THE GLOBE AND MAIL

Fairfax shares merit consideration for investors willing to look beyond past headlines

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PUBLISHED OCTOBER 4, 2022
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In Berkshire Hathaway's 1985 shareholder letter, Warren Buffett discussed his 1973 partial purchase of The Washington Post, which he had viewed as value hiding in plain sight, and which subsequently skyrocketed to more than 20 times his initial cost.

"Our advantage, rather, was attitude: We had learned from Ben Graham that the key to successful investing was the purchase of shares in good businesses when market prices were at a large discount from underlying business values."

Mr. Buffett's ability to ignore preconceived notions and instead focus on the underlying value allowed him to invest in a fantastic company at a bargain basement price.

I believe there is a similar behavioural investment opportunity currently with Fairfax Financial FFH-T (/investing/markets/stocks/FFH-T/) -1.63% ▼ , a US$11-billion Toronto-based property and casualty insurer that is being punished today for the sins of its past.

In what now feels like a lifetime ago, Fairfax was once wildly popular with Bay Street fund managers and traded at an astounding four times its book value (an accounting term equal to a firm's assets minus its liabilities). But for the past decade investor opinions have soured, with many lamenting its weak insurance underwriting and costly macro economic speculation.

Consequently, Fairfax trades for 0.75 times its book value (half of its peer group), indicating investors now believe it will be unable to earn a satisfactory return.

Much like a large ship turning at sea, it takes time to change investor opinions, and Fairfax is no exception. Although the company suffered from underwriting losses in 14 of the 20 years leading up to 2011, since then it has turned an underwriting profit in every year except one. Furthermore, the large macro investment calls were stopped back in 2016 with follow-up declarations from management that they will not return to shorting the market or individual stocks. Yet investors refuse to update their prior views to this new simplified reality. Even when an undeniably positive event happens to Fairfax, investors often greet the news with little more than a shrug.

A recent example occurred in June when the company unexpectedly announced it had sold its pet insurance division for US$1.4-billion, or approximately six times its book value. This was a massive win for shareholders, yet the stock decreased slightly for the week while the insurance sector advanced.

Continuing with the nautical metaphor, the investment horizon has never been brighter for Fairfax. Insurance is one of the few industries that actually benefits from higher interest rates (owing to an insurer's ability to invest customer premiums prior to claims).

Fairfax's bond portfolio is uniquely positioned for this new higher interest rate reality. When rates were low, Fairfax did not "reach for yield" like many of its peers. Management tolerated the lower yielding cash and short term debt, unwilling to lock shareholders into bonds that would provide a negative real return. With central banks now aggressively hiking rates to fight inflation, Fairfax's interest and dividend income will double this year to US$1-billion.

Even better, the massive decline in long-term bond values is constraining competitors' capacity to write new policies, allowing Fairfax to aggressively capitalize on this opportunity. In fact, most readers might be surprised to learn that Fairfax's gross insurance premiums have grown from US$8-billion in 2015 to an expected US$28-billion in 2022. This is an incredible transformation, yet Fairfax shares today trade for less than they did seven years ago.

Undoubtedly, risks remain with Fairfax; shareholders will only find out in the future whether today's insurance underwriting was adequate, management could revert to macro speculation and with the global economy slowing, bond yields could give up some of their recent move higher. However, today's stock price has already deeply discounted many of these pessimistic scenarios and I believe Fairfax shares merit consideration for investors willing to look beyond past headlines to its underlying business value.

Full disclosure: The author and his clients have a position in Fairfax shares.

Trevor Scott is the portfolio manager and founder of Tidefall Capital Management.