Tidefall Capital LP
Q3 2021
October 14, 2021

	Q3 2021	Year To Date	Since Inception (Jan 21, 2020)
TIDEFALL (after fees)	-5.8%	15.4%	113.8%
S&P (total return)	0.6%	15.9%	33.0%
TSX (total return)	0.2%	17.5%	20.2%

Fairfax Financial is a US$10.6b holding company based in Toronto that has undergone a steady improvement in both its insurance underwriting and more recently in its investment operations yet trades at a large discount to its book value, a figure which is also understated by accounting rules.

Fairfax has a strong history of growing book value *(18% per year since 1985)*, but its past decade has been lacklustre with just 4% annual growth. During this time Fairfax's insurance operations have actually been steadily improving with favorable reserve developments and an underwriting loss in just one year. However, the company's investment strategy has been suboptimal and the market now prices Fairfax at a paltry .75x of its stated book value, nearly half of the peer group multiple.

The primary investment drag has come from Fairfax's shorting strategy, which in hindsight was an error in betting against a rising market. However, the company has now definitively ended this practice. *"We will not short the indices… we won't short companies at all, ever. There'll be no more of those." - Prem Watsa, Oct 30 2020.* There has also been a recent senior-level personnel change that we believe will push their deal-making into higher quality companies than what has been favored historically.

With US$2.1b in net investment gains since the beginning of this year, the effects of the change in investment strategy are already being felt. Fairfax's low multiple 'value' stocks are finally paying off as resource companies and industrials catch a bid due to the strong economic recovery. Fairfax's book value is 11% higher than 2019, yet the stock trades 20% below its pre-pandemic share price. Furthermore, their short-dated bond portfolio is well aligned with our view of rising interest rates; 40% of bonds are due in less than one year and an additional 50% are due in less than five years.

Fairfax's stated book value is US$541 per share, but this does not include some material aspects of shareholder value. Non-insurance associates and consolidated non-insurance subsidiaries are accounted for using the equity method but when adjusted to the actual market values, it increases book value by US$603m after tax or US$23 per share. However, far more important and potentially transformational is Digit Insurance.

In 2017, Fairfax backed Kamesh Goyal, an insurance veteran who believed the Indian insurance market could be disrupted by simplifying the customers' experience via smartphones. Four years later, Digit has grown to over 20 million customers and written over $400m in premiums. This past July, Digit raised capital at a US$3.5b valuation from investors including Sequoia. Upon final approval, Fairfax's value in Digit will increase to $2.3b, or an additional US$46 in book value per share. It's remarkable that not only has Fairfax made 15x on their investment with Digit but it now represents over one fifth of Fairfax's market capitalization. With such a scalable solution and large addressable market, higher valuations and an eventual IPO seem likely.

With these two adjustments Fairfax's true book value increases to US$610 per share, meaning the stock is trading at just .66x of book value. This valuation level has rarely been seen in its history and is a far cry from 1.5x book value in the mid 2000s *(and even further from 4x book value in the late 90s).*

The insurance industry is currently in a hard market, which refers to insurance pricing being attractive to write. This is part of the reason why Fairfax has not been even more aggressive on its buyback *($387m since 2019)*. To supplement the buyback, Fairfax has acquired swaps on its own shares with an original notional amount of US$733m. *(Watsa also personally acquired US$150m of stock in 2020).* Moving forward, we view two likely scenarios: either insurance pricing remains hard and Fairfax earns strong underwriting profits *(7x 2022 consensus earnings estimates)* or pricing moderates which frees up capital to take advantage of what we believe is a very attractive share price. Fairfax is no stranger to buybacks, having once retired 25% of its shares outstanding in a single year.

Trevor Scott