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The \$2-Billion Man

Prem Watsa is the richest, savviest guy you've never heard of. He predicted the crash of '87, the Japanese collapse of 1990 and last year's meltdown, which he parlayed into a huge payoff. Now he's gobbling up shares at rock-bottom prices. What he knows and why you should pay attention [By Alec Scott](#)



Crash course: Prem Watsa delivers his visionary speech at a board of trade conference in 2007

Image credit: David Cooper/Toronto Star

Two years ago, in April 2007, the Dow Jones Industrial Average hit 13,000 for the first time ever. It was the culmination of six months of record highs— a whopping 38 in total. Traders were drunk on their own optimism, investors were still making unprecedented returns, and there seemed to be no end to what had been dubbed the “Energizer Bunny Economy.” When it comes to investing in the stock market, groupthink often prevails, and there were plenty of cheerleaders—from analysts to economics professors to business journalists—in the unrelenting pep rally.

A few weeks after the Dow Jones record, a soft-spoken Toronto insurance and investment company executive named Prem Watsa stood before a crowd at the board of trade and delivered a buzz kill of a speech. The conference was one of the first major events hosted by the Ben Graham Centre for Value Investing at Western's Ivey School of Business, for which Watsa, an Ivey graduate, had been a lead donor. But his mood was far from celebratory—he didn't spend any time patting himself on the back. Instead, he issued a dire warning. “There's a possibility of a one-in-50- or a one-in-100-year storm coming,” he said. “When the music stops, it stops very quickly.”

Near the end of July came one of the first signs of the storm Watsa had predicted: the Dow had its first mini-meltdown, losing about 400 points in one day. Watsa had already protected himself. He'd moved the bulk of his company's \$16-billion (U.S.) portfolio out of the stock market and into relatively recession-proof treasury bonds and cash. Although he hadn't participated in the market's champagne swilling, he was determined to avoid the brutal hangover. In addition to moving his investments to higher ground, he used credit default swaps to wager that the U.S. credit market would go belly up. His bet: \$341 million. His take-home when the house of cards came tumbling down: more than \$2 billion.

After such a win, many would have sat on the sidelines, cash in hand, smugly watching as the world's financial systems collapsed. Yet Watsa's company, Fairfax Financial Holdings—named for its “fair and friendly” acquisitions strategy—has recently waded back into the beleaguered market, spending \$2.3 billion buying equity shares in troubled companies.

Watsa is something of a puzzle—he was relentlessly bearish in the bull market, and now he's bullishly throwing his weight around in what looks like one of the worst bears in history. The man who not only called the crisis but profited from it may be Bay Street's savviest investor.

Watsa's rags-to-riches narrative stretches over two generations. His father, born in Mangalore, India, in 1910, was orphaned young and rose to become a respected principal of the posh Hyderabad Public School, India's Upper Canada College. Watsa was born in Hyderabad in 1950 and eventually attended the elite school, where he was an outsider, one of the few boys who didn't come from a rich or aristocratic family.

After high school, Watsa gained admission to the prestigious chemical engineering program at the Indian Institute of Technology. (While studying there, he met his wife, Nalini, with whom he has three children—two daughters and a son.) He didn't want the plodding life of a chemical engineer, so his father encouraged him to take his chances in Canada, where his brother was already working. Watsa decided to move to London, Ontario, where he enrolled in the MBA program at Western, selling air conditioners and furnaces to pay his way through. “I went to the Ivey not because it was good, though it turned out it was, but because it was near where my brother lived,” he says. Following business school, he worked for almost a decade in the investment wing at the now defunct Confederation Life, a department famous for its rigorous research. “There were four people selected for a second interview,” he once said. “The reason I got the job was that the three other guys didn't show up.”

It was at Confederation that Watsa had what he calls a “road to Damascus moment,” when his boss handed him a book by a Columbia business school prof and investment manager named Ben Graham. Graham was the original value investor. After losing almost everything in the 1929 crash and the Great Depression, he devised a risk-averse approach to playing the market, one that distinguished between investment and speculation. Generally, a value investor makes medium- and long-term investments in

thoroughly investigated, demonstrably well-run companies. Analysis and discipline are key, and if there's no margin of safety, you don't invest. "You have to turn your back sometimes," says Watsa.

Perhaps it was his conservative upbringing, or simply a function of his personality, but Watsa was drawn to the relatively safe and steady (if unsexy) approach of value investing. He became a Ben Graham disciple.

The richest and most famous value investor in the world is Warren Buffett—the Omaha, Nebraska, newspaper boy who grew his fortune from nothing to \$62 billion. Watsa (who's been called the Buffett of the North) tracks almost every move his American counterpart makes. Buffett, for instance, gave his elder son the middle name Graham, after Ben Graham. Watsa named his son Ben. Both Buffett and Watsa have based their fortunes on a bedrock of insurance: Buffett's company, Berkshire Hathaway, has for years had a huge stake in GEICO, which spins tidy profits for him to invest elsewhere. Watsa began acquiring insurance companies in the mid-1980s. (Collectively, Fairfax subsidiaries constitute the largest property and casualty insurer in Canada, and they have a significant presence on the U.S. market.) More recently, after the Oracle of Omaha backed the ailing Goldman Sachs, the Oracle of Ontario came to the rescue of Toronto's GMP Capital—no Goldman Sachs, to be sure, but a medium-sized presence on Bay Street. And Berkshire and Fairfax recently announced their first co-investment, buying significant shares in Chicago's building materials company USG: \$100 million from Watsa, \$300 million from Buffett.

Like Buffett, Watsa draws a salary that is modest for the field (\$600,000) but owns a controlling stake in the companies he's building. (Watsa's net worth is difficult to establish, but estimates run as high as \$4.16 billion.) Both Berkshire and Fairfax have offices staffed by skeletal crews, and spacious libraries with extensive archives of corporate annual reports. The most significant difference between the two men is that Buffett is a garrulous cable news commentator, conference keynote and commencement speaker. For years, Watsa wouldn't talk to the media, wouldn't even speak to analysts to discuss quarterly results. "Buffett you can get on the phone. He's available, he's on MSNBC," says Ira Gluskin, the head of the Toronto firm Gluskin Sheff. "Prem loved cultivating the image of not being available, that he was all about the work." The image fits with descriptions of Watsa. According to one visitor, he wanders about his messy office like an absent-minded professor.

Value investors buck the creed that has governed market regulation for the past two decades: that the market is efficient; that share prices will right themselves, accurately reflecting the health of companies even if individual shareholder behaviour is erratic. Buffett and Watsa believe the market is inherently inefficient and unruly, that it often overvalues or undervalues companies, that it panics beyond need or else talks itself into believing in a bubble. Watsa describes the stock market as manic depressive: "Sometimes it buys at a high price and sells at a low price. Don't ever think that it knows more than you."

At the core, Watsa's approach evinces a fundamental distrust in the rationality of investors. Shareholders, after all, are overwhelmingly propelled by two emotions: fear and jubilation. Usually, both of them—in response to a headline, say, or an annual report—are simultaneously at play as stocks are bought and sold. It's when one becomes dominant that everyone gets into trouble. But it's not only emotion that scares value investors, it's the corresponding bandwagon effect. At about the time that everyone comes to a consensus over something in the market, the consensus usually turns out to be wrong. And by then, a vulnerable company could be sunk.

Professor Andrew Lo, the director of MIT's Laboratory for Financial Engineering, studies the psychology of the market. While Lo believes the markets are capable of rational behaviour, he says they become irrational when investors' animal instincts take over and their pleasure or fear receptors are activated. "That period of extended prosperity we had [before the crash] acted like a drug, stimulating the same pleasure centres in the brain that cocaine does. [The euphoria] removes inhibition; we forget that it's possible to lose money," he says. When the market showed signs of turning, another instinct took hold. "After the bubble burst," he says, "the violent flight kicked in—another level of irrationality."

Lo believes that individuals who, like Watsa, got out of the market before the crash likely have a more highly developed instinct for fear. They can sniff out trouble well before the average unsuspecting investor. They might be naturally temperate (a kind of market ascetic), but they are also a more highly evolved animal. "Either he has experienced this before, so he has a memory of pain or loss," Lo says, "or he has developed certain models or forecasts that trigger in his brain the potential for pain."

In Watsa's case, it's a bit of both. He's not only a long-time student of crashes; he also has first-hand knowledge of what it means to almost lose it all.

In the late '90s, Fairfax acquired a troubled New York-based insurer, TIG, for \$847 million (U.S.). The company turned out to be more of a dog than Watsa realized: it took years for Fairfax to integrate the few profitable parts of TIG into its other, healthier subsidiaries, and to shut down the many unprofitable sectors. After 9/11, Fairfax's insurance group was hit with millions of dollars in claims: the company posted its first ever annual loss of \$346 million. To raise funds, Fairfax listed its shares on the New York exchange in December of 2002, but within a week, two million shares were sold short—a harbinger of Fairfax's tumultuous relationship with American hedge funds. In the summer of 2003, the company took public a large portion of its profitable subsidiary, Northbridge Financial, earning \$200 million on the markets. (Watsa prefers not to be at the mercy of the market and recently bought back the shares, reprivatizing the company.)

Certain hedge funds, not satisfied that Fairfax had done enough to deal with its losses, continued to short-sell its shares, betting that the company would nose-dive. Contributing to the short-selling was a report released in January 2003 by a Memphis-based broker, Morgan Keegan, claiming Fairfax had insufficient reserves to cover its outstanding insurance policies.

A short-seller promises to supply shares to a buyer at a certain price, although the actual shares are not in hand. The seller later secures the shares, preferably once the price has dipped, profiting from the difference. (Of course, if the price goes up, a loss occurs.) In this high-risk and often predatory practice, the short-seller has a vested interest in seeing the company's shares go down. There are plenty of scandalous stories of short-sellers allegedly planting false rumours to score fat profits, and among the most scandalous is one involving Fairfax.

The precise facts will become known at a trial in New Jersey later this year, but the outline is not pretty. Fairfax alleges that a group of hedge funds conspired to drive down its stock price. Through mid-2003, negative stories about Fairfax's supposed financial weakness were rampant in the financial press. Among the headlines on the popular on-line business publication thestreet.com: "Fairfax's Buffett Pose Falls Short," "Fairfax Walks the High Wire on Rates," "Fairfax Fog Only Thickens."

From there, things got a little weird. According to court documents, the hedge fund companies allegedly retained an obscure operative named Spyro Contogouris to drive down Fairfax's share price, a task he went about with alacrity. In 2005, he's said to have approached the company's former CFO, claiming (falsely) that he'd been deputized by the FBI to obtain evidence of financial improprieties. He is thought to be the author of a widely circulated 30-page letter that, among other things, compared Watsa to the convicted fraudster Martin Frankel. (It was even sent to the priest of Watsa's church, St. Paul's Anglican on Bloor.) In 2006, several false rumours began circulating: one claimed that the RCMP were pursuing Watsa; another said that they were about to raid Fairfax's office; yet another claimed he'd placed his assets in his wife's name and fled the country. By then, the company's stock had tumbled from highs in the \$400 range to less than \$100 a share.

At first, the intensely private Watsa wasn't sure how to respond. But he ultimately countered with a PR offensive of his own, speaking to *Forbes* and other business publications in an effort to set the record straight. In the summer of 2006, he filed a \$6-billion lawsuit against the hedge funds. (The SEC is investigating the charges; the hedge funds have denied any wrongdoing.) Many of Watsa's largest investors stuck with Fairfax, which had made them a lot of money. With this support, and the company's continuing good results, Watsa gradually restored Fairfax's reputation—and its tarnished stock price.

Throughout the bull market that preceded the crash, Watsa was most concerned about the secondary credit market, in which groups of loans made by primary lenders were bundled and sold. Of course, in hindsight, the signs of trouble are obvious. But Watsa first grew wary way back in 2003, well before anyone else, and four years before his warning at the board of trade. The now infamous speech was posted on YouTube, where it has since gained a cult following among avid students of the market. In flat tones, with a slight Elmer Fudd lisp, Watsa outlined both the macro and micro of what would come to pass.

And he continues to go against the grain. “Prem spends a lot of time trying to disagree with the conventional wisdom,” says Gluskin. “He’ll go out of his way to say, ‘If this is what everybody believes, it’s probably wrong, and the opposite is the way to make money.’ ” But there’s more to Watsa’s success than his contrarian streak. For one thing, he’s not entirely risk-averse—unlike Buffett, who doesn’t buy into companies where there’s been a whiff of controversy. “Buffett doesn’t like trouble,” says Wade Burton, a portfolio manager at Mackenzie Cundill, a long-time Fairfax watcher and investor. “Prem doesn’t mind mucking about in the mud, so long as the price is right.” In this, he more resembles yet another role model: John Templeton, the small-town Tennessee boy turned poker-playing buccaneer who made very good on the markets. Having met—and charmed—the eminent financier in the late ’70s, Watsa visited him at his palatial digs in the Bahamas once a year. He even keeps a bust of Templeton in his boardroom.

Watsa’s recent buying spree is all Templeton. When the legendary investor died last summer, *The Economist* wrote, “At the point of maximum pessimism, he would enter and clean up”; or, to put it more bluntly, he bought when there was blood on the streets. When investors fled the New York market after the Second World War was declared, Templeton borrowed \$10,000 to scoop up stocks priced at less than a dollar, often in companies that were near bankruptcy. In four years, he sold the stock, paid off the debt and pocketed \$40,000—the seed money for Templeton Growth Fund, a market beater for many years.

Similarly, Watsa has lately been buying stakes in unlikely companies in troubled industries: from newsprint purveyors and media companies (AbitibiBowater, Torstar and Canwest) to commercial real estate (H&R); from building materials (Chicago’s USG) to coal (International Coal Group) and computers (the out-of-favour Dell). Fairfax is betting that soon enough, with the help of the government cash being spread about, fundamentally solid companies will bounce back. The timing of the investments suggests Watsa thinks the bottom has been reached, or that it’s close enough. “Trees don’t grow to the sky,” Watsa likes to say, “and markets don’t fall to the floor.”

Fairfax has just enjoyed its best year ever; it was Canada’s most profitable corporation in 2008. Just as Watsa avoided the irrational exuberance of the boom, he’s kept his head about him in the aftermath. It turns out the more evolved investor, with his heightened fear receptors, is also able to keep his fear in check. By most accounts, Watsa is an unemotional man. As one of his investors says, “There’s little amplitude to him. He’s never too high, never too low. If he ever had that tendency, he’s trained himself out of it.” There’s no flash to Prem Watsa, and this has served him well.