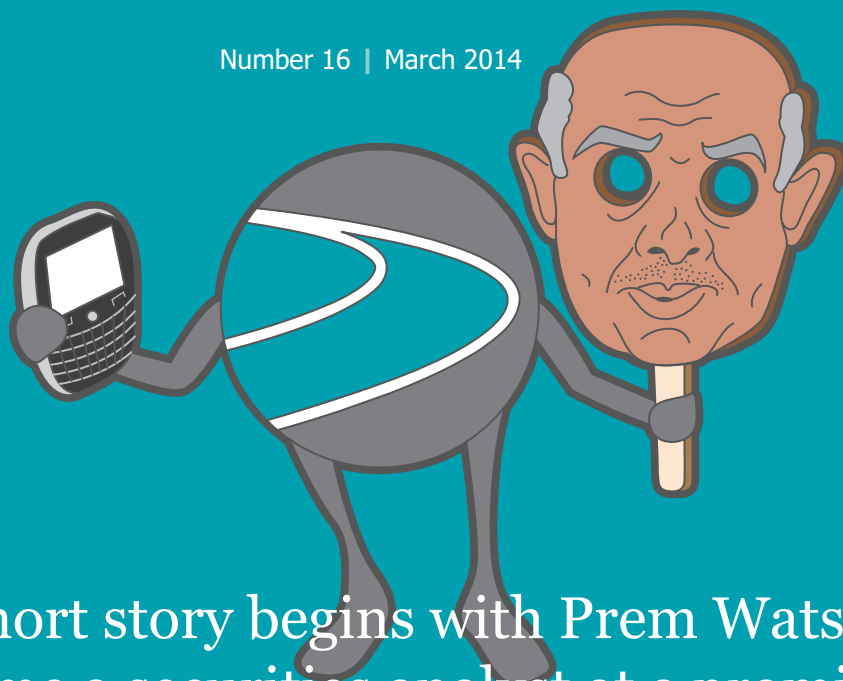
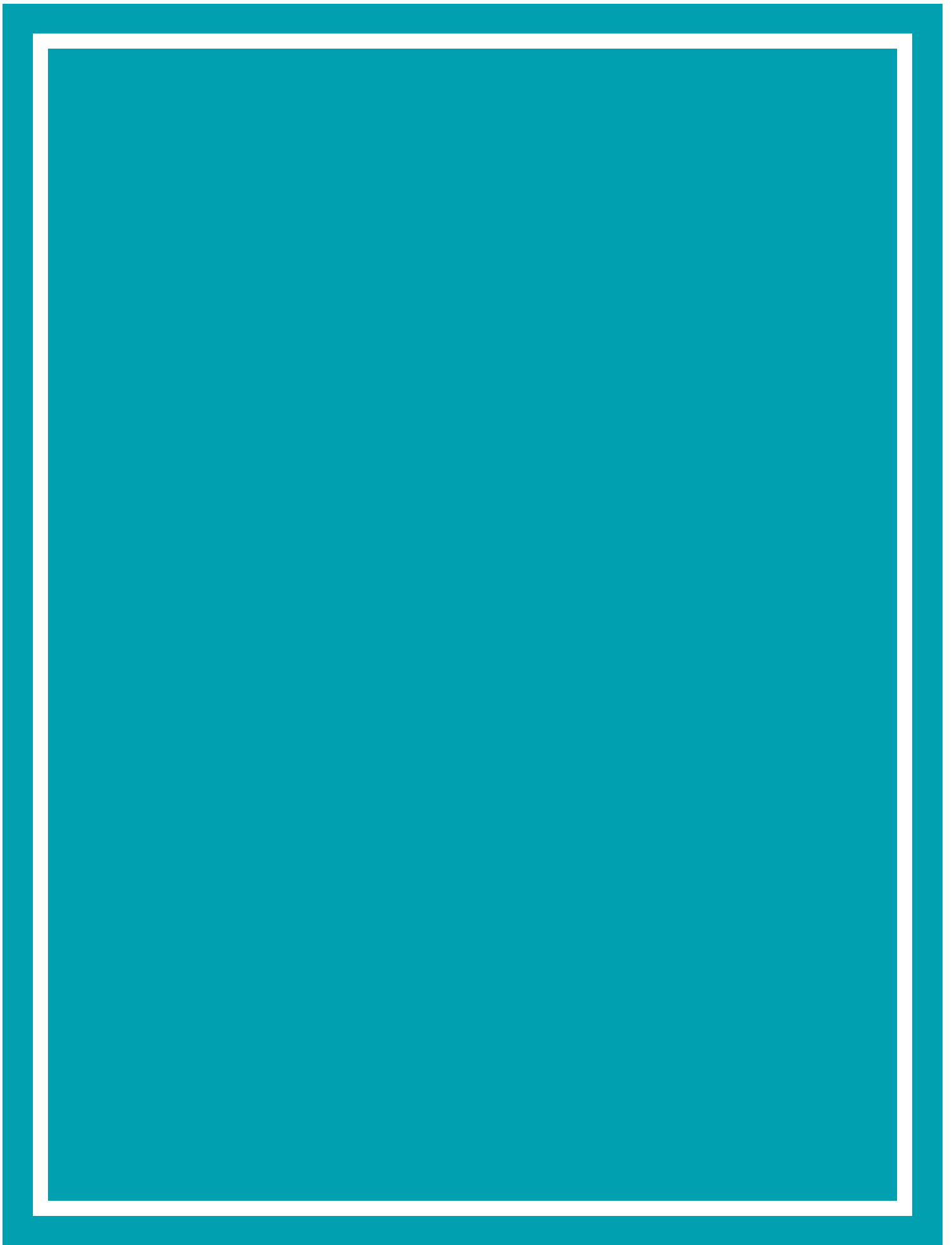


What Would You Do if You Were Prem Watsa?

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“The short story begins with Prem Watsa... he became a securities analyst at a prominent value-based insurance company, left to start his own investment firm, bought a small insurance company, and voila, a few decades later, he owns roughly 44% of a global insurance and reinsurance operation worth over \$10 billion. Not too shabby.”



What Would You Do if You Were Prem Watsa?

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MARCH 2014 — The short answer is that I would certainly be in my house in the Bahamas and not bunkered up in Fairfax Financial global headquarters in Toronto...in March.

The longer story is as follows and is relevant both to the shares of Fairfax Financial as a possible investment and investing in general. The talk last week was all about Berkshire Hathaway's annual report and Warren's words of wisdom (which were pretty damn insightful this year). Receiving much less press was the letter penned by Prem Watsa of Fairfax Financial, a man who does not get anywhere near as much ink even though he has compounded book value at 21% for 28 years in a public forum. Yes, there is some funny "Leucadia math" involving compounding off of a very small base, but I am happy to be in print saying Prem is arguably one of the best investors of our generation and his performance was generated in public and private equity markets, in equity as well as debt, and in North America as well as in truly international investing. That is not easy work.

For some serious background on the company, go to Fairfax.ca. The short story begins with Prem Watsa, whose family emigrated from India and wound up in Canada. There he became a securities analyst at a prominent value-based insurance company, left to start his own investment firm, bought a small insurance company, and voila, a few decades later, he owns roughly 44% of a global insurance and reinsurance operation worth over \$10 billion. Not too shabby. There have been a few legitimately white knuckle moments, which were how we got acquainted about 12 years ago. While financial complexity can scare some and

insurance can bore others, a complex financial entity also allows a lot of different levers to be pulled that are not obviously apparent to a financial journalist who cries wolf in a crowded theater while shilling for prominent short sellers (and you know you are). Regretfully, I sold the stock after a 4-bagger a number of years ago, only to miss another 100% move—perfection remains comfortably out of reach here at Cove Street Capital.

Fast forward to today. Lessons were learned and Fairfax has a collection of mostly solid global insurance and reinsurance businesses (although I am still not convinced about Crum and Forster) that are all under one roof and have competent management teams that are willing to step on the neck of the underwriters when profitable business cannot be written. Insurance is "soft" now, and Fairfax is writing at a 0.8 ratio of premium to surplus, a number that is roughly 70% of the business the company "could" write in proper conditions. This is precisely what you would want as a shareholder. Fairfax has also stealthily built an interesting emerging markets exposure with a large position in India and businesses that are growing toward materiality in Asia.

There is one conceptual problem. This man is bearish, and bearish with the conviction of a self-made billionaire who runs nearly permanent capital. Whether that in and of itself is a problem is one issue as obviously it could be a virtue in some periods of time. But deciding it is not enough to have reduced positions in credit instruments and stocks to minimal levels, he has essentially hedged 100% of his equity portfolio for the past three years—and naturally that has not been a good thing, as any

underlying profitability of operations and investments has been more than eaten by hedge losses...of...\$1.9 billion in 2013. That is a \$70 per share after-tax book value that started the year at \$378, chewing a decent size hole in the “mathematics of compounding” argument.

And thus we pose the question: regardless of his long-term investing record, is ANYONE so good that he can put on a 100% hedge and be right? And no the answer is not “John Paulson,” who bet hard with derivatives that represented a small percentage of his total capital and was so right that nothing else will ever matter. While in attendance at Jim Grant’s 30 year anniversary conference last fall, I heard one really successful investor after another recap his career with the sheepish conclusion that timing is hard and they stink at it. (Ok, maybe not as bad as most.) Fairfax has been around for 28 years and seems to be built for at least another 28. Compounding book value is the goal, not hitting it big and running. And so one asks: if one is running a public company with outside shareholders, isn’t being major league defensive enough? To achieve that, there are a number of options to protect shareholders from major downturns in markets:

- Hedge something less than 100% of equities.
- Maintain a truckload of cash that penalizes earnings but defends book value.
- Have either long duration bond holdings that provide income while providing the deflation hedge OR long-term deflation derivatives that provide less pivot-ability in the case of a paradigm shift.
- Entertain the possibility you could be very wrong.

Isn’t the optimal strategy for Fairfax to essentially be a defensive group of insurance and reinsurance companies with interesting emerging market growth opportunities that is run by a world class investor? While I do not pray to the false god of “consistency,” I would argue that this is a better formula towards being a great compounder of book value as opposed to what Fairfax appears to be today: an equity proxy for Nassim Taleb that offers protection against what “might” be correctly identified as a fat tail disaster scenario. It does seem to work in the short run though—check out Fairfax’s stock performance on any given down day.

One wonderful thing about having invested money for many years is having watched very smart people go through incomprehensively lengthy and self-inflicted wandering in the desolate intellectual wilderness. (It’s easier than looking in the mirror.) Every investor has held his hand out in the dark and blindly touched the fine line between being very early and very wrong. In the case of Fairfax and a number of other large firms that are returning cash to investors or are using derivatives to move positions, one can argue that the sheer velocity of change today—and the limited ability of large sums of money to attain the correct positioning just milliseconds

before the correctly identified inflection point—makes it a necessity to be early. (Cove Street ad insert—“We don’t have that problem.”) But does it make sense to lean over the edge of the scale? Does it lead to conceptually uneconomic movement such as selling large positions in Johnson and Johnson, Wells Fargo, and U.S. Bank to generate gains to offset recognizing hedge losses? We wonder.

And we ponder. Consider the following two snapshots of Fairfax Financial’s equity performance:

Now this is fun. Let’s assume that Prem has not in some way angered Vladimir Putin and thus is not being slowly poisoned with a mentally incapacitating nerve gas piped into Fairfax headquarters. That leaves the interesting mathematics of the deadly combination of dropping a really good year and adding a few self-inflicted lousy

Fairfax Investment Record 2012 Annual Report

	5 Year	10 Year	15 Year
Stocks with hedging	5.5	14.5	13.5
S&P 500	1.7	7.1	4.5

Fairfax Investment Record 2013 Annual Report

	5 Year	10 Year	15 Year
Stocks with hedging	3.2	7.6	13.5
S&P 500	17.9	7.4	4.7

years. What is fabulously interesting now is that 2013 has magically erased 2008 from 5-year performance records and investors and companies who were prescient (or lucky) to have been defensively positioned in 2008 now look hopelessly inept. This is one place to look for cheaper stocks, as a by the way, as people and companies often don’t get dumb overnight. (It takes years of planning and commitment.)

So what should we think? Is Prem running a flawed strategy or just a hellaciously volatile one? Have you filled out the Cove Street RFP for “permanent money?” Anyone who is involved with the business of managing money for other people knows how incredibly difficult it is to endure a “wilderness” period and practice what the investment business essentially preaches—buy low and sell high. If Fairfax were a mutual fund, it would be bleeding assets like anyone in a Robert Rodriguez movie and calls would go unanswered...and worse. The tables are a PERFECT reason why buying or selling near term performance is the worst idea ever invented—yet is the most popular strategy in practice—and 30 years investing other people’s money has convinced me there is no change in sight. Is Fairfax

cheap enough to discount a Dow 22,000 scenario? It sells around 1.1 times book value, a number that is within a reasonable purchase range for said entity. While the reinsurance and insurance world looks set en masse to deliver lousy economics for the foreseeable future, it is not an unreasonable contrarian thought to suggest that investment performance has been so bad that the stock should be bought on principle for inevitable mean reversion. Our present lack of ownership is partially due to being stuffed with other financials that appear to be just as inexpensive and not 100% hedged. (Buy Leucadia.)

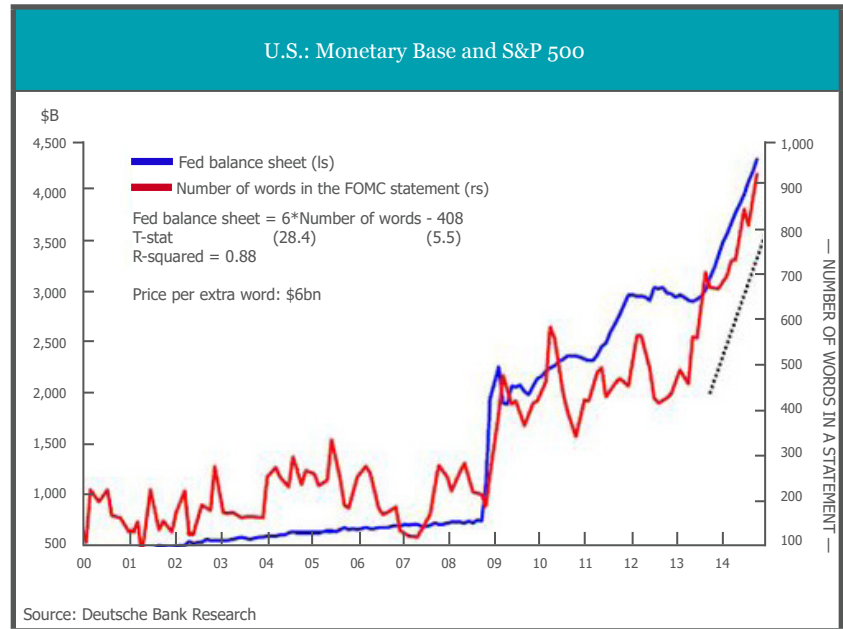
This is a natural lead-in to closing arguments and general global commentary. If a great investor who presently wears the cloak of the world's most bearish man has had a terrible time of it over the past few years, and Horace's Rule that "many shall be restored that now are fallen and many shall fall that now are in honor" remains a foundational truth, does that not suggest caution is warranted?

There is not much of an update to report on the "what now" front—things are still somewhat troubling. Year-to-date performance hovers in and around "flat" depending upon daily vicissitudes. There remain eclectic and interesting things to do, but ideas are not coming in bunches and I would again refer you to Fairfax.ca if you want the laundry list of awful things to worry about. Our personal biggest concern remains the uncertainty behind the Federal Reserve experiment in monetary policy and the unknown unknowns behind a sustained interest rate rise. To wit, this is a sound-bite from a recent conference call with an REIT management team.

"This is the least expensive debt capital I've ever experienced in my 33 years of real estate investing, and we want the company to take advantage of as much of it as it can utilize."

The sad irony behind the Fed strategy of limiting uncertainty and "risk" is that it itself has developed into

the major source of uncertainty. (See chart below.)



The same weirdness applies to Chinese financial markets and their Mandarin control. The authorities appear to be embarked on a process of changing from "no half-baked, over-leveraged venture defaults" to "let's start picking and choosing which ones can default." Per the above statement, I think there is a pretty good LEHMAN analogy that works here. Just as we didn't own mortgage assets and had little bank exposure in 2008 and it didn't seem to help us as much as we thought, we are highly cognizant of a potential second derivative fall-out from a large demand source for the global economy grinding to a halt.

We remain quietly patient and practice vigilance to weed out the more exposed securities from our portfolio and have been more active in downside protection where we have flexibility. But we do not wake-up with a dogmatic bent and are prepared to step forth as value presents itself on a case by case basis, without the hindrance of an eloquent macro-view.

Jeffrey Bronchick, CFA
Principal, Portfolio Manager

Visit our weblog at CoveStreetCapital.com/Blog and sign up to receive commentary from the CSC research team.

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