This Investment is Ready for Nearly Anything….and the Shares Should Go Up in Almost Any Bad Scenario

By Nicholas Green, CIO

The *average* 33-year price-to-book value the market has deemed rational for Fairfax Financial is 1.2x.

Fairfax Financial has appreciated at a compound average growth rate north of 18% while its price-to-book has averaged 1.2x.

That is stellar compounding through any lens. Not impressed? To put a real-world number on this phenom, $100,000 has grown into $24,000,000. Those are some serious shekels, and few companies can compare.

Right now, Fairfax Financial's price-to-book is historically undervalued at 1.08x, and the company is in an enviable position.

Fairfax Financial has broadly diversified insurance operations, and they differentiate themselves by running decentralized insurance lines – property, casualty, specialty, reinsurance – while also maintaining broad diversification across geographies. This provides protection against any one event. While you can break a pencil, you cannot break fifty.

There have been a myriad of natural catastrophes over the last few years, yet Fairfax Financial has maintained a combined ratio of under 100, at 98. This doesn't just illustrate Fairfax's underwriting discipline, it underscores their superior strategy and management team.

With a combined ratio of under 100, Fairfax has not just gotten paid to write insurance policies, but since they have a combined ratio of under 100, they get paid to *hold* the float. This has been the magic elixir of Warren Buffett.

With net premiums having grown over the years—along with float, Fairfax is in a very amiable position today.

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Fairfax Should Perform Through Almost Any Macro Environment

The investments per share at Fairfax Financial are primed, especially in this environment, to continue producing very attractive returns for shareholders.

Fairfax Financial has investments per share working on behalf of shareholders of $1,150 on a book value north of $490 (all figures in USD).

A modest increase of 6% on its investments per-share should thus produce returns to shareholders of 15% or more (6% x $1,150 = $69 + $490 = $559 * 1.08/1.20 = 15% - 20%).

75% of Fairfax's investments per share are in cash, short-term investments, and bonds. If interest rates continue to rise, a 6% return on Fairfax's investments per share should be an easy hurdle.

During the Fed's zero-percent interest rate policy over the last 10-years, the Fairfax team *still mustered a total return on its investments of 6.45%*. For regulatory purposes, they must maintain a significant amount of short-term cash, thus hampering returns in a period of low interest rates.

A rise in rates will only help with Fairfax's investment per-share results! If inflation continues to heat up or the Fed continues to unwind its balance sheet (putting upward pressure on interest rates) or interest rates get out of control for any other reason, Fairfax will benefit enormously.

However, and instead, let's just game-theory for a moment that the entire credit market is about to blow up again like it did in 2008/2009 and deflationary forces take hold.

Fairfax's 75% position in cash, short-term investments, and bonds will still be ultra-safe. But there would be no benefit to the upward lift in a rising interest-rate environment.

If a deflationary/credit contraction period were to take hold again because the Federal Reserve tightens too much and the wealth effect evaporates like a sandcastle into the sea, Fairfax Financial will *still* make ridiculous sums of money. Why is that?

Because lo! There is a hidden asset within Fairfax. The Fairfax team was convinced that deflation was going to set in a few years ago and they purchased CPI-linked derivative contracts.

Like buying a put, the most Fairfax can lose on these contracts today is only $40 million, which represents just a small sliver of the company's book value (under 0.40%)! For $40 million, owners of Fairfax get a $117 billion notional deflationary hedge.

Should the world blow-down in a deflationary-fit and not inflation up within the next 5 years, Fairfax will make 10s of billions of dollars. With a market cap that's not even $15 billion, the upside in a deflationary route would be substantial.

For these reasons, Fairfax Financial is not just a great business run by great people with net premiums and float increasing over time, it is a great macro hedge against inflation or big-time deflation. Either scenario, even at extremes, or especially at extremes, and Fairfax should be a big winner.