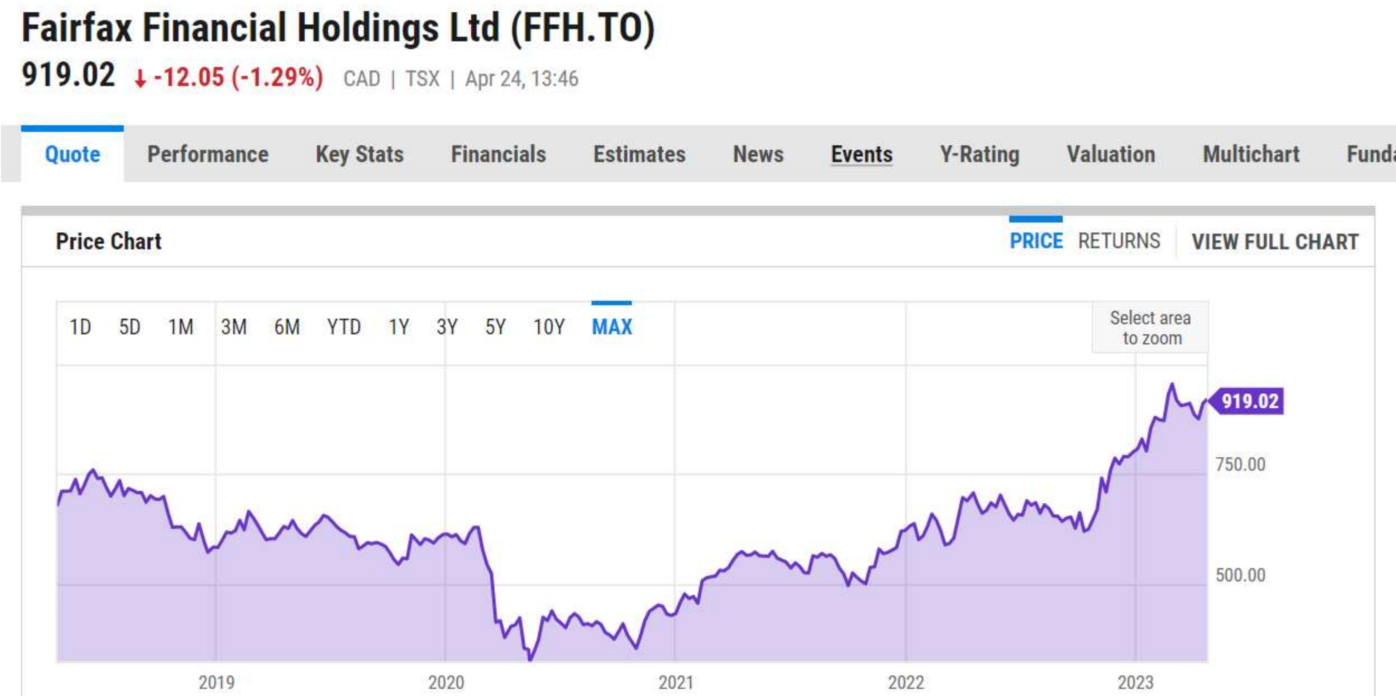
Northlake Wealth Management

May 19th, 2023

Good afternoon Northlake investors,

With inflation, Gross Domestic Product (GDP), employment numbers and monetary policy at the forefront of headline news it's not easy to remain optimistic. This quarter we thought we would take a different approach and shed some light on the investment managers we work with, and what they do to uncover opportunities in times such as these. As you know, we design client portfolios using an overlay strategy. We buy and sell individual stocks and "overlay" in various ETFs, mutual funds and hedge funds. This helps diversify portfolios, but also give us access to strategies we cannot replicate ourselves. Within a fund structure it's not always easy for our clients to see what businesses they own or have owned in the past. Furthermore, it helps show which businesses were successful ideas by the managers and compounded wealth over time. For this piece, we have chosen one of the investment managers we work with and are highlighting their insights on a specific business. The intention is to show their thesis and thought process during security selection. This case study is proof that it requires independent thought, discipline, and process to compound wealth. This is only one example, but in many instances, it can take several years for the market to realize the intrinsic value of a company. We believe investors must remain patient if they wish to participate in future growth. Many great investors have preached that volatility is the short-term sacrifice for growth in the future.

Investment Manager: EdgePoint Wealth Management
Fund: EdgePoint Global Portfolio
Security: Fairfax Financial Holdings LTD.
Sector: Insurance
Purchased: May 2020, June 2020, July 2020, September 2020, November 2020
Status: Continue to hold position today



Source: YCharts

Written by:

Andrew Pastor - EdgePoint Portfolio Manager & Partner

More than Fair

Fairfax is a property & casualty (P&C) insurer that we hold across our Portfolios. The idea embodies many of the patterns that we look for in an investment. The following list isn't an exhaustive one, but it covers some of the biggest reasons why we like the business.

A former shining start that lost its luster. Investors were burned in the past and avoided Fairfax Financial completely being afraid of suffering large losses once again. The stock price declined from $600 USD in 1998 to approximately $100 USD by 2002. It took nearly 25 years for the stock price to surpass it's 1999 peak! (Imagine recommending buying this stock - a tough sell to say the least)

People form strong views about a business and assume that what happened recently will continue forever. If a business is prone to missteps, investors assume it will keep making them. This means that quality upgrades can go unnoticed for a long period of time and investors are slow to recognize these inflection points.

Fairfax was a business that was getting stronger but had gone unnoticed by investors. Its business model is unrecognizable from a decade ago. Fairfax transitioned from a volatile business into a durable growth company. Insurance companies have two main ways of making money – underwriting profits from the insurance business and investing the float. Both the insurance and investment engines are the strongest ever and yet few investors are paying attention. Fairfax is one of the most under-owned large-cap stocks we've come across.

Investors were missing two important changes:

- The quality of the insurance operations is the best in its history, and
- The size of the insurance operations has grown significantly.

What changed? For the first 20 years, Fairfax neglected its insurance operations because it operated in an environment with high interest rates that allowed its bond investments to generate very pleasing returns. While the strategy worked because of its incredible investment results, it wasn't sustainable. As interest rates went lower and bond yields shrunk, the investment profits couldn't outrun the insurance losses.

In 2011, Fairfax appointed the CEO of its most successful insurance division to oversee its global operations. It also realigned incentives to focus on underwriting profitability and began acquiring high-quality insurance businesses.

Finding growth in less-obvious places. When you hear the term "growth stock", you're probably thinking about software, internet, biotech. Unless you're an actuary, most people wouldn't say P&C insurance is exciting. However, Fairfax has a track record of growth that would be on par with a tech company.

Over the past seven years, Fairfax has almost tripled its insurance revenues. From 2015 to 2018, Fairfax made several large insurance acquisitions (such as Brit and Allied World) and expanded its global insurance footprint. In 2019, investors entered into a hard market, a period of time when insurance prices are increasing, and industry profitability is high. We're currently in the fourth year of the strongest insurance pricing cycle in a generation.

A rising tide lifts all boats, but we aren't aware of another insurance company that's taken as much advantage of the strong insurance pricing to grow. Fairfax was the fastest-growing company of the top-25 global insurers last year and did it organically without having to pay a premium to acquire new business.

Company management teams that are willing to stand out from the crowd and defer short-term gratification to increase long-term value. One of the core drivers of an insurance company is its bond returns. Insurers collect premiums upfront and pay the claims in the future. They use their float to invest in bonds. The average P&C insurer has a duration on its bond portfolio of four-to-five years. Fairfax did something radical and kept its duration close to one year. Instead of reaching for yield, it protected its balance sheet. This was painful as Fairfax's investment income was falling while its peers were showing healthy profits.

Investors are now being rewarded for deferring gratification. In 2022, interest rates have risen dramatically and so has Fairfax's investment income. Because of rising interest rates, Fairfax's peers have experienced large declines in their bond portfolios which has resulted in a 15% to 30% reduction in their cumulative net worth (book value). Conversely, we think Fairfax will finish the year without experiencing any decline in its book value, an extraordinary feat. In addition to protecting its downside, Fairfax has the most upside from rising interest rates. Its investment income is now at a run rate of US$1.2 billion, the highest in the company's history. If interest rates stay flat, we wouldn't be surprised to see Fairfax's investment income grow to US$1.5 billion next year, almost triple what it was just a few years ago.

While Fairfax's stock price has rallied from its Covid lows, we continue to think its future prospects are bright. Fairfax is a growth company that's hiding in plain sight. Fortunately for us, misconceptions still happen and that's why we can find opportunities in the market.

We hope you enjoyed the insights from the PM team at EdgePoint Wealth Management. This was just one example of many that exist across our model portfolios. We are grateful to be working with these "unicorns" of the industry and remain committed to working hard every day to achieve pleasing results for your future.

"Today I will do what others won't, so tomorrow I can do what others can't." – Jerry Rice

Warm regards,

Northlake Wealth Management

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