Will Prem Watsa's $109 Billion Bet Pay Off?

Description

Since Prem Watsa took over **Fairfax Financial Holdings Ltd.** (TSX:FFH), it's been a pretty good ride for shareholders.

When Watsa first established control in 1985, shares of Fairfax traded at just $1.52 each. Just over 30 years later the share price is $731.02, which includes a massive run-up of more than 20% over the last six months. Overall, Fairfax has returned approximately 22% per year to its shareholders.

This has made Fairfax's main man a very wealthy individual. According to the latest numbers from Forbes, Watsa's personal net worth–which consists almost entirely of Fairfax shares–is comfortably over US$1 billion. Not bad for a guy who started his life in Canada by selling appliances door to door.

Over the years, Watsa has followed the lead of another famous investor, Warren Buffett. Like Buffett, Watsa uses excess capital generated by Fairfax's profitable insurance operations to invest in undervalued stocks. This capital–called "float" by those in the industry–gives Fairfax a source of nearly free leverage that can be used to goose returns.

But unlike Buffett, who famously doesn't spend much time thinking about the overall economy, Watsa is famous for his macro calls. He bet aggressively on overpriced stocks back in 2006, buying put options on the overall market and moving much of Fairfax's portfolio into cash and government bonds. He also used derivatives to bet against the U.S. mortgage market.

It turned out to be a very astute move. While other financial companies were scrambling to clean up their balance sheets in the wake of the Great Recession, Fairfax raked in a profit of more than $2 billion on Watsa's bearish bet. Watsa also used the opportunity to pick up undervalued stocks that were crushed by the calamity of the market.

Fresh after getting that call right, Watsa started to turn bearish again a couple of years ago. This time, instead of betting against U.S. mortgages, he's picked a new target–one with a much higher payoff.

The $100 billion man?

Watsa's new bet is on deflation.

Essentially, he bought several large derivative contracts that pay out if the consumer price index in certain countries dips below a specific number in the life of the contract.

Think of it like it's an insurance deal. Watsa spends a fractionally small amount (approximately $650 million) to get paid $109 billion if deflation hits the United States, European Union, United Kingdom, or France in a major way by the year 2022.

Although it's unlikely Fairfax will ever see the full $109 billion because of the way the contracts are structured, a payday of $10-15 billion is very possible if deflation strikes in a major way. This is still very good news for a company with a market cap of $16.2 billion.

When Watsa was first placing this bet, it didn't seem like such a good idea. The Canadian economy was riding a commodity and real estate boom. The United States was recovering nicely from the Great Recession. And Europe had successfully shrugged off its own crisis with Greece.

Oh, what a difference a few years makes. With stock markets around the world tanking and negative interest rates becoming commonplace in both Europe and Japan, the market is beginning to price in deflation as a real possibility. Fairfax had decreased the carrying value of its derivatives from their cost of $651 million to $238 million at the end of 2014. By the end of the third quarter it booked a gain of $125 million as the prices of similar contracts have gone up.

It's hard to say whether Watsa's bet on deflation will end up paying off. But considering the man's track record in calling macro events and as an investor in general, I don't think betting against the man is a good idea. If he ends up being right, it'll be very good news for Fairfax shareholders.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:FFH (Fairfax Financial Holdings Limited)

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