Fairfax's Prem Watsa Continues to Bet on a Coming Crash

Description

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Dear Fellow Fools,

Every year at about this time the investment world has about 10,000 words of wisdom poured all over it with the release of Warren Buffett's annual letter to shareholders.

That's 10,000 words that most know about. Buffett's letter came out a few weeks back and you'd be hard pressed to find a financial media outlet that didn't provide their thoughts. To say the letter was "picked apart" would be an understatement.

There is another letter from a very successful investor that also comes out at about this time every year but doesn't receive anything close to the attention that Buffett's letter derives. Perhaps the under-the-radar nature of these 10,000 words is because it comes from a Canadian.

Prem Watsa, the CEO and founder of **Fairfax Financial** (TSX:FFH), has put together a fantastic investment record since founding the company back in 1985 and is somebody that you should pay attention to – if you're not already.

With his annual letter arriving just a few days ago, this week's Take Stock provides a summary of how the Oracle of, um, Toronto has positioned Fairfax's investment portfolio as well as his current thoughts on the market.

Fairfax India

While sporting an overall bearish tone (more on this later), one area of the world that Watsa is almost entirely optimistic about is India. Thanks in large part to a leadership change that occurred in May 2014, Watsa sees the Indian economy really hitting its stride in the coming years.

In order to capitalize on his optimistic view, Watsa created a new publicly traded company, **Fairfax India**

(TSX:FIH.U). This entity, which is essentially an investment fund, raised $1.1 billion when it was offered earlier in 2015. Fairfax Financial contributed $300 million and a collection of institutional investors kicked in the remaining $800 million.

Because it's freely traded on the Toronto Stock Exchange, we retail investors can easily participate in this fund and I must say, it's an idea that I personally plan on looking into.

BlackBerry

Fairfax Financial is one of **BlackBerry's** (TSX:BB) biggest owners. Though there was some commentary, Watsa's letter didn't really provide much insight into the company beyond what's already known. The bottom-line is that Fairfax appears ready for whatever ride BlackBerry may provide in the coming years and Watsa indicated that he has no intention of supporting a takeover of the company.

Social Media

In last year's letter, Watsa commented on the ridiculous valuation that**Facebook** (NASDAQ:FB) had just paid to acquire WhatsApp.

Social media and other tech related companies, both publicly traded and private (ie. Uber), were once again singled out in this year's letter – and it wasn't because Watsa thinks they've suddenly become an intriguing investment opportunity. Quite the opposite. Speculation abounds in this space and Watsa indicated that "we're confident that most of this will end as other speculations have – very badly!"

Macro

Over the past few years, Fairfax's investment returns have been rather lacklustre. The culprit has been the significant bets that the firm's investment portfolio has made on deflation as well as a decline in the S&P 500. As neither scenario has played out, yet, the mark-to-market losses on these bets are rather spectacular.

In the fourth quarter however, the CPI-linked derivatives caught a bit of a tailwind as evidence of a deflationary environment began to crop up on multiple fronts. Watsa cited that over the last 6-months of 2014 both the U.S. and European CPI Indices declined as primary proof that deflation is indeed upon us.

In addition, the decline that has occurred to almost every commodity that you can name and the fact that about half of the German bond market currently provides a negative yield were also pointed to as deflationary evidence.

Even though the firm's CPI-linked derivative position is underwater (to the tune of $417 million), the notional value of the bet was actually increased, significantly, during 2014 and now stands at $112 billion. Should deflation indeed take hold, Fairfax Financial will benefit more than most.

The other position that has caused significant pain in recent years has been the firm's equity hedge. This hedge carries massive unrealized losses but Watsa continues to defend the position indicating that he's "focused on protecting our company on the downside against permanent capital loss from the many potential unintended consequences that abound in the world economy".

Similar to the CPI-linked derivatives, Watsa sees that his (bad) luck on the hedge side might be turning. He warns that "the rising USD, current record after-tax profit margins, combined with deflation, could result in significant declines in the earnings of S&P 500 companies – just as the index hits record highs."

Caution within the firm's equity portfolio reigns with Watsa citing his mentor Ben Graham: "Only 1 in 100 survived the 1929-1932 debacle if one was not bearish in 1925." Translation – it's far better to be early than trying to scramble when (if) the storm hits.

Final thoughts

There's no debating the fact that Watsa has been dead wrong with his deflationary bet and equity hedge. This performance however has provided a fascinating window into the mind of one of this generation's greatest investors and the long-term thinking that he employs. Watsa remains steadfast in his beliefs that we're in for trouble at some point down the line and continues to bet heavily on these beliefs.

Clearly, the risk that he foresees more than justifies the bets that he's made. Should things turn in Watsa's direction, while many market participants are likely to suffer, Fairfax Financial is going to be a beacon in the storm – just as it was in 2007/2008 when the firm's credit default swap derivatives rocketed in value after being underwater for many years. If you're looking for a relative safe-haven, Fairfax is one to keep in mind.

To your wealth,

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