3 Key Takeaways From Fairfax Financial Holdings Ltd Q2 Earnings Release

Description

Last week I wrote about three points that I felt were important to look for when **Fairfax Financial Holdings Ltd** (TSX: FFH) released its Q2 earnings. Here are my takeaways from the report.

1. Insurance and reinsurance marketplace

As I was expecting, CEO Prem Watsa mentioned that the current environment was in a soft market, and that in the near term premiums will be pressured lower due to additional supply from new players. This is in line with what was suggested earlier in the quarter by other insurance companies.

What I liked hearing from Fairfax Financial Holdings Ltd. was that not only did it keep its combined ratio under 100%, it also brought it down further to 92.7% when consolidating all of the insurance divisions together. I said anything close to 94% would be positive for the company, and 92.7% is stellar in this environment.

Management said that in the future considering the insurance environment, companies would need low-90 to high-80% combined ratios in order to be profitable from an operating point of view — that means excluding the investment returns of the premiums collected. I am happy to have gotten more colour on the subject, but I am a bit skeptical of the number as that seems pretty steep.

All in all, excellent operating results from a great operator.

2. Investment portfolio performance

Management reported good results with gains of $329 million during the quarter. I was not worried that the investment portfolio would underperform given the track record of the company and a relatively good overall stock market performance so far in 2014.

However, I was surprised at the amount of cash held (28%) and the percentage of the equity portfolio that is hedged to the downside (85%). This positioning along with the CEO's comments on market valuation adds another investor to the list of cautious ones.

On the conference call, Mr. Watsa mentioned that while the equity portfolio was hedged it could still do very well. So we cannot assume that this part of the investment portfolio will stand still in the coming months.

3. Book value per share

Considering that the operating divisions of the business did extremely well and that the investment portfolio performed admirably, it is no surprise that book value per share went up 17.1% during the first half of 2014. This is adjusted for the $10 dividend per share paid in the first quarter.

I noted last week that in order for Fairfax to trade at its historical price-to-book value, it would need to show an increase of 30% and while it did not achieve that — I was not expecting it, nor should anyone — a 17% increase in six months is nothing short of excellent.

On the capital allocation side, management was pretty quiet and with the amount of cash they are holding in the investment portfolio it's clear that they want to keep some liquidity in the event of a market correction. So no heavy buybacks or dividend boosts, but then again Watsa seems to know what he is doing with his shareholders' money.

Should you buy?

This was the question asked in my last article and here again, I do not believe current valuation warrants a buy. According to management, the insurance marketplace is heading for a soft market, and overall stock market valuations warrant a heavy hedge.

I was listening to the conference call to get a sense of the insurance market as a whole and received more information than I was looking for. That being said, I will sit patiently on the sidelines.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:FFH (Fairfax Financial Holdings Limited)

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