



Don't Overthink it: Just Buy Fairfax Financial Holdings Ltd.

Description

Over the last 30 years, it's been good to invest with Prem Watsa, the chairman and CEO behind **Fairfax Financial Holdings Ltd.** ([TSX:FFH](#)).

The company has compounded the share price by 19.4% annually and increased book value by 21.2% when including dividends. That long-term record is best among North American property and casualty insurers, and second best among all Canadian companies with a comparable record.

It doesn't get much better than that.

But can Watsa maintain this streak? I think he can. Here's why.

The genius of Fairfax

Prem Watsa is a genius; there's little doubt about that. Yet his best idea was stolen.

Fairfax has been intentionally modeled almost identically to **Berkshire Hathaway**, Warren Buffett's company. The world's greatest investor loaded Berkshire Hathaway up with businesses (and individual stocks) that spun off a lot of cash. This cash was then reinvested, creating one heck of a compounding machine.

A big part of Berkshire's success has been the insurance business. The reason why Berkshire is heavily invested in insurance is because of float.

Float is the premiums from insurance that haven't been paid out. Since a customer can pay premiums for years without incident, the opportunity exists for the insurance company to invest this cash. If the insurance company can invest as well as Buffett, it's a huge advantage.

Once he realized how powerful this model was, Prem Watsa didn't try to reinvent the wheel. He just stole the idea.

As Fairfax has matured, it has started copying other Berkshire Hathaway characteristics, including

buying whole companies. It recently agreed to acquire retailer Golf Town from the chain's U.S. parent, which is seeking bankruptcy protection. It partnered with **CI Financial** on the deal.

But at the same time, there are a few big differences between Fairfax and Berkshire.

Value to the core

Warren Buffett realized his strategy of buying cheap, out-of-favour stocks was something that was never going to scale. So he started looking for terrific businesses, investments that could be purchased and held for a very long time.

While Watsa will certainly buy what he views as good businesses, he's also much more willing to buy beaten-up value stocks nobody likes.

Take one of Fairfax's most recently announced investments. The company told investors back in August that it purchased an additional 3.5 million shares of **Torstar Corporation** ([TSX:TS.B](#)), the troubled publisher of *The Toronto Star*. In total, Fairfax now owns 27.4% of the company.

Many other value investors hate the newspaper industry. They view it as a declining business with terrible economics. It's hard to have pricing power with advertisers when they have little interest in your publication.

So why did Fairfax buy? Because Torstar is ridiculously cheap. Shares trade at about half of book value. Heck, they trade at about half of the company's stake in VerticalScope, a \$200 million investment acquired in 2015 that's growing revenue at a nice clip.

Torstar also just announced it sold a building in Vaughn for \$54.2 million—a big payday for a company with a market cap of \$111 million.

An added bonus

Watsa is a terrific capital allocator; Fairfax's returns attest to that. He's also adept at profiting off huge macro trends.

Watsa not only predicted the U.S. housing collapse, but he also positioned Fairfax to profit from the carnage. As most other financial companies licked their wounds after 2008, Fairfax reported investment gains of US\$2.7 billion.

Watsa has recently loaded up on a new macro bet, this time on deflation. These contracts—which have cost a total of US\$668.2 million thus far—will pay out if deflation hits the United States, the U.K., or the E.U. in a significant way.

They could be worth as much as US\$112 billion, but only if the value of the underlying index hits zero. Realistically, they're worth a few billion if Watsa gets the bet right.

The bottom line

Prem Watsa is one of Canada's best capital allocators. Combine that with his proven track record, the terrific group of insurance companies owned by Fairfax, and the bonus potential from the deflation derivatives, and it's easy to see why many investors have made Fairfax a core holding.

CATEGORY

1. Dividend Stocks
2. Investing

TICKERS GLOBAL

1. TSX:FFH (Fairfax Financial Holdings Limited)
2. TSX:TS.B (Torstar)

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