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**FAIRFAX**  
FINANCIAL HOLDINGS LIMITED

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**1999 Annual Report**

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**1999 Annual Report**

**Five Year Financial Highlights**

*(in \$ millions except share and per share data)*

	<b>1999</b>	<b>1998</b>	<b>1997</b>	<b>1996</b>	<b>1995</b>
Revenue	5,788.5	3,574.3	2,088.3	1,475.8	1,145.5
Net earnings	124.2	387.5	232.5	150.8	87.5
Total assets	31,935.3	20,886.7	10,207.3	5,778.4	2,873.5
Common shareholders' equity	3,116.0	2,238.9*	1,395.7	911.1	472.6
Common shares outstanding - year-end <i>(mil.)</i>	13.4	12.1*	11.1	10.5	8.9
Return on average equity	4.3%	20.1%	20.4%	21.4%	20.1%
<i>Per share</i>					
Net earnings	9.20	32.63	21.59	15.36	9.79
Common shareholders' equity	231.98	184.54	125.38	87.05	53.28
<i>Market prices per share</i>					
High	610.00	603.00	403.00	310.00	100.00
Low	180.00	253.00	285.00	98.00	66.25
Close	245.50	540.00	320.00	290.00	98.00

\* not including share subscription receipts issued December 22, 1998 or their proceeds

## Corporate Profile

**Fairfax Financial Holdings Limited** is a financial services holding company whose corporate objective is to achieve a high rate of return on invested capital and build long term shareholder value. The company has been under present management since September 1985.

### *Insurance subsidiaries*

**Commonwealth Insurance**, based in Vancouver, offers commercial property and oil, gas and petrochemicals insurance in Canada, the United States and internationally, and commercial casualty insurance in Canada. The company has been in business since 1947. In 1999, Commonwealth's net premiums written were \$46.1 million. At year-end, the company had capital and surplus of \$148.3 million and there were 125 employees.

**Crum & Forster (C&F)**, based in Morristown, New Jersey, is a national commercial lines property and casualty insurance group in the United States that operates on a regional basis and produces business through a limited number of independent agents and brokers. The company has been in business since 1896. In 1999, C&F's net premiums written were US\$599.1 million. At year-end, the company had capital and surplus of US\$929.2 million and there were 1,400 employees.

**Falcon Insurance**, based in Hong Kong, writes property and casualty insurance to niche markets in Hong Kong. In 1999, Falcon's net premiums written were HK\$60.5 million (approximately HK\$5 = C\$1). At year-end, the company had capital and surplus of HK\$241.7 million and there were 42 employees.

**Federated Insurance**, based in Winnipeg, markets a broad range of insurance products in Canada primarily for commercial customers. The company has been in business since 1920. In 1999, Federated's net premiums written were \$69.9 million, consisting of \$55.6 million of property and casualty business and \$14.3 million of life and group health and disability products. At year-end, the company had capital and surplus of \$44.5 million and there were 266 employees.

**Lombard Insurance**, based in Toronto, writes a complete range of commercial and personal insurance products in Canada. The company has been in business since 1904. In 1999, Lombard's net premiums written were \$350.1 million. At year-end, the company had capital and surplus of \$183.7 million and there were 676 employees.

**Markel Insurance**, based in Toronto, is the leading trucking insurance company in Canada and has provided the Canadian trucking industry with a continuous market for this class of insurance since 1951. In 1999, Markel's net premiums written were \$54.8 million. At year-end, the company had capital and surplus of \$51.8 million and there were 125 employees.

**Ranger Insurance**, based in Houston, Texas, specializes in writing property and casualty insurance in the United States to niche markets such as propane distributors and agri-products. The company has been in business since 1923. In 1999, net premiums written were US\$88.3 million. At year-end, the company had capital and surplus of US\$120.4 million and there were 200 employees.

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**TIG Specialty Insurance**, based in Dallas, Texas, is licensed to write substantially all lines of property and casualty insurance in all states of the United States. The company has been in business since 1911. In 1999, TIG's net premiums written were US\$1,074.7 million. At year-end, the company had capital and surplus of US\$1,044.2 million and there were 730 employees. TIG was acquired on April 13, 1999.

### ***Reinsurance subsidiaries***

**CRC (Bermuda) Reinsurance**, based in Bermuda, continues to be a major reinsurer of Lombard Insurance. In 1999, net premiums written were \$123.8 million. At year-end, the company had capital and surplus of \$119.8 million.

**ORC Re**, based in Dublin, Ireland, was established in 1997 and writes selected long term property and casualty reinsurance. In 1999, ORC Re's net premiums written were US\$644.2 million. At year-end, the company had capital and surplus of US\$1,175.7 million and there were 6 employees.

**Wentworth Insurance**, based in Barbados, was incorporated in 1990. In 1999, Wentworth's net premiums written were US\$2.2 million. At year-end, the company had capital and surplus of US\$158.9 million and there were 7 employees.

### **Odyssey Re Group**

Odyssey Re Group underwrites treaty and facultative reinsurance as well as certain insurance business from five centers: Stamford (Connecticut), London, Paris, Singapore and Mexico City. Underwriting operations are also conducted from offices in Atlanta, Bermuda, Chicago, Cologne, Miami, New York, San Francisco, Stockholm and Toronto. In 1999, the Group's net premiums written were US\$859.2 million. At year-end, the Group had capital and surplus of US\$1.4 billion and there were 467 employees.

**Odyssey America Reinsurance**, based in Stamford, Connecticut, underwrites property and casualty reinsurance in the United States and Canada. In 1999, Odyssey America Re's net premiums written were US\$579.0 million. At year-end, the company had capital and surplus of US\$1,013.3 million. London market business is underwritten through Odyssey America Re's branch office located at the London Underwriting Centre, as well as through Syndicate #1218 at Lloyd's. In 1999, London's net premiums written (included in Odyssey America Re's net premiums written) were US\$101.8 million.

**Compagnie Transcontinentale de Réassurance (CTR)**, based in Paris, France (with a branch in Singapore), writes property and casualty and life reinsurance internationally. In 1999, CTR's net premiums written were US\$234.8 million. At year-end, the company had capital and surplus of US\$123.3 million.

### ***Runoff subsidiaries***

**Sphere Drake** ceased active underwriting effective May 25, 1999 as part of Odyssey Re Group's consolidation of its London market operations on the acquisition of TIG Re. At year-end, the company had capital and surplus of US\$257.4 million and there were 144 employees.

**Odyssey Re Stockholm** manages a runoff reinsurance portfolio retained when the company (then called Skandia International) was acquired. At year-end, the company had capital and surplus of SEK503.5 million (approximately SEK6 = C\$1) and there were 21 employees.

**The Resolution Group (TRG)** was formed in 1993 to manage the runoff of International Insurance and other discontinued lines of business written by the former Talegen group of insurance companies. The runoff required effective management of major direct excess and surplus lines insurance and reinsurance liabilities, the resolution of complex litigation and the collection and management of reinsurance assets. At year-end, International Insurance had capital and surplus of US\$531.2 million and there were 97 employees. An effective 27.5% equity (100% voting) interest in TRG was acquired on August 11, 1999.

**RiverStone Group (RiverStone)** was established following the acquisition of TRG to manage the runoff of certain Fairfax insurance subsidiaries and other discontinued lines of business written by other Fairfax companies. RiverStone is managed separately from TRG by TRG management and provides its services only to Fairfax and its subsidiaries. RiverStone manages the Sphere Drake and Odyssey Re Stockholm runoff operations.

### ***Claims adjusting and insurance brokerage***

**Lindsey Morden Group** is engaged in providing claims adjusting, appraisal and loss management services to a wide variety of insurance companies and self-insured organizations in Canada, the United States, the United Kingdom, continental Europe, the Far East, Latin America and the Middle East. In 1999, revenue totalled \$443.1 million. The company was established in 1923, and at year-end the group had 3,766 employees located in 350 offices.

**The Hub Group** is an insurance brokerage company with 1,370 employees in over 100 offices in Canada and the United States. The company sells a broad range of commercial, personal and life insurance products.

### ***Investment management subsidiary***

**Hamblin Watsa Investment Counsel** provides discretionary investment management, primarily to the insurance, reinsurance and runoff subsidiaries of Fairfax and pension funds. Hamblin Watsa was founded in 1984, and at year-end managed approximately \$16.2 billion.

*Note: All companies are wholly owned except TRG (as noted above); Lindsey Morden Group, a public company of which Fairfax owns 59% of the equity and 85% of the votes; and The Hub Group, a public company of which Fairfax owns 40%.*

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## **To Our Shareholders**

It happened again. For the third time in 14 years and the first time in the last five years, we did not earn a return on equity in excess of 20%. We earned 4.3% on shareholders' equity in 1999 (versus 6.2% for the TSE 300) – the lowest return on equity since we began in 1985 and the first time we have not earned as much as the TSE 300. And it gets worse! Net income after taxes dropped by 68% to \$124.2 million, while earnings per share dropped by 72% to \$9.20 per share because of a 12% increase in shares outstanding. Book value per share, however, increased by 26% to \$231.98 while our share price dropped by 55% to \$245.50 per share from \$540 at year-end 1998. From a net income and return point of view, there is no question that 1999 was the worst year we have had in our 14 year history.

While 1999 was very disappointing, Fairfax has had an enviable track record since we began in 1985. Book value per share has compounded at 40% annually while our stock price, even after the decline in 1999, has compounded at 36% annually. In fact, there are only two companies in Canada and eight in the U.S. whose stock price has compounded at a rate faster than ours over the last 14 years. While the low return on equity in 1999 resulted in our long term average return on equity slipping slightly below our objective of 20% (to 19.2%) since inception, there were only two companies in Canada and 75 companies in the U.S. that have had a higher return on equity than ours over the period. In fact, in the U.S. property and casualty industry, there is only one company that has had a higher ROE than Fairfax in the last 14 years and *none* have compounded book value or stock price as fast. So you can see why we are so grateful for this long term record – which has been achieved during the longest and toughest *down-cycle* in the history of the property and casualty insurance business.

Having given you the bad (quantitative) news about 1999, let me highlight for you the good (qualitative) news that will impact Fairfax in the years to come. Fairfax enters 2000 with the strongest management team at both the subsidiary and holding company level that it has ever had. While we have always emphasized underwriting profit, today, at Fairfax, there is a renewed focus on achieving a 100% combined ratio by each President. Anything less is *unacceptable*. Also, we ended the year 1999 in the strongest financial position in our history with cash and marketable securities at the holding company in excess of \$700 million and long term undrawn, unsecured bank lines in excess of \$1.3 billion. In our letter to you on November 3, 1999 (reprinted in Appendix I), which was prompted by the significant decline in our stock price, we discussed these factors further and also commented on stock price fluctuations and intrinsic value. As we know this is a subject near and dear to your heart, we felt we should review this again for the benefit of those who may not have read this letter.

The table below shows Fairfax's annual stock price fluctuations compared to intrinsic value as represented by return on shareholders' equity (ROE) and annual book value changes.

### **Intrinsic Value vs Stock Price Fluctuations**

	<u>INTRINSIC VALUE</u>		<u>STOCK PRICE</u>
	ROE %	% Change in Book Value* Per Share	% Change in Stock Price
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
<b>1985-1999</b>	<b>19.2%</b>	<b>+ 40%</b>	<b>+ 36%</b>

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

In our 1997 Annual Report, we discussed the relationship between intrinsic values and book values and the fact that return on shareholders' equity is the link between them as future earnings will be determined by the return on equity. We have stated many times that for Fairfax, the percentage change in book value is a good first approximation of the percentage change in intrinsic value in any single year.

From the table the following observations can be made.

- 1) Book value has never decreased and has in fact compounded at 40% annually over the 14 year stretch. Even after a significant decline in stock prices in 1999, over the long term, stock prices and book values (and thus intrinsic values) have compounded at roughly comparable rates. In the past, depending on the year-end, stock prices have compounded at slightly higher or slightly lower rates than book value – but always roughly comparable. Some of you book value skeptics may want to note page 71 which shows that investments per share have compounded at 46% annually over the past 14 years. Growth of investments per share and investment income per share of course ultimately drives the growth of earnings per share and book value per share.
- 2) On a yearly basis, stock price changes have no correlation with book value or intrinsic value changes. In 1986, Fairfax's stock price increased by 292% even though the book value only increased 183%. In 1990, our stock price *dropped* 41% even though our book

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value *increased* 39% and Fairfax earned a 23% ROE. A careful examination of the table will show you that stock price fluctuations on an annual basis are quite random but reflect economic reality (or intrinsic value) only in the long term. In 1999, our stock price dropped 55% even though book value has increased 26% and investments per share have increased 30% to \$1,299 per share. As in 1990, the stock market is not reflecting the build-up of long term intrinsic value at Fairfax but the short term volatility in its earnings.

- 3) So do annual stock price fluctuations connote high risk? Was the price decline in 1990 or in 1999 because Fairfax was a very risky company? Not at all! As I have said previously, Fairfax has the best management team it has ever had and is in the strongest financial position since it began in 1985. Stock price fluctuations reflect short term earnings and are based on emotions of the day and do not reflect the long term fundamentals of the company.

So how do we feel about the stock price decline in 1999? First of all, much poorer!! Remember, directors, officers and employees of the company own 16% of the shares outstanding and have not sold any shares of consequence. All the key officers of Fairfax, including myself, most of our directors, the principals at Hamblin Watsa and most of our subsidiaries' Presidents have a very significant portion (more than 90% in my case) of their net worth in Fairfax shares. So we certainly believe in eating our own cooking! Having said that, we have consistently advised you that Fairfax is run for the long term, that quarterly earnings surprises will come and will not bother us (no profit warnings from Fairfax), and that you should be prepared for stock price fluctuations of 50-60% as they have happened before for Fairfax – and almost every other company listed on the TSE or NYSE at one time or another.

We have also said (as recently as in our 1997 Annual Report) that we would not respond to stock price fluctuations (i.e. answer telephone calls from worried investors) and our press policy would be maintained (i.e. no comment!). We take very seriously our responsibility to disclose the pluses and particularly the minuses to you each year and feel very comfortable that we have done exactly that over the past 14 years. Any further comment is unnecessary and distracting. Our belief is that results will prevail in the long term and short term promotion of Fairfax is neither necessary nor desirable.

So we feel satisfied that we have adequately warned you about the possibility of fluctuations and have always emphasized the long term. In fact, when we sold shares at \$500 for the TIG acquisition, we told our investors that we expected them to make a good return in the long term – as no one knows what will happen in the short term. There is no change in our expectations. As we said in our 1994 Annual Report, “we are concerned about making our investors look good in the long term – not in the short term”. So while we feel good about warning you about short term fluctuations, we hope to make you feel even better in five years time when, based on our performance, these fluctuations will be as irrelevant as the ones in 1990 were. I should add that my multiple voting shares allowed me to sleep a little better in 1999. Sorry, no takeovers at Fairfax!

There is a silver lining in every cloud. Because of the very significant decline in our stock price, we were able to buy back 706,103 shares of Fairfax at an average price of \$293 per share –

approximately 5% of the shares outstanding. So far in 2000, we have repurchased an additional 244,044 shares at an average price of \$190 per share. In 1990, under similar conditions, we repurchased 1.8 million shares or 25% of the shares outstanding at approximately \$9 per share – one of the better investments we have made!

As far as buybacks are concerned, please note:

- 1) We have always considered investing in our stock first (i.e. stock buybacks) before making any acquisitions. We do not plan to issue our stock at prices less than \$500 per share to buy another company – however attractive it may be.
- 2) We issued 1 million shares for the purchase of Crum & Forster (C&F). By repurchasing almost 1 million shares while maintaining our very strong financial position, we feel our shareholders will have been able to effectively buy C&F at no cost or dilution to them. We are now working on TIG!!
- 3) Similar to our acquisition policy, we will not buy back our shares at the expense of our financial position.

While buying back shares at attractive prices does not increase the total intrinsic value of the company, it significantly increases *the intrinsic value per share* of the company. Also, by shrinking the denominator, it will help us achieve our 20% return on equity objective over time.

In March of 1999, we issued US\$275 million in seven year bonds with a coupon of 7<sup>3</sup>/<sub>8</sub>% to finance the purchase of TIG. In the fourth quarter, we issued two tranches of Fairfax preferred securities for \$400 million: \$200 million of perpetual preferred shares with a five year reset provision (please see note 7) and \$200 million (US\$136 million) of RHINOS (through Fairfax Inc., our U.S. holding company), which are quasi-preferreds with a three year maturity (please see note 6). Both preferreds were issued to raise cash in the holding company and provide us with additional resources to repurchase our shares.

As you know, we have encouraged our Presidents and key executives in our subsidiaries and in the holding company to own shares of Fairfax through interest-free loans. While this worked well in Canada, it was less effective on a global basis for tax and other reasons. So late in 1999, we implemented a restricted stock plan for our key management with vesting periods of up to ten years. As in the loan plan, these shares are purchased in the open market, financing costs are expensed as incurred and principal is amortized over the term of the plan. We expect this to be a significant plus for our key executives. The total cost for all these share plans is \$74.9 million (520,734 shares at an average cost of \$144 per share). Annual after-tax principal and interest costs (at 7% interest) are about \$7 million or \$0.53 per share.

Also, in late 1999, for the first time we implemented a plan that similarly awards restricted stock every year, equal to 5% of salary, to each and every employee of our insurance and reinsurance subsidiaries if their company achieves its combined ratio objective for the year. This is in addition to the employee share purchase plan described in past Annual Reports.

It has been more than ten years since we developed our guiding principles for Fairfax based on the three objectives that we have had from our inception in September 1985. We have made

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the point that everything can be changed in our company except these guiding principles that have served us so well for so long. These guiding principles are now so entrenched in our company that we have decided to share them publicly in Appendix II (we waited to make sure our guiding principles “guide” before sharing them with you). The key section in our guiding principles is the section on values. We have clearly stated that we do not want to succeed at the expense of our values.

In its first year of operation, The Hub Group, under John Varnell and Rick Gulliver, completed a significant number of acquisitions of insurance brokers in Canada and entered the U.S. through the purchase of Mack & Parker. Marty Hughes, President and CEO of Mack & Parker, joins Rick Gulliver as the management team responsible for The Hub Group’s North American operations. In one year, The Hub Group has become the buyer of choice and the third largest insurance broker in Canada. The opportunities for growth in the U.S. are significant. We continue to be very excited about the possibilities of The Hub Group in the long term. For more information, please read The Hub Group’s first annual report, which you can get by phoning Pat Hios at 416-979-5866.

An extremely important strategic acquisition for us in 1999 was the purchase of TRG Holdings, the company that manages the runoff of International Insurance Company and other discontinued lines of business written by the former Talegen group of insurance companies. We purchased TRG because of its excellent management team led by Michael Coutu and Dennis Gibbs who run among the best runoff operations in the U.S., including the resolution of complex litigation, the collection of reinsurance assets and the settlement of environmental and other latent claim litigation. We purchased all the Class 1 common shares of TRG for US\$97 million which is below the Class 1 shareholders’ US\$140 million share of TRG’s underlying net assets. The outstanding Class 2 non-voting, participating preferred shares continue to be held by Xerox Financial Services, Inc. TRG owns International Insurance Company and has an investment portfolio of US\$1.1 billion and total Class 1 and 2 shareholders’ equity of US\$0.5 billion.

With this acquisition, TRG management, through RiverStone, will be responsible for the management of all runoff operations, the settlement of environmental and other latent claims, the collection of impaired reinsurance recoverables and the resolution of complex litigation for all Fairfax companies. We welcome Michael Coutu, Dennis Gibbs and all the employees of TRG and RiverStone to the Fairfax Group and look forward to their very significant contributions to our group.

In June 1999, we had the opportunity to purchase approximately 6.6 million shares of Zenith National Insurance Corp. (about 38.4% of the shares outstanding) at US\$28 per share – a little higher than the underlying book value of approximately US\$26 per share at the time. Zenith National, a specialist in workers’ compensation insurance, particularly in California, has been run by Stanley Zax since 1977. Stanley has among the best records in the business with a combined ratio of 102.9% over the past 21 years, and under his watch, book value per share has compounded at approximately 19% per year. You can understand why we paid a premium for Zenith!!

In last year's Annual Report, we mentioned the fact that Sphere Drake (formerly Odyssey Re London) had entered into various reinsurance contracts principally covering personal accident and workers' compensation risks which were in dispute. Later, in March 1999, we commenced litigation over these contracts, the first time we have ever commenced legal proceedings. Since that time, the workers' compensation fiasco, particularly Unicover, has hit front page news. Essentially what happened was U.S. primary workers' compensation insurers were buying very cheap reinsurance by retaining most of the premium and passing most of the losses to their reinsurers – who then passed it on to their reinsurers who in turn passed it along to their reinsurers who in turn passed it along to their reinsurers – and the chain continued through many levels and then it appears that these losses were passed back again to the top of the chain, causing what is known in the business as “a spiral”. The industry discovered this spiral in 1999 and many participants, including Sphere Drake, rescinded the contracts and returned the premiums to the ceding companies. More recently, there have been many settlements up the chain which is good news for Sphere Drake as it means the losses are unlikely to flow down the chain. While it will likely take some time to finally settle this fiasco, we think it is very unlikely to be significant for Fairfax (even if our first defence, the rescission of our contracts, is not successful) because of the following reasons:

- 1) The primary workers' compensation insurance companies, the major beneficiaries of these contracts, have a huge incentive to settle as they have to pay their customers' claims immediately and then try to collect from their reinsurers, many of whom have rescinded their contracts alleging misrepresentation, fraud, etc. The incentive for the industry to put this behind it is very high.
- 2) Sphere Drake received cumulative gross premiums from this business of US\$27 million. Although the final impact of these contracts will not be known for some time, Sphere Drake's net exposures reported under these contracts through the end of 1999 have not been material.
- 3) Our US\$1 billion Swiss Re cover (more on this later) protects Fairfax from potential losses from these contracts.

Andy Barnard and others at Odyssey Re Group spent much time on this problem during 1999 but were happy to pass this on to TRG for resolution. In the future, these types of problems (hopefully we won't have any!) will not distract our operating management as they will be passed on to TRG immediately.

The purchase of TIG, the lawsuit in Sphere Drake and the relatively low after-tax cost resulted in Fairfax purchasing a US\$1 billion adverse loss development reinsurance cover from a AAA rated subsidiary of Swiss Re Group. This cover protects Fairfax from development in claims and uncollectible reinsurance above the reserves set up by our insurance and reinsurance subsidiaries (including TIG but not International Insurance) as of December 31, 1998. As mentioned earlier, this includes the potential workers' compensation claims from Sphere Drake.

At December 31, 1999, Fairfax ceded US\$191 million to Swiss Re in respect of TIG's strengthening of 1998 and prior claims. This adverse claims development was fully reflected in the purchase price for TIG, which was at a US\$280 million discount to book value (as described

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on page 68 in the commentary to the TIG balance sheet at the date of acquisition). In addition, we ceded a further US\$60 million to Swiss Re in respect of other subsidiaries' 1998 and prior claims, principally relating to Ranger, C&F and Sphere Drake.

The protection provided by this cover is in addition to the vendor indemnifications and other reinsurance protections of \$1,804 million received by Fairfax (including a \$254 million indemnification now provided by a Fairfax reinsurance subsidiary, as described on page 67) and by Fairfax's accumulated negative goodwill and other purchase provisions of about \$550 million. These protections are, in the main, why we stated in our November 3, 1999 letter that Fairfax has a rock solid balance sheet.

In our 1997 Annual Report, I said that a major strength at Fairfax is a lean head office team which is experienced in monitoring operations and reacting quickly to opportunities but always focusing on downside protection from worst case events. In 1999, the Fairfax team excelled at protecting the company from worst case events as the earlier discussion on the US\$1 billion reinsurance cover shows. The head office team grew again in 1999 as Jean Cloutier (actuarial) joined us from Lombard and David Ma (systems) joined us from Markel, while Jim Migliorini (reinsurance underwriting), Scott Galiardo (actuarial) and Denise Davies (systems) from Odyssey Re Group joined our small U.S. holding company office. These additions add tremendous depth to Fairfax. Please don't extrapolate this growth!!

In 1999, we had our first retirement at the holding company. Brenda Harvey, our Corporate Secretary, who was responsible for our name (fair, friendly, acquisitions), these Annual Reports and for providing organization and stability amidst the general confusion and chaos created by your Chairman, has retired. Now you know the real reason for the collapse in our stock price! We will miss Brenda and, on behalf of all of you, we want to thank her again and wish her a very happy retirement. We welcome Elizabeth Murphy, formerly Secretary Treasurer of Commonwealth, as our new Corporate Secretary. Promotion from within is alive and well at Fairfax!

Y2K came and went and we had no problems anywhere in the Group because of the hard work and careful planning by all our systems people across our companies. Externally, Y2K is another example of a "popular" issue never becoming a problem; it's always the unexpected that can be lethal!

While we are hugely skeptical about internet stocks and their valuations (more later), we do think the internet will affect us and others significantly – and can perhaps help provide entrepreneurial companies, like ours, with a competitive edge. Sam Chan is in charge of implementing this technology at Fairfax, working closely with the Presidents of each of our subsidiaries.

The table below shows the sources of our net earnings:

	<b>1999</b>	<b>1998</b>
	<i>(\$ millions)</i>	
Insurance underwriting	(617.1)	(311.4)
Interest and dividends	711.5	432.0
<i>Total</i>	94.4	120.6
Realized gains	121.7	440.8
Runoff	(54.2)	–
Claims adjusting (Fairfax portion)	2.8	12.4
Interest expense	(129.3)	(84.4)
Goodwill and other amortization	(5.1)	(5.0)
Swiss Re premium	(35.3)	–
Corporate overhead and other	(20.2)	(15.9)
Pre-tax income (loss)	(25.2)	468.5
Less: (recovery of) taxes	(158.0)	81.0
Less: non-controlling interest	8.6	–
Net earnings	<u>124.2</u>	<u>387.5</u>

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 (from July 1, 1999) 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 (\$3.6 million). The corporate overhead expense is net of Hamblin Watsa's pre-tax income and interest income on Fairfax cash balances and includes one time expenses associated with our acquisitions and our issues of securities (don't worry – overhead at Fairfax has not increased much). The first year's premium payable to Swiss Re of \$35.3 million is shown separately. 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 80 to 85.

The very large underwriting loss in 1999 was mainly due to C&F (\$211.1 million), TIG (\$64.2 million) and Odyssey Re Group (\$247.4 million). Catastrophes significantly impacted us in 1999 as there were more than ten worldwide catastrophes compared to a more normal one or two. Catastrophes in 1999, including earthquakes in Taiwan, Turkey and Colombia, windstorms in Europe and Florida and typhoons in Japan and Korea, cost us \$190 million. Almost makes you nervous watching the weather channel!

Interest and dividend income, as well as interest expense, increased because of the C&F acquisition in 1998 and the TIG and TRG acquisitions in 1999. Lindsey Morden's contribution declined significantly while corporate overhead and other increased because of the above-mentioned one time expenses.

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Our runoff operations (TRG, Odyssey Re Stockholm and Sphere Drake) cost us \$54.2 million, mainly because of losses from Sphere Drake's unearned premium (on transfer to runoff), including losses from the European storms.

Realized gains dropped significantly in 1999 and, combined with the significant underwriting losses, were the main reason for the pre-tax loss in 1999 – the second time we have had a pre-tax loss in our history, the first time being 1990! We had a tax recovery of \$158.0 million because our underwriting losses were in high tax jurisdictions while other income was earned in areas with lower tax rates.

Book value increased from \$184.54 to \$231.98 per share, as a result of increases from our share issue and our earnings and a reduction from our repurchase of shares above book value.

### **Insurance operations**

The table below shows the combined ratios of each of our companies for 1998 and 1999. As you can see, 1999 was a disaster for almost all our underwriting operations. There is no other word for it. I am embarrassed by these results and apologize for them – particularly because I do feel that we have an outstanding group of companies run by an exceptionally talented group of Presidents. None of our companies achieved our 100% combined ratio. In fact, Commonwealth had its worst year ever! Our Canadian insurance operations had a very poor year with a combined ratio of 114.9%. Ranger continued to have an unacceptable combined ratio of 149.4%. C&F had a combined ratio of 120.9%, more than 4 points worse than 1998 and 11 points worse than our expectations. TIG was also worse than we expected at 109.7% before purchase adjustments (105.6% after purchase adjustments). Odyssey Re Group, largely due to catastrophes, had a very poor year in 1999. While the industry was highly competitive again in 1999, our performance was significantly worse. We suffered a year in 1999 in which the risks of the insurance business were crystallized widely and substantially throughout all our companies. Catastrophes and a high frequency of large losses in a very soft (read underpriced) insurance market took their toll on all our insurance operations. Excluding the impact of

catastrophes, the total combined ratio for 1999 was 110.1%, compared with 110.9% excluding catastrophes for 1998.

	<b>1999</b>	<b>1998</b>
	%	%
Commonwealth	186.7	108.5
Federated	113.8	100.1
Lombard	105.0	102.8
Markel	104.6	106.8
<i>Total Canadian insurance</i>	<i>114.9</i>	<i>105.2</i>
Ranger	149.4	156.8
C&F	120.9	116.6
TIG	105.6	-
<i>Total U.S. insurance</i>	<i>111.8</i>	<i>123.2</i>
Odyssey Re Group*	119.4	115.6
<i>Total reinsurance</i>	<i>119.4</i>	<i>115.6</i>
<i>Total</i>	<i>114.6</i>	<i>113.0</i>

*\* includes Sphere Drake for six months in 1999*

Having not sugar-coated the results for 1999, I must tell you that we have the strongest group of Presidents running our decentralized operations that we have ever had. In 2000, we expect all our Canadian companies to get back to the 100% or better combined ratio they have achieved in the past. Ranger has a target of 100%; TIG, 105%; C&F, 110% (a stretch given their starting point); and Odyssey Re Group, 104%. Our consolidated target combined ratio for the Fairfax Group in 2000 is 105% and all our companies are striving for 100% in 2001. We have to prove to you (and ourselves) that we can achieve these results in 2000.

If Commonwealth hit an air pocket in 1998, in 1999 it went into a tail spin! Because of a combined ratio of 186.7%, Commonwealth suffered its first net loss after taxes in its history. John Watson and Ron Schwab and their management team have analyzed the results and, with hindsight, feel there was little they would do differently in 1999. Commonwealth suffered from an unprecedented number of large and medium sized losses arising mainly from its Oil, Gas & Petrochemicals and U.S. Property business written in the 1998 underwriting year, combined with declining premium income, the soft insurance market and the company's willingness to walk away from underpriced accounts. Higher reinsurance costs in its Oil, Gas & Petrochemicals division further exacerbated the results. In 1999, gross premiums written dropped 13% to \$170.9 million while net premiums written dropped by 37% to \$46.1 million. Commonwealth lost \$12 million after taxes.

Federated, under John Paisley's leadership, had an unusually poor year (for them!) with a combined ratio of 116.4% for the P&C company (113.8% including the life operations). This is only the second time in the last ten years that Federated had a combined ratio above 100%. Again, a high frequency of large losses, combined with some reserve strengthening, were the

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main culprits. John has raised prices, increased deductibles and discontinued the propane line – he is clearly focused on not allowing this to happen again.

Federated's P&C company's gross premiums written increased by 3% to \$63.6 million while its net premiums written also increased by 3% to \$55.6 million. Federated maintained a competitive expense ratio of 30.0%. It earned \$2.3 million after taxes in 1999 versus \$8.1 million in 1998.

Lombard's combined ratio increased significantly in 1999 to 105.0%, much to Byron Messier's chagrin. Byron and his management team are focused on reversing the negative trend since they first hit 100% in 1996.

Excluding the continuing high marketing costs for the Privilege 50 program and the final expenses related to the Year 2000 issue, Lombard had a combined ratio of 102.7%.

Net premiums written from the Privilege 50 program increased by 15% to \$29.8 million in 1999. While the loss ratio on this business was higher, in the 84% area, lower marketing costs resulted in a combined ratio of 115.0% (144.5% in 1998) for this program. This program is now maturing and, as we expected, the results are beginning to improve. We continue to expect this to be a good program for Lombard and its customers in the future.

Lombard's gross premiums written (including CRC (Bermuda)) remained steady at \$511.4 million (\$512.4 million in 1998), while net premiums written decreased a little to \$466.5 million. Net income after taxes dropped by 43% to \$29.7 million due to lower realized gains.

In a very competitive and extremely soft market, Falcon, led by Kenneth Kwok, has been very careful about writing business. Falcon wrote HK\$60.5 million (C\$12.1 million) in net premiums in 1999 with a combined ratio of 165.1%, as it is still in a start-up phase. We have an extremely talented group of employees at Falcon but are not interested in writing business at unprofitable rates. We are very patient!

Markel had another steady year in 1999 with a combined ratio of 104.6%. Mark Ram and his team have continued to provide consistency during an extremely soft trucking insurance market while their competitors have suffered severe underwriting losses. Markel's combined ratio over the past five years, while not meeting our 100% target, has averaged a steady 103.9%. The company is well on the way to achieving the 100% mark. Markel continues to provide unique value added services and products designed to increase insured and broker loyalty over the long term. Gross premiums written were steady at \$77 million while net premiums written decreased by 7% to \$54.8 million. Net income after taxes was a little lower at \$5.6 million.

Phil Broughton downsized Ranger significantly in 1999, discontinuing approximately half the book of business and reducing expenses commensurately. Phil reduced the agency force from 600+ agents to 100 as he cancelled unprofitable and unproductive agents. While these were very dramatic actions, they were very much needed. There is no substitute for long term profitability in any business. The time had come to take action and Phil took it. While the combined ratio was 149.4% (121.2% after internal stop loss), reflecting higher losses in the discontinued lines and higher ALAE reserves, we can finally, under Phil's strong leadership, see

the light for Ranger at the end of a very long tunnel. Gross premiums written declined from US\$211.2 million in 1998 to US\$137.6 million in 1999 while net premiums written dropped by 32% to US\$88.3 million. Ranger's continuing lines book in 2000 is expected to be just over US\$80 million. Ranger had a pre-tax loss of US\$25.6 million in 1999 (before stop loss) versus US\$48.5 million (before stop loss) in 1998. Although Ranger produced an unacceptable combined ratio in 1999, we believe that the enormous changes executed during the year by Phil and his team will yield significant profits in the years to come. I know some of you are saying, "Show me"!!

The major plus for C&F (and Fairfax) was that Bruce Esselborn joined the company in October 1999 to become Chairman and CEO. Bruce was with AIG for almost 20 years before leaving in 1986 to found United Capitol Insurance Company, an excess and surplus lines insurer. United Capitol was sold to Capsure Holdings, a NYSE-traded insurance holding company of which Bruce became President. After selling Capsure to CNA in 1997, Bruce was a consultant with Marsh & McLennan Capital for 18 months before joining C&F. The average combined ratio for Capsure and United Capitol for the years that Bruce ran these companies was significantly below 100%.

Also in the fourth quarter, Mary Jane Robertson, Bruce's Chief Financial Officer at both United Capitol and Capsure, joined C&F as Executive Vice President and CFO, along with Nick Antonopoulos, an AIG and Marsh & McLennan Capital colleague of Bruce's, as Executive Vice President and COO. With this management team in place, we at Fairfax feel very confident that Crum & Forster will once again become an excellent underwriting company. Fairfax's ability to attract management of the caliber of Bruce Esselborn and his team is a major long term strength of the company.

In 1999, C&F's gross premiums written declined 15% to US\$745 million while net premiums written declined 23% to US\$599 million. As I mentioned earlier, C&F had a combined ratio of 120.9% in 1999 and, after a US\$32 million restructuring charge, it lost US\$20 million after taxes.

1999 was a year of significant consolidation for Odyssey Re Group under Andy Barnard's leadership. The most important step forward in 1999 has been the successful merger of Odyssey Reinsurance (New York) and TIG Re. The resulting company, Odyssey America Re, is now a commanding presence in the North American broker reinsurance market, ranking among the largest reinsurance companies in the United States, with annual net premiums written of approximately US\$580 million and capital and surplus of US\$1.0 billion.

Under the leadership of Andy, Mike Wacek and Roland Jackson, the combination of two separate companies into a new, single company took place briskly and effectively. Within Odyssey America Re, Mike has reorganized our treaty, program and Latin divisions around first rate managers who will lead our underwriting efforts in the future.

Also, at the end of 1999, Andy strengthened the management of our overseas operations by appointing Lucien Pietropoli the new General Manager of our businesses run from Paris and Singapore, while Jean-Philippe Casanova continues as Chairman. Lucien will bring over 20 years of strong underwriting experience in the global reinsurance markets to the task of charting our way forward in the overseas markets in the coming years.

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In London, the U.K. operations of Odyssey Re were consolidated into the TIG Re branch and Odyssey Re London ceased active underwriting and is now under the management of TRG. The David Newman Syndicate at Lloyd's will remain part of Odyssey Re whereas we are reviewing our options for Kingsmead (Lloyd's syndicates).

In 1999, Odyssey Re Group had a combined ratio of 119.4% mainly because of worldwide catastrophes which cost US\$86 million or 9.9% on the combined ratio. In fact, CTR experienced the worst year in its history. Andy's objective in 2000 is to have the Group achieve a combined ratio of 104% – with no exceptions!! We continue to be confident about the long term prospects for underwriting profits for Odyssey Re Group under Andy's leadership.

TIG Specialty Insurance Solutions (the new name for TIG Insurance Company), led by Courtney Smith, had an excellent first year as part of Fairfax even though they did not meet the 105% combined ratio objective for 1999. Courtney was able to attract Scott Donovan (CFO), Fred Fontein (underwriting) and Jim O'Brien (claims) from his previous employer, joining Steve Brett, Frank Taylor, Lon McClimon and Bill Huff at TIG, to form a very strong management team. Courtney and his team have restructured the organization and focused it on achieving a 100% combined ratio by 2001 (105% in 2000). It will take longer than we expected to achieve underwriting profitability but there was significant work to be done. At Fairfax, we feel comfortable that Courtney and TIG will achieve their objectives in 2000 and 2001.

TIG's gross premiums written in 1999 were US\$1,551 million versus US\$1,597 million in 1998. Net premiums written increased 7% to US\$1,075 million and the combined ratio for 1999 was 109.7% before purchase adjustments. Net loss after taxes, since acquisition, amounted to US\$24 million.

Our insurance companies continue to be well capitalized as shown on page 74.

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 1999? We provide extensive disclosure on our claims reserves beginning on page 54 in the MD&A. In Canada, our insurance companies had redundancies of \$8 million in 1999 while in the U.S. Ranger and C&F had an aggregate deficiency of US\$30 million. Our reinsurance companies had an aggregate redundancy of US\$16 million after the impact of foreign exchange on reserves (an aggregate deficiency of US\$11 million before that impact). We continue to work to get our U.S. and reinsurance reserves to the standards of our Canadian reserves.

When we purchased Lombard five years ago, we had a reserve indemnification of \$40 million. This was settled during the year for no payment as there was no reserve development since our purchase.

Ranger, however, was a different story. Adverse reserve development far exceeded our indemnification of US\$20 million and so we are realizing value from the real estate assets backing this indemnification.

### **Claims adjusting**

1999 was a year of consolidation for Lindsey Morden also. The merger of Ellis & Buckle with the U.K. operations of Cunningham Group was completed, creating Cunningham Ellis & Buckle, the largest loss adjuster in the U.K., while the Canadian operations are being restructured under Ferd Roibas' leadership. In spite of these significant changes and a consolidating marketplace, under Ken Polley's leadership, Lindsey Morden generated record free cash flow, excluding the effect of overfunding pension contributions, of \$25.6 million or \$2.17 per share.

We have a very strong management team at Lindsey Morden with Ken Polley, Ferd Roibas, Don Smith (U.S. operations), Gerry Loughney and Andrew Lund (U.K.), Pim Polak Schoute (Europe) and Jim Grant (International). Ferd Roibas, Lindsey Morden's Chief Financial Officer, has been promoted to Executive Vice President and Chief Operating Officer, with his first assignment being the Canadian operations. Ken is on the lookout for an outstanding CFO to replace Ferd. The management team is very focused on increasing free cash flow in 2000 and achieving their goal of 20% free cash flow return on equity.

Because of record free cash flow and a strong financial position, the board of Lindsey Morden will continue to review its dividend payout of \$1.00 per share during 2000. As one of the very few global adjusters in the world, with 350 branches and almost \$450 million in revenue, Lindsey Morden has excellent possibilities ahead. Now it has to capitalize on these opportunities.

As actions speak louder than words, you may be interested in knowing that in 1999 we purchased 768,700 shares of Lindsey Morden, at an average price of \$20 per share, to own a total of over 7,000,000 Lindsey Morden multiple and subordinate voting shares.

### **Investment management**

Remarkably, 1999 was another good year for the U.S. and Canadian equity markets. The international equity markets also did very well. While our equity results did not keep pace with the U.S. markets, we did very well in the Canadian and international markets. The U.S. bond market had one of its worst years ever in 1999 and our bond results reflected this.

The key, of course, is long term and as shown in the table below, HWIC has produced excellent results in all of the areas in which it provides investment management – Canadian and U.S. equities and Canadian and U.S. bonds. HWIC now shows 20 year results as the investment team, consisting of five partners, has worked together for over 25 years.

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*Annualized rates of return (%)*

*Cumulative periods ended December 31, 1999*

	<b>5 years</b>	<b>10 years</b>	<b>15 years</b>	<b>20 years</b>
Canadian Equities	14.2	11.4	14.4	14.6
TSE 300	17.0	10.6	11.8	11.4
U.S. Equities	18.8	20.0	18.5	19.0
S&P 500	29.3	20.8	19.6	19.1
Canadian Bonds	10.6	11.5	11.9	–
SM Index	9.9	10.1	10.9	–
U.S. Bonds	7.3	8.5	–	–
ML Index	7.0	7.1	–	–
Balanced Fund	11.7	12.0	14.1	–

*Source: Representative balanced fund managed by HWIC for fifteen years. Equity results for an additional five years are from the organization for which the principals previously worked.*

Total fees in 1999 were \$16.0 million, up from \$12.3 million in 1998 mainly because of the addition of C&F, TIG and TRG. Fairfax earned a 24% pre-tax cash return in 1999 on its \$14 million investment in HWIC. Cumulatively, on a pre-tax basis, Fairfax has earned 215% since it acquired HWIC in 1992. On our books, HWIC has been depreciated down to \$4 million, on which we earned a pre-tax income of \$3.4 million in 1999.

### **Financial position**

As mentioned in previous reports, we feel our unaudited balance sheet with Lindsey Morden equity accounted (shown on page 82) is the best way to understand our financial position. Below, we show you our year-end financial position compared to the end of 1998.

	<b>1999</b>	<b>1998</b>
	<i>(\$ millions)</i>	
Cash and marketable securities	712.7	305.4
Long term debt	1,959.0	1,444.4
Net debt	1,246.3	1,139.0
Common shareholders' equity	3,116.0	2,238.9
Preferred securities (including RHINOS)	578.8	–
Total equity	3,694.8	2,238.9
<b>Net debt/equity</b>	<b>34%</b>	<b>51%</b>
<b>Net debt/total capital</b>	<b>25%</b>	<b>34%</b>

As shown, common shareholders' equity, our capital, increased by \$877.1 million, with \$959.7 million from the common stock issue for TIG and \$124.2 million from net income partially offset by \$206.8 million used to repurchase 706,103 of our shares at an average cost of \$293 per share. Long term debt increased due to our US\$275 million debenture issue in connection with the purchase of TIG; TIG's US\$100 million note payable, US\$25 million in preferred stock due in 2000 and other long term debt of US\$28 million; and TRG's bank debt of US\$42 million (to be repaid by TRG within the next year); partially offset by a stronger Canadian dollar in 1999. TIG also had issued US\$125 million in capital preferred securities (8.597% coupon with a 30 year term) and for the first time ever, we issued Fairfax perpetual

preferreds and RHINOS preferred securities for a total of \$400 million (please see notes 6 and 7).

These preferred issues increased our cash position to a record high of \$712.7 million. Our net debt to equity and net debt to total capital ratios dropped significantly, if you classify all of our preferred securities as equity. Internally, we think we maintained our ratios but increased financial flexibility significantly by increasing our cash position to \$712.7 million.

Below we show you our cash position and financial ratios for the past 5 years.

	1999	1998	1997	1996	1995
Cash and marketable securities (\$ millions)	712.7	305.4	207.1	101.1	70.4
Net debt/equity	34%	51%	37%	41%	48%
Net debt/total capital	25%	34%	27%	29%	33%

The table shows you that in spite of tremendous growth in the past five years (with revenue increasing from \$1 billion to almost \$6 billion, and total assets from \$3 billion to \$32 billion), we have maintained our financial ratios and ended 1999 with record cash and marketable securities plus undrawn long term bank lines in excess of \$1.3 billion. This, of course, is after the repurchase of over \$200 million of Fairfax stock in 1999. Please note that if we make no acquisitions and do not buy back our shares significantly, our financial position should improve dramatically in the future.

As we have said in past Annual Reports and repeat here, our financial position at year-end 1999 continues to be very strong for the following reasons:

- 1) We have no bank debt. Our debt consists of seven public debentures with a long term to maturity (4 years to 38 years) and low interest rates (6.875% to 8.30%), three small debentures issued to vendors, and certain debt assumed with the acquisitions of TIG and TRG. 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 and the debentures mentioned in the next sentence) into floating rates, saving approximately 125 basis points on average currently. Also, 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). Including the amortization of the unrealized foreign exchange loss on this swap over the remaining term to maturity, the effective rate for 1999 rises to 5.62% per annum, still below the 7.375% coupon rate of the swapped debentures.
- 2) We have undrawn, unsecured, committed, long term bank lines in excess of \$1.3 billion with excellent covenants. These bank lines are with five Canadian, five U.S. and three European banks. In addition, we have LOC facilities in excess of \$100 million.
- 3) Our net long term debt is less than three times our normalized earnings base. Also, our earnings base is well diversified among many insurance and reinsurance companies, Lindsey Morden and HWIC and geographically from Canadian, U.S. and international sources of income.

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- 4) Available cash flow at the Fairfax (holding company) level from dividends, management fees and interest covers our expenses (administrative and interest) 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 parent company-only income statement on page 87.
  - 5) With more than \$700 million in cash in the holding company, we can pay our administrative and interest expenses at Fairfax, with *no* dividends from any of our insurance or reinsurance companies, for five to six years – our management holding company survival ratio!
  - 6) As discussed in the MD&A, our insurance companies are over-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 the U.S. debenture issues and the purchase of foreign exchange contracts.

### **Investments**

While equity markets worldwide went up in 1999, U.S. bond markets had one of the worst years in the last 50 years as U.S. long treasuries declined 19.5%. The unrealized gains (losses) as of year-end are shown below:

	<b>1999</b>	<b>1998</b>
	<i>(\$ millions)</i>	
Bonds	(1,241.0)	28.0
Preferred stocks	(1.3)	4.4
Common stocks	15.7	(26.9)
	<u>(1,226.6)</u>	<u>5.5</u>

We realized \$121.7 million in gains in 1999 – little more than one-quarter of the gains realized in 1998. The unrealized losses at year-end of \$1,226.6 million were largely due to higher interest rates. While the pre-tax unrealized losses at year-end amounted to approximately one-third of common shareholders' equity, we emphasized to you in our letter of November 3, 1999 that we are not concerned as:

- a) the unrealized bond losses do not impact our U.S. subsidiaries' regulatory capital, and
- b) these losses will not be realized as we can and will hold these bonds to maturity or until interest rates drop.

In fact, we said in the letter that if long U.S. Treasury bond yields, which began the year 1999 at about 5% and ended the year at about 6<sup>1</sup>/<sub>2</sub>%, were to go back down to 5%, our unrealized bond losses of \$1,241.0 million would become a \$500+ million unrealized gain assuming corporate spreads remain the same. Almost a decade ago, in 1990, unrealized investment losses were approximately \$34 million on our equity base of \$95 million – about one-third of the equity on a pre-tax basis, but at that time, the unrealized losses were mainly due to common stocks. Within 18 months, the unrealized losses had disappeared – a less certain happening than with unrealized bond losses.

We began investing outside North America in 1996. As the Korean market more than doubled in 1999 (in US\$), we decided to liquidate our portfolios and realized more than \$120 million in 1998 and 1999 from Korea (a 60% + gain on our approximately \$200 million investment in 1997). As the Japanese markets did well also, we realized \$28 million in Japan (57% on our \$49 million investment). A big thank you to Francis Chou, Paul Fink and Chandran Ratnaswami.

Gross realized gains totaled \$218 million. After realized losses of \$36 million and increased provisions of \$60 million (primarily on the S & P Index put contracts in excess of negative goodwill amortization), net realized gains were \$122 million. Net gains from fixed income securities were \$31 million while net gains from common stocks and other investments were \$91 million. The principal contributors to the stock realized gains were Korean stocks (\$87 million), Japanese stocks (\$28 million) and dilution gains on the issue of Hub shares on broker acquisitions (\$12.5 million).

The table on page 70 shows the return on our investment portfolio. Investment income (interest and dividends) increased again in 1999 due to the purchase of C&F, TIG and TRG. Pre-tax investment income has increased from \$37.37 per share in 1998 to \$56.48 per share in 1999. Our annualized investment income is currently running at \$65 per share.

As you know, we have been getting concerned about U.S. equity markets since late in 1996 – and more concerned as the markets have gone higher. Here’s what the S&P 500 has done in the past three years.

#### S & P 500

<i>As of December 31</i>	<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%
1996-1999		+26%	+60%	+98%

While earnings have gone up 26% in the last three years, the price to earnings (P/E) ratio has increased 60% to 30x – higher than it’s ever been (other than in 1998!). As we said in our 1996 Annual Report, a continued P/E expansion over the long term is not sustainable – even though in the short term anything is possible.

In our last three Annual Reports, we have documented the unbelievable speculation that is taking place in the U.S. equity markets – particularly highlighted by internet stocks. Here’s what some of the “senior” issues are selling for.

	<b>Price/ Revenue</b>	<b>Price/ Earnings</b>	<b>Price/ Book Value</b>
AOL	29x	179x	45x
Amazon.com	14x	*	88x
Yahoo!	148x	1,425x	69x

\* Loss in 1999

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Yes, Amazon.com has a market value of US\$23 billion versus shareholders' equity of US\$266 million at December 31, 1999.

Here are some of the "junior" issues.

	<b>Market Cap</b>	<b>Revenue</b>	<b>Profit (Loss)</b>	<b>Price Change in 1999</b>
	<i>(US\$ millions)</i>			
DoubleClick	10,700	258	(56)	+1,037%
Go2Net	2,400	22	(1)	+884%
InfoSpace.com	21,700	37	(10)	+1,023%
Red Hat	10,300	25	(18)	+655%
VerticalNet	8,000	21	(53)	+925%

Are these stocks being purchased by long term investors? DoubleClick turned over its capitalization 21 times in 1999, i.e. an "investor" held it for an average of 17.1 days!! An "investor" held Red Hat for an average of 45.8 days and the others are very similar! Can you believe this?? If history is any guide, when the music stops, these stocks will be down 90%+, unless they are taken over by another high valued company. Have you noticed the acquisitions made by Northern Telecom and Cisco Systems recently? Northern Telecom paid US\$3.25 billion for Qtera Corp., a company that was formed in mid-1998 and had no revenues!!! Not to be outdone, around the same time, Cisco Systems paid US\$6.9 billion for Cerent Corp., which had US\$10 million in revenues. These valuations have prompted Grant's Interest Rate Observer to say "possibly never have American investors financed loss-making enterprises as they have today". It is interesting to observe that in our 1989 Annual Report, we noted that Mr. Batra's book "The Great Depression of 1990" sold 500,000 copies while Mr. Kandel's book "How to Cash in on the Coming Stock Market Boom" sold 15,000 copies. Messrs. Glassman and Hassett's recent book, "36,000 on the Dow", is perhaps timed as well as Mr. Batra's book was in 1989!!! Talking about timing, isn't it interesting that the man who has lost almost US\$1 billion is Time Magazine's "Man of the Year" (Jeff Bezos from Amazon.com) while the greatest investor of all time who has made nothing but money, Warren Buffett, is yesterday's man.

We have been very wrong over the past three years as the S&P 500 has done very well – but we will not *speculate* and buy things that don't make any economic sense. We do not believe in "New Eras" and feel that most participants in today's equity markets in the U.S. will suffer significant *permanent* loss. It is very likely that the high price for the S&P 500 and Dow Jones reached in this cycle (which may have already taken place) will not be seen again in the next ten years – not unlike the Nikkei Dow that peaked in 1989 at 39,000 and is still trading around 20,000 currently, ten years later.

As you know, we have backed our view on the U.S. markets with a purchase of US\$700 million (notional value) in S&P 500 Index puts and also US\$162 million (notional value) in similar two to three year contracts on a basket of technology stocks (not looking good right now!). At the time of this writing, only US\$300 million of the original S&P Index puts have not expired but we have added US\$200 million in S&P Index puts and US\$100 million in NASDAQ Index puts to continue to have a total of US\$600 million with maturities of up to two years.

We continue to have approximately 8% of our investment portfolios in common shares and almost all the rest in cash and good quality marketable bonds (89% of the bonds in the portfolio are rated A or above). By country, our common stock investments at December 31, 1999 were as follows:

	<b>Book Value</b>	<b>Market Value</b>
	<i>(\$ millions)</i>	
U.S.	298	256
Canada	223	203
Japan	102	92
Latin America	327	508
Other	448	355
	<u>1,398</u>	<u>1,414</u>

As shown, most of our common stock investments continue to be outside North America – in Asia and Latin America – where we think the long term investment values are. Our S&P 500 Index puts and our similar contracts on technology stocks are included in Other. Over time, we expect to realize gains on these investments.

As we have stated in our 1998 Annual Report, we expect a full testing of our “doomsday” scenario soon.

#### **Miscellaneous**

In 1999, Fairfax and its subsidiaries donated \$2.7 million to a variety of charities across North America. On a cumulative basis, since we began our donations program in 1991, we have donated \$15.4 million to charitable institutions. One of our U.S. subsidiaries made a one time significant donation to the charity of its choice in its community in 1999. This one time gift will spread each year to the other communities where Fairfax operates across the world.

Please review page 86, which is an unaudited unconsolidated balance sheet showing you where your money is invested.

You will note that as a Canadian company reporting in Canadian dollars, we have always hedged our foreign exchange exposures when we purchased companies in the U.S. or in other countries. At the end of 1999, we have approximately 75% of our business in U.S. dollars and approximately 75% of our employees are in the U.S. For these reasons, we plan to go to U.S. dollar reporting and also list on the NYSE within the next two years. The exact timing will be dictated by the appropriate time to unwind our hedges. While on the subject of hedging, it is interesting to note that since we bought the first of our U.S. companies at the end of 1993, the Canadian dollar has steadily trended down from US75.5¢ to US69¢ currently – we would have been smart not to have hedged any of our exposures!!

In our 1997 Annual Report, we listed the strengths that Fairfax has to achieve its 20% return on equity objective over time, and they have not changed. Neither have the risks – that we have again listed for you on pages 76 and 77. We are in an extremely difficult insurance and investment environment – with many pitfalls facing us daily – but we continue to focus on combined ratios below 100% leading to returns on equity in excess of 20%. With the best

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management we have ever had, investment portfolios in excess of \$17 billion and some good fortune, we look forward to achieving our objectives for you, our shareholders. Also, we do not plan to make any significant acquisitions (other than potential small bolt-on acquisitions by our subsidiaries) until we have achieved a combined ratio of 105% and are clearly on our way to 100%.

Our Annual Meeting this year will continue to be at the Metro Toronto Convention Centre, and will take place on Tuesday, April 11, 2000 in Room 106 at 9:30 a.m. Yes, we have changed the time of our meeting from 4:30 p.m. to 9:30 a.m. to allow more time to answer all your questions – we thought you may have more this year!! While we cannot answer your questions on the telephone, we look forward to answering them all at our Annual Meeting – and our Presidents, Fairfax officers and HWIC principals will also all be there, to shield me from the tomatoes, I hope!!

I want to remind you that our Annual Reports (all 15 of them) are now available on our website at [www.fairfax.ca](http://www.fairfax.ca). Any press releases are immediately posted to our website. Our quarterly reports for 2000 will be posted to our website on the following days: first quarter – May 4, second quarter – August 8, third quarter – November 7 and fourth quarter – February 9, 2001.

Again, on your behalf, I would like to thank the board and the management and employees of all our companies for their dedication and hard work during a very challenging year.

March 1, 2000



V. Prem Watsa  
*Chairman and  
Chief Executive Officer*

## Consolidated Financial Statements

### Consolidated Balance Sheets

as at December 31, 1999 and 1998

	<b>1999</b>	<b>1998</b>
	(\$000)	(\$000)
<b>Assets</b>		
Cash and short term investments .....	613,197	245,999
Marketable securities .....	99,479	59,366
Share subscription receipts cash in trust (note 7) .....	–	959,700
Accounts receivable and other .....	3,661,069	2,777,788
Recoverable from reinsurers (note 8) .....	8,671,639	3,820,426
Income taxes refundable .....	83,167	7,109
	<u>13,128,551</u>	<u>7,870,388</u>
<i>Portfolio investments</i> (note 2)		
Subsidiary cash and short term investments (market value – \$1,802,905; 1998 – \$896,248) .....	1,802,905	896,248
Bonds (market value – \$12,065,723; 1998-\$9,887,952) .....	13,306,760	9,859,921
Preferred stocks (market value – \$132,614; 1998 – \$159,337) .....	133,928	154,980
Common stocks (market value – \$1,413,643; 1998 – \$770,512) .....	1,397,905	797,400
Real estate (market value – \$80,735; 1998 – \$94,460) .....	80,735	94,460
Total (market value – \$15,495,620; 1998 – \$11,808,509) ...	<u>16,722,233</u>	<u>11,803,009</u>
Investments in Hub and Zenith National .....	363,380	–
Deferred premium acquisition costs .....	361,146	277,292
Deferred income taxes (note 9) .....	893,034	523,977
Capital assets .....	122,223	94,588
Goodwill .....	246,099	276,400
Other assets .....	98,622	41,040
	<u>31,935,288</u>	<u>20,886,694</u>

Signed on behalf of the Board

*V. P. Watson*

Director

*R. ...*

Director

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	<b>1999</b> (\$000)	<b>1998</b> (\$000)
<b>Liabilities</b>		
Share subscription receipts (note 7) .....	–	959,700
Accounts payable and accrued liabilities .....	1,385,613	880,211
Premium deposits .....	1,198,516	97,443
	<u>2,584,129</u>	<u>1,937,354</u>
Provision for claims (note 3) .....	20,442,199	13,161,215
Unearned premiums .....	2,276,344	1,651,498
Long term debt (note 5) .....	2,102,010	1,582,066
Trust preferred securities of subsidiaries (note 6) .....	378,789	–
	<u>25,199,342</u>	<u>16,394,779</u>
Non-controlling interest .....	601,595	87,908
Excess of net assets acquired over purchase price paid .....	234,243	227,803
<b>Shareholders' Equity</b>		
Common stock (note 7) .....	2,066,297	1,222,339
Preferred stock (note 7) .....	200,000	–
Retained earnings .....	1,049,682	1,016,511
	<u>3,315,979</u>	<u>2,238,850</u>
	<u>31,935,288</u>	<u>20,886,694</u>

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**Consolidated Statements of Earnings***for the years ended December 31, 1999 and 1998*

	<b>1999</b> (\$000)	<b>1998</b> (\$000)
<b>Revenue</b>		
Gross premiums written .....	5,707,518	2,966,376
Net premiums written .....	4,151,129	2,276,607
Net premiums earned .....	4,470,719	2,394,851
Interest and dividends (note 2) .....	752,980	443,838
Realized gains on investments (note 2) .....	121,670	440,785
Claims fees .....	443,085	294,843
	<u>5,788,454</u>	<u>3,574,317</u>
<b>Expenses</b>		
Losses on claims .....	3,578,337	1,889,412
Operating expenses .....	1,216,326	667,950
Commissions, net .....	869,696	442,205
Interest expense .....	141,410	89,966
	<u>5,805,769</u>	<u>3,089,533</u>
<b>Earnings (loss) before income taxes</b> .....	(17,315)	484,784
Provision for (recovery of) income taxes (note 9) .....	(152,085)	86,362
Earnings from operations .....	134,770	398,422
Non-controlling interest .....	(10,562)	(10,887)
<b>Net earnings</b> .....	<u>124,208</u>	<u>387,535</u>
<b>Net earnings per share</b> (note 13) .....	\$ 9.20	\$ 32.63

**Consolidated Statements of Retained Earnings***for the years ended December 31, 1999 and 1998*

	<b>1999</b> (\$000)	<b>1998</b> (\$000)
<b>Retained earnings – beginning of year</b> .....	1,016,511	628,976
Net earnings for the year .....	124,208	387,535
Excess over stated value of shares purchased for cancellation (note 7) .....	(91,037)	–
<b>Retained earnings – end of year</b> .....	<u>1,049,682</u>	<u>1,016,511</u>

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## Consolidated Statements of Changes in Cash Resources

for the years ended December 31, 1999 and 1998

	1999 (\$000)	1998 (\$000)
<b>Operating activities</b>		
Earnings from operations .....	134,770	398,422
Amortization .....	27,322	8,975
Deferred income taxes .....	(62,019)	10,555
Gains on investments .....	(121,670)	(440,785)
	(21,597)	(22,833)
Increase (decrease) in:		
Provision for claims .....	(1,247,420)	935,536
Unearned premiums .....	(567,193)	(109,050)
Accounts receivable and other .....	101,435	(53,266)
Recoverable from reinsurers .....	1,166,629	(491,954)
Income tax refundable .....	(76,058)	24,339
Accounts payable and accrued liabilities .....	(200,062)	169,837
Other .....	(45,723)	(40,702)
Cash provided by (used in) operating activities .....	(889,989)	411,907
<b>Investing activities</b>		
Investments – purchases .....	(8,540,043)	(8,983,257)
– sales .....	10,300,070	8,277,759
Purchase of marketable securities .....	(40,113)	(59,366)
Purchase of capital assets .....	(6,622)	(12,467)
Investments in Hub and Zenith National .....	(346,104)	–
Purchase of subsidiaries, net of cash acquired .....	(765,872)	(774,936)
Cash provided by (used in) investing activities .....	601,316	(1,552,267)
<b>Financing activities</b>		
Subordinate voting shares (note 7) .....	752,921	455,600
Preferred shares .....	200,000	–
Trust preferred securities of subsidiary .....	200,000	–
Long term debt (note 5) .....	429,668	740,223
Non-controlling interest .....	(20,061)	56,512
Cash provided by financing activities .....	1,562,528	1,252,335
<b>Increase in cash resources</b> .....	1,273,855	111,975
<b>Cash resources – beginning of year</b> .....	1,142,247	1,030,272
<b>Cash resources – end of year</b> .....	2,416,102	1,142,247

Cash resources consist of cash and short term investments, including subsidiary cash and short term investments.

February 2, 2000

**Auditors' Report to the Shareholders**

We have audited the consolidated balance sheets of Fairfax Financial Holdings Limited as at December 31, 1999 and 1998 and the consolidated statements of earnings, retained earnings and changes in cash resources for the years then ended. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the company as at December 31, 1999 and 1998 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.



PricewaterhouseCoopers LLP  
Chartered Accountants  
Toronto, Ontario

February 2, 2000

**Valuation Actuary's Report**

PricewaterhouseCoopers LLP has reviewed management's valuation, including management's selection of appropriate assumptions and methods, of the policy liabilities of the subsidiary insurance and reinsurance companies of Fairfax Financial Holdings Limited in its consolidated balance sheet at December 31, 1999 and their change as reflected in its consolidated statement of earnings for the year then ended, in accordance with accepted actuarial practice.

In our opinion, management's valuation is appropriate, except as noted in the following paragraph, and the consolidated financial statements fairly present its results.

Under accepted actuarial practice, the valuation of policy liabilities reflects the time value of money. Management has chosen not to reflect the time value of money in its valuation of the policy liabilities.



PricewaterhouseCoopers LLP  
Richard Gauthier, FCIA, FCAS  
Toronto, Ontario

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## Notes To Consolidated Financial Statements

for the years ended December 31, 1999 and 1998

(in \$000s except per share amounts and as otherwise indicated)

### 1. Summary of Significant Accounting Policies

The preparation of financial statements in accordance with generally accepted accounting principles requires management to make estimates and assumptions that affect reported amounts of assets and liabilities and disclosures of contingent assets and liabilities as at the date of the financial statements and the reported amounts of revenue and expenses during the periods covered by the financial statements. Actual results could differ from those estimates.

#### *Business operations*

The company is a financial services holding company which, through its subsidiaries, is principally engaged in property and casualty insurance conducted on a direct and reinsurance basis, investment management and insurance claims management.

#### *Principles of consolidation*

The consolidated financial statements include the accounts of the company and all of its subsidiaries:

#### **Insurance**

Commonwealth Insurance Company  
Crum & Forster Holdings, Inc.  
Falcon Insurance Company Limited  
Federated Insurance Holdings of  
Canada Ltd.  
Lombard General Insurance Company  
of Canada  
Markel Insurance Company of Canada  
Ranger Insurance Company  
TIG Specialty Insurance Company

#### **Reinsurance**

Odyssey Re Group Ltd., consisting of:  
Odyssey America Reinsurance Corporation  
Compagnie Transcontinentale de  
Réassurance  
Syndicate 1218 at Lloyd's  
CRC (Bermuda) Reinsurance Limited  
ORC Re Limited  
Wentworth Insurance Company Ltd.

#### **Runoff**

The Resolution Group, Inc.  
Sphere Drake Limited  
Odyssey Re Stockholm Insurance Corporation (publ)

#### **Other**

Hamblin Watsa Investment Counsel Ltd. (investment management)  
Lindsey Morden Group Inc. (insurance claims management)

All subsidiaries are wholly-owned except for The Resolution Group with an effective 27.5% equity and 100% voting interest, and Lindsey Morden with a 59% equity and 85% voting interest. The company has affiliated company investments in The Hub Group Limited with a 40% equity interest and Zenith National Insurance Corp. with a 38% equity interest.

Acquisitions are accounted for by the purchase method, whereby the results of acquired companies are included only from the date of acquisition. Divestitures are included up to the date of disposal.

*Premiums*

Insurance and reinsurance premiums are taken into income evenly throughout the terms of the related policies.

*Deferred premium acquisition costs*

Certain costs, consisting of brokers' commissions and premium taxes, of acquiring insurance premiums are deferred, to the extent that they are considered recoverable, and charged to income as the premiums are earned. The ultimate recoverability of deferred premium acquisition costs is determined without regard to investment income.

*Investments*

Bonds are carried at amortized cost providing for the amortization of the discount or premium on a yield to maturity basis. Preferred and common stocks are carried at cost. Real estate is carried at book value. When there has been a loss in value of an investment that is other than temporary, the investment is written down to its estimated net realizable value. Such writedowns are reflected in realized gains (losses) on investments. At December 31, 1999, the aggregate provision for losses on investments was \$26.4 million (1998 – \$22.9 million).

The company purchases foreign currency forward contracts to hedge its foreign equity portfolio. At December 31, 1999, the company held Yen 22.5 billion of such contracts, maturing in 2002 and 2003. Once the securities are sold, the contracts are closed out and any gain or loss is then included in realized gain or loss on sale of investments. Gains or losses on contracts in excess of hedging requirements are recorded in income as they arise.

*Provision for claims*

Claim provisions are established by the case method as claims are reported. For reinsurance, the provision for claims is based on reports and individual case estimates received from ceding companies. The estimates are regularly reviewed and updated as additional information on the estimated claims becomes known and any resulting adjustments are included in income. A provision is also made for management's calculation of factors affecting the future development of claims including claims incurred but not reported (IBNR) based on the volume of business currently in force and the historical experience on claims.

*Translation of foreign currencies*

Assets and liabilities in foreign currencies are translated into Canadian dollars at year-end exchange rates. Income and expenses are translated at the exchange rates in effect at the date incurred. Realized gains and losses on foreign exchange transactions are recognized in the statements of earnings.

The operations of the company's subsidiaries (principally in the United States, France and the U.K.) are self-sustaining. As a result, the assets and liabilities of these subsidiaries are translated at the year-end rates of exchange. Revenue and expenses are translated at the

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average rate of exchange for the years. The company enters into foreign currency contracts from time to time to hedge the foreign currency exposure related to its net investments in self-sustaining foreign operations. Such contracts are translated at the year-end rates of exchange. The net unrealized gains or losses, which result from translation, less related hedging gains or losses, are deferred and included in shareholders' equity.

At December 31, 1999, the company had net foreign currency contracts hedging its self-sustaining subsidiaries, maturing as follows:

	<b>Notional Value</b>	
	<i>(millions)</i>	
	<b>US\$</b>	<b>£</b>
2001	350	–
2002	220	–
2003	925	–
2004	130	82
2006	370	–
2007	470	–
2008	75	–
	<u>2,540</u>	<u>82</u>

#### *Goodwill*

The excesses of purchase cost over the fair value of the net assets of acquired businesses are amortized on the straight line basis over their estimated useful lives which range from 10 years for Hamblin Watsa Investment Counsel Ltd. and Ranger Insurance Company to 40 years for Lindsey Morden Group Inc. The company assesses the continuing value of goodwill based on the underlying undiscounted cash flows and operating results of the subsidiaries.

The excess of net assets acquired over purchase price paid for acquired businesses is amortized to earnings on the straight line basis over 10 years.

#### *Reinsurance*

The company reflects third party reinsurance balances on the balance sheet on a gross basis to indicate the extent of credit risk related to third party reinsurance and its obligations to policyholders and on a net basis in the statement of earnings to indicate the results of its retention of premiums written.

#### *Income taxes*

Income taxes reflect the expected future tax consequences of temporary differences between the carrying amounts of assets and liabilities and their tax bases based on tax rates which are expected to be in effect when the asset or liability is settled.

**2. Investment Information**

	1999		1998	
	Book Value (\$000)	Estimated Fair Value (\$000)	Book Value (\$000)	Estimated Fair Value (\$000)
Subsidiary cash and short term investments . . . . .	1,802,905	1,802,905	896,248	896,248
Bonds				
Canadian – government . . .	785,073	727,547	809,281	823,428
– corporate . . . . .	276,847	248,003	286,933	294,150
U.S. – government . . . . .	6,151,941	5,490,068	4,288,488	4,245,512
– corporate . . . . .	5,369,040	4,916,635	3,556,587	3,617,404
Other – government . . . . .	574,247	543,759	702,537	696,394
– corporate . . . . .	149,612	139,711	216,095	211,064
Preferred stocks				
Canadian . . . . .	113,994	112,680	134,938	137,255
Other . . . . .	19,934	19,934	20,042	22,082
Common stocks				
Canadian . . . . .	222,998	202,930	181,789	155,212
U.S. . . . .	298,331	255,861	195,344	197,988
Other . . . . .	876,576	954,852	420,267	417,312
Real estate . . . . .	80,735	80,735	94,460	94,460
	<u>16,722,233</u>	<u>15,495,620</u>	<u>11,803,009</u>	<u>11,808,509</u>

The estimated fair values of preferred and common stocks and debt securities are based on quoted market values. The book value of real estate approximates fair value. At December 31, 1999, the company had S&P put contracts with a weighted average strike price of 1,157 and a notional value of US\$500 million. The premiums paid to acquire these contracts are being charged to realized losses on equity investments on a straight line basis over their term to maturity, ranging from 2000 to 2001.

Management has reviewed currently available information regarding those investments whose estimated fair value is less than book value, amounting to an aggregate unrealized loss of \$1,582 million at December 31, 1999, and has determined that the book values are expected to be recovered. Debt securities whose book value exceeds market value can be held until maturity. Preferred and common stock investments have been reviewed to ensure that corporate performance expectations have not changed significantly to adversely affect the market value of these securities other than on a temporary basis.

The company's subsidiaries have pledged (either directly or indirectly to support letters of credit) cash and investments of \$2,391,175 as security for reinsurance balances and regulatory deposits.

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**Liquidity and Interest Rate Risk**

Maturity profile as at December 31, 1999:

	<b>Within 1 Year</b> (\$000)	<b>1 to 5 Years</b> (\$000)	<b>6 to 10 Years</b> (\$000)	<b>Over 10 Years</b> (\$000)	<b>Total</b> (\$000)
Bonds					
(book value)	355,132	1,831,313	7,475,917	3,644,398	13,306,760
Effective interest rate					5.80%

Bonds are classified at the earliest of the available maturity dates.

**Investment Income**

	<b>1999</b> (\$000)	<b>1998</b> (\$000)
Interest and dividends:		
Cash and short term investments	89,929	54,496
Bonds	640,474	372,986
Preferred stocks	7,371	16,406
Common stocks	20,348	5,407
	<u>758,122</u>	<u>449,295</u>
Expenses	<u>(5,142)</u>	<u>(5,457)</u>
	<u>752,980</u>	<u>443,838</u>
Gain on sale of investments:		
Bonds	31,194	342,180
Preferred stocks	10	4,892
Common stocks	95,944	92,348
Other	(6,151)	150
Decrease in provision for loss	<u>673</u>	<u>1,215</u>
	<u>121,670</u>	<u>440,785</u>
Net investment income	<u>874,650</u>	<u>884,623</u>

**3. Provision for Claims**

The provisions for unpaid claims and adjustment expenses and for the third party reinsurers' share thereof are estimates subject to variability, and the variability could be material in the near term. The variability arises because all events affecting the ultimate settlement of claims have not taken place and may not take place for some time. Variability can be caused by receipt of additional claim information, changes in judicial interpretation of contracts or liability or significant changes in severity or frequency of claims from historical trends. The estimates are principally based on the company's historical experience. Methods of estimation have been used which the company believes produce reasonable results given current information.

Changes in claim liabilities recorded on the balance sheet for the years ended December 31, 1999 and 1998 and their impact on unpaid claims and adjustment expenses for these two years are as shown in the following table:

	<b>1999</b> (\$000)	<b>1998</b> (\$000)
Unpaid claim liabilities – beginning of year – net	9,320,581	4,125,760
Foreign exchange effect of change in claims liabilities	(438,057)	286,277
Increase in estimated losses and expenses for losses occurring in prior years	83,238	91,221
Recovery under Swiss Re cover	(89,720)	–
Provision for losses and expenses on claims occurring in the current year	2,695,419	1,509,865
Paid on claims occurring during:		
the current year	(793,294)	(827,333)
prior years	(2,054,037)	(1,030,277)
Unpaid claim liabilities at December 31 of:		
TIG	1,187,246	–
Odyssey America Re	1,394,859	–
TRG	873,276	–
Falcon	–	8,539
Crum & Forster	–	3,794,255
Odyssey Re Stockholm	–	684,178
ORC Re	–	678,096
Unpaid claim liabilities before reserve indemnification – end of year – net	12,179,511	9,320,581
Unpaid claim liabilities at December 31 of Federated Life	28,500	26,675
Reserve indemnification	–	(52,299)
Unpaid claim liabilities – end of year – net	12,208,011	9,294,957
Reinsurance gross-up	8,234,188	3,866,258
Unpaid claim liabilities – end of year – gross	<u>20,442,199</u>	<u>13,161,215</u>

The foreign exchange effect of change in claims liabilities results from the fluctuation of the value of the Canadian dollar in relation to the U.S. dollar and European currencies.

The basic assumptions made in establishing actuarial liabilities are best estimates of possible outcomes. The company presents its claims on an undiscounted basis.

The company's provision for asbestos, pollution and other hazards claims is set out in the table on page 63 of the MD&A.

As part of its acquisition strategy, the company generally obtains vendor indemnifications from adverse development in the acquired company's claims reserves and unrecoverable reinsurance. In addition, as part of its acquisition of TIG, the company purchased a US\$1 billion insurance cover from Swiss Re to protect itself from adverse development in its subsidiaries' (including TIG) claims reserves and unrecoverable reinsurance at December 31, 1998. A summary of these indemnifications is set out in the table on page 67 of the MD&A.

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#### **4. Contingent Value Rights**

As part of the consideration for the purchase of Sphere Drake, the company issued contingent value rights ("CVRs") of US\$171 million bearing effectively 8% interest per annum and payable in 2007, subject to earlier redemption at the option of the company. The amount payable at maturity is subject to adjustments for the development of Sphere Drake's provision for claims as of December 31, 1996, the development of Sphere Drake's reserves for unrecoverable receivables from reinsurers and indemnifiers as of December 31, 1996, the result of commutations and certain actuarial expenses. At December 31, 1999, adverse development has amounted to \$173 million (US\$119 million), with a remaining CVR obligation of US\$52 million (the present value of which at December 31, 1999 was \$40 million (US\$28 million)).

**5. Long Term Debt**

The long term debt at December 31 consists of the following balances:

	<b>1999</b>	<b>1998</b>
	(\$000)	(\$000)
Fairfax unsecured note with interest based on STIBOR due September 4, 2000	53,925	60,292
Fairfax unsecured senior notes of US\$100 million at 7.75% due December 15, 2003	145,130	153,820
Fairfax unsecured senior note at 7.75% due December 15, 2003	25,000	25,000
Fairfax unsecured senior notes of US\$275 million at 7 <sup>3</sup> / <sub>8</sub> % due March 15, 2006 <sup>(1)</sup>	399,107	–
Fairfax FF300 million unsecured debt at 2 <sup>1</sup> / <sub>2</sub> % due February 27, 2007 (effectively a FF200 million debt at 8%)	51,699	59,867
Fairfax unsecured senior notes of US\$175 million at 6.875% due April 15, 2008 <sup>(1)</sup>	253,977	269,185
Fairfax unsecured senior notes of US\$100 million at 8.25% due October 1, 2015 <sup>(1)</sup>	145,130	153,820
Fairfax unsecured senior notes of US\$225 million at 7.375% due April 15, 2018 <sup>(1)(2)</sup>	326,542	346,095
Fairfax unsecured senior notes of US\$125 million at 8.30% due April 15, 2026 <sup>(1)</sup>	181,413	192,275
Fairfax unsecured senior notes of US\$125 million at 7.75% due July 15, 2037 <sup>(1)</sup>	181,413	192,275
Mandatory redeemable preferred stock of TIG, with an annual cash dividend of US\$7.75 per share and redemption value of US\$100 per share, due April 27, 2000 (250,000 shares)	36,282	–
TIG senior unsecured non-callable notes of US\$100 million at 8.125% due April 15, 2005	145,130	–
Other long term debt of TIG	40,211	–
Lindsey Morden unsecured Series B debentures at 7% due June 16, 2008	125,000	125,000
Other long term debt of Lindsey Morden	17,968	12,655
Other long term debt of The Resolution Group	60,229	–
	<u>2,188,156</u>	<u>1,590,284</u>
Less: Lindsey Morden debentures held by Fairfax	(8,218)	(8,218)
Fairfax debentures held by subsidiaries	(77,928)	–
	<u>2,102,010</u>	<u>1,582,066</u>

(1) The company has entered into various interest rate swap agreements on the above-noted debt with an aggregate balance of \$1,487,582 whereby it now pays interest on that debt at a rate linked to LIBOR, saving approximately 125 basis points on average during 1999.

(2) During 1998, the company swapped US\$125 million of its debt at 7.375% due April 15, 2018 for Japanese yen denominated debt of the same maturity, with fixed interest at 3.48% per annum. The pre-tax unrealized loss, net of accumulated amortization, on the foreign exchange component of

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*the yen debt swap amounted to \$44.6 million at December 31, 1999 and is being amortized to income over the remaining term to maturity. To date, net interest received under the yen debt swap has exceeded the accumulated amortization of the unrealized foreign exchange loss by \$8.4 million.*

Interest expense on long term debt amounted to \$141,410 (1998 – \$89,966).

Principal repayments are due as follows:

	<i>(\$000)</i>
2000	110,010
2001	38,061
2002	38,880
2003	179,864
2004	2,258
Thereafter	1,732,937

#### **6. Trust Preferred Securities of Subsidiaries**

TIG Holdings has issued \$178,789 (US\$128.75 million) of 8.597% junior subordinated debentures to TIG Capital Trust (a statutory business trust subsidiary of TIG Holdings) which, in turn, issued US\$125 million of 8.597% mandatory redeemable capital securities, maturing in 2027.

On November 24, 1999, Fairfax RHINOS Trust (a statutory business trust subsidiary of Fairfax Inc.) issued \$200,000 (US\$136 million) of Redeemable Hybrid Income Overnight Shares (RHINOS) (136,000 trust preferred securities) with a distribution rate of LIBOR plus 150 basis points maturing February 24, 2003. The company has agreed to issue US\$136 million of subordinate voting shares (or convertible preferred shares) by November 24, 2002, which proceeds will be used to mandatorily redeem the outstanding RHINOS.

#### **7. Capital Stock**

##### *Authorized capital*

The authorized share capital of the company consists of an unlimited number of preferred shares issuable in series, an unlimited number of multiple voting shares carrying ten votes per share and an unlimited number of subordinate voting shares carrying one vote per share.

*Issued capital*

	1999		1998	
	<i>number</i>	<i>(\$000)</i>	<i>number</i>	<i>(\$000)</i>
Subordinate voting shares	12,677,427	2,080,319	11,383,530	1,236,361
Multiple voting shares	<u>1,548,000</u>	<u>5,000</u>	<u>1,548,000</u>	<u>5,000</u>
	14,225,427	2,085,319	12,931,530	1,241,361
Interest in shares held through ownership interest in shareholder	<u>(799,230)</u>	<u>(19,022)</u>	<u>(799,230)</u>	<u>(19,022)</u>
Net shares effectively outstanding	<u>13,426,197</u>	<u>2,066,297</u>	<u>12,132,300</u>	<u>1,222,339</u>
Fixed/floating cumulative redeemable preferred shares, Series A, with a fixed dividend of 6.5% per annum until November 30, 2004 and stated capital of \$25 per share	<u>8,000,000</u>	<u>200,000</u>	<u>-</u>	<u>-</u>

On December 22, 1998, the company issued 2,000,000 subscription receipts, each representing the right to receive one subordinate voting share of the company from treasury, at \$500 per subscription receipt, for net proceeds of \$959,700, which, on April 13, 1999, were exchanged upon the completion of the acquisition of TIG Holdings into 2,000,000 subordinate voting shares.

On November 18, 1999, the company issued 8,000,000 fixed/floating cumulative redeemable preferred shares, Series A, at \$25 per share for cash of \$200 million.

In 1999, under the terms of normal course issuer bids approved by The Toronto Stock Exchange, the company purchased and cancelled 706,103 subordinate voting shares for an aggregate cost of \$206,779, of which \$91,037 was charged to retained earnings.

On April 3, 1998, the company issued 1,000,000 subordinate voting shares at \$475 per share for net proceeds of \$455,600.

## **8. Reinsurance**

The company follows the policy of underwriting and reinsuring contracts of insurance and reinsurance which, depending on the type of contract, generally limits the liability of the individual insurance and reinsurance subsidiaries to a maximum amount on any one loss of \$7 million. Reinsurance is generally placed on an excess of loss basis in several layers. The company's reinsurance does not, however, relieve the company of its primary obligation to the policyholders.

The company has guidelines and a review process in place to assess the creditworthiness of the companies to which it cedes.

The company makes specific provisions against reinsurance recoverable from companies considered to be in financial difficulty. In addition, the company records a general allowance based upon analysis of historical recoveries, the level of allowance already in place and management's judgment. The allocation of the allowance for loss is as follows:

	<b>1999</b> <i>(\$000)</i>	<b>1998</b> <i>(\$000)</i>
Specific	895,104	86,871
General	<u>73,302</u>	<u>81,553</u>
Total	<u>968,406</u>	<u>168,424</u>

The increase in the specific allowance resulted primarily from the acquisitions of TIG (\$49 million) and TRG (\$745 million).

A summary of the company's major reinsurers, showing their A.M. Best rating and outstanding balance at December 31, 1999, is set out in the table on page 65 of the MD&A.

During the year, the company ceded premiums earned of \$1,522,714 (1998 – \$740,318) and \$2,540,104 (1998 – \$817,815) of claims incurred.

## **9. Income Taxes**

The provision for income taxes differs from the statutory marginal rate as certain sources of income are exempt from tax or are taxed at other than the marginal rate.

A reconciliation of income tax calculated at the statutory marginal tax rate with the income tax provision at the effective tax rate in the financial statements is summarized in the following table:

	<b>1999</b> <i>(\$000)</i>	<b>1998</b> <i>(\$000)</i>
Provision for (recovery of) income taxes at statutory marginal income tax rate	(7,705)	213,305
Non-taxable investment income	(40,436)	(28,940)
Income earned outside Canada	(72,400)	(87,269)
Utilization of prior years' losses and other	<u>(31,544)</u>	<u>(10,734)</u>
Provision for (recovery of) income taxes	<u>(152,085)</u>	<u>86,362</u>

Deferred income taxes of the company are as follows:

	<b>1999</b>	<b>1998</b>
	(\$000)	(\$000)
Operating and capital losses	508,592	101,385
Claims discount	357,215	320,248
Unearned premium reserve	103,510	69,827
Deferred premium acquisition cost	(105,871)	(76,325)
Investments	(135,230)	(36,551)
Allowance for doubtful accounts	34,735	5,739
Accounts payable and other	181,786	139,654
Valuation allowance	(51,703)	-
Deferred income taxes	<u>893,034</u>	<u>523,977</u>

The increase in operating and capital losses resulted primarily from the acquisition of TIG. The deferred income tax asset relating to these losses is expected to be recovered from future profitable operations.

#### **10. Statutory Requirements**

The company's insurance subsidiaries are subject to certain requirements and restrictions under their respective insurance company Acts including minimum asset requirements and dividend restrictions.

The company can receive up to \$510 million as dividends from insurance and reinsurance subsidiaries without obtaining the prior approval of insurance regulators.

At December 31, 1999, statutory surplus, determined in accordance with the various insurance regulations, amounted to \$3.1 billion for the insurance subsidiaries, \$1.7 billion for the reinsurance subsidiaries and \$0.8 billion for the runoff subsidiaries.

#### **11. Contingencies and Commitments**

In 1999, Sphere Drake commenced legal proceedings against a group of agents and intermediaries whom it alleges fraudulently obtained and utilized a binding authority to write reinsurance contracts which expose Sphere Drake to significantly under-priced U.S. workers' compensation business. Sphere Drake is also seeking rescission of the reinsurance contracts with its cedants. Sphere Drake further alleges that this group of agents and intermediaries subsequently compounded the fraud by arranging outwards reinsurance which concealed that some of the same business was retroceded back to it, resulting in Sphere Drake's being exposed to those same losses for a substantially eroded premium. It is not yet possible to develop any reasonably based estimate of the amount of claims which might be made on these contracts. However, based on extensive legal advice, Sphere Drake believes that there is abundant evidence of fraud and that it has substantial grounds to challenge the enforceability of the business bound on its behalf. Whilst the eventual outcome is uncertain, the company believes that the likely ultimate net liability which might arise in respect of this business will not be material to Sphere Drake's financial position.

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Subsidiaries of the company are also defendants in several damage suits and have been named as third party in other suits. The uninsured exposure to the company is not considered to be material to the company's financial position.

Letters of credit aggregating \$185,758 have been issued in support of the company's obligations, as well as of regulatory deposits of its subsidiaries.

The company may under certain circumstances be obligated to purchase loans to officers and directors of the company and its subsidiaries from Canadian chartered banks totalling \$15,728 (1998 – \$13,582) for which 335,846 (1998 – 356,880) subordinate voting shares of the company with a year-end market value of \$82,450 (1998 – \$192,715) have been pledged as security. During 1999, the company implemented a restricted stock plan for the management of its subsidiaries with vesting periods of up to ten years from the date of grant. Stock grant costs are amortized to compensation expense over the vesting period. Shares for the plan are purchased on the open market. At December 31, 1999, 179,088 subordinate voting shares had been purchased for the plan at a cost of \$57,910.

The Year 2000 issue arises because many computerized systems use two digits rather than four to identify a year. Date-sensitive systems may recognize the year 2000 as 1900 or some other date, resulting in errors when information using year 2000 dates is processed. In addition, similar problems may arise in some systems which use certain dates in 1999 to represent something other than a date. Although the change in date has occurred, it is not possible to conclude that all aspects of the Year 2000 issue that may affect the company, including those related to customers, suppliers or other third parties, have been fully resolved.

## **12. Operating Leases**

Aggregate future commitments at December 31, 1999 under operating leases relating to premises, automobiles and equipment for various terms up to ten years are as follows:

	<i>(\$000)</i>
2000	91,800
2001	78,500
2002	63,700
2003	54,700
2004	41,800
Thereafter (in aggregate)	130,000

## **13. Earnings per Share**

Earnings per share are calculated after providing for dividends on the Series A fixed/floating cumulative redeemable preferred shares.

Fully diluted and basic earnings per share are the same in 1999 and 1998. The weighted average number of shares for 1999 was 13,331,671 (1998 – 11,877,505).

## **14. Acquisitions**

Effective August 11, 1999, the company purchased the class 1 voting shares of TRG Holding Corporation of Chicago for US\$97 million (\$144 million) cash. At August 11, 1999, TRG had

US\$2.6 billion in total assets and US\$2.1 billion in total liabilities, at fair value, and non-controlling interest (consisting of class 2 non-voting participating preferred shares) of US\$368 million, resulting in an excess of the fair value of net assets acquired over the purchase price paid of US\$40.0 million. Effective December 31, 1992, Ridge Re, a wholly-owned subsidiary of Xerox Financial Services, provided US\$578 million of aggregate excess of loss reinsurance to International Insurance, a wholly-owned subsidiary of TRG, covering any inadequacy in International's provision for claims as at December 31, 1992 and for any of International's reinsurance receivable relating to the period up to December 31, 1992 which subsequently becomes unrecoverable, net of 15% coinsurance. International has not written any business since 1992. At December 31, 1999, the remaining reinsurance under the Ridge Re contract was US\$212 million, net of 15% coinsurance.

Effective April 13, 1999, the company purchased TIG Holdings, Inc. of New York for US\$847 million (\$1,262 million) cash. At April 13, 1999, TIG had US\$7.5 billion in total assets and US\$6.7 billion in total liabilities, at fair value. As part of its acquisition of TIG, the company purchased a US\$1 billion insurance cover from Swiss Re to protect itself from adverse development in its subsidiaries' (including TIG) claims reserves and unrecoverable reinsurance at December 31, 1998.

Effective September 4, 1998, the company purchased certain runoff reinsurance operations of Skandia International Insurance Corporation of Stockholm, Sweden for US\$75 million (\$115 million) cash and a note to the vendor, due September 4, 2000, of \$60 million. At September 4, 1998, Skandia had US\$689 million in total assets and US\$544 million in total liabilities at fair value.

Effective August 13, 1998, the company purchased Crum & Forster Holdings, Inc. of Morristown, New Jersey for US\$565 million (\$859 million) cash. At August 13, 1998 (after repayment of its US\$115 million debt), Crum & Forster had US\$5,180 million in total assets and US\$4,468 million in total liabilities (including a restructuring accrual of US\$41 million for severance, lease termination and related costs on the downsizing of C&F's regional of ce network) at fair value. The vendor purchased a reinsurance contract for Crum & Forster's benefit of US\$400 million for any inadequacy in Crum & Forster's provision for claims as at August 13, 1998 and for any of Crum & Forster's reinsurance receivable relating to the period up to August 13, 1998 which subsequently becomes unrecoverable.

Effective January 16, 1998, the company purchased Falcon Insurance Company Limited of Hong Kong for HK\$23 million (\$4 million) cash. At January 16, 1998, Falcon had HK\$40 million in total assets and HK\$75 million in total liabilities at fair value. The excess of the purchase price paid over net assets acquired has been assigned to the value of the licence and is being amortized to expense on a straight line basis over ten years.

On June 19, 1998, Lindsey Morden Group (LMG) purchased Hambro Insurance Services (HIS) of London, England for cash of \$217 million. The purchase was primarily funded by the issuance of 4 million LMG subordinate voting shares for net proceeds of \$78.1 million and the issuance of \$125 million 7% unsecured debentures due June 16, 2008. At June 19, 1998, HIS had \$123 million in total assets and \$37 million in total liabilities, at fair value. The difference of \$131 million has been allocated to goodwill. Subsequently, on November 30, 1998, LMG

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sold Hambro Assistance, a unit of HIS, for \$130 million, consisting of cash of \$122 million and \$8 million (£3 million) by a subordinated loan note repayable in two years and with interest at UK Sterling LIBOR plus 2%. On December 29, 1998, HIS sold its 33% interest in Oracle Service Networks Corporation in exchange for common shares of the purchaser with a value of \$20 million (subsequently effectively sold in 1999). LMG recorded an after-tax gain of \$13 million on the sale of the companies.

On October 30, 1998, LMG purchased Ellis & Buckle of the UK for an aggregate purchase price of \$148 million consisting of 1,930,800 LMG subordinate voting shares, valued at \$39 million, and notes to the vendor of \$109 million (later repaid from the proceeds of sale of Hambro Assistance). At October 30, 1998, E&B had \$70 million in total assets and \$111 million in total liabilities (including a restructuring accrual of \$16 million consisting of severance, lease termination and related costs on the integration of the HIS UK operations with E&B), at fair value. The difference of \$189 million has been allocated to goodwill.

**15. Segmented Information**

The company is a financial services holding company which, through its subsidiaries, is primarily engaged in property and casualty insurance conducted on a direct and reinsurance basis. With the acquisition of The Resolution Group in 1999, the company now has a runoff operation consisting of TRG's wholly-owned subsidiary, International Insurance, and the runoff operations of Odyssey Re Stockholm and Sphere Drake. The company also provides claims adjusting, appraisal and loss management services and investment management services.

	Canada		United States		Europe and Far East		Total	
	1999	1998	1999	1998	1999	1998	1999	1998
	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)
<b>Revenue</b>								
Insurance	797,430	801,597	2,528,349	1,022,163	9,598	-	3,335,377	1,823,760
Reinsurance	8,427	8,239	927,156	440,098	759,362	931,728	1,694,945	1,380,065
Claims adjusting	45,982	62,668	115,333	118,464	281,770	113,711	443,085	294,843
Runoff	-	-	19,607	-	226,293	-	245,900	-
	<u>851,839</u>	<u>872,504</u>	<u>3,590,445</u>	<u>1,580,725</u>	<u>1,277,023</u>	<u>1,045,439</u>	<u>5,719,307</u>	<u>3,498,668</u>
Corporate and other							69,147	75,649
							<u>5,788,454</u>	<u>3,574,317</u>
	14.7%	24.4%	62.0%	44.2%	22.1%	29.2%		
<b>Earnings before income taxes</b>								
Insurance	(8,333)	60,312	25,253	196,737	(8,250)	-	8,670	257,049
Reinsurance	2,749	(3,115)	71,221	89,498	98,367	154,163	172,337	240,546
Claims adjusting	(13,357)	(1,341)	(2,183)	5,279	26,191	24,721	10,651	28,659
Runoff	-	-	19,607	-	(87,403)	-	(67,796)	-
	<u>(18,941)</u>	<u>55,856</u>	<u>113,898</u>	<u>291,514</u>	<u>28,905</u>	<u>178,884</u>	<u>123,862</u>	<u>526,254</u>
Corporate and other							(141,177)	(41,470)
							<u>(17,315)</u>	<u>484,784</u>
<b>Identifiable assets</b>								
Insurance	2,272,030	2,132,768	11,713,505	8,543,014	-	-	13,985,535	10,675,782
Reinsurance	69,987	23,293	6,890,585	4,682,770	4,391,098	3,684,756	11,351,670	8,390,819
Claims adjusting	51,675	52,430	67,685	70,084	308,205	368,477	427,565	490,991
Runoff	-	-	1,531,129	-	3,835,958	-	5,367,087	-
	<u>2,393,692</u>	<u>2,208,421</u>	<u>20,202,904</u>	<u>13,295,868</u>	<u>8,535,261</u>	<u>4,053,233</u>	<u>31,131,857</u>	<u>19,557,592</u>
Corporate and other							803,431	1,329,102
							<u>31,935,288</u>	<u>20,886,694</u>
	7.5%	10.6%	63.3%	63.7%	26.7%	19.4%		
<b>Amortization</b>	23,777	5,980	3,545	2,995	-	-	27,322	8,975
<b>Interest expense</b>							141,410	89,966

Geographic revenue is determined based on the domicile of the various subsidiaries and where they primarily derive their revenue.

CRC (Bermuda) Reinsurance is included in the Canadian segment and Wentworth Insurance is included in the United States segment.

Corporate and other revenue includes interest on the company's cash balances, management fees and other. Corporate and other earnings before income taxes includes the company's interest expense and corporate overhead. Corporate and other identifiable assets include cash in the holding company and, at December 31, 1998, the share subscription receipts.

## 16. Fair Value

Information on the fair values of financial instruments of the company where those values differ from their carrying values in the financial statements at December 31, 1999 include:

	<b>Note Reference</b>	<b>Book Value (\$000)</b>	<b>Estimated Fair Value (\$000)</b>
Portfolio investments	2	16,722,233	15,495,620
Investments in Hub and Zenith National	–	363,380	325,506
Long term debt	5	2,102,010	2,034,554
Trust preferred securities of subsidiaries	6	378,789	340,196
Foreign exchange contracts	1	–	(7,162)

The amounts do not include the fair value of underlying lines of business. While fair value amounts are designed to represent estimates of the amounts at which instruments could be exchanged in current transactions between willing parties, certain of the company's financial instruments lack an available trading market. Therefore, these instruments have been valued on a going concern basis. Fair value information on the provision for claims is not determinable.

These fair values have not been reflected on the financial statements.

## 17. US GAAP Reconciliation

The consolidated financial statements of the company have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP") which are different in some respects from those applicable in the United States, as described below.

### *Consolidated Statements of Earnings*

There were no significant differences between the consolidated net earnings as reported under Canadian GAAP for the year ended December 31, 1998 and the consolidated net earnings which would be reported by applying US GAAP.

For the year ended December 31, 1999, significant differences between consolidated net earnings under Canadian GAAP and consolidated net earnings under US GAAP were as follows:

- (a) In Canada, the unrealized loss on the translation of the foreign exchange component of the yen debt swap is deferred and amortized to income over the remaining term to maturity. In the U.S., the unrealized foreign exchange loss is recognized in income in the year, although there is no intention to settle the swap prior to maturity.

- (b) In Canada, the Swiss Re recoveries are recorded at the same time as the claims incurred are ceded to Swiss Re. In the U.S., the Swiss Re recoveries are recorded up to the amount of the premium paid and on a cash basis thereafter.
- (c) In Canada, the cost to close duplicate facilities in the London market operations on the acquisition of TIG Holdings was accrued for in the purchase equation. In the U.S., such costs are expensed as they relate to the closure of the company's own operations.

The following shows the net earnings in accordance with US GAAP:

	<b>1999</b>
	(\$000)
Net earnings, Canadian GAAP	124,208
Foreign exchange loss on yen debt swap, net of tax	(10,636)
Recovery on Swiss Re cover, net of tax	(24,154)
Closure costs, net of tax	(11,266)
Net earnings, US GAAP	<u>78,152</u>
Net earnings per share, US GAAP	<u>\$ 5.86</u>

#### *Consolidated Balance Sheets*

In Canada, portfolio investments are carried at cost or amortized cost with a provision for declines in value which are considered to be other than temporary. In the U.S., such investments are classified as available for sale and marked to market through shareholders' equity.

In Canada, trust preferred securities of subsidiaries (including RHINOS) are included in total liabilities. In the U.S., trust preferred securities are shown as a separate caption after total liabilities, in a manner similar to non-controlling interests.

The following shows the balance sheet amounts in accordance with US GAAP, setting out individual amounts where different from the amounts reported under Canadian GAAP:

	<b>1999</b> (\$000)	<b>1998</b> (\$000)
<b>Assets</b>		
Portfolio investments		
Bonds	12,065,723	9,887,952
Preferred stocks	132,614	159,337
Common stocks	<u>1,413,643</u>	<u>770,512</u>
Total portfolio investments	13,611,980	10,817,801
Deferred income taxes	1,402,841	521,887
Recoverable from reinsurers	8,531,428	3,820,426
All other assets	<u>7,532,031</u>	<u>5,729,990</u>
Total assets	<u>31,078,280</u>	<u>20,890,104</u>
<b>Liabilities</b>		
Accounts payable and accrued liabilities	1,398,868	880,211
All other liabilities	<u>26,024,805</u>	<u>17,451,922</u>
Total liabilities	<u>27,423,673</u>	<u>18,332,133</u>
Trust preferred securities of subsidiaries	378,789	-
Excess of net assets acquired over purchase price paid	154,062	227,803
Non-controlling interest	<u>601,595</u>	<u>87,908</u>
	<u>1,134,446</u>	<u>315,711</u>
<b>Shareholders' Equity</b>		
Total shareholders' equity	<u>2,520,161</u>	<u>2,242,260</u>

The difference in consolidated shareholders' equity is as follows:

	<b>1999</b> (\$000)	<b>1998</b> (\$000)
Shareholders' equity based on Canadian GAAP	3,315,979	2,238,850
Other comprehensive income	(749,762)	3,410
Reduction in 1999 net earnings under US GAAP	<u>(46,056)</u>	<u>-</u>
Shareholders' equity based on US GAAP	<u>2,520,161</u>	<u>2,242,260</u>

Statement of Financial Accounting Standards No. 130 "Reporting Comprehensive Income" requires the company to disclose items of other comprehensive income in a financial statement and to disclose accumulated balances of other comprehensive income in the equity

section of a financial statement. Other comprehensive income includes unrealized gains and losses on investments, as follows:

	<b>1999</b>	<b>1998</b>
	(\$000)	(\$000)
Unrealized gain (loss) on investments available for sale	(1,226,613)	5,500
Less: related deferred income taxes	<u>476,851</u>	<u>(2,090)</u>
	<u>(749,762)</u>	<u>3,410</u>

*Disclosure of interest and taxes paid*

The aggregate amount of interest paid (excluding interest received on interest rate swaps) for the years ended December 31, 1999 and 1998 was \$161,162 and \$80,706 respectively. The aggregate amount of taxes paid for the years ended December 31, 1999 and 1998 was \$24,235 and \$59,279 respectively.

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## Management's Discussion and Analysis of Financial Condition and Results of Operations

### Sources of Revenue

Revenue reflected in the consolidated financial statements includes premiums earned and investment income of the insurance and reinsurance companies, claims adjusting fees of Lindsey Morden and other miscellaneous income for the past five years. With the acquisition of an effective 27.5% equity and 100% voting interest in The Resolution Group ("TRG") on August 11, 1999, the company now has a runoff operations business segment, consisting of TRG's wholly-owned subsidiary, International Insurance, the runoff operations of Odyssey Re Stockholm, and Sphere Drake, which ceased active underwriting effective May 25, 1999 as part of the company's consolidation of its London market operations.

#### Revenue by Line of Business

	<b>1999</b> (\$000)	<b>1998</b> (\$000)	<b>1997</b> (\$000)	<b>1996</b> (\$000)	<b>1995</b> (\$000)
Insurance	3,335,377	1,823,760	1,086,854	1,026,107	985,916
Reinsurance	1,694,945	1,380,065	801,864	273,340	-
Claims adjusting	443,085	294,843	166,331	162,266	154,914
Runoff	245,900	-	-	-	-
Corporate and other	69,147	75,649	33,258	14,102	4,690
	<u>5,788,454</u>	<u>3,574,317</u>	<u>2,088,307</u>	<u>1,475,815</u>	<u>1,145,520</u>

The 1999 increase in insurance revenue was mainly the result of the August 13, 1998 acquisition of Crum & Forster and the April 13, 1999 acquisition of TIG Specialty Insurance ("TIG"). The increase in reinsurance revenue in 1999 over 1998 was mainly the result of the inclusion of Odyssey America Re (formerly TIG Re) since April 13, 1999. The 1999 increase in claims adjusting revenue reflects Lindsey Morden's acquisition of Hambro Insurance Services effective June 19, 1998 and Ellis & Buckle effective October 30, 1998. The runoff operations comprise Odyssey Re Stockholm for all of 1999, Sphere Drake since July 1, 1999 and TRG since August 11, 1999.

On a geographic basis, the United States operations accounted for approximately 62% of total revenue in 1999 compared with 44% of revenue in 1998. Operating profit from U.S. operations amounted to \$113.9 million in 1999 compared with \$291.5 million in 1998. Canadian operations accounted for approximately 15% of Fairfax's revenue in 1999 compared with 24% of revenue in 1998. Operating loss from Canadian operations amounted to \$18.9 million in 1999 compared with an operating profit of \$55.9 million in 1998. The Europe and Far East operations accounted for approximately 22% of revenue in 1999 compared with 29% of revenue in 1998. Operating profit from Europe and Far East operations amounted to \$28.9 million in 1999 compared with \$178.9 million in 1998. The balance of revenue and operating profit or loss was related to corporate and other.

**Net Earnings**

Sources of net earnings with Lindsey Morden equity accounted were as follows for the past five years:

	<b>1999</b> (\$000)	<b>1998</b> (\$000)	<b>1997</b> (\$000)	<b>1996</b> (\$000)	<b>1995</b> (\$000)
Underwriting					
Insurance					
Canada	(96,570)	(40,338)	5,202	3,921	(4,578)
U.S.	(273,131)	(116,470)	(25,572)	(49,767)	(36,305)
Reinsurance	(247,364)	(154,571)	(35,787)	(4,717)	-
Interest and dividends	<u>711,475</u>	<u>432,024</u>	<u>242,300</u>	<u>144,101</u>	<u>86,274</u>
Insurance and reinsurance					
earnings before realized gains	94,410	120,645	186,143	93,538	45,391
Realized gains	121,670	440,785	206,773	131,274	71,912
Runoff	(54,231)	-	-	-	-
Claims adjusting (Fairfax					
portion)	2,784	12,388	1,824	2,298	2,098
Interest expense	(129,262)	(84,356)	(43,182)	(34,997)	(19,086)
Goodwill and other					
amortization	(5,067)	(4,985)	(4,817)	(4,765)	(4,765)
Swiss Re premium	(35,312)	-	-	-	-
Corporate overhead and other	<u>(20,174)</u>	<u>(15,963)</u>	<u>(14,991)</u>	<u>(6,656)</u>	<u>(5,618)</u>
Pre-tax income (loss)	(25,182)	468,514	331,750	180,692	89,932
Less: taxes	(158,023)	80,979	99,252	29,872	2,435
Less: non-controlling interest	<u>8,633</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
Net earnings	<u>124,208</u>	<u>387,535</u>	<u>232,498</u>	<u>150,820</u>	<u>87,497</u>

Net earnings in 1999 were \$124.2 million, a decrease of \$263.3 million or 68% from 1998 net earnings of \$387.5 million.

The major changes which affected net earnings were:

- Insurance and reinsurance earnings before realized gains decreased by \$26.2 million over 1998 due to higher underwriting losses from large property and international catastrophe-related losses and the recent acquisitions of C&F and TIG. Underwriting losses reflect the benefit of the Swiss Re cover
- Net realized gains decreased in 1999 to \$121.7 million from \$440.8 million in 1998
- Runoff operations comprise Odyssey Re Stockholm for all of 1999, Sphere Drake since July 1, 1999 and TRG since August 11, 1999
- Interest expense increased in 1999 due to interest expense from the debt issued in 1998 related to the purchases of C&F and Odyssey Re Stockholm and in 1999 related to the purchases of TIG and TRG
- Corporate overhead and other is net of Hamblin Watsa's pre-tax income and interest income on Fairfax cash balances and includes one time expenses associated with the acquisitions and issues of securities effected in 1999

- The first year's premium on the US\$1 billion Swiss Re cover amounted to \$35.3 million. Additional premium will be payable to Swiss Re if additional losses are ceded to this cover in future years
- The company recorded a recovery for income taxes in 1999 due to income earned outside Canada at lower rates of tax and operating losses in higher tax rate jurisdictions.

### **Insurance Underwriting**

Fairfax's insurance and reinsurance companies employ disciplined underwriting practices with the objective of rejecting underpriced risks. The combined loss and expense ratio is the traditional measure of underwriting results of property and casualty companies. In any year when the ratio exceeds 100%, it generally indicates that unprofitable business has been underwritten.

A summary follows of the net premiums written and earned, and the loss, expense and combined ratios, for the past fifteen years for Fairfax's insurance companies and, for Fairfax's reinsurance companies, for the four years that Fairfax has owned these companies.

### **Insurance**

	<b>NET PREMIUMS</b>		<b>RATIOS</b>		
	<b>Written</b> (\$000)	<b>Earned</b> (\$000)	<b>Loss</b> (%)	<b>Expense</b> (%)	<b>Combined</b> (%)
1985	23,415	14,049	96	30	126
1986	55,992	40,885	72	23	95
1987	71,378	62,012	73	25	98
1988	68,224	66,265	73	19	92
1989	35,477	40,444	100	40	140
1990	74,487	78,427	82	31	113
1991	93,450	90,507	60	34	94
1992	128,664	118,854	79	35	114
1993	163,508	150,844	73	26	99
1994	411,570	400,559	74	30	104
1995	864,589	829,340	74	31	105
1996	879,687	864,169	75	31	106
1997	864,708	867,218	71	31	102
1998	1,310,141	1,402,771	78	33	111
1999	2,745,629	2,957,006	77	36	113

In 1999, the combined ratio was well above 100% with a combined ratio of 115% for the Canadian insurance companies and 112% for the U.S. insurance companies. Since current management took over in September 1985 Fairfax has had combined ratios of less than 100% in five of the fourteen full years and greater than 100% in the remaining nine years.

**Reinsurance**

	NET PREMIUMS		RATIOS		
	Written (\$000)	Earned (\$000)	Loss (%)	Expense (%)	Combined (%)
1996	163,392	166,719	62	34	96
1997	527,919	593,423	72	35	107
1998	966,466	992,080	80	36	116
1999	1,276,912	1,275,245	85	34	119

In 1999, the combined ratio increased to 119% due to international catastrophe-related losses of \$127 million. Excluding international catastrophe-related losses, the combined ratio was 109.5%.

**Provision for Claims**

Claim provisions are established by the case method as claims are reported. The provisions are subsequently adjusted as additional information on the estimated amount of a claim becomes known during the course of its settlement. A provision is also made for management's calculation of factors affecting the future development of claims including claims incurred but not reported (IBNR) based on the volume of business currently in force and the historical experience on claims.

As time passes, more information about the claims becomes known and provision estimates are appropriately adjusted upward or downward. Because of the estimation elements encompassed in this process, and the time it takes to settle many of the more substantial claims, several years are required before a meaningful comparison of actual losses to the original provisions can be developed.

The development of the provision for claims is shown by the difference between estimates of reserves as of the initial year-end and the re-estimated liability at each subsequent year-end. This is based on actual payments in full or partial settlement of claims, plus re-estimates of the reserves required for claims still open or claims still unreported. Unfavourable development means that the original reserve estimates were lower than subsequently indicated.

The following table presents a reconciliation of the provision for claims and loss adjustment expense (LAE) for the insurance and reinsurance lines of business for the past five years. As shown in the table, the sum of the provision for claims for all of Fairfax's insurance and reinsurance subsidiaries (including runoff subsidiaries) is \$20,442.2 million as at December 31, 1999 – the amount shown as Provision for claims on Fairfax's balance sheet on page 27. The "Other" shown in the table below was the \$14 million Fairfax indemnification of Ranger reserves.

*Reconciliation of Provision for Claims  
and LAE as at December 31*

	<b>1999</b> (\$000)	<b>1998</b> (\$000)	<b>1997</b> (\$000)	<b>1996</b> (\$000)	<b>1995</b> (\$000)
Insurance subsidiaries owned throughout the year – net of indemnification	4,258,180	1,107,551	978,498	956,704	864,346
Insurance subsidiaries acquired during the year	<u>1,187,246</u>	<u>3,802,794</u>	<u>–</u>	<u>–</u>	<u>–</u>
Total insurance subsidiaries	<u>5,445,426</u>	<u>4,910,345</u>	<u>978,498</u>	<u>956,704</u>	<u>864,346</u>
Reinsurance subsidiaries owned throughout the year	2,732,941	2,981,663	1,215,130	13,363	12,095
Reinsurance subsidiaries acquired during the year	<u>1,394,859</u>	<u>1,362,274</u>	<u>1,869,526</u>	<u>1,138,865</u>	<u>–</u>
Total reinsurance subsidiaries	<u>4,127,800</u>	<u>4,343,937</u>	<u>3,084,656</u>	<u>1,152,228</u>	<u>12,095</u>
Runoff subsidiaries owned throughout the year	1,733,009	–	–	–	–
Runoff subsidiaries acquired during the year	<u>873,276</u>	<u>–</u>	<u>–</u>	<u>–</u>	<u>–</u>
Total runoff subsidiaries	<u>2,606,285</u>	<u>–</u>	<u>–</u>	<u>–</u>	<u>–</u>
Federated Life	28,500	26,675	24,626	23,095	22,214
Other	<u>–</u>	<u>14,000</u>	<u>14,000</u>	<u>14,000</u>	<u>14,000</u>
Total provision for claims and LAE	12,208,011	9,294,957	4,101,780	2,146,027	912,655
Reinsurance gross-up	<u>8,234,188</u>	<u>3,866,258</u>	<u>2,220,957</u>	<u>1,147,422</u>	<u>414,482</u>
Total including gross-up	<u>20,442,199</u>	<u>13,161,215</u>	<u>6,322,737</u>	<u>3,293,449</u>	<u>1,327,137</u>

The seven tables that follow show the reconciliation and the reserve development of the insurance (Canadian and U.S.), reinsurance and runoff subsidiaries' provision for claims. Because business is done in various locations, there will necessarily be some distortions caused by foreign exchange fluctuations. The insurance subsidiaries' tables are presented in Canadian dollars for the Canadian subsidiaries and in U.S. dollars for the U.S. subsidiaries (Falcon is

included with the U.S. insurance subsidiaries for convenience). The reinsurance and runoff subsidiaries' tables are presented in U.S. dollars as the reinsurance and runoff businesses are substantially transacted in that currency.

#### *Canadian Insurance Subsidiaries*

The following table shows for Fairfax's Canadian insurance subsidiaries the provision for claims liability for unpaid losses and LAE as originally and as ultimately estimated for the years 1995 through 1999. The favourable or unfavourable development from prior years is credited or charged to each year's earnings.

#### *Reconciliation of Provision for Claims – Canadian Insurance Subsidiaries*

	<b>1999</b>	<b>1998</b>	<b>1997</b>	<b>1996</b>	<b>1995</b>
	<i>(\$000)</i>	<i>(\$000)</i>	<i>(\$000)</i>	<i>(\$000)</i>	<i>(\$000)</i>
Provision for claims and LAE at January 1	<u>818,840</u>	<u>764,052</u>	<u>746,119</u>	<u>695,328</u>	<u>673,789</u>
Incurring losses on claims and LAE					
Provision for current accident year's claims	560,961	545,306	553,902	482,970	456,967
Increase (decrease) in provision for prior accident years' claims	<u>(8,010)</u>	<u>(2,464)</u>	<u>(11,974)</u>	<u>(16,692)</u>	<u>4,149</u>
Total incurred losses on claims and LAE	<u>552,951</u>	<u>542,842</u>	<u>541,928</u>	<u>466,278</u>	<u>461,116</u>
Payments for losses on claims and LAE					
Payments on current accident year's claims	(230,996)	(239,426)	(285,067)	(195,604)	(205,766)
Payments on prior accident years' claims	<u>(250,435)</u>	<u>(248,628)</u>	<u>(238,928)</u>	<u>(219,883)</u>	<u>(233,811)</u>
Total payments for losses on claims and LAE	<u>(481,431)</u>	<u>(488,054)</u>	<u>(523,995)</u>	<u>(415,487)</u>	<u>(439,577)</u>
Provision for claims and LAE at December 31	<u>890,360</u>	<u>818,840</u>	<u>764,052</u>	<u>746,119</u>	<u>695,328</u>

The company strives to establish adequate provisions at the original valuation date. It is the company's objective to have favourable development from the past. The reserves will always be subject to upward or downward development in the future.

The following table shows for Fairfax's Canadian insurance subsidiaries the original provision for claims reserves including LAE at each calendar year-end commencing in 1989 with the subsequent cumulative payments made from these years and the subsequent re-estimated amount of these reserves. The following Canadian insurance subsidiaries' reserves are included from the respective years in which such subsidiaries were acquired:

	<b>Year Acquired</b>
Markel	1985
Federated	1990
Commonwealth	1990
Lombard (including CRC (Bermuda))	1994

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*Provision for Canadian Insurance Subsidiaries' Claims Reserve Development*

<b>As at December 31</b>	<b>1989 and prior</b>	<b>1990</b>	<b>1991</b>	<b>1992</b>	<b>1993</b>	<b>1994</b>	<b>1995</b>	<b>1996</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>
	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)
Provision for claims including LAE	79,357	192,372	168,393	179,587	185,010	673,789	695,328	746,119	764,052	818,840	890,360
Cumulative payments as of:											
One year later	25,194	44,055	48,050	56,824	62,955	233,811	219,883	238,928	248,628	250,435	
Two years later	35,440	76,947	75,403	87,878	105,537	351,600	355,035	386,447	392,699		
Three years later	44,169	98,150	94,834	110,565	127,418	457,680	455,301	494,014			
Four years later	50,120	115,417	110,838	126,123	147,296	525,453	531,979				
Five years later	55,310	127,003	120,435	137,732	159,482	577,504					
Six years later	58,687	135,020	128,060	145,986	166,015						
Seven years later	60,422	142,082	134,465	150,589							
Eight years later	61,625	147,015	138,286								
Nine years later	62,009	149,732									
Ten years later	62,012										
Reserves re-estimated as of:											
One year later	80,602	175,138	168,001	179,948	187,819	677,938	678,636	734,145	761,588	810,830	
Two years later	73,904	173,992	157,849	174,820	191,825	676,826	692,888	743,443	758,562		
Three years later	71,810	165,753	157,671	171,833	197,833	685,675	704,431	748,532			
Four years later	67,166	166,797	156,291	177,451	198,650	688,769	707,148				
Five years later	65,414	165,625	158,366	177,370	199,317	695,907					
Six years later	65,181	167,289	161,088	177,964	197,691						
Seven years later	64,087	169,803	162,501	175,936							
Eight years later	64,196	171,625	160,606								
Nine years later	63,916	170,215									
Ten years later	63,465										
Favourable (unfavourable) development	15,892	22,157	7,787	3,651	(12,681)	(22,118)	(11,820)	(2,413)	5,490	8,010	

The Canadian insurance subsidiaries had a net redundancy (favourable development) of \$8.0 million during 1999, primarily relating to conservative reserving at Lombard and Markel. The net deficiency in 1993 resulted from the impact of U.S. floods on Commonwealth. The net deficiency in 1994 relates to the understatement of the impact of Lombard's increase in its casualty retention. The net deficiency in 1995 relates to an excess of loss contract assumed by CRC (Bermuda) which had higher than expected losses.

Management is pleased with the generally favourable development for the Canadian insurance subsidiaries over the years. Future development could be significantly different from the past due to many unknown factors.

*U.S. Insurance Subsidiaries*

The following table shows for Fairfax's U.S. insurance subsidiaries the provision for claims liability for unpaid losses and LAE as originally and as ultimately estimated for the years 1995 through 1999. The favourable or unfavourable development from prior years is credited or charged to each year's earnings.

Reconciliation of Provision for Claims –  
U.S. Insurance Subsidiaries

	<b>1999</b> <i>(US\$000)</i>	<b>1998</b> <i>(US\$000)</i>	<b>1997</b> <i>(US\$000)</i>	<b>1996</b> <i>(US\$000)</i>	<b>1995</b> <i>(US\$000)</i>
Provision for claims and LAE at January 1 for Ranger and, beginning in 1999, C&F and Falcon	2,693,929	184,000	187,640	157,800	154,870
Incurred losses on claims and LAE					
Provision for current accident year's claims	624,666	104,477	105,462	111,607	90,192
Increase in provision for prior accident years' claims	29,753	43,821	8,681	25,352	36,168
Total incurred losses on claims and LAE	654,419	148,298	114,143	136,959	126,360
Payments for losses on claims and LAE					
Payments on current accident year's claims	(272,502)	(40,477)	(37,962)	(37,767)	(34,333)
Payments on prior accident years' claims	(755,292)	(70,130)	(79,822)	(69,352)	(89,093)
Total payments for losses on claims and LAE	(1,027,794)	(110,607)	(117,784)	(107,119)	(123,426)
Provision for claims and LAE at December 31	2,320,554	221,694	184,003	187,644	157,804
Provision for claims and LAE for TIG Specialty Insurance at December 31	818,057	-	-	-	-
Provision for claims and LAE for C&F at December 31	-	2,466,680	-	-	-
Provision for claims and LAE for Falcon at December 31	-	5,550	-	-	-
Provision for claims and LAE for U.S. insurance subsidiaries at December 31 before indemnification	3,138,611	2,693,929	184,003	187,644	157,804
Reserve indemnification	-	(34,000)	(34,000)	(34,000)	(34,000)
Provision for claims and LAE for U.S. insurance subsidiaries after indemnification	3,138,611	2,659,929	150,003	153,644	123,804
Exchange rate	1.4513	1.5382	1.4296	1.3706	1.3652
Converted to Canadian dollars	C\$4,555,066	C\$4,091,505	C\$214,445	C\$210,585	C\$169,017

The company strives to establish adequate provisions at the original valuation date. It is the company's objective to have favourable development from the past. The reserves will always be subject to upward or downward development in the future.

The following table shows for Fairfax's U.S. insurance subsidiaries the original provision for claims reserves including LAE at each calendar year-end commencing in 1993 (the date of Ranger's acquisition) with the subsequent cumulative payments made from these years and the subsequent re-estimated amounts of these reserves. The following U.S. insurance subsidiaries' reserves are included from the respective years in which such subsidiaries were acquired:

	<b>Year Acquired</b>
Ranger	1993
C&F	1998
Falcon	1998
TIG	1999

*Provision for U.S. Insurance Subsidiaries' Claims Reserve Development*

<b>As at</b>							
<b>December 31</b>	<b>1993</b>	<b>1994</b>	<b>1995</b>	<b>1996</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>
	<i>(US\$000)</i>						
Provision for claims							
including LAE	173,887	154,870	157,804	187,644	184,003	2,693,929	3,138,611
Cumulative payments as of:							
One year later	78,544	89,093	69,352	79,822	70,130	755,292	
Two years later	141,662	130,040	119,882	125,286	128,042		
Three years later	169,259	158,738	135,225	157,508			
Four years later	185,800	166,941	155,229				
Five years later	188,254	179,913					
Six years later	194,391						
Reserves re-estimated as of:							
One year later	171,418	191,038	183,156	195,925	227,824	2,723,682	
Two years later	199,586	206,856	190,861	229,083	236,318		
Three years later	214,492	216,783	210,832	236,311			
Four years later	222,191	226,006	212,900				
Five years later	227,579	229,793					
Six years later	229,418						
Favourable (unfavourable)							
development	(55,531)	(74,923)	(55,096)	(48,667)	(52,315)	(29,753)	

Ranger has had significant net deficiencies in each year since 1993. Its generally unfavourable development over the years has been a source of significant concern. Ranger's new senior management team is continuing to take the necessary steps to eliminate and significantly reduce unprofitable lines of business. Ranger's net deficiency of US\$14.7 million in 1999 was principally due to the strengthening of prior years' ALAE reserves to provide for the effect of prior Ranger management's claims handling practices. C&F had a net deficiency of US\$15.0 million relating to the understatement of expected loss ratios for the 1998 underwriting year. Future development could be significantly different from the past due to many unknown factors.

*Reinsurance Subsidiaries*

The following table shows for Fairfax's reinsurance subsidiaries the provision for claims liability for unpaid losses and LAE as originally and as ultimately estimated for the years 1997 through 1999. The favourable or unfavourable development from prior years is credited or charged to each year's earnings.

*Reconciliation of Provision for Claims –  
Reinsurance Subsidiaries*

	<b>1999</b> <i>(US\$000)</i>	<b>1998</b> <i>(US\$000)</i>	<b>1997</b> <i>(US\$000)</i>
Provision for claims and LAE at January 1 (in 1997, only for Odyssey Reinsurance (New York) and Wentworth)	2,824,039	2,157,706	858,469
Provision for claims and LAE for Sphere Drake and Odyssey Re Stockholm (transferred to runoff)	<u>(1,264,470)</u>	<u>–</u>	<u>–</u>
Adjusted provision for claims and LAE at January 1	<u>1,559,569</u>	<u>2,157,706</u>	<u>858,469</u>
Incurred losses on claims and LAE			
Provision for current accident year's claims	623,730	504,347	150,166
Increase (decrease) in provision for prior accident years' claims	<u>(15,909)</u>	<u>26,017</u>	<u>(7,901)</u>
Total incurred losses on claims and LAE	<u>607,821</u>	<u>530,364</u>	<u>142,265</u>
Payments for losses on claims and LAE			
Payments on current accident year's claims	(6,392)	(292,325)	(31,055)
Payments on prior accident years' claims	<u>(277,900)</u>	<u>(457,334)</u>	<u>(119,698)</u>
Total payments for losses on claims and LAE	<u>(284,292)</u>	<u>(749,659)</u>	<u>(150,753)</u>
Provision for claims and LAE at December 31	1,883,098	1,938,411	849,981
Provision for claims and LAE for CTR and Sphere Drake at December 31	–	–	1,307,725
Provision for claims and LAE for Odyssey Re Stockholm and ORC Re at December 31	–	885,628	–
Provision for claims and LAE for TIG Re at December 31	<u>961,110</u>	<u>–</u>	<u>–</u>
Provision for claims and LAE for reinsurance subsidiaries at December 31	2,844,208	2,824,039	2,157,706
<i>Exchange rate</i>	<i>1.4513</i>	<i>1.5382</i>	<i>1.4296</i>
Converted to Canadian dollars	<u>C\$4,127,800</u>	<u>C\$4,343,937</u>	<u>C\$3,084,656</u>

The company strives to establish adequate provisions at the original valuation date. It is the company's intention to have favourable development from the past. The reserves will always be subject to upward or downward development in the future.

The following table shows for Fairfax's reinsurance subsidiaries the original provision for claims reserves including LAE at each calendar year-end with the subsequent cumulative payments made from these years and the subsequent re-estimated amount of these reserves. The following reinsurance subsidiaries' reserves are included from the respective years in which such subsidiaries were acquired or established:

Wentworth	1990
Odyssey Reinsurance (New York)	1996
CTR	1997
Sphere Drake (transferred to runoff June 30, 1999)	1997
ORC Re	1998
TIG Re	1999

*Provision for Reinsurance Subsidiaries' Claims Reserve Development*

<b>As at December 31</b>	<b>1996</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>
	<i>(US\$000)</i>	<i>(US\$000)</i>	<i>(US\$000)</i>	<i>(US\$000)</i>
Provision for claims including LAE	858,469	2,157,706	2,824,039	2,844,208
Provision for claims including LAE for Sphere Drake and Odyssey Re Stockholm (transferred to runoff)	—	(886,508)	(1,264,470)	—
Adjusted provision for claims including LAE	858,469	1,271,198	1,559,569	2,844,208
Cumulative payments as of:				
One year later	119,698	205,256	277,900	
Two years later	229,077	362,558		
Three years later	314,048			
Reserves re-estimated as of:				
One year later	850,568	1,275,299	1,543,660	
Two years later	834,308	1,237,397		
Three years later	857,159			
Favourable development	1,310	33,801	15,909	

The favourable development of US\$15.9 million in 1999 was due to a favourable foreign exchange effect on CTR's reserves of US\$27.1 million offset by adverse development of CTR's reserves of US\$4.9 million and of Odyssey Reinsurance (New York)'s reserves of US\$6.3 million, primarily relating to recent underwriting years. The favourable development in 1998 was principally due to a favourable foreign exchange effect on CTR's reserves. Future development could be significantly different from the past due to many unknown factors.

*Runoff Subsidiaries*

The following table shows for Fairfax's runoff subsidiaries the provision for claims liability for unpaid losses and LAE as originally and as ultimately estimated since 1998. The favourable or unfavourable development from prior years is credited or charged to each year's earnings.

*Reconciliation of Provision for Claims –  
Runoff Subsidiaries*

	<b>1999</b> <i>(US\$000)</i>
Provision for claims and LAE at January 1 for Odyssey Re Stockholm and Sphere Drake	1,264,470
Incurring losses on claims and LAE	
Foreign exchange effect on claims	(19,056)
Provision for current accident year's claims	187,790
Increase in provision for prior accident years' claims	40,709
Total incurred losses on claims and LAE	209,443
Payments for losses on claims and LAE	
Payments on current accident year's claims	(99,447)
Payments on prior accident years' claims	(180,358)
Total payments for losses on claims and LAE	(279,805)
Provision for claims and LAE at December 31	1,194,108
Provision for claims and LAE for TRG at December 31	601,720
Provision for claims and LAE for runoff subsidiaries at December 31	1,795,828
<i>Exchange rate</i>	1.4513
Converted to Canadian dollars	<u>C\$2,606,285</u>

Sphere Drake is included in the above table for the full year even though it was transferred to runoff effective July 1, 1999. The unfavourable reserve development of US\$40.7 million was due to additional development of reserves at Sphere Drake in 1996 and subsequent underwriting years.

The company strives to establish adequate provisions at the original valuation rate. It is the company's objective to have favourable development from the past. The reserves will always be subject to upward or downward development in the future.

### Asbestos, Pollution and Other Hazards

Fairfax's reinsurance subsidiaries in the Odyssey Re Group, as well as Ranger, C&F, TIG and International Insurance, wrote insurance and reinsurance policies prior to their acquisition by Fairfax which involve asbestos related, environmental pollution and other hazards (APH) coverage, primarily in the United States. Following is an analysis of Fairfax's gross and net reserves from APH exposures at year-end and the movement in gross and net reserves for the year.

	1999		1998	
	Gross (US\$000)	Net (US\$000)	Gross (US\$000)	Net (US\$000)
Provision for APH claims and LAE at				
January 1	864,196	595,952	402,911	255,558
APH losses and LAE incurred during the				
year	92,390	55,734	48,851	32,357
APH losses and LAE paid during the year	(93,886)	(72,930)	(45,648)	(22,357)
Provision for APH claims and LAE at				
December 31	862,700	578,756	406,114	265,558
C&F provision for APH claims and LAE at				
December 31	-	-	458,082	330,394
TIG provision for APH claims and LAE at				
December 31	159,398	51,939	-	-
TRG provision for APH claims and LAE at				
December 31	1,168,000	224,000	-	-
Total provision for APH claims and LAE at				
December 31	<u>2,190,098</u>	<u>854,695</u>	<u>864,196</u>	<u>595,952</u>
Comprising:				
Outstanding	871,996	251,818	466,494	290,718
IBNR	1,318,102	602,877	397,702	305,234
Survival ratio – 3 year				
(before indemnifications)		10.0		12.0
Survival ratio – 3 year				
(after indemnifications)		19.2		18.2

The gross amount of US\$2,190.1 million is included in the C\$20,442.2 million shown as Provision for claims at December 31, 1999 on Fairfax's balance sheet on page 27.

The three year survival ratio represents the outstanding APH claims and LAE (including IBNR) at December 31 divided by the average paid APH claims for the last three years (including TIG and our effective 27.5% equity interest in International Insurance). The survival ratio after indemnifications includes one-half of the remaining indemnifications at December 31, 1999 for Odyssey Reinsurance (New York) (an internal indemnification as described on page 67), CTR, Sphere Drake, C&F and International Insurance and one-half of the remaining Swiss Re cover.

Many insurance coverage issues and circumstantial uncertainties make the estimation of these reserves very difficult. Inconsistencies among the states with regard to coverage, occurrence definitions and Superfund reform can all affect the outcome of APH claims.

These APH reserves are continuously monitored by management and are reviewed extensively by independent consulting actuaries.

Fairfax is protected against adverse development of these reserves at Odyssey Reinsurance (New York) (by an internal indemnification described on page 67), CTR, Sphere Drake, C&F and International Insurance from their levels at the time of acquisition of those companies (December 31, 1992 in the case of International Insurance) to the extent of the available indemnifications obtained in connection with those acquisitions, as discussed under Indemnifications on page 67, and at all Fairfax subsidiaries (including TIG but not International Insurance) by the Swiss Re cover.

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### Reinsurance Recoverables

Fairfax's subsidiaries purchase certain reinsurance so as to reduce their liability on the insurance and reinsurance risks which they write. Fairfax strives to minimize the credit risk of purchasing reinsurance through adherence to its internal reinsurance guidelines. To be an ongoing reinsurer of Fairfax, a company must have high A.M. Best and/or Standard & Poor's ratings and maintain capital and surplus exceeding \$100 million. The following table shows Fairfax's top twenty reinsurers at December 31, 1999. These twenty reinsurers represent 64% of Fairfax's \$8,671.6 million in reinsurance recoverable on unpaid losses (which total is net of bad debt reserves aggregating \$968.4 million).

<b>Reinsurers</b>	<b>A.M. Best Rating</b>	<b>Reinsurance Recoverable (\$000)</b>
Zurich Reinsurance	A+	765,045
Swiss Re	A+	550,606
Equitas	NR	517,845
London Life & Casualty Reinsurance	A	516,085
Ridge Reinsurance	NR	444,226
American Re	A++	336,189
ARC Insurance Company	NR	269,297
Underwriters Re	A+	252,773
General Reinsurance	A++	223,638
Nationwide Mutual Insurance Company	A+	187,634
Lloyd's of London Underwriters	A+	184,636
Security Insurance Company of Hartford	A	183,471
Employers Reinsurance Company	A++	172,965
Mountain Ridge Insurance Company	NR	153,958
Westchester Fire	A	141,389
Gerling Global	B+	140,404
SCOR	A+	140,161
Pyramid Insurance Company	NR	133,700
NAC Re	A+	131,819
Inter Ocean Re	A*	122,993
Other reinsurers		<u>4,071,211</u>
Total reinsurance recoverable on unpaid losses		9,640,045
Provision for uncollectible reinsurance		(968,406)
Net reinsurance recoverable on unpaid losses		<u>8,671,639</u>

\* S&P rating

The following table shows the classification of the total reinsurance recoverable on unpaid losses, by credit rating of the responsible reinsurers:

	<b>A.M. Best Rating (or S&amp;P equivalent)</b>	<b>Reinsurance Recoverable (\$000)</b>	<b>Outstanding Balances for which Security is Held (\$000)</b>
	A++	1,250,309	158,700
	A+	2,382,830	623,822
	A	2,053,302	413,754
	A-	220,133	39,249
	B++	484,987	192,056
	B+	265,471	140,416
	B	96,786	6,654
	D	1,295	70
	E	22,562	1,518
	Not rated	<u>2,862,370</u>	<u>1,608,814</u>
Total reinsurance recoverable on unpaid losses		9,640,045	<u>3,185,053</u>
Provision for uncollectible insurance		<u>(968,406)</u>	
Net reinsurance recoverable on unpaid losses		<u>8,671,639</u>	

To support total reinsurance recoverable balances, Fairfax has the benefit of letters of credit, trust funds or offsetting balances payable totalling \$3,185.1 million, as follows:

for reinsurers rated A- or better, Fairfax has security of \$1,235.5 million against outstanding reinsurance recoverable of \$5,906.6 million;

for reinsurers rated B++ or lower, Fairfax has security of \$340.7 million against outstanding reinsurance recoverable of \$871.1 million; and

for unrated reinsurers, Fairfax has security of \$1,608.9 million against outstanding reinsurance recoverable of \$2,862.4 million.

Equitas and Lloyd's are also required to maintain funds in Canada and the United States which are monitored by the applicable regulatory authorities. Fairfax has an aggregate provision for uncollectible reinsurance of \$968.4 million at December 31, 1999 compared with unsecured reinsurance recoverable from unrated reinsurers and reinsurers rated B++ or lower totalling \$1,783.9 million. Fairfax believes that this provision provides for all likely losses arising from uncollectible reinsurance at December 31, 1999.

Reinsurance treaties typically contain provisions concerning ceding commissions, required reports to the reinsurers, responsibility for taxes and arbitration in the event of a dispute, and provisions allowing the company to demand that a reinsurer post letters of credit or assets as security if a reinsurer becomes an "unauthorized" or "unapproved" reinsurer under applicable laws and regulations.

Fairfax is protected against adverse development of the reserves and unrecoverable reinsurance at Odyssey Re (New York) (by an internal indemnification described below), CTR, Sphere Drake, C&F and International Insurance from their levels at the time of acquisition of those companies (December 31, 1992 in the case of International Insurance) to the extent of the available indemnifications obtained in connection with those acquisitions, as discussed under Indemnifications below. In addition, Fairfax has a US\$1 billion cover from Swiss Re protecting it from adverse development in its subsidiaries' (including TIG but not International Insurance) claims reserves and unrecoverable reinsurance at December 31, 1998.

### Indemnifications

Shown below are the indemnifications originally received by Fairfax on previous acquisitions. These indemnifications protect Fairfax from adverse development in the respective companies' claims reserves and unrecoverable reinsurance as at the end (or, as regards C&F, as of August 13) of the respective original years shown. Those indemnifications for which a settlement year is shown will be settled as of the end of the respective settlement years shown.

During 1999, the indemnity in respect of Odyssey Reinsurance (New York) was assumed by a Fairfax reinsurance subsidiary in consideration of a cash payment made to that reinsurer, which Fairfax believes represented fair value to assume that indemnity.

Year	Company	Amount		Settlement Year
		(millions)	(C\$ millions)	
1992	International Insurance	US \$491**	713**	None
1995*	Odyssey Reinsurance (New York)	US \$175	254	2005
1995	CTR	FF 250	55	2005
1996	Sphere Drake	US \$171	248	2006
1998	C&F	US \$368**	534**	None
1998	All Fairfax subsidiaries, including TIG but not International Insurance	US \$1,000	<u>1,451</u>	None
			<u>3,255**</u>	

\* This indemnity is provided by a Fairfax reinsurance subsidiary, as described above.

\*\* After coinsurance.

At December 31, 1999, the company estimates that the indemnifications have been used to the following extent: International Insurance – US\$279 million (C\$405 million), Odyssey Reinsurance (New York) – US\$67 million (C\$97 million), CTR – FF146 million (C\$32 million), Sphere Drake – US\$119 million (C\$173 million) (as described in note 4 to the consolidated financial statements), C&F – US\$84 million (C\$122 million) and the US\$1 billion Swiss Re cover – US\$251 million (C\$364 million), leaving remaining indemnifications for future years totalling C\$2,062 million (\$1,905 excluding the internal indemnification).

### Year 2000

The company's systems were not adversely impacted by the year 2000 date change. To date, the company has not been notified of significant problems associated with the date change by

policyholders, brokers or suppliers. However, it is not possible to conclude that all aspects of the Year 2000 issue that may affect the company, including those related to customers, suppliers or other third parties, have been fully resolved.

### **Insurance Environment**

The property and casualty insurance market continued to be very competitive in 1999 with combined ratios in Canada and the U.S. expected to be approximately 105% and 108% respectively, versus 107% and 106% respectively in 1998. Increased catastrophe activity combined with very inadequate pricing resulted in the higher combined ratios in 1999. Significant restructuring and consolidation continues to take place in the industry. We continue to believe that over time price increases must take place to compensate for the underwriting losses combined with interest rates which are insufficient to adequately offset these losses. Currently, however, the industry continues to be highly competitive.

### **TIG Holdings Acquisition**

Effective April 13, 1999, the company acquired TIG Holdings. The consolidated balance sheet of TIG upon acquisition was as follows:

	<i>(US\$ millions)</i>
Investments, including cash	3,756
Deferred premium acquisition costs	101
Accounts receivable, including reinsurance	3,260
Deferred income taxes	291
Other assets	103
Total assets	<u>7,511</u>
Provision for claims	4,403
Unearned premiums	800
Other liabilities	<u>1,461</u>
Shareholders' equity	<u>847</u>

The purchase price of US\$847 million (\$1,262 million) was paid in cash.

The estimated discount to book value of US\$280 million at December 31, 1998 was allocated in the final purchase equation as follows:

US\$67 million to the decrease in the value of TIG's bond portfolio due to higher interest rates;

US\$38 million in acquisition related costs;

US\$40 million for TIG's share of the estimated premium for Fairfax's US\$1 billion Swiss Re cover; and

US\$135 million in other fair value adjustments, including additional reinsurance premiums payable, restructuring costs and the write down of non-current assets.

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TIG Insurance is licensed to write substantially all lines of property and casualty insurance in all states of the United States. In 1999, TIG Insurance's net premiums written were US\$1.1 billion. At year-end, the company had capital and surplus of US\$1.0 billion. TIG is rated A by A. M. Best.

**TRG Acquisition**

Effective August 11, 1999, the company acquired the class 1 voting shares of TRG Holding Corporation (representing an effective 27.5% equity and 100% voting interest). The consolidated balance sheet of TRG upon acquisition was as follows:

	<i>(US\$ millions)</i>
Investments, including cash	1,124
Accounts receivable, including reinsurance	1,422
Other assets	<u>51</u>
Total assets	2,597
Provision for claims	1,983
Other liabilities	<u>106</u>
Shareholders' equity	<u>508</u>

The acquisition price of US\$97 million (\$144 million) for the class 1 voting shares was paid in cash.

TRG was formed in 1993 to manage the runoff of International Insurance and other discontinued lines of business written by the former Talegen group of insurance companies. The runoff required effective management of major direct excess and surplus lines insurance and reinsurance liabilities, the resolution of complex litigation and the collection and management of reinsurance assets. At year-end, International Insurance had capital and surplus of US\$531.2 million.

**Interest and Dividend Income**

The majority of interest and dividend income is earned by the insurance and reinsurance companies. Major acquisitions were added to the portfolios in the following years:

<b>Acquisition Date</b>		<b>Portfolio</b> <i>(\$ millions)</i>
March 21, 1990	Federated	101
November 14, 1990	Commonwealth	130
December 31, 1993	Ranger	400
November 30, 1994	Lombard (including CRC (Bermuda))	684
May 31, 1996	Odyssey Reinsurance (New York)	1,490
February 27, 1997	CTR	764
December 3, 1997	Sphere Drake	1,068
August 13, 1998	Crum & Forster	4,955
September 4, 1998	Odyssey Re Stockholm	831
April 13, 1999	TIG	5,597
August 11, 1999	TRG	1,670

	<b>Average</b> <b>Investments</b> <b>at Book Value</b> <i>(\$000)</i>	<b>Interest and Dividend Income</b>					
		<b>Amount</b> <i>(\$000)</i>	<b>Pre-Tax</b>		<b>After-Tax</b>		
			<b>Yield</b> <i>(%)</i>	<b>Per Share</b> <i>(\$)</i>	<b>Amount</b> <i>(\$000)</i>	<b>Yield</b> <i>(%)</i>	<b>Per Share</b> <i>(\$)</i>
1985	29,060	2,445	8.45	0.87	1,271	4.37	0.45
1986	64,181	4,678	7.29	0.96	2,522	3.93	0.52
1987	109,825	8,042	7.32	1.10	5,499	5.01	0.77
1988	130,782	8,922	6.82	1.22	6,618	5.06	0.90
1989	135,703	11,628	8.57	1.51	8,537	6.29	1.11
1990	237,868	20,704	8.70	2.75	14,017	5.89	1.86
1991	338,461	26,051	7.70	4.44	17,731	5.24	3.02
1992	366,481	23,988	6.55	4.17	17,749	4.84	3.09
1993	418,207	23,251	5.56	3.78	17,994	4.30	2.92
1994	852,010	58,219	6.83	7.12	39,608	4.65	4.85
1995	1,608,054	89,354	5.56	10.00	73,664	4.58	8.25
1996	2,548,076	151,387	5.94	15.42	111,458	4.37	11.35
1997	4,584,569	254,562	5.55	23.64	174,408	3.80	16.19
1998	8,877,495	443,838	5.00	37.37	337,519	3.80	28.42
1999	14,684,044	752,980	5.13	56.48	492,033	3.35	36.91

Interest and dividend income increased in 1999 due to the acquisitions of Crum & Forster and Odyssey Re Stockholm in 1998 and the acquisitions of TIG and TRG in 1999. As shown, the pre-tax income yield increased in 1999 to 5.13% due to increasing interest rates in 1999, partially offset by a stronger Canadian dollar. The after-tax income yield decreased in 1999 because of less investment income earned in lower tax rate jurisdictions. Since 1985 pre-tax interest and dividend income per share has compounded at 35%% per year.

Investments for the past fifteen years are shown in the following table, the first five columns of which show them at the average of their carrying values at the beginning and end of each year, and the final two columns of which show them at year-end.

	<b>Cash and</b>				<b>Total Investments</b>		
	<b>Short Term</b>	<b>Bonds</b>	<b>Preferreds</b>	<b>Common</b>	<b>Average</b>	<b>Year-End</b>	<b>Per Share</b>
	<b>Investments</b>						
	<i>(\$000)</i>	<i>(\$000)</i>	<i>(\$000)</i>	<i>(\$000)</i>	<i>(\$000)</i>	<i>(\$000)</i>	<i>(\$)</i>
1985	10,526	15,388	732	2,414	29,060	32,728	6.55
1986	16,605	24,523	7,979	15,074	64,181	95,633	13.65
1987	28,025	26,242	16,516	39,042	109,825	124,016	16.90
1988	29,843	23,575	25,191	52,173	130,782	137,548	18.79
1989	20,623	28,528	32,212	54,340	135,703	133,858	18.30
1990	33,596	99,220	45,652	59,400	237,868	335,740	61.30
1991	60,099	140,177	75,685	62,500	338,461	341,180	62.54
1992	77,929	108,818	99,821	79,913	366,481	396,240	65.44
1993	102,968	90,682	118,604	105,953	418,207	848,774	106.70
1994	226,205	303,859	132,138	189,808	852,010	1,551,343	173.25
1995	297,989	796,310	157,017	356,738	1,608,054	1,668,656	188.14
1996	470,651	1,462,064	168,438	446,923	2,548,076	3,454,521	330.07
1997	822,569	2,989,063	226,936	546,001	4,584,569	5,795,703	520.62
1998	1,116,239	6,856,713	213,311	691,232	8,877,495	12,108,374	998.03
1999	1,858,597	11,583,341	144,454	1,097,653	14,684,045	17,434,909	1,298.57

Total investments per share at year-end 1999 increased significantly due to the TIG and TRG acquisitions, partially offset by a stronger Canadian dollar. Since 1985 investments per share have compounded at 46% per year.

The breakdown of the fixed income portfolio, by the higher of the S&P and Moody's credit ratings, as at December 31, 1999 was as follows:

<b>Credit Rating</b>	<b>Book Value</b>	<b>Market Value</b>
	<i>(\$000)</i>	<i>(\$000)</i>
AAA	7,837,145	7,059,383
AA	1,473,447	1,356,087
A	2,517,808	2,315,259
BBB	1,401,641	1,273,954
BB	18,800	17,442
B	21,182	8,631
C	599	635
NR	36,138	34,332
Total	<u>13,306,760</u>	<u>12,065,723</u>

89% of the fixed income portfolio is rated A or better.

**Return on Investment Portfolio**

The following table shows the performance of the investment portfolio for the past fifteen years. The total return includes all interest and dividend income, gains (losses) on the disposal of securities and the change in the unrealized gains (losses) during the year.

	<b>Average Investments at Book Value</b> (\$000)	<b>Interest and Dividends Earned</b> (\$000)	<b>Realized Gains (Losses) after Provisions</b> (\$000)	<b>Change in Unrealized Gains (Losses)</b> (\$000)	<b>Total Return on Average Investments</b> (\$000) (%)	
1985	29,060	2,455	459	878	3,792	13
1986	64,181	4,678	952	(352)	5,278	8
1987	109,825	8,042	9,159	(7,976)	9,225	8
1988	130,782	8,922	7,802	12,131	28,855	22
1989	135,703	11,628	15,458	(6,272)	20,814	15
1990	237,868	20,704	2,278	(32,943)	(9,961)	(4)
1991	338,461	26,051	(4,512)	27,866	49,405	15
1992	366,481	23,988	3,400	(11,197)	16,191	4
1993	418,207	23,251	27,822	28,792	79,865	19
1994	852,010	58,219	20,026	(42,407)	35,838	4
1995	1,608,054	89,354	71,912	45,438	206,704	13
1996	2,548,076	151,387	131,274	112,676	395,337	16
1997	4,584,569	254,562	206,773	(4,479)	456,856	10
1998	8,877,495	443,838	440,785	(117,169)	767,454	9
1999	14,684,045	752,980	121,670	(1,232,111)	(357,461)	(2)

Investment gains (losses) have been an important component of Fairfax's net earnings since 1985. The amount has fluctuated significantly from period to period, but the amount of investment gains (losses) for any period has no predictive value and variations in amount from period to period have no practical analytic value. At December 31, 1999, the aggregate provision for losses on investments was \$26.4 million (1998 - \$22.9 million). At December 31, 1999 the Fairfax investment portfolio had an unrealized loss of \$1,226.6 million compared to an unrealized gain at December 31, 1998 of \$5.5 million.

The company has a long term value-oriented investment philosophy. It continues to expect fluctuations in the stock market.

**Capital Resources**

At December 31, 1999, total capital, comprising shareholders' equity and non-controlling (minority) interest, was \$3,917.6 million, compared to \$2,326.8 million at December 31, 1998.

The following table shows the level of capital as at December 31 for the past five years:

	<b>1999</b>	<b>1998</b>	<b>1997</b>	<b>1996</b>	<b>1995</b>
	<i>(\$ millions)</i>				
Non-controlling interest	601.6	87.9	20.5	21.0	18.9
Common shareholders' equity	3,116.0	2,238.9	1,395.7	911.1	472.6
Preferred stock	<u>200.0</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>
	<u>3,917.6</u>	<u>2,326.8</u>	<u>1,416.2</u>	<u>932.1</u>	<u>491.5</u>

Fairfax's consolidated balance sheet as at December 31, 1999 continues to reflect significant financial strength. Fairfax's shareholders' equity has increased from \$2,238.9 million at December 31, 1998 to \$3,316.0 million at December 31, 1999, which includes the issuance of \$200 million perpetual preferred shares on November 18, 1999.

The company has issued and repurchased common shares over the last five years as follows:

<b>Date</b>	<b>Number of subordinate voting shares</b>	<b>Average issue/repurchase price per share (\$)</b>	<b>Net proceeds/ repurchase cost (\$ millions)</b>
1995 – repurchase of shares	(85,100)	80.99	(6.9)
1996 – issue of shares	1,600,000	187.81	288.3
– repurchase of shares	(3,500)	160.07	(0.6)
1997 – issue of shares	671,472	393.30	253.7
– repurchase of shares	(5,100)	308.82	(1.6)
1998 – issue of shares	1,000,000	475.00	455.6
1999 – issue of shares	2,000,000	500.00	959.7
– repurchase of shares	(706,103)	292.88	(206.8)

Fairfax's indirect ownership of its own shares through The Sixty Two Investment Company Limited results in an effective reduction of shares outstanding by 799,230, and this reduction has been reflected in the earnings per share and book value per share figures.

A common measure of capital adequacy in the property and casualty industry is the premiums to surplus (or common shareholders' equity) ratio. This is shown for the insurance and reinsurance subsidiaries of Fairfax for the past five years in the following table:

	<b>Net Premiums Written to Surplus (Common Shareholders' Equity)</b>				
	<b>1999</b>	<b>1998</b>	<b>1997</b>	<b>1996</b>	<b>1995</b>
<b>Insurance</b>					
Commonwealth	0.3	0.5	0.6	0.6	0.7
Crum & Forster	0.6	0.7	-	-	-
Falcon	0.3	0.1	-	-	-
Federated	1.6	1.6	1.2	1.2	1.2
Lombard	1.7	1.7	1.4	1.7	2.0
Markel	1.1	1.3	0.9	1.2	1.6
Ranger	0.8	1.2	1.1	1.1	1.2
TIG Specialty Insurance	1.1	-	-	-	-
<b>Reinsurance</b>					
Odyssey America	0.6	0.5	0.5	0.6	-
CTR	1.8	1.0	-	-	-
Canadian insurance industry	1.2	1.2	1.2	1.3	1.3
U.S. insurance industry	0.8	0.8	0.9	1.0	1.1

CTR's ratio of net premiums written to surplus increased to 1.8 in 1999 due to the high level of catastrophe losses incurred.

In Canada, property and casualty companies are regulated by the Office of the Superintendent of Financial Institutions on the basis of their Section 516 surplus. At December 31, 1999, Fairfax's Canadian property and casualty insurance subsidiaries had a combined Section 516 surplus of approximately \$233 million (1998 - \$274 million), in excess of minimum requirements.

In the U.S., the National Association of Insurance Commissioners (NAIC) has developed a model law and risk-based capital (RBC) formula designed to help regulators identify property-casualty insurers that may be inadequately capitalized. Under the NAIC's requirements an insurer must maintain total capital and surplus above a calculated threshold or face varying levels of regulatory action. The threshold is based on a formula that attempts to quantify the risk of a company's insurance, investment and other business activities. Fairfax does not anticipate any adverse effects of such requirements. At the end of 1999, the U.S. insurance and reinsurance subsidiaries had capital and surplus in excess of regulatory requirements. After taking into account vendor and other indemnifications, the U.S. subsidiaries had capital and surplus in excess of three times the authorized control level individually (in excess of two times in the case of TIG) and on an aggregate basis. The company's objective is for each of its U.S. subsidiaries to have capital and surplus in excess of three times the authorized control level within three years.

Fairfax and its insurance and reinsurance subsidiaries are rated as follows by the respective rating agencies:

	<b>A.M. Best</b>	<b>Standard &amp; Poor's</b>	<b>Duff &amp; Phelps</b>	<b>DBRS</b>	<b>Moody's</b>
Fairfax	–	BBB+	BBB+*	A–	Baa3
Commonwealth	A	A–	A	–	–
Crum & Forster	A–	A–	A	–	–
Falcon	–	A–	–	–	–
Federated	A	A–	A	–	–
Lombard	A–	A–	A	–	–
Markel	A–	A–	A	–	–
Ranger	B++	–	A	–	–
TIG Specialty Insurance	A	A–	A		
CRC (Bermuda)	A–	–	–	–	–
CTR	A–	A–	A	–	–
Odyssey America	A	A–	A	–	–
ORC Re	–	–	A	–	–
Wentworth	A	–	–	–	–

\*Fairfax's claims paying ability is rated a by Duff & Phelps.

### **Liquidity**

The purpose of liquidity management is to ensure that there is sufficient cash to meet all financial commitments and obligations as they fall due.

Fairfax's parent company-only income statement is disclosed on page 87. As shown, Fairfax had net revenue of \$405.8 million in 1999, consisting of dividends from its insurance and reinsurance subsidiaries (\$191.3 million), management fees (\$21.7 million), interest income (\$32.8 million) and recovery under the Swiss Re cover (\$206.5 million), offset by realized losses primarily from the amortization of the S&P puts (\$46.5 million). After interest expense (\$106.3 million), operating expenses (\$20.7 million) and non-recurring expenses (\$8.8 million), the parent company (or holding company) had earnings of \$270.0 million before taxes. As inter-company dividends are tax free, the parent company paid no income taxes. After recording a recovery of deferred income taxes of \$12.5 million for the parent company's tax losses, net earnings after taxes amounted to \$282.5 million. This income statement shows that in 1999, Fairfax comfortably met all its obligations from internal sources.

In 2000, Fairfax continues to have access to dividends and management fees and should again comfortably meet all its obligations from internal sources.

Fairfax has a large cash and liquid investment holding of \$712.7 million available to meet unexpected requirements. The cash in the holding company would permit Fairfax to meet its net interest and other expenses for five to six years without access to any dividends from its insurance and reinsurance subsidiaries.

Also, Fairfax has in excess of \$1.3 billion of undrawn, unsecured, committed, five year bank lines. The only significant covenant attached to these lines is a covenant to maintain a net debt to equity ratio not exceeding 1:1.

The company manages its debt levels based on the following financial measurements and ratios (with Lindsey Morden equity accounted):

	1999	1998	1997	1996	1995
			(\$ millions)		
Cash and marketable securities	712.7	305.4	207.1	101.1	70.4
Long term debt	1,959.0	1,444.4	718.4	470.5	298.0
Net debt	1,246.3	1,139.0	511.3	369.4	227.6
Common shareholders' equity	3,116.0	2,238.9	1,395.7	911.1	472.6
Preferred shares and trust preferred securities of subsidiaries	578.8	—	—	—	—
Total equity	3,694.8	2,238.9	1,395.7	911.1	472.6
Net debt/equity	34%	51%	37%	41%	48%
Net debt/total capital	25%	34%	27%	29%	33%
Net debt/earnings	10.0x	3.1x	2.2x	2.4x	2.6x
Interest coverage	0.7x	6.6x	8.7x	6.2x	5.7x

The company's financial position is very strong. The decrease in net debt/equity and net debt/total capital ratios in 1999 is principally due to the issue of \$200 million of preferred shares and US\$136 million of RHINOS preferred securities, classified as equity (see notes 6 and 7 to the consolidated financial statements). The higher net debt/earnings ratio and the lower interest coverage ratio reflect the company's low level of earnings in 1999. Excluding international catastrophe-related losses, in 1999 the net debt/earnings ratio would be 5.3x and the interest coverage ratio would be 2.2x.

The company has not paid and does not intend to pay common share dividends as long as it can reinvest its funds and earn a 20% return on equity over time.

### Issues and Risks

The following issues and risks, among others, should also be considered in evaluating the outlook of the company.

#### *Claims Reserves*

The major risk that all property and casualty insurance and reinsurance companies face is that the provision for claims is an estimate and may be found to be deficient in the future for a variety of reasons including unpredictable jury verdicts, expansion of insurance coverage to include exposures not contemplated at the time of policy issue (e.g. asbestos, pollution, breast implants), or poor weather. The provision for claims amounted to \$20,442.2 million on Fairfax's balance sheet as at December 31, 1999.

#### *Reinsurance Recoverables*

Most insurance and reinsurance companies reduce their liability for any individual claim by reinsuring amounts in excess of the maximum they want to retain. This third party reinsurance does not relieve the company of its primary obligation to the insured. Reinsurance recoverables can become an issue mainly due to solvency credit concerns but also due to policy disputes. Fairfax had \$8,671.6 million recoverable from reinsurers as at December 31, 1999.

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#### *Catastrophe Exposure*

Insurance and reinsurance companies are subject to losses from catastrophes like earthquakes, windstorms or hailstorms, which are unpredictable and can be very significant.

#### *Prices*

Prices in the insurance and reinsurance industry are cyclical and can fluctuate quite dramatically. With under-reserving, competitors can price below underlying costs for many years and still survive.

#### *Foreign Exchange*

The company has assets, liabilities, revenue and costs that are subject to currency fluctuations, particularly in the U.S. dollar but also other foreign currencies. These currency fluctuations have been and can be very significant.

#### *Cost of Revenue*

Unlike most businesses, the insurance and reinsurance business can have enormous costs that bear no relation to revenue. Similar to short selling in the stock market (selling shares not owned), there is no limit to the losses that can arise from most insurance policies.

#### *Regulation*

Insurance and reinsurance companies are regulated businesses which means that Fairfax does not have access to its insurance and reinsurance subsidiaries' net income and shareholders' capital without the requisite approval of applicable insurance regulatory authorities.

#### *Common Stock Holdings*

The company has common stocks in its portfolio. As common stocks fluctuate, the company's equity (or surplus) is exposed to fluctuations in the stock market.

#### *Goodwill*

Most of the goodwill on the balance sheet comes from Lindsey Morden. Continued profitability is essential for there to be no deterioration in the carrying value of the goodwill.

#### *Ratings*

The company has excellent claims paying and debt ratings by the major rating agencies in North America. As financial stability is very important to its customers, the company is vulnerable to downgrades by the rating agencies.

#### *Holding Company*

Being a small holding company, Fairfax is very dependent on strong operating management, which makes it vulnerable to management turnover.

**Quarterly Data (unaudited)***(in \$ millions except per share data)*

<i>Years ended December 31</i>	<b>First quarter</b>	<b>Second quarter</b>	<b>Third quarter</b>	<b>Fourth quarter</b>	<b>Full year</b>
1999					
Revenue	1,023.2	1,569.9	1,501.9	1,684.8	5,788.5
Net earnings (loss)	78.1	40.9	35.3	(30.1)	124.2
Net earnings (loss) per share	\$6.37	\$2.82	\$2.45	\$(2.44)	\$9.20
1998					
Revenue	637.2	648.2	1,157.8	1,131.1	3,574.3
Net earnings	52.8	58.1	108.7	167.9	387.5
Net earnings per share	\$4.75	\$4.79	\$9.08	\$14.01	\$32.63

**Stock Prices**

Below are The Toronto Stock Exchange high, low and closing prices of subordinate voting shares of Fairfax for each quarter of 1999 and 1998.

	<b>First quarter</b>	<b>Second quarter</b>	<b>Third quarter</b>	<b>Fourth quarter</b>
	<i>(\$)</i>	<i>(\$)</i>	<i>(\$)</i>	<i>(\$)</i>
1999				
High	610.00	460.00	425.00	279.50
Low	415.00	361.00	194.00	180.00
Close	440.00	395.00	220.00	245.50
1998				
High	500.00	600.00	603.00	575.00
Low	253.00	487.00	420.00	390.00
Close	487.00	574.00	441.00	540.00

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**Fairfax Insurance and Reinsurance Companies****Combined Balance Sheets**

as at December 31, 1999 and 1998

(unaudited)

	<b>1999</b> (\$000)	<b>1998</b> (\$000)
<b>Assets</b>		
Accounts receivable and other .....	2,747,044	2,563,649
Recoverable from reinsurers .....	7,194,901	3,820,426
Income taxes refundable .....	—	24,243
	<u>9,941,945</u>	<u>6,408,318</u>
<i>Portfolio investments (at book value)</i>		
Cash and short term investments .....	1,321,018	897,728
Bonds .....	11,531,924	9,861,070
Preferred stocks .....	116,549	156,980
Common stocks .....	1,854,692	801,723
Real estate .....	48,790	94,012
	<u>14,872,973</u>	<u>11,811,513</u>
Deferred premium acquisition costs .....	336,874	277,292
Deferred income taxes .....	893,742	491,767
Capital assets .....	46,854	52,375
Other assets .....	27,426	25,336
	<u>26,119,814</u>	<u>19,066,601</u>
<b>Liabilities</b>		
Accounts payable and accrued liabilities .....	1,188,955	862,448
Premium deposits .....	1,198,516	97,443
Income taxes payable .....	57,070	—
	<u>2,444,541</u>	<u>959,891</u>
Provision for claims .....	17,168,763	13,161,215
Unearned premiums .....	2,050,160	1,651,498
	<u>19,218,923</u>	<u>14,812,713</u>
<b>Shareholders' Equity</b>		
Capital stock .....	3,331,453	2,511,457
Contributed surplus .....	39,542	21,932
Retained earnings .....	1,085,355	760,608
	<u>4,456,350</u>	<u>3,293,997</u>
	<u>26,119,814</u>	<u>19,066,601</u>

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**Fairfax Insurance and Reinsurance Companies****Combined Statements of Earnings***for the years ended December 31, 1999 and 1998**(unaudited)*

	<b>1999</b> <i>(\$000)</i>	<b>1998</b> <i>(\$000)</i>
<b>Revenue</b>		
Gross premiums written .....	5,540,508	2,966,376
Net premiums written .....	4,022,541	2,276,607
Net premiums earned .....	4,232,251	2,394,851
<b>Expenses</b>		
Losses on claims .....	3,346,505	1,889,412
Operating expenses .....	633,114	374,613
Commissions, net .....	869,696	442,205
	4,849,315	2,706,230
<b>Underwriting loss</b> .....	(617,064)	(311,379)
<b>Investment and other income (expense)</b>		
Interest and dividends .....	711,475	432,024
Realized gains on investments .....	149,678	429,766
	861,153	861,790
Other .....	(63,082)	(52,816)
	798,071	808,974
<b>Earnings before income taxes</b> .....	181,007	497,595
Provision for (recovery of) income taxes .....	(143,740)	109,838
<b>Net earnings</b> .....	324,747	387,757
<b>Loss ratio</b> .....	79.1%	78.9%
<b>Expense ratio</b> .....	35.5%	34.1%
<b>Combined ratio</b> .....	114.6%	113.0%

**Fairfax Insurance and Reinsurance Companies**

Fairfax's insurance business is conducted by a number of subsidiaries. These subsidiaries underwrite a wide range of commercial and personal property, oil and gas, casualty and life insurance and property, casualty and life reinsurance in Canada, the United States and internationally.

**Fairfax with Equity Accounting of Lindsey Morden****Consolidated Balance Sheets**

as at December 31, 1999 and 1998

(unaudited)

	<b>1999</b> (\$000)	<b>1998</b> (\$000)
<b>Assets</b>		
Cash and short term investments .....	613,197	245,999
Marketable securities .....	99,479	59,366
Share subscription receipts cash in trust .....	–	959,700
Accounts receivable and other .....	3,485,634	2,609,033
Recoverable from reinsurers .....	8,671,639	3,820,426
Income taxes refundable .....	96,812	18,629
	<u>12,966,761</u>	<u>7,713,153</u>
<i>Portfolio investments</i>		
Subsidiary cash and short term investments (market value – \$1,844,218; 1998 – \$898,975) .....	1,844,218	898,975
Bonds (market value – \$12,065,723; 1998 – \$9,879,987) .....	13,306,760	9,851,956
Preferred stocks (market value – \$132,614; 1998 – \$159,337) .....	133,928	154,980
Common stocks (market value – \$1,403,367; 1998 – \$767,200) .....	1,387,628	794,088
Real estate (market value – \$80,735; 1998 – \$94,460) .....	80,735	94,460
Total (market value – \$15,526,657; 1998 – \$11,799,959) ..	<u>16,753,269</u>	<u>11,794,459</u>
Investment in Lindsey Morden .....	104,607	101,786
Investments in Hub and Zenith National .....	363,380	–
Deferred premium acquisition costs .....	361,146	277,292
Deferred income taxes .....	890,574	521,834
Capital assets .....	89,567	53,990
Goodwill .....	6,690	8,974
Other assets .....	95,103	37,522
	<u>31,631,097</u>	<u>20,509,010</u>
	<b>1999</b> (\$000)	<b>1998</b> (\$000)
<b>Liabilities</b>		
Share subscription receipts .....	–	959,700
Accounts payable and accrued liabilities .....	1,296,872	728,090
Premium deposits .....	1,198,516	97,443
	<u>2,495,388</u>	<u>1,785,233</u>
Provision for claims .....	20,442,199	13,161,215
Unearned premiums .....	2,276,344	1,651,498
Long term debt .....	1,959,042	1,444,411
Trust preferred securities of subsidiaries .....	378,789	–
	<u>25,056,374</u>	<u>16,257,124</u>
Non-controlling interest .....	529,113	–
Excess of net assets acquired over purchase price paid ...	234,243	227,803
	<u>25,819,730</u>	<u>16,484,927</u>
<b>Shareholders' Equity</b>		
Common stock .....	2,066,297	1,222,339
Preferred stock .....	200,000	–
Retained earnings .....	1,049,682	1,016,511
	<u>3,315,979</u>	<u>2,238,850</u>
	<u>31,631,097</u>	<u>20,509,010</u>

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**Fairfax with Equity Accounting of Lindsey Morden****Consolidated Statements of Earnings***for the years ended December 31, 1999 and 1998**(unaudited)*

	<b>1999</b> <i>(\$000)</i>	<b>1998</b> <i>(\$000)</i>
<b>Revenue</b>		
Gross premiums written .....	5,707,518	2,966,376
Net premiums written .....	4,151,129	2,276,607
Net premiums earned .....	4,470,719	2,394,851
Interest and dividends .....	752,980	443,838
Realized gains on investments .....	121,670	440,785
Equity earnings of Lindsey Morden, net of dividends .....	2,784	12,388
	<u>5,348,153</u>	<u>3,291,862</u>
<b>Expenses</b>		
Losses on claims .....	3,578,337	1,889,412
Operating expenses .....	796,040	407,375
Commissions, net .....	869,696	442,205
Interest expense .....	129,262	84,356
	<u>5,373,335</u>	<u>2,823,348</u>
<b>Earnings (loss) before income taxes</b> .....	(25,182)	468,514
Provision for (recovery of) income taxes .....	(158,023)	80,979
<b>Net earnings before non-controlling interest</b> .....	132,841	387,535
Non-controlling interest .....	(8,633)	-
<b>Net earnings</b> .....	<u>124,208</u>	<u>387,535</u>
<b>Net earnings per share</b> .....	\$ 9.20	\$ 32.63

**Lindsey Morden Group Inc.****Consolidated Balance Sheets***as at December 31, 1999 and 1998*

	<b>1999</b> (\$000)	<b>1998</b> (\$000)
<b>Assets</b>		
Cash .....	2,488	8,360
Accounts receivable.....	95,275	93,738
Claims in process.....	56,355	61,981
Temporary investment in common shares.....	10,277	20,331
Prepaid expenses .....	3,989	7,230
Income tax recoverable .....	2,687	—
	<u>171,071</u>	<u>191,640</u>
Property and equipment .....	32,656	40,598
Goodwill .....	239,409	267,426
Future income taxes .....	7,038	2,355
Other assets .....	23,333	18,401
	<u>473,507</u>	<u>520,420</u>
<b>Liabilities</b>		
Bank indebtedness.....	43,801	31,824
Accounts payable and accrued liabilities .....	80,682	111,894
Income taxes payable .....	16,332	8,037
Current portion of long term debt .....	2,165	6,581
Deferred income taxes .....	4,577	5,852
	<u>147,557</u>	<u>164,188</u>
Long term debt .....	132,840	137,655
Future retirement payments .....	5,893	6,644
Pension and other liabilities.....	10,128	20,694
	<u>296,418</u>	<u>329,181</u>
<b>Shareholders' Equity</b>		
Capital stock .....	145,205	152,228
Retained earnings .....	31,884	39,011
	<u>177,089</u>	<u>191,239</u>
	<u>473,507</u>	<u>520,420</u>

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**Lindsey Morden Group Inc.**  
**Consolidated Statements of Earnings**  
*for the years ended December 31, 1999 and 1998*

	<b>1999</b> <i>(\$000)</i>	<b>1998</b> <i>(\$000)</i>
<b>Revenue</b> .....	443,085	294,843
<b>Cost and expenses</b>		
Cost of service .....	333,870	211,482
Selling, general and administration .....	76,898	62,145
Interest .....	12,148	5,610
	<u>422,916</u>	<u>279,237</u>
<b>Earnings before income taxes</b> .....	20,196	15,606
Provision for income taxes .....	5,938	5,384
	<u>14,231</u>	<u>10,222</u>
<b>Net earnings from continuing operations before goodwill</b> .....	14,231	10,222
<b>Goodwill amortization</b> .....	9,518	2,935
	<u>4,713</u>	<u>7,287</u>
<b>Net earnings from continuing operations</b> .....	4,713	7,287
<b>Discontinued operations</b> .....	-	15,988
	<u>4,713</u>	<u>23,275</u>
<b>Net earnings</b> .....	<u>4,713</u>	<u>23,275</u>

**Consolidated Statements of Retained Earnings**  
*for the years ended December 31, 1999 and 1998*

	<b>1999</b> <i>(\$000)</i>	<b>1998</b> <i>(\$000)</i>
<b>Retained earnings – beginning of year</b> .....	39,011	20,708
Net earnings for the year .....	4,713	23,275
Dividends .....	(11,840)	(4,972)
	<u>31,884</u>	<u>39,011</u>
<b>Retained earnings – end of year</b> .....	<u>31,884</u>	<u>39,011</u>

*These condensed financial statements have been prepared from the Lindsey Morden Group Inc. audited consolidated financial statements as at and for the years ended December 31, 1999 and 1998, copies of which are available on request.*

**Fairfax Financial Holdings Limited****Unconsolidated Balance Sheets**

as at December 31, 1999 and 1998

(unaudited)

	<b>1999</b>	<b>1998</b>
	(\$000)	(\$000)
<b>Assets</b>		
<i>Subsidiary companies</i>		
Insurance companies .....	2,302,193	1,789,263
Reinsurance companies .....	1,400,716	1,573,505
Runoff companies .....	601,584	–
Hamblin Watsa .....	3,967	5,367
Noro .....	1,372	2,027
Other investments .....	10,606	8,218
	<u>4,320,438</u>	<u>3,378,380</u>
Cash and short term investments .....	613,197	245,999
Marketable securities .....	99,479	59,366
Share subscription receipts cash in trust .....	–	959,700
Swiss Re recoverable .....	225,365	–
Other assets .....	49,033	101,875
	<u>5,307,512</u>	<u>4,745,320</u>
<b>Liabilities</b>		
Share subscription receipts .....	–	959,700
Accounts payable and other liabilities .....	282,122	102,359
Long term debt .....	1,709,411	1,444,411
	<u>1,991,533</u>	<u>2,506,470</u>
<b>Shareholders' Equity</b>		
Common stock .....	2,066,297	1,222,339
Preferred stock .....	200,000	–
Retained earnings .....	1,049,682	1,016,511
	<u>3,315,979</u>	<u>2,238,850</u>
	<u>5,307,512</u>	<u>4,745,320</u>

The investments in subsidiaries are carried on the equity basis whereby they are included at their original purchase price plus Fairfax's share of the earnings less dividends. The investments in Hub, Zenith National and Lindsey Morden are held through the company's insurance and reinsurance subsidiaries.

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**Fairfax Financial Holdings Limited**  
**Unconsolidated Statements of Earnings**

(parent company-only income statement)

for the years ended December 31, 1999 and 1998

(unaudited)

	<b>1999</b>	<b>1998</b>
	(\$000)	(\$000)
<b>Revenue</b>		
Swiss Re recovery (net) .....	206,513	–
Dividend income .....	191,326	135,289
Interest income .....	32,767	29,883
Management fees .....	21,675	16,376
Realized losses .....	<u>(46,496)</u>	<u>(14,674)</u>
	<u>405,785</u>	<u>166,874</u>
<b>Expenses</b>		
Interest expense .....	106,267	80,713
Operating expenses .....	20,700	16,662
Non-recurring expenses .....	<u>8,797</u>	<u>10,084</u>
	<u>135,764</u>	<u>107,459</u>
<b>Earnings before income taxes</b> .....	270,021	59,415
Recovery of income taxes .....	<u>12,500</u>	<u>30,000</u>
<b>Net earnings</b> .....	<u>282,521</u>	<u>89,415</u>

## APPENDIX I

To Our Shareholders:

November 3, 1999

August is usually the month when the U.S. hurricane season begins. While we were spared a physical hurricane in August, our stock price faced gale force winds when we reported our second quarter results, dropping 30% on August 5, 1999. At \$210, Fairfax's stock price is down 61% from year-end 1998 and 66% from its high of \$610 recorded on February 3, 1999. While I have refrained from discussing fluctuations in our stock price – up or down – this recent significant decline prompted me to write this letter to you.

### **Fairfax is run for the long term**

Since we began in September 1985, we have emphasized to you our shareholders that our company is run for the long term. We have never been concerned about short term results and have stated many times that “we will accept short term volatility in our earnings for better long term results.” Please re-read the previous line as it is the single most important statement about understanding the Fairfax philosophy. While we have achieved an average ROE of 20.4% in the past 13 years, there have been two years, 1992 and 1994, when we have earned only 7.7% and 12.1% respectively. While 1999 may be another one of these years, I believe the *long term* prospects for Fairfax have never been brighter. Here are some of the reasons for my optimism.

#### 1) **Size and scope of our operations**

With \$5+ billion in premiums, \$32+ billion in assets and extremely capable management running our subsidiaries, we have scale in our insurance operations in Canada and the U.S. and our worldwide reinsurance operations. This means we have the ability to attract the very best management to join our company. This was demonstrated again recently with our announcement that Bruce Esselborn has joined us to run the Crum & Forster (C&F) group of companies. As we look at our companies today, we think it is fair to say that we have the strongest group of Presidents running our decentralized operations that we have ever had. Each of our Presidents is focused on underwriting profit and *not* on market share. While our Canadian companies have historically achieved our 100% combined ratio target, we expect to see our U.S. operations, C&F, Ranger, and TIG, and our worldwide reinsurance operation, Odyssey Re Group, continue to demonstrate a clear trend to underwriting profitability beginning in 2000. Our consolidated target combined ratio for the Fairfax group in 2000 is 105% and all our companies are striving for 100% in 2001.

#### 2) **Strong financial position**

We have always maintained a very strong balance sheet. Our accounting policies are very conservative and our balance sheet is very sound. The major risks on our balance sheet, reserve development and bad debt on reinsurance recoverables, are well protected by approximately \$1 billion of vendor indemnifications followed by our US\$1 billion reinsurance cover from Swiss Re\* followed by negative goodwill (\$285 million) and

\* The Swiss Re reinsurance also covers the losses that may arise from the Odyssey Re London contracts that are in dispute.

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additional provisions in excess of \$200 million. While there are no guarantees in life, it is highly unlikely that all of these protections would be required. For some of you who are confused, our negative goodwill is shown as a liability on our balance sheet while the only positive goodwill on our consolidated balance sheet is from Lindsey Morden (very justified for a service company with 3,750 employees and a worldwide network of 450 offices). With these protections, we believe our shareholders' equity of \$3.2 billion is rock solid. Finally, our cash flows from our insurance companies, combined with the very significant cash we maintain at our holding company, together with long term unused bank lines well in excess of \$1 billion, give us a very strong financial position.

3) **Investment portfolios and unrealized losses**

As discussed in our 1998 Annual Report, we continue to be very concerned about the level of the U.S. stock market. Our portfolios are largely in high quality bonds (90%+) and the rest mainly in stocks outside North America. While our results in the past two years have been penalized by our asset mix and by our purchase of S&P puts, we feel very comfortable that we have protected our company from the turmoil in the U.S. stock markets that has *yet to come*. Please remember our first rule is to protect our capital from permanent loss and only then to make a return. With tremendous speculation all around us, protection of capital is paramount today.

The unrealized loss of \$940 million in our bond portfolio is a result of rising interest rates during 1999. This unrealized loss does not impact our regulatory capital (as bonds are recorded at cost in the U.S.) and will not be realized as we will hold these bonds to maturity or until interest rates drop. As a significant amount of our bonds have dual maturities, if interest rates drop, our bonds will trade to the long maturity. For example, if long U.S. Treasury bond yields, which began the year at about 5% and currently exceed 6%, go back down to 5%, our unrealized loss of \$940 million in our bond portfolio becomes a \$500+ million unrealized gain assuming corporate bond spreads don't widen from current levels. Conversely, if rates were to rise further, we would hold the bonds to maturity and would not realize a loss, assuming that the credits are not impaired. We feel very comfortable with our investment portfolios, again, particularly in light of the speculative activity that is all around us.

Long term, a very significant positive for our company is our marketable investment portfolio of \$18 billion (\$1,300 per share) which generates interest and dividends of \$900 million pretax annually (\$65 per share) – excluding capital gains!

4) **Stock fluctuations and intrinsic value**

At our annual meeting on April 13, 1999, I presented a slide that showed that stock fluctuations had nothing to do with the intrinsic value of a company in the short term but very much reflected it in the long term. I have reproduced that slide for you in this letter.

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**SHAREHOLDER VALUE VS STOCK PRICE FLUCTUATIONS**

	SHAREHOLDER VALUE		STOCK PRICE
	ROE %	% Change in Book Value* Per Share	% Change in Stock Price
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
1985-98	20.4%	+41%	+48%

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

As shown in the table, in 1986, Fairfax's stock price increased 292% even though the book value increased only 183%. In 1990, our stock price dropped 41% even though the book value of our company increased 39%. Over the long term though (i.e. 13 years), book value and our stock price have compounded at roughly the same rates. As of November 3, our stock is down 61% during 1999 even though the book value of our company has increased 26% and investments per share have increased by 30% to \$1,300 per share. As in 1990, the stock market is not reflecting the build-up of long term intrinsic value at Fairfax but the short term volatility in its earnings.

Currently, Fairfax is selling below its book value for the first time since 1990/91. In 1990, we repurchased 25% of our shares outstanding at an average cost of \$9 per share. In 1999, we have repurchased 522,000 shares at an average cost of \$309 per share – approximately 4% of the shares outstanding prior to these purchases.

You can rest assured that at current prices, the best opportunity for our company will be to retire as many shares as possible while maintaining a very strong financial position. We continue to be very confident of the **long term** prospects for our company.

*V. P. Watsa*

V. Prem Watsa  
Chairman and Chief  
Executive Officer

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## APPENDIX II

### GUIDING PRINCIPLES FOR FAIRFAX FINANCIAL HOLDINGS LIMITED

#### OBJECTIVES:

- 1) We expect to earn long term results on shareholders' equity in excess of 20% annually by running Fairfax and its subsidiaries for the long term benefit of customers, employees and shareholders – at the expense of short term profits if necessary.

Our focus is long term growth in book value per share and not quarterly earnings. We plan to grow through internal means as well as through friendly acquisitions.

- 2) We always want to be soundly financed.
- 3) We provide complete disclosure annually to our shareholders.

#### STRUCTURE:

- 1) Our companies are decentralized and run by the presidents except for performance evaluation, succession planning, acquisitions and financing which are done by or with Fairfax. Cooperation among companies is encouraged to the benefit of Fairfax in total.
- 2) Complete and open communication between Fairfax and subsidiaries is an essential requirement at Fairfax.
- 3) Share ownership and large incentives are encouraged across the Group.
- 4) Fairfax will always be a very small holding company and not an operating company.

#### VALUES:

- 1) Honesty and integrity are essential in all our relationships and will never be compromised.
- 2) We are results oriented – not political.
- 3) We are team players – no “egos”. A confrontational style is not appropriate. We value loyalty – to Fairfax and our colleagues.
- 4) We are hard working but not at the expense of our families.
- 5) We always look at opportunities but emphasize downside protection and look for ways to minimize loss of capital.
- 6) We are entrepreneurial. We encourage calculated risk taking. It is all right to fail but we should learn from our mistakes.
- 7) We will never bet the company on any project or acquisition.
- 8) We believe in having fun – at work!

**Consolidated Financial Summary** (in \$ millions except share and per share data)

	Per Share			Revenue	Earnings before income taxes	Net earnings	Total assets <sup>(1)</sup>	Investments	Net debt <sup>(2)</sup>	Shareholders' equity	Shares outstanding at year-end (000)	Closing stock price
	Return on average shareholders' equity	Shareholders' equity	Net earnings - fully diluted									
<i>For the years ended December 31:</i>												
1985	—	2.08	(1.89)	17.0	(0.9)	(0.9)	41.5	32.7	—	10.4	5,000	3.25 <sup>(3)</sup>
1986	25.4%	5.89	1.35	53.7	9.1	6.5	129.8	95.6	2.8	41.3	7,007	12.75
1987	31.3%	8.32	2.23	113.0	18.2	16.0	185.4	124.0	2.8	61.0	7,337	12.37
1988	21.2%	10.13	1.94	133.6	21.3	14.4	246.8	137.5	28.2	74.2	7,322	15.00
1989	20.3%	12.41	2.25	125.8	19.2	16.7	248.1	133.9	22.0	90.8	7,316	18.75
1990	23.0%	17.29	2.92	195.4	23.2	21.3	536.0	335.7	65.9	94.7	5,477	11.00
1991	21.3%	21.41	3.94	250.0	32.5	22.5	516.6	341.2	51.3	116.8	5,455	21.25
1992	7.7%	23.76	1.76	286.8	7.0	10.0	590.5	396.2	68.2	143.8	6,055	25.00
1993	20.3%	35.13	5.42	344.0	46.7	33.3	1,200.3	848.8	132.4	279.5	7,955	61.25
1994	12.1%	43.77	4.66	634.9	46.0	38.1	2,173.4	1,551.3	218.0	391.9	8,955	67.00
1995	20.1%	53.28	9.79	1,145.5	95.9	87.5	2,873.5	1,668.1	227.7	472.6	8,869	98.00
1996	21.4%	87.05	15.36	1,475.8	187.3	150.8	5,778.4	3,454.5	369.4	911.1	10,466	290.00
1997	20.4%	125.38	21.59	2,088.3	336.0	232.5	10,207.3	5,795.7	511.3	1,395.7	11,132	320.00
1998	20.1%	184.54	32.63	3,574.3	484.8	387.5	20,886.7	12,108.4	1,139.0	2,238.9	12,132	540.00
1999	4.3%	231.98	9.20	5,788.5	(17.3)	124.2	31,935.3	17,434.9	1,246.3	3,116.0 <sup>(4)</sup>	13,426	245.50

<sup>(1)</sup> Commencing in 1995, reflects a change in accounting policy for reinsurance recoverables

<sup>(2)</sup> Total debt (beginning in 1994, net of cash in the holding company) with Lindsey Morden equity accounted

<sup>(3)</sup> When current management took over in September 1985

<sup>(4)</sup> Excluding \$200.0 million of preferred stock and \$378.8 million of other preferred securities

Readers of the Management's Discussion and Analysis should review the entire Annual Report for additional commentary and information.

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### **Directors of the Company**

- \* Winslow W. Bennett  
President, Winwood Holdings Ltd.
- \* Robbert Hartog  
President, Robhar Investments Ltd.  
Kenneth R. Polley  
President and Chief Executive Officer  
Lindsey Morden Group Inc.  
John C. Puddington  
President  
Trilwood Investments Limited
- \* V. Prem Watsa  
Chairman and Chief Executive Officer
- \* *Audit Committee Member*

### **Operating Management**

John Watson, Chairman  
Ronald Schwab, President  
*Commonwealth Insurance Company*  
Bruce Esselborn, Chairman  
*Crum & Forster Holdings, Inc.*  
Kenneth Kwok, President  
*Falcon Insurance Company Limited*  
John M. Paisley, President  
*Federated Insurance Company of Canada*  
Anthony F. Hamblin, President  
*Hamblin Watsa Investment Counsel Ltd.*  
Marty Hughes, Chairman  
Richard A. Gulliver, President  
*The Hub Group Limited*  
Kenneth R. Polley, President  
*Lindsey Morden Group Inc.*  
Byron G. Messier, President  
*Lombard General Insurance Company of Canada*  
Mark J. Ram, President  
*Markel Insurance Company of Canada*  
Andrew A. Barnard, President  
*Odyssey Re Group Ltd.*  
Michael Wacek, President  
*Odyssey America Reinsurance Corporation*  
Jean-Philippe Casanova, Chairman  
Lucien Pietropoli, President  
*Compagnie Transcontinentale de Réassurance*  
Philip Broughton, President  
*Ranger Insurance Company*  
Courtney Smith, President  
*TIG Specialty Insurance Company*  
Michael A. Coutu, Chairman  
Dennis C. Gibbs, President  
*TRG Holding Corporation*

### **Officers of the Company**

Trevor J. Ambridge  
Vice President and Chief Financial Officer  
Sam Chan  
Vice President  
Francis Chou  
Vice President  
Jean Cloutier  
Vice President  
J. Paul T. Fink  
Vice President  
Bradley P. Martin  
Vice President  
Elizabeth J. Murphy  
Vice President and Corporate Secretary  
Eric P. Salsberg  
Vice President, Corporate Affairs  
Ronald Schokking  
Vice President, Finance  
John C. Varnell  
Vice President  
V. Prem Watsa  
Chairman and Chief Executive Officer

### **Officers of Fairfax Inc.**

Denise Davies, Vice President  
James F. Dowd, President  
Scott Galiardo, Vice President  
James Migliorini, Vice President  
James Stark, Chairman

### **Head Office**

95 Wellington Street West  
Suite 800  
Toronto, Ontario, Canada M5J 2N7  
Telephone (416) 367-4941  
Web site [www.fairfax.ca](http://www.fairfax.ca)

### **Auditors**

PricewaterhouseCoopers LLP

### **General Counsel**

Torlys

### **Transfer Agent and Registrar**

CIBC Mellon Trust Company

### **Share Listing**

The Toronto Stock Exchange  
Stock Symbol FFH

### **Annual Meeting**

The annual meeting of shareholders of Fairfax Financial Holdings Limited will be held on Tuesday, April 11, 2000 at 9:30 a.m. in Room 106 at the Metro Toronto Convention Centre, 255 Front Street West, Toronto.

