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## **To Our Shareholders**

I was too optimistic! For the fourth time in 15 years and the first consecutive two year period, we did not earn a return on equity in excess of 20%. We earned 4.1% on shareholders' equity in 2000 (versus 11.4% for the TSE300) – another year of very low returns on equity and again, for the second year in a row, a return less than the TSE300. Net income after taxes increased by 11% to \$137.4 million while earnings per share increased by only 2% (because of preferred share dividends in 2000 of \$13.4 million) to \$9.41 from \$9.20 per share. Book value per share increased by 5% to \$242.75 while our share price dropped 7% to \$228.50 from \$245.50 at year-end 1999. From a net income and return point of view, there is no question that 1999 and 2000 were the worst years we have had in our 15 year history. This resulted in our stock price selling below book value for 15 months – from September 1999 to December 2000 – only the second time this has happened in our 15 year history (the first was from March 1990 to September 1991). Our low stock price attracted many “deep value” investors who purchased our stock just as they purchased bankrupt Loewen Group bonds. For most of 2000, Fairfax was worth more dead than alive and, given our results, it was easy to see why! 2000 was a very difficult and disappointing year for our company and its shareholders – and I was too optimistic as I said earlier (more on that later).

Having admitted to very disappointing results in the last two years, I want to remind you again that since we began in September 1985, our company has always been run for the long term. We have stressed many times over the years and more recently in our November 1999 letter to you, our shareholders, that “we will accept short term volatility in our earnings for better long term results”. While the future is always uncertain, I continue to believe that the long term prospects for Fairfax have never been brighter.

Before discussing 2000 (easier to discuss the past than the present!), let me reiterate Fairfax's excellent long term track record which has been achieved during the longest and toughest down-cycle in the history of the property and casualty business. Book value per share has compounded at 37% annually, while our stock price, even after the recent declines in 1999 and 2000, has compounded at 33% annually. In Canada, there are only two companies, and in the U.S., eight companies, whose stock price has compounded at a rate faster than ours over the past 15 years. Our company has earned an average 18.2% on shareholders' equity since we began 15 years ago (below our objective of 20%, because of our low profits in the past two years) versus 9.4% for the 25 leading U.S. property and casualty insurers. There is only one property and casualty company in the U.S. and Canada that has had a higher return on equity than Fairfax in the past 15 years and none has compounded book value or stock price as fast. You can see why we are so grateful for this long term record.

So what's wrong with Fairfax? When stock prices go down, most investors, various industry analysts and commentators and perhaps even some of our own shareholders are concerned about (a) the long term prospects for Fairfax (Will it ever make a 20% return on equity again?) and (b) the financial strength of the company (Can it survive?).

Both (a) and (b) arise from the fact that we purchased two very large U.S. property and casualty companies in 1998 and 1999 – Crum & Forster (C&F) and TIG. As you know, we bought them

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at discounts to book value with reinsurance protection for reserve deficiencies and unrecoverable reinsurance. Many observers believe because we purchased these companies at discounts to book value that they were “damaged goods” or have some unfixable problems. On the other hand, they believe that paying multiples of book value for a company indicates that the company has a solid franchise. Our experience is just the opposite! While there are a few companies that have excellent franchises in the P&C industry, we believe that most acquirers of P&C companies at multiples of book value will be very disappointed with the returns that they will achieve on their purchase price, especially if they have no protection from the past. An analysis of recent acquisition activity in the P&C industry, we think, will confirm our view. Speaking of protection from the past, we have mentioned to you previously that the amortization of the negative goodwill created by our acquisitions at a discount to book value provides some protection from unforeseeable events arising from those acquisitions in the future. As more fully described on page 58, in 2000 we made various reductions to the amortization periods after a thorough review and analysis of the appropriate periods for amortization, based on all available knowledge.

We continue to feel very strongly that we will achieve our 20% return on equity objective on our purchase price for both C&F and TIG – even though the returns will be delayed some! And here is where I have been too optimistic and very wrong! I underestimated the time it would take to turn around the combined ratios for C&F and TIG in the midst of a property and casualty market in 1998 and 1999 which was the softest in well over a decade. So I initially expected C&F to achieve 110% in 1999 and 106% in 2000 (versus results of 124% in 2000) and TIG to achieve 105% in 2000 (versus results of 123%). Clearly, I was too optimistic in my expectations in terms of how long it would take to reduce the combined ratios of C&F and TIG and our results have been atrocious because of that optimism. However, under the leadership of Bruce Esselborn at C&F and Courtney Smith at TIG, we believe strongly that it is not a question of “if” but only a question of “when” both companies achieve their goal of 100% combined or better. I have no forecasts as to “when” other than to say that C&F and TIG, like all of our companies, are singularly focused on this goal of underwriting profitability. The biblical “you will reap what you sow” does not make us unhappy, at least in a business sense.

For you naysayers, the following table shows our record of combined ratios by company under our ownership compared to 5 year results prior to our purchase.

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<b>Company</b>	<b>Average Combined Ratios for 5 years prior to purchase</b>	<b>Average Combined Ratios during Fairfax ownership</b>
<b>Canadian</b>		
Markel	122.4%	106.5% (103.9%) <sup>(1)</sup>
Federated	120.7%	102.5%
Commonwealth	106.1%	105.0% (98.3%) <sup>(2)</sup>
Lombard	115.7%	103.4%
<b>U.S.</b>		
Ranger	110.3%	134.0%
C&F	120.9%	118.6%
TIG	118.0%	121.2%
<b>Reinsurance</b>		
Odyssey Re Group*	113.2%	112.9% (109.5%) <sup>(3)</sup>

\* Including CTR, Odyssey Reinsurance Corporation and Odyssey America Re from their respective dates of acquisition

(1) Average combined ratio under Mark Ram's leadership, 1995-2000

(2) Excluding 1999

(3) Excluding 1999 catastrophes

C&F and TIG's experience in the next few years will likely be similar to Lombard and not Ranger. Remember Ranger was our first U.S. acquisition and it took us some time to identify and attract competent management – not dissimilar to our experience in Canada with our very first acquisition, Markel. Soon after we began in 1985, we went through the same problems at Markel as we did at Ranger. With C&F and TIG, we have been able to attract from among the very best management available in the U.S. property and casualty industry. More on combined ratios in the section on insurance operations.

2000 marked the year when the headwinds that have buffeted the U.S. P&C industry for the past 12 years changed. After years of discounting, insurance rates in the U.S. began to increase in 2000 and in fact gained momentum as the year progressed. C&F and TIG experienced price increases of 10-15% in many lines and our expectation is that this will continue in 2001 as the industry very much needs it (note you don't necessarily get what you need!). We believe this cycle may have some "shelf life" because:

- 1) Retrocessional rates (i.e. the rates reinsurers pay for their reinsurance) have increased dramatically because of the drying up of capacity in Australia and significant losses at Lloyd's.
  - 2) The worldwide reinsurance industry is running at high combined ratios.
  - 3) The 25 leading U.S. property and casualty insurers have earned a depressed average return on equity of 8.8% over the past 12 years. This has resulted in (a) very significant consolidation in the industry – most large commercial line insurers are now in strong hands (read focused on return) – and (b) management turnover at the top of those remaining independent insurers who may have still focused on market share.
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- 4) A number of insurers have experienced well-publicized serious financial difficulties. This has resulted in rating agencies being very pessimistic on the industry and access to capital from banks and capital markets being significantly reduced.
- 5) Reserve redundancies in the past five years, particularly from U.S. auto, are over. The industry has no place to hide and, in fact, reserve deficiencies from the soft markets of 1997-99 are clearly becoming more evident. Note – Fairfax’s indemnification and other protection obtained on the purchase of C&F and TIG relates to two of those three years.

Rating agency pessimism on the U.S. P&C industry, combined with their expectation that it would take us much longer to turn around the operating performance of our recent purchases, C&F and TIG, unfortunately resulted in Fairfax’s debt ratings being downgraded.

Here are some relevant statistics on our financial position as of December 31 in the past eight years.

	1993	1994	1995	1996	1997	1998	1999	2000
Holding company cash and marketable securities (\$ millions)	4.1	7.2	70.4	101.1	207.1	305.4	712.7	545.4
Net debt/equity	47%	56%	48%	41%	37%	51%	34%	35%
Long term bank lines (\$ millions)	75	105	215	600	1,000	1,300	1,300	1,265
Unused indemnifications*	26	56	33	280	334	957	673	463
Swiss Re protection**	–	–	–	–	–	–	1,087	715
Negative goodwill	–	–	–	111.7	184.1	227.8	234.2	129.8
S&P debt rating	BBB	BBB	BBB+	BBB+	BBB+	BBB+	BBB+	BBB–

\* Against pre-acquisition reserve development and unrecoverable reinsurance, excluding TRG; see page 79 in the MD&A.

\*\* See pages 56 and 57 in the MD&A.

As you can see from the table above, our financial position in terms of cash and marketable securities in the holding company, net debt/equity, long term bank lines, balance sheet protection provided by indemnifications and our corporate insurance cover from Swiss Re, and negative goodwill have never been stronger than in 1999/2000.

So while we have expanded significantly in the past five years, it has not been at the expense of our financial position. As it has always been our objective to maintain a very strong financial position, the downgrade in our debt ratings by Standard & Poor’s was very disappointing. We firmly believe that these ratings do not reflect our underlying financial strength on an absolute or relative basis. It is our expectation that improved performance by C&F and TIG will result in our ratings rising to levels that more appropriately reflect our underlying financial strength.

The problems of the P&C industry plus concerns about our ratings have increased our bond spreads (and those of other industry participants) to record levels. The spreads on bonds that we issued at 150-200 basis points over treasuries, depending on term, have now more than doubled. Who said the markets are always rational?

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Having discussed our debt ratings, I am happy to report that we were able to maintain C&F, TIG and Odyssey Re's A.M. Best ratings at the "A" level (A- for C&F) – which are very important in the U.S. P&C insurance industry.

C&F and TIG's focus on re-underwriting their books of business to concentrate on underwriting profitability resulted in negative cash flow at their level. Combined with rising interest rates for most of the year (resulting in unrealized bond losses), 2000 provided Fairfax and HWIC management with some excellent experience which we could have done without! Our small team reacted well again.

Speaking of our small team, we are very fortunate to have a "few good men and women" who, with no egos, are experienced in monitoring operations and reacting quickly to opportunities while focusing on downside protection from worst case events. The outstanding team we have at head office in Toronto includes Trevor Ambridge, Sam Chan, Francis Chou, Jean Cloutier, Brad Martin, Elizabeth Murphy, Rick Salsberg, Ron Schokking and John Varnell, and at Fairfax Inc. includes Jim Dowd, Scott Galiardo and Jim Migliorini in New York and Cindy Crandall in Dallas.

During the year, C&F purchased Seneca Insurance as a bolt-on acquisition for US\$65 million. Doug Libby, who has run Seneca for the past ten years, has had an excellent track record with combined ratios below 100% for the past five years, together with consistent reserve redundancies over the past ten years. Bruce Esselborn and Nick Antonopoulos (the President of C&F) knew Doug Libby and Seneca as they were former directors of the company. Seneca, which is headquartered in Manhattan, will serve as the New York City office for C&F. The purchase price of US\$65 million was a small premium to underlying book value of US\$59 million. We welcome Doug Libby and all the employees of Seneca to the Fairfax group and look forward to their significant contributions to our group.

As you know, in 1999 we purchased approximately 38% of Zenith National Insurance Corp. run by Stanley Zax for the past 22 years. As a bonus, Stanley introduced us to Brian Caudle who heads the Advent Group which controls three syndicates at Lloyd's of London with a combined underwriting capacity of some £250 million. Brian has one of the best track records at Lloyd's spanning some 25 years. We sold Kingsmead Agencies, a Lloyd's agency we inherited with the purchase of TIG, for 22% of Advent. We are delighted to be long term shareholders of Advent along with Brian Caudle. As an aside, insurance companies specializing in worker's compensation in California have fallen like dominoes in 1999/2000. Zenith is one of the few specialty worker's compensation insurance company survivors.

In its second year of operation, Hub International, under Chairman Marty Hughes and President Rick Gulliver, ably assisted by John Varnell of Fairfax, completed several important acquisitions in the United States and Canada. Hub continued to improve profitability and operating free cash flow in 2000 and continues to respond to opportunities for expansion in the United States and Canada. On January 20, 2001, Hub announced its agreement to purchase the Kaye Group, a NASDAQ listed brokerage group, for approximately US\$119 million. Hub has accomplished a great deal in a short period of time and is a strategic investment for Fairfax. For more information, please read Hub International's Annual Report which is posted on Hub's website [www.hubinternational.com](http://www.hubinternational.com) in the Investor Relations section under "Financial Reports".

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After about five years of watching the developments in the state owned property and casualty industry in India, Fairfax was able to announce a joint venture with ICICI, a dynamic Indian commercial bank, as the Indian government decided to open up the industry to foreign investment for the first time since 1972. The joint venture, called ICICI-Lombard, gives us a maximum equity interest of 26% (under current law) for a capital investment of \$10 million. This project required a significant commitment from a Fairfax-wide team to complete. Congratulations to Chandran Ratnaswami, Paul Fink, Jim Dowd, Jim Migliorini, Byron Messier, Kim Tan and many others for providing this long term opportunity to Fairfax. We expect to be writing policies this year.

During the year, the principals of HWIC decided to discontinue management of external funds (primarily pension funds) and focus on the management of Fairfax funds alone. HWIC has been managing pension funds and some individual funds for the better part of 16 years. For the record (and for the last time), results over that time period have been as follows:

*Annualized rates of return (%)*

*16 years ended December 31, 2000*

	<b>1985 – 2000</b>
Canadian Equities	13.3
TSE300	11.5
U.S. Equities	19.7
S&P500	17.9
Canadian Bonds	11.7
SM Index	10.8
Balanced Fund	13.8

*Source: Representative balanced fund managed by HWIC for 16 years*

These pension fund results rank HWIC among the top fund managers in Canada and the United States. The Value Fund, an HWIC managed pooled fund for individuals, compounded at 13.6% annually since inception in June 30, 1985 (versus 10.9% for the TSE300).

The compensation arrangements with the principals of HWIC were also changed from the arrangements arrived at in 1992 when HWIC was purchased by Fairfax. Going forward, the principals will have a fixed salary and a discretionary bonus based on performance as opposed to the participation in the profit sharing pools that has prevailed over the past 8 years. These new arrangements were concluded to the satisfaction of all the principals.

This brings me to my own compensation arrangements. For many years now I have felt that as a controlling shareholder involved in the management of the company, my compensation should be closely linked to all shareholders. So from 2000 onwards, my compensation will be a fixed salary of \$600,000 with no bonuses. This compensation will not increase annually, and if 1999/2000 is repeated, could decrease!! However, to make sure that my family survives, Fairfax will examine instituting a dividend – yes, a modest dividend – in 2001 at an annual rate of \$1 or \$2 per share. Going forward, the only difference between me and you, our shareholders, will be my salary of \$600,000 – which based on recent performance, many of you may think is too high! While the payment of a modest dividend results in double taxation to

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most of you and is not as economically efficient as retaining all our profits and compounding at high rates of return (as we have done for the past 15 years), this was the only way I could think of to bring my compensation in line with your interests. While I may have generated some sympathy from you, I should add that I continue to travel well – in fact a little better recently because we sold our Lear Jet for US\$2.5 million (cost US\$1.8 million) and purchased a Gulfstream II for US\$6.2 million.

Below, we update the table on intrinsic value and stock prices that we first presented last year.

	<u>INTRINSIC VALUE</u>		<u>STOCK PRICE</u>
	<b>ROE %</b>	<b>% Change in Book Value* per Share</b>	<b>% Change in Stock Price</b>
1986	25.4	+ 183	+292
1987	31.3	+ 41	- 3
1988	21.2	+ 22	+ 21
1989	20.3	+ 23	+ 25
1990	23.0	+ 39	- 41
1991	21.3	+ 24	+ 93
1992	7.7	+ 11	+ 18
1993	20.3	+ 48	+ 145
1994	12.1	+ 25	+ 9
1995	20.1	+ 22	+ 46
1996	21.4	+ 63	+ 196
1997	20.4	+ 44	+ 10
1998	20.1	+ 47	+ 69
1999	4.3	+ 26	- 55
2000	4.1	+ 5	- 7
<b>1985-2000</b>	<b>18.2%</b>	<b>+ 37%</b>	<b>+ 33%</b>

*\* First measure of intrinsic value as discussed in our 1997 Annual Report*

The table was discussed in great detail last year. I'll spare you that this year! Suffice to say that while statistically, intrinsic value did not increase much last year (book value per share increased 5% while investments per share dropped 10% in 2000), the managements of our insurance and reinsurance businesses have significantly increased the long term value of our businesses, as should become evident in the next few years. We did a good job of masking the improvement in 2000!

Of course, the low returns on equity resulted in our stock price continuing to be weak in 2000. Note, however, that over the long term, stock prices and book values have compounded at approximately comparable rates – depending on the year, book value or stock price is slightly ahead!

As discussed in our 1999 Annual Report, the low stock price for Fairfax allowed us to repurchase some of our shares – 325,309 shares at an average price of \$183.47 per share in 2000. This means that in 1999/2000 we retired 1,031,412 shares at an average price of \$258.35 per share. As discussed last year, our policy of not buying back our shares at the expense of our financial position prevented us from buying back more shares of Fairfax in 2000.

As far as future acquisitions are concerned, other than small bolt-on acquisitions like Seneca, I want to reiterate our statements from our 1999 Annual Report.

- 1) We do not plan to make any significant acquisition until our group combined ratio drops to 105% and is clearly headed lower.
- 2) We do not plan to issue our stock at prices less than \$500 per share to buy another company – however attractive it may be.

Our guiding principles (again set out in the Appendix) were tested in 2000 and, I'm happy to say, survived intact. These guiding principles are firmly entrenched in all of our companies and are a major source of our long term strength.

While internet stocks collapsed last year (more later), under Sam Chan's leadership we initiated a Fairfax intranet that links all of our operations and provides a free flow of information across all our subsidiaries. Also, we are building our e-commerce platform and have two products developed from end-to-end on the internet. In both these ventures, we have benefited greatly from the committed services of DK Matai and mi2g. We look forward to further development in 2001.

The table below shows the sources of our net earnings with Lindsey Morden equity accounted.

	<b>2000</b>	<b>1999</b>
	(\$000)	(\$000)
Underwriting		
Insurance		
Canada	(13,025)	(96,570)
U.S.	(588,408)	(273,131)
Reinsurance	(97,367)	(247,364)
Interest and dividends	<u>593,512</u>	<u>711,475</u>
Insurance and reinsurance earnings (loss)		
before realized gains	(105,288)	94,410
Realized gains	378,305	121,670
Runoff	43,303	(54,231)
Claims adjusting (Fairfax portion)	(15,387)	2,784
Interest expense	(164,743)	(129,262)
Goodwill and other amortization	(5,362)	(5,067)
Negative goodwill	99,113	-
Swiss Re premium	(167,196)	(35,312)
Kingsmead losses	(32,963)	-
Restructuring	(16,402)	-
Corporate overhead and other	<u>(22,966)</u>	<u>(20,174)</u>
Pre-tax income (loss)	(12,586)	(25,182)
Less (add): taxes	(173,306)	(158,023)
Less: non-controlling interests	<u>23,279</u>	<u>8,633</u>
Net earnings	<u>137,441</u>	<u>124,208</u>

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The table shows you the results from our insurance (underwriting and investments), runoff and non-insurance operations. *In this report, insurance operations include reinsurance operations.* Runoff operations include TRG, Odyssey Re Stockholm and Sphere Drake. Claims adjusting shows you our share of Lindsey Morden's after-tax income. Goodwill and other amortization includes Hamblin Watsa goodwill (\$1.4 million) and amortization from Ranger and Seneca. The corporate overhead expense is net of HWIC's pre-tax income and interest income on Fairfax's cash balances and, in 1999, includes one time expenses associated with our acquisitions. The premium payable to Swiss Re of \$167.2 million is shown separately and discussed in the MD&A on pages 56 and 57. Also shown separately are realized gains so that you can better understand our earnings from our operating companies. Also, please note the unaudited financial statements of our combined insurance and reinsurance operations and of Fairfax with Lindsey Morden equity accounted, as well as Lindsey Morden's financial statements, shown on pages 92 to 97.

The continued very large underwriting losses were due to TIG (\$342.9 million), C&F (\$197.9 million), Odyssey Re Group (\$97.4 million), Ranger (\$47.6 million) and the Canadian insurance companies (\$13.0 million). Reserve development for the 1999 accident year reflected in those underwriting losses cost us \$164.4 million because of TIG (\$99.4 million), C&F (\$69.8 million), Odyssey Re Group (\$5.4 million) and Ranger (\$4.8 million), offset by the Canadian insurance companies' net redundancies (\$15.0 million). As we have taken this development into account in our 2000 loss ratio picks and because of higher rates in the U.S., we do not expect this negative reserve development to be repeated in 2001.

Interest and dividends declined by \$118.0 million in 2000 to \$593.5 million because of a significant decrease in the investment portfolio of the insurance and reinsurance companies of \$2.4 billion. The major reason for the decrease in the investment portfolios is the re-underwriting that took place in 2000 (please see page 82). With higher premiums and increased volumes, this should begin to reverse itself in 2001.

Last year, we discussed Fairfax's purchase of a US\$1 billion adverse loss development reinsurance cover (for 1998 and prior claims and unrecoverable reinsurance) from an AAA rated subsidiary of Swiss Re Group. In 2000, we ceded US\$272.3 million to the cover for a cumulative total of US\$523.6 million. The adverse development arose mainly from TIG (US\$150.9 million), C&F (US\$18.1 million) and our runoff subsidiaries, mainly Sphere Drake (US\$98.6 million). The cost for this cover in 2000 is the Swiss Re premium shown of \$167.2 million (more on pages 56 and 57).

Our runoff operations (TRG, Odyssey Re Stockholm and Sphere Drake) earned us \$43.3 million, mainly because of higher investment income and realized gains on investments on the runoff portfolio, offset by losses from Sphere Drake that resulted from adverse development largely due to the 1999 European storms.

The adverse development in the 1999 underwriting year (\$164.4 million), the cost of protection (the Swiss Re premium) for 1998 and prior reserve development (\$167.2 million), restructuring costs (\$16.4 million) discussed in the MD&A on page 57, and Kingsmead losses (\$33.0 million) discussed in the MD&A on page 57, cost Fairfax a total of \$381.0 million

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pre-tax, offset by a reduction in the amortization period of negative goodwill of \$79.2 million, for a net pre-tax cost of \$301.8 million.

In spite of substantial realized gains in 2000, the very significant underwriting losses resulted in a pre-tax loss again in 2000 – similar to the one in 1999. We recorded a tax recovery of \$173.3 million because our underwriting losses are in high tax jurisdictions while other income was earned in areas with lower tax rates.

### Insurance operations

The table below shows the combined ratios of each of our companies for 2000 and 1999. While the group combined ratio in 2000 was worse than in 1999, the underlying operations are very much improved – but the figures mask the improvement. However, there is no question that I was too optimistic in my report to you last year and was wrong. As I said earlier, I underestimated the soft markets in the U.S. of 1998 and 1999, the effects of reserve deficiencies in these years on our results in 2000 and finally, the enormity of turning around these operations in the midst of these soft markets. While 1999 was impacted by catastrophes, 2000 was impacted by reserve development from the 1999 underwriting year. Excluding this reserve development, the group's combined ratio was 112.6%.

	<b>Underwriting loss</b>	<b>Combined ratio</b>	
	<b>2000</b> <i>(\$ millions)</i>	<b>2000</b> %	<b>1999</b> %
Commonwealth	3.7	105.5	186.7
Federated	4.6	106.5	113.8
Lombard	2.7	100.6	105.0
Markel	2.0	103.4	104.6
<i>Total Canadian insurance</i>	<i>13.0</i>	<i>102.0</i>	<i>114.9</i>
Ranger	47.6	146.3	149.4
C&F	197.9	124.3	120.9
TIG	345.9	123.1	105.6
<i>Total U.S. insurance</i>	<i>588.4</i>	<i>124.3</i>	<i>111.8</i>
Odyssey Re Group*	97.4	108.0	119.4
<i>Total reinsurance</i>	<i>97.4</i>	<i>108.0</i>	<i>119.4</i>
<i>Total</i>	<i>698.8</i>	<i>116.3</i>	<i>114.6</i>

\* including CTR

From the table you can see that our Canadian operations, while not yet below 100% in total, are well on their way to achieving that objective. Our U.S. operations, particularly TIG and C&F, were significantly impacted by reserve development from the 1999 year. Excluding this development, the combined ratio for TIG was 116.4% and C&F 116.3%. Given the re-underwriting that was done in both companies and the price increases achieved, the

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combined ratios for both companies should decline significantly in 2001 but not to our targeted level of 100% – yet!

For all our U.S. insurance business, price increases and improved policy conditions were applied gradually over the year, with price increases accelerating to their highest levels in the fourth quarter. While these measures are partially reflected in this year's underwriting results, their full impact will not be realized until 2001.

Commonwealth, with its significant U.S. property and oil and gas business, bounced back in 2000 with a combined ratio of 105.5% from its record high ratio of 186.7% in 1999. Gross premiums written increased by 25% over the prior year to \$213.0 million while net premiums written increased by 74% to \$80.0 million.

Commonwealth's expense ratio dropped by 9.2 percentage points to 25.1% as underwriting expenses declined by 9% to \$15.6 million. Commonwealth should have an excellent year in 2001 barring catastrophes. In 2000, the company earned \$6.8 million after tax compared to a loss of \$12.0 million in 1999. During the year, John Watson passed the CEO title to Ron Schwab but will continue as Chairman of the company. During his tenure as CEO of Commonwealth, John Watson took the company from \$68.4 million in gross premiums written in 1977 to \$213.0 million gross premiums written in 2000 with a cumulative combined ratio of 98.3% (excluding 1999). Cumulative after-tax income earned during John Watson's tenure was more than \$182 million. During this period, Commonwealth's shareholders' equity increased from \$3.3 million in 1977 to \$146.9 million at the end of 2000, after net dividends paid of \$70.3 million. Commonwealth has been a great investment for Fairfax and on behalf of all our shareholders, we thank John for his superb performance. John will continue to help Fairfax in a variety of ways.

Federated, under John Paisley's leadership, improved its combined ratio to 106.5% in 2000 from 113.8% in 1999 (including the life company). The reason Federated did not achieve its 100% goal was again due to a high frequency of large "individual risk" losses. For example, in 2000, Federated had its largest property loss ever, which was a total fire loss of an equipment dealership with an excellent twelve year relationship with the company. This is the inherent risk in our business! John Paisley has achieved a 10% rate increase during 2000, has continued re-underwriting the book of business including exiting the fertilizer dealer market, and with a high 88% retention ratio expects to have a combined ratio below 100% in 2001. Federated's property and casualty gross premiums written increased by 2% to \$65.0 million while its net premiums written increased by 1% to \$56.0 million. Federated maintained its expense ratio below 30%. It earned \$0.9 million after tax in 2000 versus \$2.3 million in 1999 mainly due to reduced realized gains. Federated Life had gross premiums written of \$18.5 million, an increase of 8% from 1999. Net premiums written increased by 4% to \$15.0 million. Profit after tax was \$1.5 million, almost twice that earned in 1999 because of reduced expenses, lower loss ratios and higher investment income. Federated Life will be changing its name so as to access new distribution channels, markets and partners.

Lombard's combined ratio improved significantly to 100.6% due to strict underwriting discipline (resulting in a 38% drop in new business written) combined with reserve redundancies from past years. During the year, Byron Messier and his management team

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undertook a company-wide focus to reduce underwriting and claims leakage (not charging enough for your services and paying too much for claims). Together with a continued focus on underwriting profitability, Byron expects to achieve a combined ratio below 100% in 2001. In late 2000, Lombard formed a strategic partnership with CARP (Canadian Association of Retired Persons) as sole supplier of property and casualty products through CARP to Canadians over the age of 50. I'm a member also but definitely not retired!! This strategic partnership will help Lombard's Privilege 50 program which had net premiums of \$30.8 million (versus \$29.8 million in 1999) with a combined ratio of 101.4% (115.0% in 1999).

Lombard's gross premiums written (including cessions to CRC (Bermuda)) were down 2% to \$501.5 million in 2000 while net premiums written (on the same basis) were down 5% to \$444.7 million. Net income after taxes increased to \$41.2 million from \$29.7 million in 1999.

Falcon, led by Kenneth Kwok, continued to write very little business due to soft markets in 2000. Falcon wrote net premiums of HK\$66.1 million (Cdn\$12.6 million) in 2000 versus HK\$60.5 million (Cdn\$12.1 million) in 1999. With a start-up expense ratio of 86%, Falcon had a combined ratio of 173% in 2000 versus 165% in 1999. With a hardening market at year-end 2000 and planned expense reductions, Falcon expects to get its combined ratio below 120% in 2001. Falcon lost HK\$29.1 million (Cdn\$6.7 million) in 2000.

In what was another terrible year for most writers of long-haul trucking insurance in Canada and the U.S., Markel, under Mark Ram's management, once again delivered a solid combined ratio of 103.4% in 2000. With its proven leadership position in the trucking insurance marketplace, its experienced team and strong reserving practices, Markel is well-positioned to achieve its 100% combined ratio goal in 2001. Over the past six years under current management, Markel has outperformed both the long-haul trucking insurance marketplace and the general property and casualty industry in Canada, writing a total of \$500 million of business with an average combined ratio of 103.9%. In 2001, Markel will be celebrating its 50<sup>th</sup> anniversary serving the Canadian trucking industry. We're certainly looking forward to the next 50 under Mark's leadership!! Gross premiums written in 2000 increased by 16% to \$89 million while net premiums written rose by 19% to \$65 million. Net income after taxes was down \$4.5 million to \$1.1 million due primarily to lower investment returns.

The downsizing of Ranger continued in 2000. The company's gross written premiums declined to US\$78.0 million from US\$137.6 million in 1999, and its net written premiums to US\$47.0 million from US\$88.3 million – both down about 50% from 1999. While the all-in combined ratio was 146.3%, excluding discontinued lines the combined ratio was 121.6%. In spite of an expense reduction of 31% to US\$32.6 million in 2000, Ranger has an extremely high expense ratio (including commissions) of 50% which we are working with Phil Broughton to reduce. Ranger, like other U.S. companies, has had significant rate increases recently – and we wait patiently for improved results. Ranger had a pre-tax loss of US\$19.1 million (before stop loss) versus US\$25.6 million in 1999 (before stop loss). Ranger's management continues to take the actions necessary to improve results – but no forecasts from me for 2001!

Our confidence in Bruce Esselborn was not misplaced. Bruce, Nick, Mary Jane Robertson (C&F's CFO) and the new management team are well on their way to restoring the excellent underwriting reputation that C&F once had many decades ago. As shareholders, you will be

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extremely pleased at the huge asset that this team is expected to develop for Fairfax over the next few years. Bruce is very much focused on underwriting profitability and is shooting for “a nickel on the dollar” in terms of underwriting profits.

Here’s what the C&F team has done in 2000:

- 1) The management team was strengthened significantly, particularly with underwriting talent.
- 2) Underwriting focus and discipline was restored.
- 3) Pricing (renewal pricing up 11.9% in the fourth quarter) and policy terms were improved.
- 4) Unprofitable business was shed.
- 5) Commissions were reduced by almost 3 percentage points.
- 6) Operating expenses were cut by US\$18.7 million.
- 7) Product offerings were expanded (D&O and Surety, for example).
- 8) Seneca and Transnational (a surplus lines shell renamed Crum & Forster Specialty) were acquired.
- 9) The agency force was refreshed and expanded with 277 appointments and 32 terminations.

These significant actions were masked by the high combined ratio of 124.3% that C&F had for 2000. The trend in combined ratios and renewal rate increases is shown below.

	<b>2000</b>			
	<b>First quarter</b>	<b>Second quarter</b>	<b>Third quarter</b>	<b>Fourth quarter</b>
Renewal rate increase	10.6%	10.2%	13.0%	11.9%
Combined ratio (accident year)	133.3%	123.9%	119.9%	111.5%

In 2000, C&F’s gross premiums written declined 9% to US\$679.8 million while net premiums written declined 15% to US\$506.5 million. The retention ratio of 51% during 2000 reflected the re-underwriting done during the year. Excluding Seneca, new business premium in 2000 was up 18% to US\$170.7 million. Loss after taxes in 2000 was US\$15.5 million.

C&F had a strong month in January 2001 with gross premiums written of US\$105.5 million (versus US\$55.7 million in January 2000), not counting US\$11.4 million from the 2000 acquisition of Seneca.

The full force of management’s actions will be felt in large part in 2001. More significantly, we expect that over the next few years, Crum & Forster will become one of the excellent underwriting focused insurance companies in the U.S.

TIG Specialty Insurance had an extremely difficult year in 2000 with a combined ratio of 123.1% versus a target ratio of 105%. This was mainly due to a significant underestimation of the 1999 accident year loss and LAE ratio. When the 2000 plan was created, TIG thought that

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the 1999 underwriting year was 18 points better than it actually turned out to be. This was a result of the very soft market in 1999 generally, mentioned earlier, together with significant negative development taking place in most of its business segments including Workers' Compensation, Excess Casualty, Non-Standard Auto and Sports and Leisure. This shortfall was accentuated by very poor results in an expanding non-standard auto book as well as some drag from clean-up activities of the past. As TIG distributes its products through managing general agents (MGAs), pricing and claims management initiatives took longer to take hold.

As at C&F, Courtney Smith and his management team have made very significant improvements in TIG's operations, which have been masked by the very poor results in 2000. Some of these improvements were:

- 1) The management team was strengthened significantly, particularly in claims and actuarial.
- 2) A management reporting and control system is now in place by customer group.
- 3) Key producer contracts were renegotiated to provide more pricing, underwriting and claims control.
- 4) Pricing (renewal pricing up 13% in the fourth quarter) and policy terms were improved.
- 5) Unprofitable distribution relationships were terminated.
- 6) Third party administrator relationships on 24 programs were terminated. Those claims are now being handled in-house. Improvements in the quality of claims handling at TIG should significantly reduce claims costs in the future.
- 7) Operating expenses were cut by US\$5.6 million.
- 8) Commission rates were reduced for many underperforming programs and more closely linked to underwriting performance.
- 9) The Special Risk Operations Unit (US\$41.8 million in net premiums written) and Hawaii (US\$54.8 million in net premiums written) achieved combined ratios below 100%.

A very strong focus on strict underwriting (in spite of the MGA relationships), higher price increases, a changing mix of business and much improved claims management should yield substantially improved results in 2001. TIG remains committed to achieving an underwriting profit in 2002.

TIG's gross premiums written in 2000 were US\$1,379.4 million versus US\$1,350.0 million in 1999. Net premiums written increased 2% to US\$978.6 million and the combined ratio for 2000 was 116.4% (excluding 1999 reserve strengthening) versus a restated combined ratio for 1999 of 118.4%. Net loss after taxes for 2000 was US\$125.9 million versus US\$24 million for nine months in 1999.

Under Andy Barnard's leadership, Odyssey Re Group consolidated its global franchise via a branch network with offices all over the world. The company operates with a capital base of over US\$1 billion and had a worldwide gross premium base of US\$986 million. Net premiums

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written worldwide decreased by 3% in 2000 to US\$787.5 million from US\$814.9 million in 1999. The combined ratio for 2000 was 108.0%. While these results did not achieve our objective of 104% for 2000, we expect that Andy and Odyssey Re Group outperformed the reinsurance industry's 2000 combined ratio. Given the increase in underlying insurance rates and the higher reinsurance rates experienced in January 2001, Odyssey Re Group is well positioned to drop its combined ratios to the 103%-104% area in 2001. Odyssey Re Group earned US\$110.4 million after taxes in 2000 versus a loss of US\$48.0 million in 1999.

With the exception of TIG, our insurance companies continue to be well capitalized as shown on page 85. Important information for you to review when you look at insurance companies is the disclosure regarding their claims reserves. As you know, it is our policy to have our reserves set at a level that results in redundancies in future years. How did we do in 2000? We provide extensive disclosure on our claims reserves beginning on page 62 in the MD&A. In Canada, our insurance companies had redundancies of \$17.1 million in 2000 while in the U.S., C&F, TIG and Ranger had an aggregate deficiency of US\$284.8 million. Odyssey Re Group had an aggregate deficiency of US\$62.1 million. The reasons for these deficiencies, including the softness of the insurance market in 1999, are discussed on pages 68 to 72 in the MD&A. We continue to work to get our U.S. and reinsurance reserves to the standards of our Canadian reserves.

During the year, the RiverStone Group (TRG), led by Mike Coutu and Dennis Gibbs, took over the runoff of all discontinued operations across the Fairfax group. As well, they became responsible for:

- a) settling all latent claims including asbestos, pollution and other hazards. Also, all construction defect claims, originating mainly from California, were centralized under RiverStone;
- b) the management of reinsurance recoverables across the group, particularly ones in dispute or with financial problems. They are also responsible for all commutations as well as the security list for ongoing reinsurers; and
- c) the management of any significant lawsuits, including the personal accident and worker's compensation dispute described in last year's Annual Report.

TRG has been a tremendous resource for us and the 160 people that they have at Manchester, New Hampshire are a welcome addition to the Fairfax family. Please review the MD&A for more details on our runoff operations.

### **Claims adjusting**

2000 was a very poor year for Lindsey Morden. Revenue dropped 15% to \$376.9 million in 2000, while the company lost \$23.1 million after taxes – the largest loss in its history. The losses were mainly due to poor results in North America and the United Kingdom. Free cash flow was negative \$7.7 million (\$0.64 per share) compared to a positive \$25.6 million (\$2.17 per share) in 1999. These poor results resulted in the elimination of the dividend in early 2001.

In normal succession planning, Ferd Roibas was made President and Chief Operating Officer as of September 14, 2000 while Ken Polley became Chairman of the Board replacing me. Ken has

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retired as CEO after almost 35 years with Lindsey Morden, and on an interim basis Francis Chou has become Chief Executive Officer. Ken's dedication to Lindsey Morden was legendary, and he was at the helm as it developed from a purely Canadian operation, with annual revenue of \$31 million when it went public in 1987, into one of the few global claims management companies, with revenue of \$377 million last year. During the year, Karen Murphy, former Chief Financial Officer of a large property and casualty insurance company in Canada, joined Lindsey Morden as Chief Financial Officer. Peter Fritze, from Torys, joined Lindsey Morden as Senior Vice President, Corporate Affairs. Farid Nagji was promoted to President, U.S. Operations on Don Smith's retirement. This team has the urgent task of returning Lindsey Morden to profitability immediately and then capitalizing on its opportunities as one of the few global adjusters in the world.

To maintain Lindsey Morden's financial strength, the company did a \$20 million rights issue (at \$8.50 per share) in late 2000 back-stopped by Fairfax. The issue was almost totally subscribed by Fairfax. Only a year ago, I happily reported to you that we bought 0.8 million shares at \$20.00 per share!! For more information on Lindsey Morden, please refer to their annual report that you can get from their website ([www.cunninghamlindsey.com](http://www.cunninghamlindsey.com)).

### Financial position

As mentioned in previous Annual Reports, we feel our unaudited balance sheet with Lindsey Morden equity accounted (shown on page 94) is the best way to understand our financial position. Below, we show you our year-end financial position compared to the end of 1999.

	<b>2000</b>	<b>1999</b>
	<i>(\$ millions)</i>	
Cash and marketable securities	545.4	712.7
Long term debt	1,851.4	1,959.0
Net debt	1,306.0	1,246.3
Common shareholders' equity	3,180.3	3,116.0
Preferred securities	592.0	578.8
Total equity	3,772.3	3,694.8
<b>Net debt/equity</b>	<b>35%</b>	<b>34%</b>
<b>Net debt/total capital</b>	<b>26%</b>	<b>25%</b>

As shown, there was very little change in our financial position during the year 2000. Similar to only once before (1990), shareholders' equity did not increase significantly in 2000. Our net debt to equity and net debt to total capital ratios increased a little because of a reduction in cash and marketable securities in the holding company and the effect of the lower Canadian dollar on U.S. dollar denominated debt.

As insurance company balance sheets can be complicated, this year we wanted to review for you on a line-by-line basis all of the major assets and liabilities on our balance sheet. To spare some of you less-detailed types, this commentary is included in the MD&A beginning on page 60. From this review, you can see why we feel our balance sheet is very sound and conservatively accounts for our assets and liabilities.

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Due to our low profits in the last two years, our financial position at year-end 2000 is not as strong as it was last year. However, it continues to be strong for the following reasons:

- 1) We have no bank debt. Our debt consists of seven public debentures with a long term to maturity (3 years to 37 years) and low interest rates (6.875% to 8.30%), two small debentures issued to vendors, and certain debt assumed with the acquisition of TIG. All of the public debentures were issued under a single trust indenture containing no restrictive covenants, thus providing us with great flexibility. We have swapped the fixed interest rates on all of the public debentures (with the exception of the ones maturing in 2003) into floating rates (or as noted in the next sentence), saving approximately 69 basis points on average currently. We swapped US\$125 million of our 7.375% debentures due April 15, 2018 for Japanese yen denominated debt of the same maturity with a fixed rate of 3.48% per annum (see note 5 to the consolidated financial statements). Including the amortization of the unrealized foreign exchange loss on this swap over the remaining term to maturity, the effective rate for 2000 was 5.081% per annum, still below the 7.375% coupon rate of the swapped debentures.
  - 2) We have unsecured, committed, long term bank lines in excess of \$1.2 billion with excellent covenants. These bank lines are with five Canadian, five U.S. and three European banks. Please see the details on page 87 in the MD&A.
  - 3) Our net long term debt is less than three times our normalized earnings base (you have yet to see it!). Also, our earnings base is well diversified among many insurance and reinsurance companies and Lindsey Morden and geographically from Canadian, U.S. and international sources of income.
  - 4) Available cash flow at the Fairfax (holding company) level from dividends, management fees and interest covers our administrative and interest expenses and preferred dividends by about two times. This is based on normal dividend payouts from our insurance companies, which are much less than our maximum dividend-paying capacity. Note Fairfax's combined holding company income statement on page 99.
  - 5) With more than \$500 million in cash and marketable securities in the holding company at year-end, we could pay our administrative and interest expenses and preferred dividends at Fairfax, with *no* dividends from any of our insurance or reinsurance companies, for approximately two years – our management holding company survival ratio! This is less than our target of three to four years.
  - 6) As discussed on page 85 in the MD&A, all our insurance and reinsurance companies (with the exception of TIG) are well capitalized with significant solvency margins in excess of mandated regulatory levels.
  - 7) Our foreign exchange exposure from our U.S. insurance and reinsurance companies has been fully hedged by our U.S. dollar debenture issues and the purchase of foreign exchange contracts.
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**Investments**

Finally, equity markets in the U.S. declined in 2000, with the S&P500 down 10% and the NASDAQ down 39%. The TSE300 was up slightly (6%) while U.S. long treasuries increased significantly as long term interest rates dropped from 6<sup>1</sup>/<sub>2</sub>% to 5<sup>1</sup>/<sub>2</sub>%.

The unrealized gains (losses) as of year-end are as follows:

	<b>2000</b>	<b>1999</b>
	<i>(\$ millions)</i>	
Bonds	(463.3)	(1,241.0)
Preferred stocks	(0.7)	(1.3)
Common stocks	<u>(25.2)</u>	<u>15.7</u>
	<u>(489.2)</u>	<u>(1,226.6)</u>

We realized \$382.8 million in gains in 2000 – more than triple what we realized in 1999 and almost equal to the record realized gains in 1998 of \$441 million. Unrealized bond losses declined significantly from \$1,241.0 million as of December 31, 1999 to \$463.3 million as of December 31, 2000 and continued to decline in 2001 to about \$220 million as of February 28, primarily reflecting declining long term interest rates. Assuming corporate spreads remain at their current levels (they deteriorated in 2000), our unrealized bond losses would disappear at long term interest rates of 5% and would become an \$800 million unrealized gain at long term interest rates of 4%.

We are relieved that our comment to you last year, that unrealized bond losses do not impact our regulatory capital in the U.S. and will not be realized (as we can hold these bonds to maturity or until interest rates drop), was justified only one year later. However, not realizing significant bond losses at C&F and TIG, in a negative cash flow environment resulting from declining premiums (because of very soft industry pricing), was much more difficult than we expected and required the talents of all of our people, including HWIC, Fairfax and the financial staff at both companies.

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Shown below is our record of realized gains since inception.

	1986	1987	1988	1989	1990	1991	1992	1993
Investment portfolio (average)								
(\$ millions)	64.2	109.8	130.8	135.7	237.9	338.5	366.5	418.2
<b>Realized gains</b>								
– (\$ millions)	1.0	9.2	7.8	15.5	2.3	(4.5)	3.4	27.8
<b>– % of portfolio</b>	<b>1.6</b>	<b>8.4</b>	<b>6.0</b>	<b>11.4</b>	<b>1.0</b>	<b>(1.3)</b>	<b>0.9</b>	<b>6.6</b>
Unrealized gains (losses)								
(at year-end)								
– (\$ millions)	1.1	(6.9)	5.2	(1.1)	(34.0)	(6.1)	(17.3)	11.5
– % of portfolio	1.2	(5.6)	3.8	(0.8)	(10.1)	(1.8)	(4.4)	1.4
	<b>1994</b>	<b>1995</b>	<b>1996</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>	
Investment portfolio (average)								
(\$ millions)	852.0	1,608.1	2,548.1	4,584.6	8,877.5	14,684.0	16,306.2	
<b>Realized gains</b>								
– (\$ millions)	20.0	71.9	131.3	206.8	440.8	121.7	382.8	
<b>– % of portfolio</b>	<b>2.3</b>	<b>4.5</b>	<b>5.2</b>	<b>4.5</b>	<b>5.0</b>	<b>0.8</b>	<b>2.3</b>	
Unrealized gains (losses)								
(at year-end)								
– (\$ millions)	(30.9)	14.5	127.2	122.7	5.5	(1,226.6)	(489.2)	
– % of portfolio	(2.0)	(0.9)	8.7	2.1	0.0	(7.0)	(3.2)	

You will note the following from the table above:

1. Realized gains have been significant over the years with no predictability whatsoever. However, we have earned realized gains in some years in excess of 5% of the portfolio. While unable to predict when, we think this is still a very realistic possibility for Fairfax even with a \$15 billion investment portfolio.
2. Unrealized gains/losses have no predictability whatsoever in terms of future realized gains.
3. Cumulative realized gains since we began in 1985 have been \$1.4 billion. With a much larger portfolio to work with and the same investment team (a little older now), we expect to earn significant realized gains in the future. Discontinuing management of pension and individual portfolios allows HWIC to focus even more on this objective.

As discussed in our 1998 Annual Report, the possibilities for realized gains continue to be:

1. We have approximately \$5.5 billion invested in “put” bonds (described in our 1997 Annual Report) that have significant upside potential if interest rates decline (limited downside if interest rates increase). As a result of these put bonds, our bond portfolio has an average maturity of 8 years to the put date and 18 years to the long date.
2. We continue to have US\$800 million in S&P500 Index puts at an average level of 1,277, which can result in large profits if the U.S. stock market declines significantly. Since we began buying these puts three years ago, they have cost us US\$163 million, of which US\$115 million has been written off at December 31, 2000.
3. We have \$885 million invested in common stock on which we expect to make significant gains.

Gross realized gains in 2000 totaled \$488.5 million. After realized losses of \$12.4 million and increased provisions of \$93.3 million (primarily on the S&P500 Index put contracts and on a preferred stock inherited on an acquisition), net realized gains were \$382.8 million. Net gains from fixed income securities were \$22.4 million while net gains from common stocks and other investments were \$360.4 million. The principal contributors to the stock realized gains were Latin American stocks (\$247.8 million), Loews (\$53.4 million), put contracts on a basket of technology stocks (\$47.4 million), Samsung Fire & Marine (\$7.5 million), Everest Re (\$6.8 million) and Old Republic (\$6.3 million). As an aside, we have made cumulative realized gains in excess of \$500 million outside North America since we began investing internationally in 1997.

The table on page 83 shows the return on our investment portfolio. Investment income (interest and dividends) increased in 2000 due to the inclusion of TIG Specialty Insurance and Odyssey America Re for a full year, partially offset by a reduction in premiums due to re-underwriting and the runoff of certain insurance company portfolios. Pre-tax investment income increased to \$62.10 per share in 2000 from \$56.48 in 1999.

The speculation that we documented in our 1999 Annual Report ended with a thud in 2000 as technology stocks came back to earth. As shown below, the "senior" issues have dropped by more than 50% while the junior issues are down over 90%, as expected. By the way, we would consider these declines as "permanent" losses as mentioned in last year's Annual Report, as it is highly unlikely that any of these companies will see the high prices that prevailed in 1999/2000 again in the next ten years.

	<b>December 31, 1999</b>	<b>December 31, 2000</b>	<b>% change</b>
<i>"Senior" issues</i>			
AOL Time Warner	75.88	34.80	-54
Amazon.com	76.13	15.56	-80
Yahoo!	216.34	30.06	-86
Cisco	53.56	38.25	-29 (-55)*
Dell	51.00	17.44	-66
<i>"Junior" issues</i>			
DoubleClick	126.53	11.00	-91
Go2Net	87.00	16.10	-81 (-92)*
Infospace.com	53.50	8.84	-83 (-93)*
Red Hat	105.63	6.25	-94
VerticalNet	82.00	6.66	-92
<i>* at February 27, 2001</i>			

When you consider that AOL Time Warner is still selling at 61x cash earnings (pro forma loss of \$1.02 per share), Yahoo! at 59x cash earnings (before charges related to acquisitions, investment losses, etc.) and Amazon.com is still losing money, you may feel like us that there is still plenty of downside left.

While technology stocks have come down significantly, as we have just discussed, the S&P500 is still selling at very high levels. I have to admit that we first began getting concerned about U.S. equity markets in late 1996 and very concerned from 1998 onwards. As the markets went

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higher, we felt we were from another planet (another country I can understand!). Here's an update on the S&P500 since 1996.

<b>As of December 31</b>	<b>Index</b>	<b>Earnings</b>	<b>Price/ Earnings</b>	<b>% Change in Index</b>
1996	741	39	19x	
1997	970	40	24x	+31%
1998	1229	38	33x	+27%
1999	1469	49	30x	+20%
2000	1320	54	25x	-10%
<b>1996-2000</b>		<b>+38%</b>	<b>+32%</b>	<b>+78%</b>

As you can see, the S&P500 was down 10% in 2000 but is still a far cry from where it was in 1996. While the P/E ratio declined in 2000, it is still at very high and vulnerable levels. As an example of high P/E ratios, we observed in 1997 that GE was selling at 27.5x earnings. Currently, GE is selling at 38x earnings. Perhaps we are in a "New Era" with an all-powerful Federal Reserve that justifies GE selling at 38x earnings and 9.4x book value. We beg to differ and remind you that the S&P500 dropped by approximately 50% between 1972 and 1974, the last time GE sold at an astronomical P/E of 28x earnings. GE, by the way, dropped 59% in that time period. And yes, it took GE ten years to get back to the high price that it sold at in 1972.

While the investment climate appears to have decidedly turned bearish in the past three months, we want to remind you that we continue to think that most participants in today's equity markets in the U.S. will suffer significant permanent loss and it is very likely that the high price for the S&P500 (1,552) and Dow Jones (11,750) reached in early 2000 will not be seen again in the next ten years. While this may sound like a very bold statement, all it reflects is the fact that the median P/E over the past 100 years in the U.S. is approximately 15x and long term earnings growth for the S&P500 has been in the 6% – 7% area annually. So-called "long term" investors in the marketplace who are extrapolating the 15% – 20% return of the past decade are very likely to be disappointed.

We must also remind you again of two major risks that we see in the U.S. and Canadian financial markets that we first commented on in our 1997 Annual Report. The first is a potential "run" on mutual funds and the second is the possibility of "repricing of risk" as the default experience of bonds collateralized with consumer debt (credit card receivables, second mortgages, auto dealer receivables, etc.) becomes significantly worse than in the past. These are very significant risks given that more than 50% of all Americans are now in the stock market. It could be very dangerous.

As you know, we have backed our concerns about the U.S. markets with US\$800 million (notional value) in S&P500 Index puts and also US\$142 million (notional value) in similar one year contracts on a basket of technology stocks (we realized some of the gains in 2000). The S&P puts have already cost us US\$115 million over the past three years as we have expensed the purchase costs of these puts over the terms of the contracts. The US\$800 million in S&P puts have a carrying value of US\$48 million in our books (current value approximately US\$68 million).

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We have approximately 6% of our investment portfolios in common shares and almost all the rest in cash and good quality marketable bonds (86.5% of the bonds are rated A or above, and almost none are below a BBB rating – please see page 83). By country, our common stock investments at December 31, 2000 were as follows:

	<b>Book Value</b>	<b>Market Value</b>
	<i>(\$ millions)</i>	
Canada	167	166
Japan	155	153
U.S.	122	125
Other	441	416
	<u>885</u>	<u>860</u>

As shown, most of our common stock investments continue to be outside of North America – particularly in Asia. Our S&P500 Index puts and our similar contracts on technology stocks are included in Other. Over time, we expect to realize gains on these investments – particularly if there is a full testing of our “doomsday” scenario.

#### **Miscellaneous**

In 2000, Fairfax and its subsidiaries donated \$2.4 million to a variety of charities across North America. On a cumulative basis, since we began our donations program in 1991, we have donated \$18.4 million to charitable institutions – and to think our whole company was worth \$1.8 million when we began in September 1985!

Please review page 98 which is an unaudited unconsolidated balance sheet showing you where your money is invested. We have yet to list on the NYSE as the lower Canadian dollar has not made it conducive to unwind our foreign exchange hedges. However, it will be only a question of time before we list on the Big Board.

Given our poor performance in 1999/2000, I noticed that we have attracted for the first time a new type of investor in Fairfax – a few short sellers!! We had 47,100 shares sold short (i.e. hoping to benefit from a decline in our share price) as of December 31, 2000 – and I thought we attracted long term investors only!

Our strengths that we listed for you in the 1997 Annual Report continue to hold – and so have the risks, listed again on pages 88 and 89. We are very disappointed with our performance for you, our shareholders, in the last two years. Rest assured that we are totally focused on achieving our objective of a 20% return on equity over time – again. I wish I could tell you when but, like each of the past 15 years, I couldn’t forecast the next quarter, let alone the next year. However, with the best management team we have ever had, investment portfolios of approximately \$15 billion and some better fortune, we expect to get into your good books again.

Our Annual Meeting this year will continue to be held at the Metro Toronto Convention Centre and will take place on Tuesday, April 17, 2001 in Room 106 at 9:30 a.m. We will be ready to answer all your questions and, of course, all our Presidents, Fairfax officers and Hamblin Watsa principals will also be there to share in the glory!

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John Puddington will be retiring this year as a director of Fairfax. John has been a pleasure to work with for the past ten years and has always been supportive of our company and its interests. As we wish him all the best in the future, we welcome Paul Ingrey to the Board. Paul has had one of the best track records in the reinsurance business, having founded and run F&G Re (part of U.S. F&G, now St. Paul's) for 14 years with a cumulative combined ratio of 91%. We look forward to Paul's wise counsel in the years to come.

I want to again highlight our website for you ([www.fairfax.ca](http://www.fairfax.ca)) and remind you that all our 16 Annual Reports are readily available there. Our press releases are immediately posted to our website. Our quarterly reports for 2001 will be posted to our website on the following days after the market close: first quarter – May 3, second quarter – August 7, and third quarter – November 6. Our Annual Report will be posted on March 8, 2002.

Again, on your behalf, I would like to thank the Board and the management and employees of all our companies for their dedication and commitment during an extremely difficult year.

March 1, 2001

*V. Prem Watsa (signed)*

V. Prem Watsa  
*Chairman and  
Chief Executive Officer*