# Think the Market's About to Crash? So Does "Canada's Buffett"

## Description

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Dear Fellow Fools,

Warren Buffett's annual letter to **Berkshire Hathaway** (NYSE:BRK-A)(NYSE:BRK-B) shareholders is a must-read for investors the world over.

Though less well-known, Prem Watsa, Chairman and CEO of **Fairfax Financial** (TSX:FFH), has attained guru status as an investor and garnered a very real following over the years. Some even refer to him as "Canada's Buffett." Watsa's annual letter to shareholders was released in the past week and, as usual, I encourage investors to check it out.

**Ouch**

For the uninitiated, Fairfax Financial is a holding company that owns a collection of mostly insurance-related entities. At the core of every insurance-related entity is an investment portfolio. And over the long term, the performance of the investment portfolio plays a very significant role in dictating the success of the entire firm.

Given Watsa's fame, it's evident that he and his team of investors have done a bang-up job with this portfolio over the years. Traditionally, Watsa's been known as a long-term, value-oriented, bottom-up investor—a style that has garnered him some big wins. But one of his biggest wins came as a result of a macro call that paid off during the recent financial crisis.

Though many claim to have predicted the collapse of the U.S. housing market and near demolition of the entire financial system that followed, Watsa was one of the relative few who put his money where his mouth was, so to speak. Thanks to hedges he had in place as well as a portfolio of credit default swaps, Fairfax came through the financial crisis in fine form. Watsa closed out the hedges and swaps and ended up with a combined $4.7 billion haul over 2007-08. Fun!

After closing out these positions, and then seeing the market rally through 2009, Watsa began to worry again, and in 2010 began putting the hedges back. These hedges are still in place, and have turned into a very painful position to maintain as the market (U.S.) has done nothing but go up since 2010. What had been fun is now … not so much fun.

There is perhaps no more startling figure in Watsa's letter than the cumulative (but mostly unrealized) loss that these hedges have caused—***$3.5 billion***, with nearly $2 billion of that loss occurring in 2013 alone! Even though Fairfax realized significant gains by selling several equity positions in 2013—including **Wells Fargo** (NYSE:WFC), **Johnson & Johnson** (NYSE:JNJ), **U.S. Bancorp** (NYSE:USB), and **The Brick**—these gains were essentially nullified by the realized losses on the hedge positions that occurred.

As indicated, the bulk of the losses thus far are *unrealized*, which means if markets reverse, the picture will get much rosier for Fairfax. In the meantime, one has to believe that there's some serious teeth-grinding going on within the Fairfax head office every time the U.S. market touches a new high.

**Not Fazed**

There's no hint however of teeth-grinding in Watsa's letter, which has an unwavering tone throughout. This is perhaps the biggest difference between how Watsa (or an insurance company in general) and a mutual fund manager might react to such significant losses and the impact they've had on performance.

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You see, mutual fund managers are evaluated on their ability to beat a broad market index over a relatively short period of time. Over the past five years, Fairfax's equity portfolio has posted an annualized return of 3.2%. The S&P 500? 17.9%. If a mutual fund manager were to make this kind of bet and lose the way Fairfax has, thus far, they'd be fired—and probably never seen or heard from again.

Watsa has a far different mandate: He has a company to preserve. His priority lies there—not with beating the market over a randomly selected time period.

Watsa has very real fears about the implications of all of the monetary and fiscal mumbo jumbo that has occurred over the past half-decade or so. And he doesn't believe the full impact of this has come close to playing out. Unintended consequences are lurking. With this view in mind, Watsa is convinced that the short-term pain caused by these hedges is well worth the trouble if in the longer term it helps protect the company from a permanent loss of capital.

As the letter conveys, contributing to his fears are such things as:

- A still-elevated total debt/GDP ratio in the U.S., Europe, and the U.K.
- Weak economic growth in the developed world despite a highly stimulative environment
- Nonexistent inflation
- The mess that is China
- The growing speculative excess that he sees in the U.S. stock market specifically (one example: **Facebook** (NASDAQ:FB) acquiring WhatsApp and its $20 million in revenues for $19 billion).

**The Road Ahead**

Watsa is just fine to wait on these hedges (and the paper losses they've brought). As he quips, "It's better to be wrong, wrong, wrong and then right than the other way around!"

That's fair enough, but for this non-Fairfax shareholder, I wonder about the behavioural/emotional angle that's in play here.

After his windfall in 2007-08, Watsa is seemingly looking to catch lightning in a bottle for the second time (using a similar strategy). Time will tell if he's right, but at what point does he pull the plug on the whole idea? He's been publicly defending his position for four years now—that kind of posturing tends to alter the brain's ability to objectively evaluate these kinds of things.

After all, it's well proven that over the long-term, the stock market rises. Therefore, long-term, Watsa's got a losing bet on his hands. It's just a matter of how the path from here to there unfolds.

Even though Watsa controls Fairfax, it's a publicly traded entity. Given this portfolio positioning, Fairfax is a possible haven for investors who share some or all of Watsa's concerns over the state of the world's financial system. After all, Fairfax's coffers stand to benefit significantly if Watsa ends up being right. Therefore, in the face of an equity market pullback, Fairfax is likely to be one of the few places you can potentially hide to ride through the storm.

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**The Bottom Line**

Watsa has proven himself as an outstanding steward of capital over the years. His success has been rooted in long-term thinking and a tried-and-true style—one that we adhere to as well with each and every stock we recommend in our market-beating *Stock Advisor Canada* advisory service.

However, with his bet against the global economy firmly in place, he seems to have betrayed the long-term thinking that has brought Fairfax to its current standing. Watsa has made a short-/medium-term bet on a macro view with a good chunk of his firm's investment portfolio. How this bet turns out is going to dictate Fairfax's overall performance over the next 5 to 10 years. Stay tuned!

**Ask a Fool**

As always, feel free to pass along any thoughts, comments, criticisms, endorsements, etc. We'd love to hear them! Drop us a line at CanadaEditorial@fool.com with whatever might be on your mind!

Foolishly yours,

Iain Butler

Chief Investment Adviser

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**CATEGORY**

1. Investing

**TICKERS GLOBAL**

1. TSX:FFH (Fairfax Financial Holdings Limited)

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1. Investing

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