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# Fairfax can offer a port in the post-bubble storm

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In *Irrational Exuberance*, published in 2000, Yale economics professor Robert Shiller defines a speculative bubble as "a situation in which temporarily high prices are sustained largely by investors' enthusiasm rather than by consistent estimation of real value". Such phenomena have become all too familiar in the past decade as markets have lurched from bubble to bubble, in internet stocks, housing and – most likely today – commodities.

Because human nature plays such a central role in speculative excesses, it is inevitable that such manias will recur. This inevitability makes it important for investors to understand why bubbles happen – if for no other reason than to limit the damage inflicted on their portfolios by the next one.

One psychological underpinning of bubbles is the desire to conform. "A strong desire to be part of a group makes us susceptible to fads, fashions and idea contagions," says Michael Mauboussin, equity strategist at Legg Mason. "People actually have a preference for being an accepted part of a majority over being part of the correct minority."

Herd members frequently fall victim to the common investor mistake of over-weighting recent experience. Behavioural scientists have shown that individuals are more likely to judge recent events as more numerous and predictive of the future than those less recent. After four years of 20 per cent-plus overall market returns, investors in a December 1999 Gallup survey of investor optimism were still predicting a 15.3 per cent average return over the following 12 months.

Humans also suffer from an "illusion of control" that can cause them to ignore evidence of irrationality. James Montier, equity strategist at Société Générale, cites one academic study that found subjects were willing to pay four and a half times more for a lottery ticket that contained numbers they chose rather than those that were randomly generated. Participants also bet more on a coin toss before the coin was tossed rather than after – "as if they could influence the spin of the coin in the air", Montier notes. This perception of control can fuel speculation, as investors riding a swelling wave assume they will get to the shore well before it breaks.

Crucial lessons in all this are: make your own decisions independent of what the crowd is doing; rely on your own estimate of intrinsic value rather than a stock's current price to tell you what it is truly worth; frequently challenge your investment assumptions, and enlist others you respect to do the same; and learn from your mistakes.

Post-bubble periods can provide opportunities for smart value investors, as indiscriminate selling hits stocks of even the best companies in out-of-favour sectors. I would like to report such opportunities in the financial and real estate sectors today, but I cannot. Bottom-fishing requires believing the bottom is near, which I do not think it is with the unfolding mortgage and credit crises.

If you share this view, one intriguing way to play it is the stock of Canadian insurer **Fairfax Financial**. This company has for years been the subject of a nasty tug-of-war with short-sellers. We rarely get involved in such situations but believe Fairfax has a collection of high-quality insurance businesses that trade at a discount to intrinsic value, while the shares also offer significant upside if the financial crisis continues.

Fairfax's three principal insurance subsidiaries are doing well: they grew 19-22 per cent annually from 2001-07, their returns on equity last year ranged from 23-26 per cent, and their combined ratios (a key measure of underwriting efficacy) have fallen from 109.4 in 2005 to 94.0 in 2007, driving 2007's 32 per cent gain in underwriting profit.

As of April 25, Fairfax owned $17.5bn of credit-default swaps (CDSs), the value of which is negatively tied to the fortunes of exposed finance companies such as AIG, Fannie Mae, Freddie Mac, MGIC and Washington Mutual. If we are right that subprime damage is still in its early stages, Fairfax's CDS holdings should benefit enormously.

At about $260, Fairfax shares trade at tangible book value, or 1.3 times if one excludes the entire CDS portfolio. Because we believe its core insurance business is worth 1.5 times book value, an investor today is getting that business at a discount, while also gaining a free call option on Fairfax's CDS portfolio, which could be worth billions more than its current stated book value.

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