1,062 and yesterday's close was 1,066. So effectively, the hedge - and its impact on us is flat right now. And as Prem said, we felt that was a prudent thing to do. We've locked in a significant portion of these - of what were a lot of unrealized gains on the equity portfolio.

And Prem, that's all my comments.

Prem Watsa
And now, we are happy to answer your questions.

Question and Answer

Operator

One moment please. Please standby, thank you. Thank you. (Operator Instructions). And one moment for our first question. Our first question comes from Robert Albert [ph]. You may ask your question and please state your company name.

Robert Albert
Atlas

Atlas [ph]. Good morning. Could you give us -?

Prem Watsa

Good morning, Robert.

Robert Albert
Atlas

Could you give us a quick update - I guess I have three quick questions. Could you give us a quick update on ICICI Lombard with the rebound in the markets and values, how should we think about that in terms of market value as related to book?

And then, two, do you have any views on the dollar gold - U.S. dollar gold and U.S. treasuries, and from an investment landscape perspective? And then, three, could you give an outlook on the business in terms of the underwriting, tightening of the market or continued weakness in the market? Kind of how long do you think that weakness will last and what you see happening from the operating perspective? Thanks.

Prem Watsa

Thank you, Robert. And I'll start from the third question first. In term of business, I think Greg just mentioned that the combined ratios are running at about 100%. Accident year combined ratios in the industry are running in the 100% area across the industry. Interest rates are low, so it's very difficult to make a good return on equity with those conditions. But having said that, we are not - there is no sign of a hard market. The markets continue to be soft and when they will change - we know they will change, but we don't know when it will happen. And we'll just have to wait and be patient and that's what we've done in the past.

As far as U.S. dollars and gold and treasuries, we don't invest in gold, Robert. I have nothing to add. The U.S. dollar, foreign exchange markets also, we don't really invest. We hedge our exposures and on treasuries, we've resold it about a year ago, significant amounts as you know. And we haven't gone back again. So nothing to add in those areas.

As far as ICICI Lombard is concerned, the revaluation, I'm going to ask Greg to just give you a quick update.

Greg Taylor

Sure. You can see in our quarterly report that we have shown the fair value of ICICI Lombard, fair value of our stake at about $198 million. And again, that's just for disclosure purposes. We carry that on our books at a value of $80 million. So the unrealized appreciation there is not in - it's not on our balance sheet.

Robert Albert
Atlas

Perfect. Thanks. I didn't see that.

Prem Watsa

Okay. Thank you. Shirley, next question please?

Operator

Our next question comes from Jeff Fenwick. You may ask your question. Please state your company name.

Jeff Fenwick
Cormark Securities

Good morning. With Cormark Securities.

Prem Watsa

Good morning, Jeff.

Jeff Fenwick
Cormark Securities

Good morning, Prem. So you've had a lot of success clearly executing on what your plans have been over the last year. Just wondering if you could give us your outlook in terms of strategic priorities for Fairfax going forward, particularly on the M&A front. There must be a lot of good insurance firms out there right now that are trading at depressed valuation. Any thoughts on that?

Prem Watsa

So Jeff, what's happened is our financial condition, as I said, is very, very strong. We have got a very significant dividend capacity as Greg just mentioned. And so in terms of the options available to us, not surprising for you to know, the first option of course is to always keep our financial condition strong.

So we won't do anything at the expense of our financial condition. And that also means keeping capital available for a hard market whenever it comes. But after that, we can buy stock - buy our stock back, we can make some acquisitions as and when they come, we have no plans to make any, but we could and of course, we could hold cash and continue to hold significant amounts of cash if we decide to pay some dividends out, continue to build our cash in the holding company.

So we have got all of that - those options available to us and I just wanted to continue to add to you like we say at all our conference calls and meetings, is that number one priority, Jeff, is to keep our financial condition really strong. So we won't do any of those things at the expense of our financial condition.

Jeff Fenwick
Cormark Securities

Okay, great. And just one further question. Perhaps, you mentioned internal dividend capacity between the operating companies. But how about Fairfax and the dividend to your shareholders? When would you review that and is that something that might potentially be the increase just given the improvement you've had?

Prem Watsa

So what we do, Jeff, on that is first of all, we have always said it's a nominal dividend and last year, I guess that we declared it for this year as $8 a share. We look at it closer to the end of the year, Jeff.

Jeff Fenwick
Cormark Securities

Okay, thank you very much. That's it from me.

Prem Watsa

Yes, thanks again. Shirley, next question please?

Operator

Thank you. And next question comes from Rich Derov [ph]. You may ask your question. Please state your company name.

Rich Derov

Good morning, Prem. I have a few questions for you.

Prem Watsa

Good morning, man.

Rich Derov

First one, just for the redemption on the Series A and B preferred. Was that in reference to the OdysseyRe?

Prem Watsa

No. But Greg, you want to update - provide an update on that?

Greg Taylor

Sure. So we raised Canadian $250 million in new proceeds from our Series C preferreds and again, they are - that's a better instrument at a much lower cost to capital. And so we decided to redeem our whole preferreds. We had originally a higher amount and we had redeemed some previously. So we have Canadian $150 million in par value remaining on the higher cost Series A and B. And so we are going to redeem those in December.

Prem Watsa

And those are Fairfax preferreds as opposed to OdysseyRe preferreds.

Greg Taylor

Yes, correct. Correct, yes, no connection to OdysseyRe transaction whatsoever.

Rich Derov

Okay, thanks for that clarity.

Prem Watsa

Thanks.

Rich Derov

Second question I had was you've referenced inflation and deflation kind of in a relationship to the U.S. and Japanese economies. Has there anything changed in your view? Do you think inflation has a higher risk than deflation or vice versa?

Prem Watsa

Well, again, we said in the past - we continue to monitor the - these developments. At the moment, as you have known, the third quarter the U.S. GNP went up 3.5%, a very significant increase. In the fourth quarter, perhaps the U.S. economy will go up again.

Our concern is what we have said for sometime, which is that the 20% of the economy, which is the government, the U.S. government - governments, are stimulating and providing stimulus to the economy. But the 80% - the other 80%, the private side of the U.S. economy, businesses and individuals, are either saving or not spending on capital expenditures and we see them de-leveraging. And so we continue to monitor this phenomenon and worry about what will happen in 2010, but at this point in time we are observers of what happens in the U.S. economy.

Rich Derov

Thank you very much. One more if you don't mind.

Prem Watsa

Okay.

Rich Derov

Just curious, what really keeps you up at night in terms of Fairfax? Who do you think the biggest drivers out there going forward?

Prem Watsa

Well, one of the - we keep a very strong financial position and we've always done this, but yes, you will - you might ask why we've hedged the 25% on our equity positions. As Greg has mentioned to you, the stock markets have appreciated significantly since March.

But we do testings like a 50% drop in the stock market happening at the same time as a one in 250-year event, a catastrophe event at the same time. And that means like a big Category Five storm in Miami or a big earthquake in Los Angeles or San Francisco. So we test our financial position and our cash positions in the holding company for those types of scenarios and so - so that's a constant testing. We've considered Fairfax to be as our head office is always looking at worst-case events, making sure we can survive them. But after that, I must tell you, I sleep soundly.

Rich Derov

Thank you very much.

Prem Watsa

Thank you. Shirley, next question?

Operator

Thank you. (Operator Instructions). Our next question comes from Tom Mackinnon. You may ask your question. Please state your company name.

Tom MacKinnon
Scotia Capital

Yes, Scotia Capital. Good morning, guys.

Prem Watsa

Hey, good morning, Tom.

Tom MacKinnon
Scotia Capital

Some of the questions have been answered - asked and answered already, but just with respect to the held-for-trading gains, largely unrealized in the quarter and as I can gather, they are largely due to bonds. I'm just kind of wondering where we are in terms of innings through this ballgame here. I imagine these were picked up at significantly cheap prices and you know spreads have come in. So how are we going to look that - at that number going forward? I got to figure that we are at least seven or eight innings through that ballgame. Any comment?

Prem Watsa

So Tom, I'll ask Greg to add to these comments. But as - the main source of those gains are the muni bonds that we purchased in the fourth quarter and so we bought them at 5.75%, you'll remember, predominantly guaranteed by Berkshire Hathaway. Those yields have come down, but they are still above treasury yields at this point in time.

So you've got after-tax muni bonds that are yielding more than pretax treasury bonds. And so if you look at the past, that relationship hasn't - it's been the other way, muni bonds. Not to say this will happen, but muni bonds - after tax-muni bonds have yielded less than the treasuries.

But you are right. There has been significant decrease in those yields. We - those - until - and the point we make is those are fluctuations. We like the fact that we bought them at 5.75% after tax. We get a very significant interest income - after-tax income from them and they have a maturity of at least 10 years. So we - at this point in time, things can change, but we plan to hold them for some time.

Greg, you want to add to that?

Greg Taylor

Only one thing. I was going to echo it, but you covered it off in terms of where the munis have traded in relation to treasuries over time. And again Tom, you may think it's the seventh or eight inning or whatever, but if the yields on these relative to treasuries were to return to historically where they've been, there is room for additional narrowing on those spreads is point one and Prem made that.

Point two, Prem, I'll just add about credit risk. And talking about sleeping soundly, the vast majority of our portfolio of munis comes with the Berkshire Hathaway guarantee on it. And again, we've seen some events happen with some of the issuers in the U.S. municipalities and states and things like that. And again, we've got a very strong portfolio with - again, virtually the whole portfolio coming with guarantees from Berkshire Hathaway. So again, very low credit risk in our assessment.

Tom MacKinnon
Scotia Capital

Thanks very much.

Prem Watsa

Thank you, Tom. Shirley, next question?

Operator

Thank you. Our next question comes from Mark Dwelle. You may ask your question. Please state your company name.

Mark Dwelle
RBC Capital Markets

Yes, Mark Dwelle, RBC Capital Markets.

Prem Watsa

Hey, good morning, Mark.

Mark Dwelle
RBC Capital Markets

Good morning. A couple of questions. One, may be for Greg, in the comments related to OdysseyRe in the interim report, I noted that the U.S. Insurance division had seen a pretty substantial increase in premiums of 17.6%. That was a little bit odd in the context of falling premiums and I wonder if you had anymore detail on that.

Greg Taylor

We do and it will - you will see some more detail come out on - in the Odyssey Q that comes out probably next Wednesday or Thursday, but you'll see there was actual - an actual transfer of business between the Americas Reinsurance division and the U.S. Insurance division and it's not a huge number, but it explains a lot of that - a lot of what you've just seen. So I'll let that come out, but that's really what it is with the transfer of one particular book of business.

Mark Dwelle
RBC Capital Markets

Okay. So the big decline in the one unit is to some extent explained by the big increase in the other?

Greg Taylor

Correct.

Mark Dwelle
RBC Capital Markets

Okay. The second question I had related to the planned redemption of the Series A and B preferreds, the comment in the report suggested that there would be a charge to retained earnings of $37 million, which isn't a terribly significant charge, but I'm just trying to understand what the dynamics were there. You had said that the redemption was Canadian $150 million. Are you actually paying over par for that or how does all that work?

Greg Taylor

I'm glad you -

Prem Watsa

Greg?

Greg Taylor

Yes, I'm glad you bring that up, Mark. It's all to do with foreign currency translation rates. So we issued - obviously, those preferreds were issued in another era with different U.S.-Canada FX rate and when we actually convert it to U.S. dollar reporting, that's the translation rate that we use to convert the Canadian dollar par value that we had issued to U.S. And that - I'm just going to exaggerate to make the point, that was around 1.5 - $1.50 exchange rate and again to exaggerate a little bit, now let's call it par.

And so the FX translation rate difference is what is going to go - it's not an earnings item, it's - it's retained earnings, but we are paying par value, we are not paying any premium to retire these or paying - we are paying Canadian $150 million, which let's just say it's going to cost us U.S. $150 million at that par to exaggerate versus where we initially translated these at $1.50 FX rate. And so that's all it is, is a different - the two different translation rates in time.

Mark Dwelle
RBC Capital Markets

Okay. I understand. Those are all my questions. Thank you.

Greg Taylor

Thanks, Mark.

Prem Watsa

Thank you, Mark. And Greg, the new $250 million will be accounted in a similar way. You just want to highlight that $250 million perhaps?

Greg Taylor

Well, sure. The $250 million was issued in at the time the rate was about U.S. $0.93. So you'll see about $240 million come on to the balance sheet. And again, any fluctuations in currency translation rate will not impact our earnings. It goes straight into AOCI.

Prem Watsa

Very good, Greg. Shirley, our next question please?

Operator

Thank you. Our next question comes from Shama Thana [ph]. You may ask your question.

Shama Thana

Good morning and congratulations for your [inaudible], really impressive. My question is on the impact of high inflation should high inflation come in the future on insurance claims, in particular in the long-tail business. Do you have the possibility to re-price policies on an annual basis or could you just comment on what would be the impact on - of the high inflation on the insurance business, please?

Prem Watsa

Yes, the insurance business is predominantly a one-year policy. So you'll have the ability to re-price them every year, during the year and at year-end. And inflation is a - definitely a risk, but it's the judicial inflation that has been the problem in the past as opposed to consumer price inflation. But you can re-price them once a year on renewals.

Shama Thana

Okay, thank you. And second question is [inaudible]. I know you have a certain exposure in your investments to the pharmaceutical sector. And I was wondering if you could a make comment or two on the reform and what's your outlook there.

Prem Watsa

Our outlook, we are - we don't, first of all, make too many comments about any common stock that we have because we might be buying them or adding to them. But basically we look through these events and we are buying very good companies, very strong companies, financially very strong, long track records and selling at relatively cheap price-earnings ratios and we like them for the long term. So we look to these changes.

Shama Thana

Okay. Thank you very much and congratulations again.

Prem Watsa

Yes, thank you very much. Shirley, next question please?

Operator

At this moment, I'm showing no further questions.

Prem Watsa

So Shirley, if there is 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. And this does conclude today's conference. We thank you for your participation. At this time, you may disconnect your line.