S&P Global
Market Intelligence

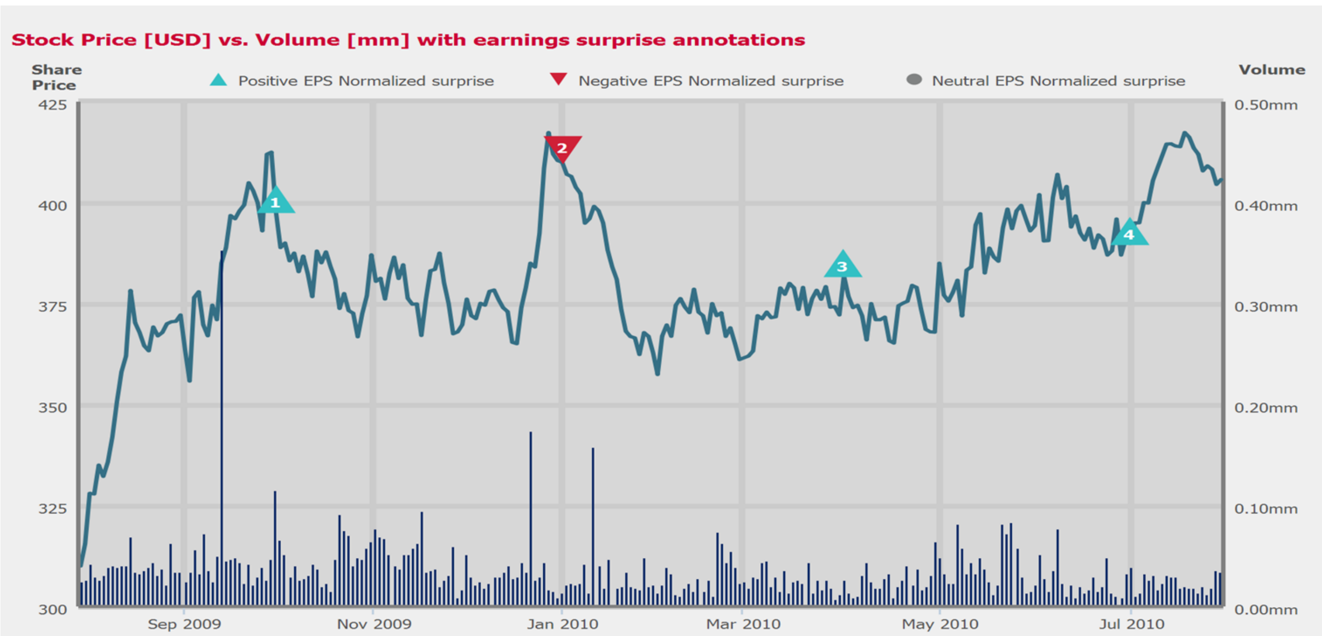
Fairfax Financial Holdings Limited
TSX:FFH
FQ3 2010 Earnings Call Transcripts

Friday, October 29, 2010 12:30 PM GMT

S&P Global Market Intelligence Estimates

	-FQ3 2010-			-FQ4 2010-	-FY 2010-	-FY 2011-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	6.24	10.24	64.10	6.62	26.16	21.58
Revenue (mm)	1601.35	1681.00	4.97	1626.35	6843.80	6576.90

Currency: USD
Consensus as of Oct-25-2010 3:17 AM GMT



- EPS NORMALIZED -	CONSENSUS	ACTUAL	SURPRISE
FQ3 2009	10.91	30.88	183.04 %
FQ4 2009	6.00	1.65	(72.50 %)
FQ1 2010	7.35	14.02	90.75 %
FQ2 2010	5.80	15.49	166.61 %

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Call Participants

EXECUTIVES

Brad Martin

John Varnell

Prem Watsa

ANALYSTS

Jeff Fenwick
Cormark Securities

Judy Delgado
Alpine Associates

Mark Dwelle
RBC Capital Markets

Tom Mackinnon
BMO Capital

Presentation

Operator

Good morning, and welcome to Fairfax's 2010 third quarter results conference call. Your lines have been placed on listen-only mode. After the presentation, we will conduct a question-and-answer session. We would kindly ask that you limit yourself to one question each. (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 2010 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 risk factors, the most foreseeable, which are vested in Fairfax's Annual Report, which is available on our website at fairfax.ca or as set out under Risk Factors in Fairfax's Base Shelf Prospectus filed with the securities and 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 John Varnell, our CFO, for additional financial results.

In the first nine months of 2010, book value per share increased by 11.2% adjusted for the $10 per share common dividend paid in the first quarter of 2010. Book value in increased to $401.32 a share, and in the third quarter, book value increased by 4.9%.

As of September 30, 2010, common shareholders' equity increased to $8.2 billion from $7.4 billion as at December 31, 2009, an increase of about $800 million after we paid $200 million in dividends and issued $200 million of common stock in the first quarter.

Highlights during the quarter, consolidated combined ratio for the third quarter was 102.6% with good reserving and our company has continued to be well capitalized. OdysseyRe had a combined ratio of 92.2%, Crum & Forster had a combined ratio of 106.4%, and Northbridge had a combined ratio of 105.4%.

Crum & Forster and Northbridge are operating in continued weak commercial lines markets, while OdysseyRe benefited from no major hurricanes in Florida and the Gulf Coast. At all of our companies, we continue to be cautious and avoid unprofitable business. However, that causes expense ratios and combined ratios to be higher. More on the combined ratios from John Varnell.

In the third quarter of 2010, interest and dividend income increased by 10% over the third quarter of 2009 to $203 million. We hold significant amounts of tax-free municipal bonds. And expressed on a pretax equivalent basis, the interest and dividend income would be $230 million. Net gains on investments in the third quarter of 2010 of $68.1 million was after $388 million of net losses on common stocks mainly because of our hedges.

The acquisition of 41% of Gulf Insurance was completed in the third quarter and will be equity accounted. Gulf Insurance operates in seven countries in the Middle East, and we are excited to be partners with KIPCO and this company. KIPCO and GIC, Gulf Insurance Company, are both world-class organizations that share our long-term corporate supports of integrity and professionalism. We are very excited about the long-term prospects of this acquisition.

Our holding company cash and marketable securities at the end of the quarter was $1.35 billion. On July 20, 2010, we raised $230 million Canadian and a 5% five-year reset of a preferred, and on October 1, 2010, we raised another $300 million Canadian in the same preferred. We've continued to maintain a very strong financial position and have effectively pre-refinanced $157 million Fairfax bonds due in 2012 and $218 million OdysseyRe bonds due in 2013.

In August, we completed our first runoff acquisition of General Fidelity Insurance Company in over five years at approximately book value. We paid $100 million in cash from our TIG runoff of subsidiary and a remainder of a non-interest bearing contingent note due in six years, which generated a gain of $83.5 million on the excess of the fair value of net asset acquired over the purchase prices. The investment portfolio of GFIC was about $661 million.

Last night we issued a press release that we entered into a merger agreement to acquire all of the outstanding shares of First Mercury Financial common stock for cash of $16.50 per share. This price is a 45% premium to First Mercury's closing price of $11.36. First Mercury is a specialty commercial lines excess in surplus underwriter focused on niche markets, which began its operations 37 years ago.

First Mercury has a very good long-term underwriting track record with a combined ratio in the low 80s over the past ten years. Gross premiums written in 2009 were $344 million in niche lines such as security guards, and First Mercury is rated A-minus positive by A.M. Best. As of September 30, 2010, the investment portfolio of First Mercury was $772 million, gross losses of $567 million, net $350 million, and stockholders' equity was $302 million, with 17.5 million shares outstanding.

The transaction is expected to close in the first quarter of 2011. First Mercury will operate in tandem with Crum & Forster, which is run by Doug Libby. Our due diligence team was led by Andy Barnard and Doug Libby with an extensive support from the Crum & Forster operations team. We welcome Richard Smith, President and CEO, and all of the employees of First Mercury to the Fairfax family.

In response to the significant appreciation in equity markets, as we suggested to you in previous calls, in 2009 and early 2010, and the economic uncertainty in the United States and Europe, we have maintained our equity hedge ratio at approximately 91% of our equity exposure.

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

John Varnell

Thanks, Prem. Just as a reminder, our full third quarter result is available on our website, www.fairfax.ca. Information is also available on SEDAR and EDGAR. First, we'll talk about our Fairfax's consolidated financial results for the third quarter, then we'll talk about operating company results, and finally we'll discuss our financial position.

So, starting with our third quarter financial results consolidated, the net earnings for Fairfax shareholders were $219 million in the third quarter. That compares to earnings of $562 million last year. Nine months earnings were $834 million this year compared to $777 million last year. The third quarter fully diluted EPS of $10.24 compares to diluted EPS of $30.88 in the quarter last year.

As Prem said, our book value per share has ended the quarter at $401.32, which is up from $382.70 at June 30, 2010. The $401.32 book value is up from the $369.80 book value at year-end. That's up about 11.2% for the first nine months. If you take into consideration the $10.00 a share of common dividend that we paid out in the first quarter.

The third quarter earnings were largely driven by three factors, and the first is the underwriting result. We had a $31 million underwriting loss in the quarter compared to a $2 million underwriting profit last year. Contributing to that underwriting loss were catastrophe losses on a pretax consolidated basis, net of reinstatement premiums, of $66 million or about 5.5 combined ratio points.

Our third quarter calendar year results, we had a combined ratio of 102.6% on a consolidated basis compared to 99.8% last year. Also note that for nine months this year, the combined ratio was 104.9%, which included 8.5 points related to catastrophe losses, and last year the combined ratio was 99.0% impacted by 3.9 points related to catastrophes.

On an accident year basis, looking at the impact on the results of prior period reserve development, we had about $13.5 million in reserve redundancies in the third quarter. That resulted in a benefit of about 1.1 combined ratio points in terms of favorable reserve development.

The result would be a third quarter accident year combined ratio this year of about 103.7% versus 101.4% last year. Now, the 2010 accident year combined ratio, excluding the cat losses, would be about 98.2%, and that would compared to 96.6% in the third quarter of '09. For comparison purposes, in the third quarter of '09, we had about $53 million in cat losses or about 4.8 combined ratio points.

The second major component of third quarter earnings was investment income. We had about $68 million of net investment gains pretax during the quarter, and we had strong quarterly interest and dividend income. Our average portfolio size continues to grow, and in the third quarter, it was $23 billion.

Remember that we had the Zenith National investment portfolio of $1.7 billion purchased on May 20, 2010, and that was added to our investments for the full quarter. And we also had the General Fidelity investment portfolio of $661 million, which was added on August 17, 2010. In the third quarter of 2010, interest and dividend income increased by 2.7% to $189 million if you exclude the interest and dividends and Zenith and General Fidelity, which were acquired during the year. The third quarter 2010 interest and dividends was $203 million in total.

Another factor impacting our results was our annualized portfolio yield. In the third quarter of 2010, that yield on an annualized basis was 3.5%, and in the third quarter of '09, the yield was also 3.5%. And that was also about the same as the second quarter of 2010 as well. We continue to carry significant liquid short-term securities and the returns reflect the low short-term rates, especially at the holding company level.

In terms of investment gains, we had a weaker quarter. We had $68 million in gains for the quarter. Last year, we had gains of $798 million. There was an other-than-temporary impairment charge of $23 million in the results for the third quarter of 2010 as well. And I'll just note for you that we had net appreciation of available for sale bonds during the quarter of $60 million pretax or about $36 million after-tax, and net appreciation of available for sale common stocks of $183 million pretax or $133 million after-tax during the quarter. And again, that didn't go through earnings, but it does work its way into book value through OCI.

On the General Fidelity transaction, we recorded a gain of $83.5 million due to the excess of the fair value of net assets acquired over the purchase price. This resulted primarily from discounting the non-interest bearing contingent note payable to the seller at a rate of 6.17% to account for the six-year term. The discount value of the note, which is $140 million at September 30, 2010, will accrete at that 6.17% rate over a six-year term.

Turning to operating company results starting with Odyssey, their underwriting results were very solid for the quarter. In the third quarter, they had a combined ratio of 92.2%, which equals an underwriting profit of $37.5 million. In the third quarter of 2009, Odyssey had a combined ratio of 96.9% and an underwriting profit of about $50 million.

The catastrophe losses for Odyssey just by comparison, Odyssey's cat losses pretax net to them third quarter 2010 were $41 million or about 8.6 combined ratio points. By comparison for the third quarter of '09, they had $36 million in cat losses or about 7.4 combined ratio points accounted for by those losses. There were no significant changes related to the Chile earthquake losses in this quarter. And if you remember, Chile was the big impact in the first quarter of 2010.

Odyssey's accident year for the third quarter 2010 combined was 92.3%. If you set aside the cat losses that Odyssey had, they were at 83.7% combined ratio. In terms of premium volumes, Odyssey's net premium written was even at $524 million this quarter compared to last year.

At Crum & Forster, the combined ratio was 106.4% in the third quarter. That compares to 107.9% a year ago. Crum & Forster had insignificant cat losses in the quarter and insignificant development in the third quarter of 2010 that resulted in 106.4% combined ratio. On an accident year basis, Crum's combined ratio was 106.4% and that compared to 109.7% in the year-ago quarter.

In terms of premium volumes, industry conditions in the US commercial line markets are still tough. The weak economy continues to have a large impact, and casualty pricing remains soft. At Crum & Forster, we saw a modest increase in net premiums written to $168 million in the third quarter of 2010 from $165 million last year.

At Northbridge, Northbridge had a combined ratio of 105.4% in the quarter that compared to 103.5% in the year-ago quarter. One of the differences was the impact of catastrophe losses in the quarter. They had 1.5 combined ratio points or 3.5 million, principally from the effects of Hurricane Igor, hailstorm in Western Canada, and that was offset by favorable claim development in the third quarter of 2010 of 5.7 combined ratio points, which would give Northbridge an accident year combined of 111%. Market conditions in Canada and commercial lines continue to be challenging.

Premium volume at Northbridge in US dollar terms in terms of net premiums written increased to $227 million this quarter from $219 million last year. However, in Canadian dollar terms, Northbridge's premiums earned declined 4.1%. And that continues to be reflective of the underwriting actions taken by Northbridge in these markets and the pricing discipline that they have been exercising in recent years.

In terms of investment income at Northbridge, we had a slight increase in interest and dividend income to $28.3 million from $29.4 million last year. We had lower investment gains of $10.4 million in the quarter, and that resulted in lower pretax income of $25.2 million compared to $101 million last year.

For Fairfax Asia, we've been reporting to you for a number of quarters profitable growth. That continued this quarter. Their combined ratio was 76.2%. Net premiums written were $36 million, up 12% from the prior year. Net premiums written for nine months of 2010 were $124 million, up 25% from nine months 2009. And their operating income was $43 million.

In our segment that we now call Reinsurance and Insurance - Other, we had a 116.5% combined ratio and an underwriting loss of $23 million due to catastrophe of 14.7 combined ratio points, which came from New Zealand, Western Canada hail, and some European floods. At Zenith, they reported a 126.8% combined ratio this quarter, as they continue to be affected by the impact of a weak economy on the payrolls of its insured customers as well as competition and rate levels.

Just a note on taxes in the quarter. You will see that we had a $10.5 million recovery for income taxes primarily as a result of the gain on General Fidelity, which is non-taxable, as well as tax re-interest and dividends from states and municipalities, and income that we earn in lower tax jurisdictions as well as some tax losses that we were able to utilize in the quarter.

Now turning to our financial position, Prem said to you that the book value of the company is $401.32 per share. That's after Fairfax paid a $10.00 a share dividend in the first quarter of 2010. Common shareholders' equity ended the quarter at $8.2billion. Preferred stock ended the quarter at $646 million. Out total debt to total capital ratio was 23.8%, and that compares to 23.0% at the year-end. And you will note that at quarter-end, Fairfax had a holding company cash and securities of $1.35 billion.

During the month of July, we received the additional net proceeds from our five-year 5% preferred Series G issue of Canadian $142 million. And on October 5th, we issued another 5% preferred Series I issue for net proceeds of Canadian $291 million to leave us with significant liquidity at the holding company.

And Prem, that's it for my section, and over to you.

Prem Watsa
Thank you, John. Now, Barb, we are happy to answer the questions that people might have on the conference call. 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. We are ready for the questions, Barb.

Question and Answer

Operator

Okay. Thank you. (Operator instructions) We have our first question, and it is from Tom MacKinnon with BMO Capital.

Tom Mackinnon
BMO Capital

Yes. Thank you very much. Good morning, everyone.

Prem Watsa

Good morning, Tom.

Tom Mackinnon
BMO Capital

Prem, two questions here. One, with respect to the gain on the acquisition, as I understand it, this excess of the fair value, did they - $83 million gain, is that effectively just the impact of discounting that note?

Prem Watsa

Yes, mainly that - it's mainly that, Tom, like we bought - we paid $100 million plus a non-interest bearing note that’s due in six years. And as John was saying, if you discount that non-interest bearing note at 6.17% and the tax consequences, you get to $83.5 million.

Tom Mackinnon
BMO Capital

No. Would that kind of unwind as the discount unwinds over the next six years on that note? Would that - so it may have helped your earnings to extend this quarter, but as the discount unwinds, is it going to hurt your earnings going forward?

Prem Watsa

Yes, it will tweak back into our income statement over the next six years, Tom. But for accounting purposes, that’s the way you’re required to recognize the transaction. So that’s what happens.

Tom Mackinnon
BMO Capital

So if there is an $83 million gain here, then we’re going to - that will be over the next six years, we’re going to get an $83 million loss. Is that way to look at that?

Prem Watsa

Yep. There will be - most of that will come back into us. You will have to also watch over the years what the development is and how much of the development goes against the note. So there will be a lot of moving pieces in that that will go one way or the other. But yes, that’s a fair way to look at it.

Tom Mackinnon
BMO Capital

If everything goes on as expected without any kind of unfavorable development as per the agreement you have, then that would be the case?

Prem Watsa

That’s right, Tom. That’s right.

Tom Mackinnon
BMO Capital

Okay. And I guess my question here is, if I'm looking at the earnings going up in the quarter, kind of - and then the book value actually going up closer to $17 quarter-over-quarter, we didn't really get much in terms of an operating number here. We do have - you are effectively 90% hedged. So I wouldn't assume then, in terms of equity, that any appreciation in the equity markets quarter-over-quarter would have helped this incremental increase in the book value. I'm just trying to - if you can help explain how the book value would have gone so much in the quarter. Is it really just unrealized gains on your bond portfolio? Is that the best way to look at that?

Prem Watsa

That's right, Tom. So when you look at our company, you have to look at the portfolio at about, as John said, close to $23 billion now, with the Zenith acquisition, with the GFIC acquisition. And so with $23 billion, we've got the stock portfolios plus or minus $5 billion, which are mainly hedged. So we don't get any pluses or minuses there. The hedge goes to our income statement. Any offsetting gain goes to the shareholders' equity. But we've got only a huge bond portfolio, and of course, we have realized gains both in the bond portfolio and in perhaps the common stock portfolio during the quarter and in the nine months. And that comes through in terms of book value. And on top of that, we did mention there are interest and dividend income that's running at - on tax equivalent basis, $230 million. So that adds up too. So those two components are the reason. Our portfolio has gone up with the Zenith acquisition of $1.7 billion and the General Fidelity runoff acquisition of $660 million. That's about $2.3 billion. So you have a significant increase in the investment portfolio, and our premiums are flat, as you understand.

Tom Mackinnon
BMO Capital

I think the 68 in terms of the net investment gains in the quarter -

Prem Watsa

Yes.

Tom Mackinnon
BMO Capital

It sounds like 422 net gains on bonds. How much of that was realized, Prem, versus unrealized? Just wondering - were you able to harvest any gains then (inaudible) yields kind of turn against you? I'm just trying to figure out how much is kind of - it's hard to look at how much is going to float around with market value.

Prem Watsa

John will give you some details later on. But the point that we would make to you is that when we look at - you'll remember, in 2008, early 2009, we bought a significant amount of corporate bonds. We went from treasury to corporate bonds. The rates came down. And we have harvested quite a significant amount of corporate bond portfolio. And we are more into treasuries right now, and that continues. The fact that the spreads have come down significantly, we have harvested a significant amount and we continue to be concerned - reason for our hedge, continue to be concerned about the economy and about the prospects going forward into 2011. We do like our common stock positions, but we are concerned about the risk in the marketplace. John, would you be able to break down realized gains and -?

John Varnell

Yes. Well, on the municipal bonds, on a mark-to-market basis, they were $131 million, Tom, on the -

Tom Mackinnon
BMO Capital

That's not realized. That's - the assets aren't realized, right?

John Varnell

Right, yes. Yes. Available for sale, you had treasuries for $72 million, some Ontario provincials available for sale of $34 million, and then you go one with another three categories for another $100 million on available for sale. Seeing all the mixture of items that we took or that increased in terms of unrealized value - unrealized gain the quarter -

Tom Mackinnon
BMO Capital

How much of 422 is realized, though, in the quarter in terms of that bond portfolio?

Prem Watsa

That would be - let's have a quick look. You'd have maybe - how much was it - $250 million, something in that area. $250 million realized.

Tom Mackinnon
BMO Capital

Okay. Thanks very much. So it seems to be a - is that a substantially higher run rate of that bond portfolio being realized than you had in the past?

Prem Watsa

No. It's a function of the marketplace, John. So the marketplace in 2008, 2009, I take you back there when the spreads really widened. I'm talking fourth quarter of 2008, first quarter of 2009. We went from treasury to corporate bonds. And now the spreads have come down significantly. Our muni bond positions, we continue to keep. John mentioned to you, we have an unrealized gain on those bonds that goes through income statement. But with the spreads coming down on the corporate bond area, we've realized - Brian Bradstreet, our bond person, has realized a significant amount of gains, as I just mentioned to you.

Tom Mackinnon
BMO Capital

Okay. And I won't keep you guys too long. Just want to - we've heard this continued story with respect to a tough commercial market in both Canada and the United States. And it's been several quarters now. And I guess, is there any indication as to when we might see some firming in this marketplace going forward - in the combined?

Prem Watsa

So, Tom, when you look at the property casualty business, the combined ratio, like John was saying on an accident year basis, that's for the business as written right now, is running at least at 100% and maybe higher. So there is very little underwriting profit in the business for everyone - not only us, but everyone in the industry. I'm talking North America. And the interest rates are very low. So every time you have maturing bonds, for the industry I'm thinking now, your reinvestment rate is very significantly low. Any cash is yielding no returns.

So the ability for the industry to make any return today is very, very difficult. You might have the investment income from bonds that you bought some time back. You might have some cushions, some underwriting redundancies in new reserve that's come in. But that will all end sometime. And you're never able to predict when that is. But we see sometime the market changing. And we are running our company with the idea that when that happens, we can expand significantly. We don't know when that will happen, and we've done this before. We're just patient and wait for that opportunity.

Tom Mackinnon
BMO Capital

Okay. Thanks very much for the details answers. Appreciate it.

Prem Watsa

Okay. Thank you, Tom. Next question, Barb?

Operator

And next is Jeff Fenwick with Cormark Securities.

Jeff Fenwick
Cormark Securities

Hi, good morning. Just a little follow-up on the investment side of the things. And I noticed in the quarter you are posting more collateral against some of your hedge positions there. Can you just explain the dynamics of how those funds are treated? And you are obviously setting them aside to the benefit of the counterparty. Does that take money effectively out of your investment portfolio and you have to hold it in something that's lower yielding if that balance grows? How did that kind of impact the overall yield on your portfolio?

Prem Watsa

Were you thinking about the collateral we have to put, Jeff? Is that what you're thinking?

Jeff Fenwick
Cormark Securities

Yes, that's right, because it seem to be - it seemed like it did rise fairly materially in the quarter.

Prem Watsa

Yes. So this collateral that we have to put to, we have our hedge on our common stock portfolios. The stock market goes up, all common stocks go up, but the hedge of course is on a negative side. And that just means that on a mark-to-market basis, the amount of collateral we have to put goes up. There is all sorts of collateral. But at some time, it's cashable, meaning we will have to pay cash on the other side. And so we can use our cash. We can sell some common stocks we have if we want to, but the collateral is mainly in the form of treasuries. Is it not, John?

John Varnell

Yes. So we still get a yield on it.

Prem Watsa

So we still get some yield on it, Jeff.

Jeff Fenwick
Cormark Securities

And that was probably what I was driving at there. Thank you. And maybe just secondly, another acquisition in the quarter here, kind of what is your view now? Like, if we're facing a flat environment for the next while, are you going to look at growth by acquisition? Do you feel like you are - are you looking for areas around your business further or is this just being opportunistic and looking for good companies on the cheap?

Prem Watsa

Yes. We've said to you we are always looking for good companies. Zenith was a company with a terrific underwriting track record that we thought was available at a good price over the long-term. And this - First Mercury is very similar. It's got - it's underwriting track record is a combined ratio significantly below 90% over the last ten years, been in business for 37 years. It's in the surplus lines area, which of course in a soft market, the industry volume in the surplus lines is smaller, it shrinks. But in a harder market, lot of the admitted business comes back into the surplus line markets, and the possibility of expansion is very significant.

And we've got Richard Smith and the team at First Mercury, a very good operation that's been in business for a long time, tremendous track record. And so we are very happy to have them. But it's opportunistic, Jeff. We've said to you, broadly speaking, we have $500 million to $1 billion in cash flow. We've provided that information in our annual report. And over time, we expect to make acquisitions, but not at the expense of our financial position. So we define that very simply as keeping in excess of $1 billion in cash and marketable securities in the holding company. So we are very, very careful to make sure we have cash and marketable securities in our holding company in excess of $1 billion. But opportunistically, we like the idea of buying companies with a great underwriting track record and looking at the possibility for expansion over the long-term. And it's always in the long-term is what we are concerned.

Jeff Fenwick
Cormark Securities

Okay. Thank you very much.

Prem Watsa

Thanks, Jeff.

Operator

And our next question comes from Mark Dwelle with RBC Capital Markets.

Mark Dwelle
RBC Capital Markets

Yes, good morning.

Prem Watsa

Good morning, Mark.

Mark Dwelle
RBC Capital Markets

A couple of questions. First, congratulations on the First Mercury deal. Quite a fine company. We followed it for a long time.

Prem Watsa

Thank you.

Mark Dwelle
RBC Capital Markets

On the municipal bond portfolio, that's obviously the most substantial single group of assets. What are the - can you give some kind of general color on the compensation of that in terms of what major states may be you have the highest concentration in, whether the revenue or general obligation, et cetera, just in broad terms? I'm not really looking for particular details.

Prem Watsa

So, Mark, the first thing you know is that a significant proportion, I think, in excess of 60%, 65% if Berkshire Hathaway guarantees. Right? You remember we bought that in the fourth quarter of 2008. We bought it at a 5.75% yield, and I think we bought the better part of $4 billion at that time. And it was guaranteed by Berkshire Hathaway. And so that, of course - we do look at the underlying credit, by the way, but the Berkshire Hathaway guarantee was a major plus for us buying them at that time.

And in terms of the others, we go through - we are going through - Brian Bradstreet and the people who work with him would look at each individual muni bond. So we'd buy airports and we'll buy water systems, essential services that even if you have a problem in a certain municipality, these are things that just have to be backed by the federal government. So, airports, water systems, transportation systems, and - and broadly speaking, we don't go with general obligation bonds. And so that's how we are managing our portfolio. We like the yield. And so you have to be careful, though. It's very treacherous to muni markets, particularly today. And so each one of these bonds are analyzed by us. We have not really - we never have been dependant on ratings. It's all analyzed internally before we buy them.

Mark Dwelle
RBC Capital Markets

Okay. That's helpful color on that. Second question I had was related to the CPI-linked derivatives. I guess the notional amount of that is increased again during the third quarter. The notional amount now I guess approximates your entire asset base. Is that a set of contracts that you view as one where you will continue to kind of flex that in proportion with the balance sheet or is that sort of finished now and you've kind of set the position? Just kind of some color on where that might be headed.

Prem Watsa

Yes. So it's about, I did say, $30 billion in notional value and I think a little below $300 million in cost. And so we think of that - and it's a ten-year contract. Right? Mark, do you understand it's a ten-year contract?

Mark Dwelle
RBC Capital Markets

Yes.

Prem Watsa

It protects us. We are concerned about the possibilities of deflation - possibilities, not the certainty. And we are concerned about the unintended consequences of this all over the place. And so we just think it's appropriate for us to protect our balance sheet, all the components of the balance sheet with these contracts. And of course, in terms of insurance pricing at which we are - we continue to study, we think it's a good hedge in terms of the unintended consequences.

We remind our investors always, remember, what happened in Japan 20 years later. You're still having deflation in spite of, in that country, a huge increase in government spending and quantitative easing in terms of money supply and low interest rates, so all of the things that we are seeing now happening in the United States. And so it's the possibility of, not the certainty, and we just think it's an appropriate time to protect ourselves. $30 billion is a significant number for us. $300 million is significant. But we are perhaps within reach of the amount that we feel comfortable.

Mark Dwelle
RBC Capital Markets

Okay. That's helpful. I'll stop there and let someone else go.

Prem Watsa

Thanks, Mark. Can I have, Barb, our next question, please?

Operator

(Operator instructions) And our next question comes from Judy Delgado with Alpine Associates.

Judy Delgado
Alpine Associates

Yes. Good morning, gentlemen.

Prem Watsa

Good morning, Judy.

Judy Delgado
Alpine Associates

We just wanted to touch based on the company's previous comments, I mean, you've talked about how it's a challenging environment for the industry. Were you surprised by First Mercury's results today?

Prem Watsa

Not really. We have been working with First Mercury, and so the results - what we do, Judy, is we're always buying any investment, any company, for the long-term. We're really not interested or don't focus too much on quarter-by-quarter results. We're looking at the long-term. These companies we will be owning forever. So a quarter here, a quarter there doesn't bother us.

Judy Delgado
Alpine Associates

Okay. And have you approached First Mercury about the merger?

Prem Watsa

I'm sorry?

Judy Delgado
Alpine Associates

Did -

Prem Watsa

You mean, how did the merger take place, Judy?

Judy Delgado
Alpine Associates

Yes. You said you've been working them for a while. So I didn't know how that transpired

Prem Watsa

That will all come in the proxy, Judy. In the next few weeks, it will come in the proxy and that's how it will all be disclosed. So you can see it for yourself.

Judy Delgado
Alpine Associates

Okay. And then just how this will impact your company going forward for the first quarter? I guess we won't see that impact until the second quarter because the merger won't close until the first quarter.

Prem Watsa

Yes. We expect it to close in the first quarter. So it will probably be - you need regulatory - first of all, you need shareholder approval. The shareholders of First Mercury have to make the decision to accept this off. So that will be the first decision and that will take a few months. And then does regulatory approval from the insurance departments. And so we expect all that to be over in the first quarter of 2011.

Judy Delgado
Alpine Associates

Okay. Would you say that a good chance may be early first quarter, state approval should run their course over the normal -?

Prem Watsa

Yes. That's why we say first quarter, Judy. We don't really know when in the first quarter, if that's what you are asking. Somewhere in the first quarter.

Judy Delgado
Alpine Associates

Okay, thank you.

Prem Watsa

Thank you very much, Judy. Next question, Barb?

Operator

And I'm showing no further questions.

Prem Watsa

Okay, Barb. If there are no further 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

And thank you for your participation in today's call. You may disconnect your line at this time.